

Maximizing the value of the audit and the external auditor

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

Introduction

On November 2, 2005, members of the Audit Committee Leadership Network came together in Washington, DC, for the network's tenth meeting. During discussions that day, the network explored how audit committees can maximize the value of the audit and the external auditor to achieve a high-quality, cost-effective audit. The discussion focused on three areas:

- **Developing the audit plan**
- **Negotiating audit fees**
- **Evaluating the performance of the external auditor**

Section 301 of the Sarbanes-Oxley Act directs the Securities and Exchange Commission (SEC) to hold audit committees responsible for appointing, compensating, and retaining the external auditor. Section 302 requires the audit committee to approve all audit services and prohibits an independent auditor from providing any otherwise permissible non-audit services without prior approval of the audit committee.

Members of the network who participated in the meeting, or in individual discussions beforehand, sit on the boards of about 30 large-, mid-, and small-cap public companies between them.

Members who participated in the meeting were:

- Jim Adams, Audit Committee Chair, Texas Instruments
- Bob Burt, former Audit Committee Chair, Pfizer
- Gene Fife, Audit Committee Chair, Caterpillar
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Sandy Warner, Audit Committee Chair, General Electric Company

Members who participated in individual discussions before the meeting were:

- John Clendenin, Audit Committee Chair, The Home Depot

- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Doug Yearley, Audit Committee Chair, Lockheed Martin

Other participants in the meeting or the individual discussions beforehand, included:

- John Ferraro, Vice Chairman, Ernst & Young
- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Comments described as being provided before the meeting were drawn from discussions with any of the members listed above.

Executive summary

The network's discussion on maximizing the value of the audit and the external auditor focused on the need to involve the audit committee in determining audit scope and audit team composition, as well as in coordinating the internal and external audit plans. The annual audit plan in most companies is developed by the external auditors with input from management and the audit committee – the triangle in the financial reporting process. Members stressed that an important part of that triangle is a relationship of trust and candor between the audit chair and the lead audit partner.

The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages:

- **Developing the audit plan** (*Page 3*)

Good audit plan development practices proposed by network members include: ensuring that the plan covers all potential financial statement risk areas, instituting an iterative process for plan development, and overseeing coordination of the internal and external audit plans.

Members recommended (1) establishing a relationship with the wider internal and external audit teams to enhance mutual trust and effectiveness and (2) considering the audit firm's view of factors that could lead to financial misstatements developed during the firm's reacceptance process. Audit chairs may help to reconcile differences in judgments made by management and the external auditor, and they believe it is important for audit chairs to develop an open, personal relationship with the lead audit partner. [An example of an audit chair-lead partner relationship can be found on page 6, "Meeting between meetings."](#)

- **Negotiating audit fees** (*Page 6*)

The Sarbanes-Oxley Act holds audit committees responsible for compensating the external auditor, but the audit committee is typically more involved in providing input to audit plan scope than in negotiating audit fees. Transparency around fees and costs – disclosure of such financial information as insurance, training, and recruitment costs, which impact the external auditor's profit margin for the

work performed – is helping some audit committees understand what drives negotiations from the audit firm’s side.

Audit chairs admit that pressure from the investor community has pushed many companies to reduce non-audit-related fees as a proportion of the external auditor’s overall fees, but they differ on the desirability of this trend: some want to maximize efficiency and shareholder value by using the external auditor wherever possible; others want to diversify supply and reduce reliance on the external auditor.

- **Evaluating the performance of the audit firm** (Page 8)

Members agree on the importance of providing annual and ongoing evaluations of and feedback to the external auditor. While members use both formal and informal evaluations, they identified a trend toward formal assessment – often involving a 360-degree process completed by key people in the finance organization and members of the audit committee – as this provides a more robust record of the assessment. [Factors one company considers in its evaluation of the external auditor can be found on page 9.](#)

Developing the audit plan

The Conference Board Commission on Public Trust and Private Enterprise stated in 2003, “The primary emphasis in choosing an audit firm should be the demonstrated experience, quality and depth of knowledge of all audit personnel to be assigned to the audit, specific industry expertise, the scope of work to be performed, and any inspection reports about the audit firm. The [audit] committee should ensure that the audit fees do not negatively impact the scope of work necessary for the auditors to perform a quality audit.”¹

The annual audit plan in most companies is developed by the external auditors, with input from management and the audit committee. Developing the audit plan typically begins by establishing the audit committee’s and management’s expectations of the external auditor based on the auditor’s plan and findings from the previous year. A question that arises is how involved the audit committee should be in the development process and how maximum value can be created for the company and its shareholders.

