



Maximizing the value of the audit and the external auditor

About this document

The Mid-Atlantic Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Mid-Atlantic region of the United States. 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 audit environment.

VantagePoint is a synthesis of some key issues arising from a facilitated discussion among members of the Mid-Atlantic Audit Committee Network. It is intended to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

Introduction

The Mid-Atlantic Audit Committee Network met for the sixth time on January 12, 2006. The primary discussion topic was how to derive maximum value from the audit and the external auditor. The members of the network present for this face-to-face meeting, who sit on the boards of 16 public companies between them, were:

- Jim Brady, Audit Committee Chair, Constellation Energy Group
- Bob Grafton, Audit Committee Chair, CarMax
- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Bill Jews, Audit Committee Chair, MBNA
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Paul Shapiro, Audit Committee Chair, Toll Brothers
- Jim Zug, Audit Committee Chair, Amkor Technology

Other participants in the meeting included:

- Mark Bartlett, Partner, Ernst & Young
- Bob Guido, Vice Chairman, Ernst & Young
- John Tierney, Partner, Ernst & Young

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.



Executive summary

Lively discussion among the members of the Mid-Atlantic Audit Committee Network brought out several important ideas, all with substantial implications for audit committee chairs. Three of these ideas are summarized below and expanded upon in subsequent pages:

- **External auditors deliver value primarily through the quality of their audit services** *(Page 3)*

Audit scope must cover all financial statement risk areas, and audit committees do not want to see reduced scope in order to minimize audit fees.

- **Effective relationships with external auditors contribute incremental value to audit committees and management** *(Page 3)*

Members state that audit partners who know when and how to take the initiative with audit committees and management enjoy respectful, impactful relationships. However, members say these relationships have been strained recently, a condition they attribute in part to audit firms' differing interpretations of regulatory guidance.

Members say that audit services are not a commodity, and audit firms can provide highly valuable service only if they can continue to develop and retain highly qualified professionals. Members fear the gradual emergence of a new generation of auditors who, although technically competent, may lack broader business knowledge because of an over-emphasis on compliance.

- **Contrary to their hopes, audit committee chairs do not expect audit fees to decline greatly over the next few years** *(Page 4)*

A widely cited Big Four study reported an expectation that Section 404 costs would fall by 40% in the second year of implementation. But those costs included all 404-related expenditures, of which the external auditor accounted for less than 30%.

Some members are frustrated that the attestation of internal controls required by Section 404 has not resulted in greater reductions in the scope of financial statement audits. Members recognize the challenges inherent in integrating the two audit procedures and do not expect to realize the full benefit of an integrated audit for two or three years. In the near term, members expect efficiency gains to be largely offset by audit firms' increasing costs.

Members also engaged in a robust discussion about challenges the audit profession faces during the transition from self-regulation to oversight by an independent regulator. One member urged the group to consider the analogy of the medical profession, which used to rely primarily upon professional standards to guide behavior. The member suggested that in the last ten years, however, *“trial lawyers and juries have told [doctors] how to practice medicine,”* and that as a result, doctors have designed practices to limit their exposure to personal liability. In many cases, he argued, doctors order unnecessary tests and *“check 12 boxes when two would be enough.”* This additional testing adds expense and contributes little to patient care.



External auditors deliver value primarily through the quality of their audit services

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.

Every company and every industry has a different risk profile, and members believe *"the bulk of the discussion has to be spent on whether the [auditor] is focused on those risks, and what it is doing about [them]."* Ultimately, the *"responsibility of the audit committee is to probe with respect to risk and get comfortable [that the audit scope addresses these] risks."*

Some members said they would push back if the audit plan did not adequately leverage the work of internal audit, or if the auditors were not sufficiently taking into account the quality of internal controls. At the same time, members agreed with the sentiment that *"my interests and those of the [other] audit committee [members] are opposite [to the interests] of management ... we want more [audit] work [done], and it's not our job to cut back [on the audit scope]."*

Recognizing that audit fees are driven in part by audit scope, one member said, *"It's not the job of the audit committee chair to get a reduced fee."* Another wondered about the relationship between audit quality and restatements: *"I worry if [the auditors] reduce the scope or quality of the audit."*

Effective relationships with external auditors contribute incremental value

One member described an open, productive relationship with the lead audit partner as *"key to my job."* Members expect auditors to keep them informed of any difficult situations they encounter, and said there is a significant problem if the lead partner doesn't trust the audit committee chair enough to discuss issues before key decisions are made. Auditors and their clients need to be able to communicate with each other effectively: one member spoke of the value of having the CEO and CFO clearly articulate their expectations for frequency and quality of communications; the audit committee can then evaluate the auditor against those expectations.

Relations have grown strained

Despite the importance of a constructive relationship between auditors and their clients, several members believe the relationship has become strained and note that *"the relationship pre-[Sarbanes-Oxley] is not going to return."* One member described communication with auditors as *"more stilted, more defensive,"* and other members said that many auditors were *"not as responsive to audit committees and clients"* as they had been in the past.

