



Maximizing the value of the audit and external auditor

Synopsis

For the benefit of the corporation, the audit committee can and often does extract considerable additional value from its external auditor, over and above the value of the basic audit. This additional value derives from the auditor's unique perspectives and expertise with regard to the company, its industry, issues related to the audit itself, and matters tangential to the audit but falling under the rubric of advisory and assurance business services. Extracting value, however, usually requires a closer, more trusting relationship between the audit chair and the lead audit partners; it also requires time. The audit partners must be prepared to offer truly value-adding initiatives. None of this need threaten or reduce in any way the professional independence of the auditor.

About this document

The North Central Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Lake Erie and Ohio Valley regions 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 new audit environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, executives, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power 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 North Central Audit Committee Network met on March 1, 2006, to discuss ways audit committees could maximize the value of the audit and the external auditor. The members of the network present at the meeting, who sit on the boards of 27 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity
- Jim Boland, Audit Committee Chair, The Goodyear Tire & Rubber Company
- Gordon Harnett, Audit Committee Chair, PolyOne
- Donna James, Audit Committee Chair, Limited Brands
- Mike Losh, Audit Committee Chair, TRW Automotive
- Russ Maier, Audit Committee Chair, FirstEnergy
- Dave McCammon, Audit Committee Chair, Pulte Homes
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Paul Smith, Audit Committee Chair, Constellation Brands



Other participants in the meeting included:

- Frank Gori, Managing Partner, Audit and Advisory Business Services, Ernst & Young
- Al Paulus, Senior Client Service 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. Network members’ remarks appear in italicized quotes.

Executive summary

The discussion revolved around several important ideas, summarized below and expanded upon in subsequent pages:

- **Auditors and their clients are rebuilding the “human side” of their relationship, but worry that Sarbanes-Oxley provisions threaten the specialization and intimacy that provided value in the past** (*Pages 3-5*)

Members say it is important to meet regularly with auditors outside audit committee meetings. While telephone discussions are helpful and necessary, members say a predictable schedule of in-person meetings is the best way for auditors and their clients to share perspectives and build trust. Mandatory rotation of the lead audit partner, while presenting additional challenges, provides an opportunity for the audit committee to solicit fresh insights from the new audit partner. Members believe industry specialists and other technical experts provide significant value; however, they worry that it will be increasingly difficult for accounting firms to retain and assign professionals because of restrictions inherent in Sarbanes-Oxley.

- **Auditors can provide a forward-looking assessment of risks and opportunities to the audit committee** (*Pages 5-6*)

Auditors are a natural source of information for audit committees on new accounting practices and regulatory policies. However, members believe that auditors are also well positioned to take on a broader advisory role: assessing risk, benchmarking accounting policies, providing a perspective on finance department staff and competencies, and suggesting leading audit committee practices. Members do not believe these activities compromise auditor independence.

- **Pre-approval of non-audit services is effective, but some members believe audit committees should oversee these services more actively** (*Page 6*)

Despite initial efforts to limit the auditor’s involvement in non-audit services, members are more willing to engage the audit firm for tax services. However, members acknowledge that there is a risk that the bureaucracy of the pre-approval process may lead financial management to hire another accounting firm for non-audit services rather than seek pre-approval.



• **Most audit committees approve, but do not negotiate, fees; however, some feel that Sarbanes-Oxley requires audit committees to take an expanded role in negotiating audit fees** *(Page 7)*

While few audit committees actively negotiate fees with the auditors, one member argued that they should if they are to satisfy their obligations under Sarbanes-Oxley Section 301. Some members pointed out that in certain circumstances it may be helpful to discuss audit scope and audit fees at different meetings because of the emotional energy the fee discussion can generate.

• **Integrated audits are evolving and may yield greater efficiencies over time** *(Page 8)*

Members believe that their auditors are trying to improve the integration of the financial statement audit and the audit of internal controls over financial reporting; members are optimistic that this effort will eventually result in efficiencies. Members want to have a better understanding of the integrated audit and the auditors' plan to improve the integration. Members also want to know what the company and the audit committee can do to accelerate these efficiencies.

Activities and practices that audit chairs say enhance the value of the audit and the external auditor

From the auditor's side

- Reviewing upcoming changes in accounting standards and practices
- Discussing regulatory developments and industry trends
- Discussing financial reporting risks that may be on the horizon due to such factors as business changes, personnel changes, new business ventures, or new geographic locations
- Comparing the risk profile and aggressiveness of the company's accounting policies with those of its industry peers
- Sharing non-proprietary best practices and common issues faced by others in the industry
- Assessing the financial and internal audit departments (staffing levels, capabilities, etc.)

From the audit committee's side

- Challenging the auditors to reflect on and respond to open-ended process improvement questions
- Meeting face-to-face with the lead audit partner on a regular, predictable basis
- Inviting key members of the audit team to attend board dinners or social gatherings periodically
- Soliciting a fresh perspective from the new lead audit partner following rotation

The "human side" of the auditor-client relationship requires active management

Audit committees expect a certain amount of tension in the relationship between a company and its external auditor, given the auditor's responsibility to provide an independent review of the company's financial statements and internal controls. Although several members have seen a shift from what they termed "constructive tension" to "adversarial tension" over the last two years, members generally agree that in



recent months *“the relationship has dramatically improved.”* After significant uncertainty during the first year of Section 404 compliance, *“people are investing again in the human side [of the relationship].”*

Auditors and their clients should establish a predictable rhythm to their interactions

Members agreed that they benefit from regular meetings with the lead audit partner, outside of audit committee meetings. Although many members reported frequent telephone contact, they said it was equally important to meet face-to-face, either quarterly or semi-annually, generally for lunch or dinner. These meetings typically cover a wide range of company and industry topics and perspectives, the discussion of which helps in *“breaking down walls and building trust.”* The meetings need not follow a specific agenda.

One member also reported an unintended second-order benefit: when the CFO knows the audit committee chair and the auditor are communicating more openly, communication between the CFO and the audit committee also tends to improve. This observation echoes one made by a CFO during a recent Audit Committee Leadership Network (ACLN) meeting. The CFO told an ACLN member, “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.”¹

Some members said they invited their external auditors to a board dinner each year, making it possible for the auditors to interact with directors whom the auditors would not normally have the opportunity to meet. One member said the audit chair’s report to the board is more effective when other directors have met the auditors and have had the opportunity to discuss key issues directly.

Regardless of the form or frequency of the interactions, members agreed they should have a predictable rhythm, with regular pre-scheduled meetings supplementing ad hoc calls. During the ACLN meeting referenced earlier, a member said the lead audit partner should report at the next audit committee meeting any issues from “meetings between meetings” that require action.²

Partner rotation threatens industry expertise, but may result in fresh insight

Section 203 of the Sarbanes-Oxley Act specifies, “It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.”³

Members are concerned about the implications of the five-year audit partner rotation requirement, and one member described a case in which such a rotation had negatively impacted the audit team’s responsiveness. This member said that *“the team didn’t know how much leeway they had to respond [to the client] under a new leader.”*

¹ Audit Committee Leadership Network, “Maximizing the value of the audit and the external auditor,” *ViewPoints*, December 9, 2005, 6.

² Ibid.

³ The complete text of the Sarbanes-Oxley act is available as a pdf document at <http://www.law.uc.edu/CCL/SOact/soact.pdf>. Section 203 is found on p. 29 of that document.



Members agreed that industry knowledge was valuable, and one member described the benefits of working with a firm that audited 11 of the top 15 companies in the industry. One member asserted that industry knowledge was an absolute necessity: *“I demand industry expertise from the lead [audit partner].”* Members said that partners with industry knowledge *“bring to our attention issues they are hearing about most often,”* and good audit partners share non-proprietary best practices they have observed elsewhere in the industry. It should be noted that audit committee chairs in some other networks believe that relying solely on industry best practices may lead to a different set of risks; they say cross-industry benchmarks are at least as valuable as those from a single industry.