One member asked whether the external auditor actually did anything for the company above and beyond providing “a *Good Housekeeping seal of approval*? We need a debate about it. What is it we get other than the opinion?” Other members described the value they receive from the external audit:

- **The external auditor’s opinion is valued by the capital markets** because it represents a consistent approach to accounting principles and leads to effective comparisons between companies in the same line of business. *“Everyone can have a transparent view of what’s driving the numbers.”*
- **An independent view of the business can challenge management groupthink.** *“Even the best companies suffer from groupthink mentality.”*
- **The external audit provides assurance for independent directors.** *“A separate set of eyes to look at [the financial statements] is really important. Directors are subject to being ‘flimflammed’. It is important to me for a lot of reasons, including personal risk.”*

¹ The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations, Part 3: Audit and Accounting* (New York: The Conference Board, 2003), 40.

Good practices in developing the audit plan include:

- Supporting the external auditor in driving the plan
- Identifying how the audit plan will cover potential risk areas that could result in financial misstatements
- Requesting and considering the audit firm's view of factors that could lead to financial statement risk
- Instituting an iterative process for developing the audit plan
- Coordinating the internal and external audit plans without restricting either party
- Establishing a relationship with the wider audit teams to enhance trust and effectiveness

The following section takes each proposal in turn and illustrates the point with further detail from the discussion with members before and during the meeting:

• **Supporting the external auditor in driving the plan**

Given that the external auditor's work represents a "seal of approval," members believe the onus should be on the external auditor to propose the audit plan. The audit committee should get involved if there is a debate with management about what the auditors need to do; the audit committee should also determine how best to deploy internal audit to help achieve the goals set by the external auditor. One member wondered if, as part of the process, the lead external audit partner should share any guidance or templates received from the national office on the development of audit plans – *"things the firm thinks are important that we may or may not have thought about."*

• **Identify how the audit plan will cover potential risk areas that could result in financial misstatements**

Members perceive that their companies are too large for the audit committee to get involved *"in the spadework, except to identify areas of risk and make sure they're covered and the percentage of transactions to be reviewed is adequate. You just know which countries will be a risk because of the culture..."* One member described having the internal and external auditors explain to the audit committee how the audit plan was developed and how it deals with risks identified in the annual business plan which could lead to financial misstatements. *"We may also have requested additional review of certain areas."*

• **Request and consider the audit firm's view of factors that could lead to financial statement risk**

In recent years, audit chairs have become more aware that, as part of the client acceptance and re-acceptance process, audit firms conduct a detailed financial risk analysis of the company. Members felt it was important that the audit firm's view of the company's financial risk considerations be shared with the audit committee, as context for the audit plan. One member said, *"We've received that [information] at our audit committee [meeting]. It was useful to see where they thought risk was."* Some members raised concerns about how the information can be shared without creating liability issues for the firm and for the board and audit committee. Members recommended that audit chairs ask their

lead audit partner two critical questions: What are the results of your financial statement risk assessment performed during reacceptance? How have you addressed these risks in your audit plan?

- **Institute an iterative process for developing the audit plan**

One member explained, *“We do an iterative process from meeting to meeting. When something comes up – for example, in a country – we note it needs to be in next year’s audit plan. One session on risk may not get you the best result. We try to improve the audit process over time.”* This approach to iterative development also applies to internal audit. In fact, one member noted, *“It is easier to change the internal audit plan because we control the resources.”*

- **Coordinate the internal and external audit plans without restricting either party**

The Institute of Internal Auditors’ performance standard on coordination states, “The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.”²

Typically, the external auditor presents its audit plan to the audit committee at the same time as internal audit is presenting its plan. Following a discussion, the audit committee then approves the plans at its next meeting. One member described a joint planning session with internal and external audit once a year. Another member commented, *“Coordination is an agreement on how things should be done; [it’s] not about restricting where internal or external audit can go. You need to ensure the basics are covered.”* Another member suggested, *“If there is a problem, we ask both internal audit and external audit why they didn’t find that problem. It is not OK for one of them to say [they] thought the other was [covering] it.”*

This general support for coordination was not universal. Speaking before the meeting, one member said the internal audit function should arrive at its plan independently, and not as part of a formulaic process, even though this might increase audit costs for the company.

- **Establish a relationship with the wider audit teams to enhance trust and effectiveness**

One member described the process the member’s audit committee uses to get to know the internal and external audit teams: *“Audit plans are drawn up by many people, so the audit committee takes 60–90 minutes to meet with the internal and external audit staffs. It is exceptionally helpful to hear questions from [the] younger people [on the audit teams]. They are not aware of the audit committee, and [from our point of view] it is good to have a feel for who is doing the work. Knowing what is done with the output [of the audit plan] and who uses it are important factors in the quality of the work done.”* Other members felt this feedback loop on the audit committee’s expectations is important: *“This is ... putting the audit committee process in context in a way that the people who do the work can understand.”*

Practices differ regarding who in management takes the lead in providing input to the audit plan with the external auditor. According to members, the chief financial officer (CFO), the controller, or the person

²Institute of Internal Auditors, *Performance Standard 2050 on Coordination, International Standards for the Professional Practice of Internal Auditing* (Institute of Internal Auditors, 2004). Available to members at http://www.theiia.org/?doc_id=1617

supporting the work of the audit committee itself, often the chief audit executive (CAE), are all potential candidates.