Members attribute these strained relationships, at least in part, to audit firms' differing interpretations of the standards set forth by the Public Company Accounting Oversight Board (PCAOB). Responding to questions from auditors and their clients, the PCAOB in May 2005 tried to stress that auditors can be



competent and objective and still provide some accounting advice without losing independence.¹ Members differ in their opinions of how much audit firms' practices have changed in response to this guidance.

Members believe it is important to attract and retain auditors with a broad business perspective

One member noted that while the new regulatory environment has affected audit firms' practices, auditors' personal characteristics have not changed. Many auditors get professional satisfaction from talking through issues with clients and are uncomfortable instructing clients to *"send me a memo and I'll get back to you."* However, other members question whether a fear of litigation might alter auditors' view of their role. As one member said, *"Once you get scared, you change everything."*

Most significantly, members warn of the *"danger of the drones"*; they worry it will be increasingly difficult to attract well-rounded businesspeople to the audit profession. Under this scenario, *"the [broader] skill set many of us rely upon is going to disappear."*

Audit fees are unlikely to decline greatly over the next few years

In April 2005 the Big Four accounting firms released a study by CRA International (CRA) based on data for a sample of the firms' Fortune 1000 clients with market capitalization over \$700 million. That study provided data on average first-year Section 404 implementation costs. As a follow-up to the April study, the Big Four re-engaged CRA to examine second-year costs. In the report that was released in December 2005, companies announced that they expected Section 404 costs to decline approximately 40% in year two.²

Several members were aware of the CRA report, but noted that cost reductions at their companies were significantly below the 40% rate quoted by CRA. One member said the total of financial audit and internal-control attestation fees declined 25% from 2004 to 2005; however, the aggregate cost was still higher than pre-Section 404. In this regard, the total audit fee is *"less painful than it used to be, but it's still painful."*

Members noted that the CRA study was considering not only external audit fees, but also internal costs, which represented more than 70% of total Section 404 costs in year one. Those internal costs are expected to decline significantly more than external fees now that initial documentation, testing, and remediation activities have been completed. Members recognize that because internal activities drive much of the Section 404 compliance cost, internal compliance efficiencies will naturally have a more significant impact on total costs than external audit fee decreases.

Integrating Section 404 and financial statement audits could reduce costs over the longer term

Members said auditors have historically argued that audit scope should be related to the quality of a company's internal financial controls. Companies made significant investments in order to comply with the

¹ Public Company Accounting Oversight Board, "Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*," PCAOB Release No. 2005-09, May 16, 2005, 11-12. Full text available at http://www.pcaobus.org/Rules/Docket_008/2005-05-16_Release_2005-009.pdf.

² CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update* (Washington, DC: CRA International, December 2005), 1. Available online at http://www.fei.org/files/spacer.cfm?file_id=1948.



internal-controls requirements of Sarbanes-Oxley Section 404, and many members hoped this investment would result in streamlined operations and a reduction in the scope of financial statement audits. However, few companies have experienced the anticipated efficiencies. As suggested earlier, several members question whether the scope of financial statement audits should be reduced as auditors attest to the effectiveness of internal controls over financial reporting.

In a report issued November 30, 2005, the PCAOB supported the concept of “an integrated audit of internal control and the financial statements, [in which] the auditor designs and simultaneously executes procedures that accomplish the objectives of both audits.”³ Auditors and audit committee chairs alike recognize the value of an integrated audit and note that “*there will be some economics*” once it is in place. However, all parties recognize the challenges inherent in integrating the two audit procedures and do not expect to realize the full benefit of an integrated audit for two or three years.

Costs in the accounting profession continue to rise

The audit profession still faces a talent shortage. Audit firms are competing for talent, not only with each other, but also with attractive opportunities throughout the broader business environment. Along with higher recruitment and training costs, salaries paid to new hires are increasing in order to ensure adequate staffing levels. Firms are also experiencing higher legal and professional indemnity costs, which members believe will continue to increase unless liability reform is enacted to prevent another debacle similar to the one that brought down Arthur Andersen in 2002.

Conclusion

The Securities and Exchange Commission and the stock exchanges require corporations to retain the services of an external auditor and file audited financial statements. Accordingly, some corporations view the external audit as a plain-vanilla service rendered. But most take a more enlightened view and work hard to derive substantial value from the audit and the auditor, thus creating real benefits for their shareholders.

At the tactical level, Mid-Atlantic Audit Committee Network members agree there is significant value to be realized from constructive relationships with independent, experienced auditors who understand the company and can communicate effectively with management and the board.

The views expressed in this document represent those of the Mid-Atlantic 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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³ Public Company Accounting Oversight Board, “Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*,” PCAOB Release No. 2005-023, November 30, 2005, 8. Full text available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf.