Guidance For The Audit Committee: Acquiring Professional Services

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Abstract

Outside firms are often called upon to provide an entity with professional services. Such services might include external audit, systems, accounting, appraisal and valuation, actuarial, consulting, tax, or agreed-upon procedures work. The audit committee of the Board of Directors is typically the party within the entity responsible for hiring and overseeing these outside professional service providers.

The Sarbanes-Oxley Act of 2002 mandates that certain professional services, which may have previously been performed by the firm engaged to do the external audit, cannot be performed by that public accounting firm. Thus, audit committees may be forced to contract with other professionals for services previously provided by the external auditors. The task of locating, contracting with, and overseeing the work of qualified firms for these professional services may seem daunting to the audit committee.

This article presents steps the audit committee should take in selecting a professional service provider and overseeing that firm's work. Also given are ways in which the entity's internal audit activity can provide significant assistance to the audit committee undertaking its tasks.

1. Introduction

The audit committee of the Board of Directors is normally the party within an entity responsible for hiring and overseeing the public accounting firm engaged to perform the external audit. Often, that accounting firm also provides other professional services to the entity. These might include systems, accounting, appraisal and valuation, actuarial, consulting, tax, or agreed-upon procedures work.

The Sarbanes-Oxley Act of 2002 prohibits the firm which performs the independent audit from simultaneously providing certain other professional activities for the client. Thus, audit committees may find themselves attempting to hire either new independent auditors or other professional services providers. Also, the SEC and the stocks exchanges are demanding that audit committees more vigilantly monitor the work of external auditors and other professional service providers.

With these increased demands, the task of searching for, hiring, and overseeing professional service providers may appear daunting to the audit committee. Following a systematic approach will ensure that the service provider best suited to undertaking the specific work requested is hired and that the entity receives quality service. Also, enlisting the aid of the internal auditors should assist the audit committee in managing this critical process.

2. Professional Guidance

Most large entities are served by an internal audit activity. The primary function of the internal audit activity is to serve the audit committee of the Board of Directors. Professional guidance for internal auditors encourages them to assist the audit committee as it undertakes the search for, the contracting with, and the monitoring of, the services of the external auditor. The literature also provides extensive recommendations to be followed in the process. While originally intended to aid in relation to the independent audit firm, the guidance is

equally applicable as the internal auditors assist the audit committee regarding the services of other types of professional providers.

Internal audit standards applicable to professional services provided to the entity are issued by the Institute of Internal Auditors (IIA). The IIA is the premier international organization for internal auditors. Professional guidance is contained in the IIA's Professional Practices Framework (PPF).

The standards in the PPF note that the acquisition of professional services can best be accomplished by approaching the process in a systematic manner. A policy regarding the requisition of proposals should be in place and the selection process should be appropriately planned and performed. Once a provider has been chosen, a contract between the entity and that firm is signed. Finally, the professional's progress on the work of the contract is monitored.

3. Policy

The PPF advises that the audit committee ascertain whether a policy regarding requests for proposals from professional services providers has been adopted by the Board. Regardless of the entity's satisfaction with the firm currently performing the work, proposals from other providers, as well as from the current professional, should periodically be sought. An established policy will help ensure that such requests are made at regular intervals.

The audit committee may find that a policy requesting professional services is not in place. For work which must be contracted for quickly, the use of existing procurement practices may be sufficient. However, for the long-term, having an established policy is advised.

A professional services policy should be applicable to both selecting a new provider and to retaining the professional currently performing the work. Such a policy should include several key elements.

The nature of the services encompassed by the policy should be documented. Besides the external audit, systems design and implementation, accounting and financial statement preparation, appraisals and valuation, actuarial work, consulting, tax, agreed-upon procedures, and other professional services might be included.

The policy should also address how often the committee is to either seek proposals or make the decision to retain the current provider. The time interval may vary, depending upon the type of service being sought and legal requirements. The frequency with which the committee requests proposals will aid in determining the period the agreement with the provider is to cover; the length of the contract should also be documented in the policy.

Another element to be included is a specification as to the members of the selection team. That is, the policy should indicate the positions held within the organization by those individuals who are to comprise the team.

The manner in which proposals from the candidate firms are evaluated should also be detailed in the policy. That is, specific criteria may be detailed or general guidelines, allowing the selection team latitude, might be provided. Finally, both caps on fees and any requirements or regulations which are unique to the industry and relevant to the professional service being requested should be included.

The items which should be covered in the policy regarding professional service providers are noted in Exhibit 1.

4. Plan, Select, and Award Contract

Working within the approved policy, the audit committee should develop a plan for the process of selecting a provider of the particular professional service needed. The plan should specify the services being requested and name the actual committee members based upon the positions given in the policy. Also, the pool of providers to

**Exhibit 1: Elements of a Policy
to Select/Retain a Professional Services Firm**

- Types of services encompassed by the policy
- Time period covered by the contract with the provider
- Frequency of decision to retain provider or seek proposals
- Composition of members of the selection team
- Criteria/guidelines to be used in evaluation of proposals
- Ceilings on fees
- Requirements/regulations specific to the industry

request proposals from can be identified. Target dates for the phases of the process should be set and deliverables to be received from the candidates in each phase should be detailed in the plan.

An efficient way to communicate information needed to interested professional service firms is to arrange a meeting with them. The entity requesting service can make a presentation and an information package regarding the service to be rendered might be distributed. If a provider is

interested in submitting a proposal, this general meeting and the distribution of the packet might be followed at a later date by discussions between management and individual provider firms.

After potential providers have been supplied with the information required to make a proposal, two additional steps may be needed before the selection team can make a decision and award a contract. In the first, the list of candidates is narrowed down. Once the field is reduced, more detailed information can be obtained from the providers.

To pare the number of candidate firms, each candidate firm should be asked to present its general qualifications, a brief history of the entity, the size of the firm, and the resources available. The firm's overall philosophy and approach and areas of expertise should be given. Finally, the office locations of the entity and short biographies of potential team members should be included. These items, comprising the responses of the candidates to the initial phase, are shown in Exhibit 2.

**Exhibit 2: Items to be Provided by Candidate
Firms - Initial Phase**

- Statement of qualifications of the provider
- History of the provider firm
- Size of provider firm
- Available resources
- Provider firm philosophy and approach
- Areas of expertise (industry, functional areas)
- Location of offices
- Biographies of potential team members

Armed with the general qualifications of possible providers, the selection team can eliminate some of the candidates. Then, in the second step of the process, more detailed information, tailored to the specific service being sought, is requested from the firms.

In this second phase, the candidates should address the deliverables requested and the target dates for their receipt. Also, a schedule for the work, including any additional meetings needed, should be presented. Finally, fees should be quoted.

**Exhibit 3 Items to be Provided by Candidate
Firms - Second Phase**

- Deliverables
- Target dates
- Schedule for remainder of selection process
- Additional meetings of candidates with the entity
- Pricing

Exhibit 3 presents the items which the candidate firms should include in response to the second phase request.

After receiving the information from the second phase, the selection team meets to make the final selection of the professional service provider. In their discussions of the proposals and professional firms, the team members should be open and candid to ensure that the most suitable candidate is selected.

Once the provider firm has been chosen, terms of the arrangement should be agreed to. If the service is an independent audit, the external firm typically documents its understanding of the work to be undertaken in an engagement letter. Both parties sign the letter; that document then serves as a contract. If the provider is not an audit firm or if an engagement letter is not used, the entity should have its attorneys draft a contract which both parties then sign.

5. Transitioning

The selection of a service provider may involve a change from one professional firm to another. If this is the case, plans should be made for a smooth transition.

A contract with a new external audit provider requires that professional standards of independent auditing be adhered to. Statement on Auditing Standards (SAS) 84, "Communication Between Predecessor and Successor Auditors,"¹ issued by the American Institute of Certified Public Accountants (AICPA), provides the applicable guidance.

The SAS calls for the successor (new) external auditor to make inquiries of the predecessor auditor. The integrity of management and disagreements between the predecessor and management must be included in the communication. Also, the successor is required to ask the predecessor about conversations that accounting firm had with the audit committee regarding fraud, possible illegal acts, and internal control. Finally, the predecessor auditor's understanding as to the reasons for the switch to a new audit firm must be discussed.

The specific topics required to be included in the communication between predecessor and successor auditors are displayed in Exhibit 4.

Exhibit 4: Topics to be Included in the Communication Between Predecessor and Successor Auditors

- Information that might bear on the integrity of the management.
- Disagreements between the predecessor auditor and management as to accounting principles, auditing procedures, or other similarly significant matters.
- Communications by the predecessor to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts, and matters related to internal control.
- The predecessor auditor's understanding as to the reasons for the change of auditors.

Source: AICPA, SAS 84, "Communications between Predecessor and Successor Auditors," 1997.

Besides the items mandated, SAS 84 encourages additional communications between the two sets of external auditors. Any matter deemed to be applicable to the current year's audit may be included in the discussion.

For external audits as well as for any other type of professional service, both the entity and the provider firm should be cognizant of applicable laws and regulations; this is especially critical when making a change to a different provider. That is, certain regulatory bodies, such as the SEC, may need to be notified.

6. Monitoring Progress

Once the contract is signed and the professional begins the engagement, progress on the work should be monitored. To help ensure efficient and effective work, the audit committee should periodically assess compliance with the terms of the contract.

Besides monitoring the work, the audit committee should also consider the independence of the external auditor on a regular basis. Independence standards are issued by many bodies, including the AICPA, the SEC, the stock exchanges, industry regulators, and state regulators and the requirements of these groups may not be consistent. Because of the significance of the auditor's independence, the audit committee should make such an assessment at least annually.

7. Role of The Internal Auditors

Throughout the process of selecting the professional service provider and monitoring that firm's work, the internal audit activity can assist the selection team and the audit committee in significant ways. Internal auditors can

help in determining if a policy regarding the selection of a provider exists and in planning the search and selection process. They can also prove invaluable assistance during the transition to a new firm and in monitoring progress on the engagement.

7.1 Policy

As the task of selecting a provider begins, the internal auditor can determine whether a policy addressing the process is already operational. If such a policy is in place, the audit committee may ask the internal auditor to review it and suggest revisions to update the document. For example, the policy may focus only on specific types of providers, such as public accounting firms. The document can easily be expanded to accommodate other types of providers and the internal auditors could readily suggest appropriate language.

The internal auditors may find that no policy covering the acquisition of professional services exists. If this is true, they can then research and draft such a policy. With that document as a starting point, the audit committee and Board can discuss, amend, and finally adopt a professional services provider policy.

7.2 Plan and Select

Besides assisting the audit committee and Board in the amendment or establishment of a provider policy, the internal auditors are also a useful resource to the selection team in planning the search for, and making the selection of, a professional service provider. Internal auditors can be assigned specific tasks in these processes.

During planning, the selection team might ask that the internal auditors assist by identifying potential providers. The internal auditors might review firms which have submitted proposals in prior years and suggest the names of additional firms.

The internal auditors can also help by proposing both target dates for each phase of the process and the contents of deliverables to be submitted at the completion of each of those phases. Further, the lead role in preparing the information to be given to candidates can be taken by the internal audit activity.

As the selection team attempts to narrow the pool of candidate providers and ultimately reach a decision, the internal auditors can assist further. The internal professionals might compile and organize the information submitted by the candidates in the first phase. Any history the providers have with the entity can be added. Preparing this information in a format allowing the team to compare across the candidates would be especially useful. For example, the internal auditors might develop and fill out a form detailing the attributes of the provider firms. Any history of the candidates with the entity, including types of services provided and fees charged, can be added. The completed form can then be distributed to the members of the selection team to facilitate their deliberations.

With the information on the form as an aid, the selection team can narrow the pool of candidates. The firms on the smaller list are then asked to submit detailed proposals. Information in the proposals should address the specific service to be performed. Again, the internal auditors can provide valuable assistance. They can again develop a form to aid the team. This second document should be filled out by each individual member of the selection team. On the form, the evaluators should note their analyses, impressions, and conclusions regarding the candidate firms.