Role of the audit committee chair

The role of the audit committee chair in the development process was outlined by one member before the meeting: *“If there are differences of opinion, the audit committee chair can play a role and mediate questions and issues.”* This mediation role may depend on how contentious the issue is. Members said they rarely saw *“people fighting it out,”* but were often involved in iterative discussions. *“We try to reconcile judgments.”* Another member said, *“If there aren’t any issues, that is a problem, and I would be suspicious; ... if they occur all the time, that would be a problem too.”*

Meeting between meetings

- One member had established regular informal meetings with the audit partner in between audit committee meetings. This member found the 60–90 minutes spent with the lead partner each month to be the most valuable of the meetings held with the external auditor. Mutual trust is important to avoid creating any issues between the audit firm and the company. The member reported that the CFO remarked, *“It is clear that you are talking to the external auditor because your questions are better and your insights are sharper. That makes it harder for us to do our job, and that is a good thing.”* If issues are raised that require action, the audit chair asks the lead partner to report to the next audit committee meeting, but *“nothing comes from me as a primary source.”*
- The member revealed that the next step is to extend the same spirit of frank, intimate exchange to the executive sessions of the audit committee. *“Let’s get good at the one-to-ones [first], and then see if they can be extended to executive sessions ... to avoid putting too much responsibility on the audit chair.”* Other members meet their lead partner quarterly, and several members noted that the nature of the discussions has changed: rather than focusing on strict accounting questions, discussions are now much broader.

Members were very interested in developing personal, confidential relationships with their lead audit partner. However, one member observed, *“These meetings seem strange to the audit partner, and there is a certain hesitancy [on the partner’s part] to impose on the audit committee chair. But the firms could push on this, and most audit chairs are willing to do what is required to get this right. We want to understand where differences of opinion have occurred and how they have been resolved, rather than just hearing the answer.”*

Negotiating audit fees

The Sarbanes–Oxley Act holds audit committees responsible for compensating the external auditor. In order to play any role in this process, audit committees need to understand the market for audit services, the economics of the auditing profession, and the subsequent impact of those factors on audit fees. The National Association of Corporate Directors Blue Ribbon Commission advises audit committees to “[j]ointly decide

on the audit fee with management. The audit committee should review and approve the adequacy of the audit fee to ensure that the economics support the approved scope of the audit.”³

The audit committee may be more involved in approving the audit plan than in negotiating audit fees, or it may be involved in both equally:

- **Involved more in approving the audit plan:** One member said, *“We don’t spend any time negotiating fees. Several years ago, we did agree on hourly rates for different levels ... The fees are a factor of the scope of the audit plan, how senior ... the people [on the audit team are], and how much we use the internal audit.”*
- **Involved equally in the audit plan and fee negotiation process:** Another member said, *“We negotiate the fee through a dialogue about [the work] we want done, with one exception: we want to reduce [Section 404] costs. The audit committee sets the framework for management ... We review the proposal.”* Another member commented, *“Usually there are no disagreements, but if there are [disagreements], the audit committee chair hears both sides’ case, and then we resolve it. The audit committee has an opportunity to talk about expectations and levels of experience. We don’t want to micromanage hours and rates, but having benchmarks is very helpful.”*

The SEC amended its rules in 2003 to require companies to disclose the fees paid to the external auditor for financial statement audits, specific IT services, tax services, and other non-audit services.⁴ This requirement created a unique opportunity for companies to benchmark their audit fees by industry and geography, and has become a standard activity for management, reviewed by the audit committee.

Along with changing the fundamental relationships among auditors, management, and audit committees, Sarbanes–Oxley, through its efforts to improve audit rigor, has also contributed directly or indirectly to higher costs for companies and their accounting and auditing firms. Transparency around audit fees – disclosure of such financial information as insurance, training, and recruitment costs, which impact the external auditor’s profit margin for the work performed – is helping some audit committees understand what drives negotiations from the audit firm’s side.

Before the meeting, one member said, *“We hold our external auditor to a principle of complete transparency as to the profit they’re generating on our audit ... I know exactly what they’re making off ... our audit versus other, unnamed clients.”* However, this push towards greater openness is not universal. Another member said before the meeting, *“We’ve tried to get that data, but we get generalities, not specifics. The external auditor is not comfortable revealing pricing and margin.”*

However, some members voiced concerns about the need for a balanced perspective on audit fees: *“My role as audit chair was to tell the CFO to get off of fee reduction. We need to be an advocate for the appropriateness of fees, not just cutting them.”* Another audit chair is concerned about *“whether we spend*

³ National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees: A Practical Guide – Updated 2004 Edition* (Washington DC: National Association of Corporate Directors, 2004), 17.

