



Maximizing the value of the audit and the external auditor

Introduction

The Midwest Audit Committee Network is a group of audit committee chairs drawn from leading Midwest companies. The third meeting of the network was held in Chicago on October 7, 2008. The meeting focused on a broad set of topics, including the relationships of the audit committee with the internal and external auditors and implications of a move from U.S. Generally Accepted Accounting Principles (U.S. GAAP) toward International Financial Reporting Standards (IFRS). Members also reflected on the network's previous discussion of enterprise-wide risk management¹ in light of the uncertainty in global financial markets.

This document reflects a synthesis of the key issues that emerged from the discussion on maximizing the value of the external audit. A separate issue of *VantagePoint* has been developed to reflect the discussion about the evolution of internal audit.² The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and their advisers, the greater the value created for all.

The members of the network present at the meeting, who sit on the boards of 25 large-, mid-, and small-cap companies between them, were:

- Howard Carver, Audit Committee Chair, Assurant
- Cheryl Francis, Audit Committee Chair, Morningstar
- Brenda Gaines, Audit Committee Chair, Office Depot
- Sandy Helton, Audit Committee Chair, Covance
- David Landsittel, Audit Committee Chair, Molex
- Cary McMillan, Audit Committee Chair, Hewitt Associates
- Rich Roedel, Audit Committee Chair, Brightpoint
- Dennis Van Mieghem, Audit Committee Chair, AEGON USA

Ernst and Young partners participating in the meeting included:

- Tony Anderson, Midwest Area Managing Partner
- Kevin Cole, Area Director of Business Development and Marketing
- Jim Logothetis, Global Client Service Partner
- Ron Weissman, Senior Partner Financial Services

¹ See Midwest Audit Committee Network, "Enterprise risk management: in search of a practical approach," *VantagePoint*, May 12, 2008. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_MWACN_Vantage_May08.pdf.

² See Midwest Audit Committee Network, "Evolution of internal audit," *VantagePoint*, October 24, 2008. Available at <http://www.tapestrynetworks.com>



VantagePoint 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 during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from members of the Midwest Audit Committee Network.

Executive summary

Network members agree that effective relationships are critical if the audit is to provide value beyond a mandated assurance activity. In particular, they observed:

- **The relationship between the audit committee and the external auditor cannot be viewed in isolation** (*page 2*)

Members recognized that a four-party control framework that includes internal audit, management, external audit and the audit committee is essential for there to be an effective relationship between the audit committee and the external auditor. Members recommend establishing multiple points of contact between the audit firm and key members of management.

- **Audit committees value business counsel and advice from the audit firm** (*page 3*)

Beyond the “*table stakes*” of technical competence, members seek more business judgment from the external auditor. There is a belief among some members that auditors have a lot more value to give than they have been getting.

- **Consultation with national office is a major source of differentiation between audit firms** (*page 4*)

Members recognize the value of an audit firm's deep technical expertise but express frustration that some firms' national offices can be “*a big black hole*” where they send their technical accounting questions and receive little communication in response. Firms vary in the autonomy given to local account teams and in the direct access clients are granted to national resources.

- **Partner rotation does not have to be painful** (*page 5*)

Although members generally regret the regulatory requirement that audit partners rotate off the account every five years, they identified several best practices to ensure a smooth transition: (1) start early, ideally 12–18 months before the rotation; (2) work with audit firm leadership to agree on characteristics and identify potential candidates; (3) involve the audit committee in the final round of interviewing; and (4) focus on cultural fit.

The relationship between the audit committee and the external auditor cannot be viewed in isolation.

While members firmly believe that an open, trusting relationship between the lead audit partner and the audit committee is a key driver of audit value, they stressed that this relationship cannot be viewed in isolation: “*Four parties need to be involved for there to be an effective relationship: internal audit, external audit, the audit committee, and senior management. The better [the four-way relationship] is, the better the*



audit committee and external audit relationship is ... It is so helpful to have all four of those parties on the same page as part of a larger relationship.”