Once the individual team members have completed the second form, the internal auditors can summarize the responses. This compilation will aid the selection team as it grapples with making its final choice.

7.3 Transitioning

If the decision of the selection team is to switch to a new provider, the internal auditors can assist the entity further by facilitating the transition.

For a change to a new external auditor, the internal auditors should become familiar with the guidance in SAS 84. The information which the successor auditor is mandated to ask the predecessor about is sensitive. To help educate the entity, the internal auditors might inform the audit committee and management as to the topics required to be included in the communication between successor and predecessor auditors. Additional subjects which might be covered should also be discussed.

Regardless of the type of professional service involved in a change to a new provider, applicable laws and regulations should be adhered to. The internal auditors can research such requirements and assist the audit committee in ensuring that the entity is in compliance.

7.4 Monitoring Progress

As noted, the audit committee is ultimately responsible for the professional engagement. Thus, that body should monitor progress made on the work. However, the members of the audit committee are not in daily or close proximity to the actual engagement as it is being performed. Again, the internal auditors can step in and assist. Because they have ready access to the provider and that firm's work, the internal auditors are a logical choice to keep current as to the status of the engagement and to advise the audit committee.

The approach taken by the internal auditors to monitoring the provider's progress might entail making comparisons between the terms of the contract, the due dates of the deliverables, and the contents of the deliverables themselves to the actual results. Such an analysis would prove quite valuable to the audit committee as it oversees the engagement.

8. Conclusion

The acquisition and oversight of the services of a professional firm, whether for external audit, systems, accounting, appraisal or valuation, actuarial, consulting, tax, agreed-upon procedures, or other work, is often assigned to the audit committee of the Board of Directors. With the implementation of the Sarbanes-Oxley Act, audit committees may be forced to divide various types of professional services work, previously performed by the CPA firm, among two or more providers.

The audit committee of the Board of Directors should determine if a policy for the acquisition of professional services is in place. If none exists, such a policy should be drafted and adapted. The search should be planned. Information regarding the entity and specific to the service being sought should be presented to candidate firms. A selection team, comprised of individuals whose positions are specified in the policy, can then narrow down the pool of candidates. More specific proposals are requested from this reduced group. Upon receipt of the proposals, individual search team members can prepare analyses and conclusions regarding the providers. After the selection of a provider is made, the entity and that firm should sign a contract.

If the choice of professional service provider involves a switch to a new firm, the transition should be planned and the audit committee should ascertain that applicable laws and regulations are complied with. Finally, progress on the professional's work should be monitored.

While the entire process may appear daunting to the audit committee at first, the internal auditors can provide valuable assistance at each stage. They can research if a professional service provider policy exists and draft an update if necessary. Assistance can be given in planning and conducting the search, as well as in making the final selection. Finally, the internal auditors can help if a transition to a new provider is necessary and in monitoring that firm's work.

9. Suggestions for Future Research

As entities adapt to the mandates of Sarbanes-Oxley regarding the acquisition of professional services, several avenues of research will prove to be of interest. Longitudinal studies exploring the methods by which audit

committees contract with providers would highlight changes in the process. Also, research focusing on how, and the degree to which, audit committees monitor progress on the professional's work, conducted over a number of years, would show whether the mandates of Sarbanes-Oxley impact the oversight performed by audit committees. Further, studies of internal audit involvement in the hiring of professional services providers, in transitioning to new providers, and in monitoring progress on the work would prove useful to audit committees interested in best practices and to standard-setters providing additional guidance to internal auditors. 📖

10. Note

1. For SEC companies, the Sabanes-Oxley Act prohibits the external auditor from simultaneously performing these services. In addition, the Public Company Accounting Oversight Board may determine other services to be impermissible.

11. Reference

1. American Institute of Certified Public Accountants, Statement on Auditing Standards, 84, "Communications Between Predecessor and Successor Auditors," AICPA, 1997.
2. Institute of Internal Auditors, Professional Practices Framework, IIA, 2002.

Notes