⁴ Securities and Exchange Commission, “SEC Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence.” Release No. 33-8183 (SEC 2003c), January 28, 2003, <http://www.sec.gov/rules/final/33-8183.htm>

enough on audit – do we have enough senior people? Efforts to drive down cost mean more junior people, or less coverage, or both.”

Non-audit fees

As noted earlier, Sarbanes-Oxley prohibits the external auditor from providing various non-audit services. The rules on permitted and proscribed tax services were further clarified by the Public Company Accounting Oversight Board in July 2005, although these clarifications have not yet been approved by the SEC.⁵ In addition, pressure from the investor community has pushed many companies to reduce non-audit fees as a proportion of audit fees. Certain shareholder advocacy groups examine fee disclosures in the proxy statement to determine if non-audit fees are excessive. When these groups deem non-audit fees to be excessive, they advise shareholders to vote against auditor ratification and to withhold votes from audit committee members responsible for approving the services provided.

Before the meeting, one member said, *“There’s a lot of concern about keeping the ratio of tax advisory work to below 50% of the general audit fee.”* Another member noted, *“On most supplier things we want a diversity of supply,”* and suggested that non-audit services should be treated the same way. However, other members believe this approach is inefficient because many companies don’t have adequate internal tax resources, which means switching the work to another audit firm that will not only face a steep learning curve, but will also have to coordinate with the external auditor.

Members described these two approaches to non-audit fees:

- **Diversify suppliers and reduce reliance on the external auditor.** *“We do pay attention to [shareholder advocacy groups]. They cause you to wake up every now and then, and they make you think. Companies want to do things the easiest way, and the efficiency argument may or may not be correct. Our policy is, if we can get things done ... as well as [our external auditor can], we’ll do it.”*
- **Maximize efficiency and shareholder value by using the external auditor wherever possible.** *“We have looked at tax and see it is less efficient to move it. The external auditor is involved in small tax issues. We are getting less and less concerned with what [shareholder advocacy groups do] ... It is not good for the shareholders if we do things inefficiently.”*

Evaluating the performance of the audit firm

Among the specific best-practice suggestions put forward by the Conference Board Commission on Public Trust and Private Enterprise was the idea that “audit committees should review their current public accounting firm at least annually...”⁶ Audit chairs believe they can use these annual performance reviews to assess and improve the performance of the external auditor. One audit chair said, *“You do everything you possibly can not to have a change [of auditor], but in the face of what’s going on you need to think through the issues.”*

⁵ Public Company Accounting Oversight Board, “Board Adopts Standard on Remediation of Material Weaknesses, Rules on Auditor Independence and Tax Services,” press release, July 26, 2005, http://www.pcaobus.org/News_and_Events/News/2005/07-26.aspx

⁶ The Conference Board Commission on Public Trust and Private Enterprise, *Finding and Recommendations, Part 3: Audit and Accounting*, 40.

Audit committees take one of two broad approaches – formal or informal evaluation:

- **Formal evaluation.** One member described a type of 360-degree evaluation using detailed rating sheets provided by the external auditor and completed by key people in the finance organization and members of the audit committee. The audit committee reviews the evaluation, focusing on areas where satisfaction has deteriorated, then discusses the data with the engagement partners: *“We now use mutual consent to share [the names of those] who rated the external auditor badly.”*
- **Informal evaluation.** One member gave an example of how the informal approach works: *“We ask management’s opinion and use what we see at board and audit committee meetings, [together with our view of] the quality of the work.”*

Factors one company considers in its annual evaluation of the external auditor

“Our view is that, given what is happening to all the firms, we need a formal process and a robust record of our assessment. We meet once a year with the CEO of the external audit [firm] and the three senior [people] on the audit. The audit committee’s commitment to go forward with a firm needs a record that we did this with our eyes open.”

The factors the evaluation considers are:

- Performance of the audit
- Performance on lawsuits, settlements, and investigations, and firm response to ethics issues
- Reputation of the firm
- Commitment to ensuring top talent is on the account globally

Conclusion

It is hard to divorce discussion of the value of the audit plan and the external auditor from the current standing of the profession post-Sarbanes-Oxley. That legislation was designed at least in part to increase the rigor of the external audit. At the same time, it has also driven up the cost of the audit. Involving the audit committee in providing input into the audit scope, the composition of the audit team, and in coordinating the activities of the internal auditors can help maximize the value of the audit. Reinforcing a relationship of trust and candor between the audit chair and the lead audit partner is an essential part of the process.

The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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