Members also highlighted the importance of the individual stakeholders’ roles and responsibilities in ensuring these broader relationships are effective: *“For a good relationship, the lead audit [partner] needs to work to add value and bring something to the table. Just going to the meetings [with clients] doesn’t equal a good relationship.”* However, it works both ways: *“It should not always be the audit partner calling the audit committee chair. The audit committee chair can also be the one to drive it. This shouldn’t be a one-way responsibility.”*

Members agreed it is critical for external auditors to forge positive relationships with the management team: *“The audit firm should have a spectacular relationship with senior management. If [the auditor partners] don’t have a good relationship with senior management, [they’re] not going to have a good relationship with the audit committee. It’s good to be nice to the part-time, ‘drive-by shooters’ – the board members – but I would prioritize the relationship with management most of all.”*

Members feel that it is important for the company to establish multiple points of contact with the audit firm, given the potential for personality clashes and inevitable lead partner turnover: *“We had a young audit partner who did not get along with management, and one of the lessons for us was that the company would have been better off having a connection with senior members of the [audit] firm as well. It’s important to have a relationship that goes beyond the lead audit partner.”*

Audit committees value business counsel and advice from the audit firm

While they recognize the value of an effective financial statement audit, some members yearn for more. One member said: *“I have a belief that auditors have a lot more value to give to me than I’m getting.”*

Some members blame lower expectations: *“The audit partners used to be expected to be a business adviser. That has changed over time. I also think the audit partners have lost that skill. Now it’s a rare company that has an auditor that ‘gets it’ and gives more than audit advice. Some [auditors] even think of external audit as a commodity.”* Another member added, *“Everything is so rules-based, and I don’t think we’re getting the good business advice we used to. [External auditors] are out [interacting with clients] all over the world, and we’d love to get [the benefit of] that input.”*

One member wondered in a pre-meeting discussion if auditors’ perceived over-scrupulousness regarding giving advice stems from concerns about independence: *“Our external auditors are always concerned about being objective and standing somewhat apart. They want to be a third party and be a source of assurance – which is what we’re paying them to do. But that also seems to create questions in their mind about what they can recommend. Oftentimes they will share things, but usually you have to ask them for insight, because they are very uncomfortable recommending anything. There are these lines that they are very concerned about crossing.”* However, another member suggested that although the passage of the Sarbanes-Oxley Act in 2002 made auditors reluctant to offer advice, *“the pendulum is swinging back now.”*



Many members said they expect the external auditor to offer value beyond the obvious technical expectations: *“You assume there are certain table stakes – the technical skills should obviously be there.”* Still, as one member remarked, *“While I value the auditor’s business judgment, too, there are other people you can turn to for that if need be. What I value most highly is having someone with a high technical competence.”*

Members are united in agreeing that an external auditor with the proper skill set can contribute substantial value. Prior to the meeting, members identified several qualities shared by outstanding auditors. In addition to business counsel and advice, members value partners with:

- **Good communication skills.** *“You can fail in a lot of things as an external auditor, but communication is not one of those things. First, second, and third for me is communication. A lot of stuff that we need to do is fairly easy, but communication is so important.”*
- **Candor.** *“I think the number one [most important quality of an external auditor] is candor and openness and talking about any issues they see for the audit committee.”* Another member shared, *“External auditors need to know they can be a great client-service person and still fulfill their audit responsibilities. We had a partner that didn’t get that. He was ... afraid of someone being critical of him ... I am certain that he was intimidated by the relationship and didn’t want to screw up, but when you handle major accounts like ours, you can’t be afraid of screwing up. You need to be able to stand up to this crowd and add value. That’s what distinguishes the great from the good.”*
- **Industry knowledge.** *“We expect them to be experts in all aspects of accounting and [to] really understand our business. They need to understand the economics of the business, know the industry we’re working with, and know what’s on the horizon as well.”*
- **A balanced approach.** *“It’s important that you ask if they are being ridiculous in what they are expecting, or are they being reasonable and balanced and looking at all aspects of an accounting issue rather than just going along with management.”* Added another member, *“If it’s something that’s a normal part of business, then I don’t want to hear about it, but if it’s something that has reputational enterprise risk, then I do want to hear about it. It’s good to have a healthy skepticism, but I think the external auditor should make an effort not to create problems when there aren’t any.”*
- **Support from their firm.** *“You can have a great relationship with the lead partner, but if they don’t get support from their firm when the rubber hits the road, then it’s not going to work.”*
- **Insight.** *“I think it’s always good to have a point of view that has been developed by having access to information about other people in the same industry. [Experienced auditors] have the potential to be very valuable because they can say, ‘You know, you may want to consider X, Y, Z.’”*

Consultation with national office is a major source of differentiation between audit firms

Members recognize that the major public accounting firms have different cultures and strengths, value different skills and personalities in their partners and senior staff, and vary in their work practices. Much to



the frustration of audit committee chairs, these cultural differences extend to the firms' consultation practices. Members acknowledge the value of an audit firm's deep technical expertise but regret that some of the firms' national offices are *"a big black hole where [technical accounting questions] get dropped in and ... never seen again."* One member said, *"Audit committees need to engage more broadly with the [audit firm's] organization. There should be an expectation that you can communicate with anyone in the [audit] firm."*

Members hope that by raising their expectations of access, and by increasing communication with the audit firm, audit committees may in fact be granted more direct access to their audit firm's national resources: *"[Establishing a more effective process for consulting with the national office] allows you to have a better dialogue and makes sure all the relevant facts are on the table. This also allows us to avoid a lot of the mystery of going to the national office."*

Although they are optimistic about improving their relationships with their firms' national offices, members agreed that access to the national office is potentially the biggest difference between firms: *"This is a significant issue for many audit firms ... I think there is a great opportunity for audit firms to take this [insight] and be more competitive."*

Partner rotation does not have to be painful

Audit partner rotation is a fact of life for audit committee chairs. Sarbanes-Oxley requires that even the most effective lead audit partners must eventually rotate off the client's audit after five years. Although most members believe *"five years is not nearly long enough"* and that the change is *"the worst thing to come out of Sarbanes-Oxley,"* they acknowledge that the partner rotation process is getting easier with time and experience.

Indeed, members of the Midwest Audit Committee Network have been able to identify several best practices that can help with a smooth transition:

- **Start early.** *"You need at least a year to 18 months of lead time for evaluating potential candidates, vetting them with management, and bringing them on board."*
- **Work with the audit firm leadership.** Members expressed a preference to work with the firm's leadership to identify a shortlist of candidates: *"It has to be a collective and collaborative effort with the audit firm ... The audit firms need to understand what we need and why we need it. We work very closely with our audit firm to make sure they understand that in the rotation process, we expect to talk to several people before we make a decision."* However, many audit firms prefer to offer one candidate they believe has the right skills and experience. One member also remarked on the value of enlisting the help of the outgoing lead audit partner as a go-between with the audit firm: *"We just finished this process, and we really relied on the current external auditor because we trusted him. He knows the personalities and the culture, and he gave us a sense of who would be the best fit."*
- **Involve the audit committee in the final round of interviewing.** *"[We] have management sit down and interview all the candidates first, and then we get involved once they have narrowed it*



down. You need to make sure the audit committee and management are aligned in what [they're] looking for.”

- **Focus on cultural fit.** “We want to get a feeling for [the candidate’s] personal characteristics, his ability to communicate, and his ability to get along with people.” Added another member, “In addition to the obvious technical capabilities, the new audit partner needs to fit with the culture.”

While partner rotation remains a challenge for many audit committees, members of the MWACN feel increasingly comfortable with the process – although there is always room for improvement. One member gave this example: “What remains to be done is the orientation going forward, once a candidate has been hired. We don’t want to undermine the current audit partner, but we want to have a seamless passing of the baton. This is something we will continue to work on.”

Conclusion

As an important player in a four-party control framework that includes internal audit, management, and the audit committee, external auditors can deliver substantial value to their clients. However, value is often proportional to the quality of personal relationships. Audit committees should ensure open, candid, and frequent dialogue with and among stakeholders. They should also encourage and support trust-based relationships not only with the lead audit partner, but also with other key leaders of the audit firm. Moreover, they should initiate regular discussions to better understand the depth and breadth of the audit firms’ resources and seek the audit partners’ perspective on their industry, the company, and broader business trends.

The views expressed in this document represent those of the Midwest Audit Committee 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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