However, members also expressed some concern that the partner rotation and prohibited service provisions of Sarbanes-Oxley will make it more difficult for accounting firms to retain auditors or technical specialists with industry expertise.

Despite the challenges of partner rotation, there can be some benefits. One member suggested the audit committee might get the most insightful feedback from their auditor during the first year of a new partner’s rotation. Following a partner rotation, audit committees should view the new lead auditor as a source of fresh insight and take additional steps to solicit his or her perspective on the company’s policies and practices.

Auditors can provide a forward-looking assessment of risks and opportunities

Members agreed that auditors must perform a well-defined set of core activities in order to deliver opinions on a company’s financial statements and the underlying internal controls. Although these baseline activities represent a minimum service threshold, members believe auditors can provide significant insights into leading proactive practices to their clients without compromising their independence.

In particular, members appreciate their auditors’ forward-looking perspective and seek input from auditors not only on anticipated changes in accounting policies or practice, but also on regulatory developments and industry trends. In addition, several members said auditors can help the audit committee assess the company’s risk profile and likely future risks, especially when the auditor is able to draw from a broad base of experience and compare the company’s risks with those of a suitable peer group.

At one member’s company, the auditor makes an annual presentation to the audit committee on the five areas in which management’s estimates most impact the financial statements and discusses the degree of conservatism of management’s accounting policies in each area. Many of the accounting policies discussed are included in the company’s 10-K, but the presentation stimulates an interactive discussion of the policies’ suitability and impact.

By virtue of their close interactions with the company’s finance staff, auditors are also well positioned to provide a perspective to the audit committee about the staffing levels and capabilities of the company’s finance organization. One audit chair said, *“We get [input on finance department personnel] on a pretty regular basis from the lead outside auditor in private session ... he goes to that every time.”* Some members felt this input was most helpful in evaluating financial staff outside the internal audit group, since *“we already have so much interaction with internal audit, and have our own opinions.”*



One member said that the audit committee ends each meeting with the audit partners with an open question, often in the form, “What can we do to...?” In this way, the audit committee tries actively to encourage the auditors to make suggestions rather than waiting for them to come forward with insights.

Audit committees might benefit from more active oversight of non-audit services

Section 201 of the Sarbanes-Oxley Act outlines services that accounting firms are prohibited from offering to their audit clients; it also articulates the audit committee’s obligation to pre-approve non-audit services that are not specifically prohibited.⁴

Although the audit committee has the authority to pre-approve non-audit services, pressure from some parts of the investor community has pushed many companies to reduce non-audit fees as a proportion of total auditor fees.

Members said that in the recent past some companies and auditors had adopted overly restrictive policies related to non-audit activities, especially tax services. However, the Public Company Accounting Oversight Board (PCAOB) clarified the rules on permitted and proscribed tax services in July 2005.⁵ Since then, members agreed that their committees have been more open to engaging auditors to provide tax services.

Members believe that the list of prohibited services outlined in Section 201 is sufficiently broad, and none of the companies restricts their auditor from performing services not specifically prohibited under Section 201. They said it was important to base pre-approval decisions on the quality and consistency of service rather than on arbitrary metrics. Few members said the decisions were motivated by external optics, which only matter *“if you are worried about [this element of] your [governance] score.”*

Members agree that pre-approval of non-audit services is generally effective. However, they recognize that it has limitations. One member described a hypothetical scenario in which the tax director hires another accounting firm even though the external auditor is a better choice, simply because he or she doesn’t want to go through the pre-approval process. Members acknowledged that the audit committee might never hear about such cases and agreed that the committee *“needs to ferret those [cases] out of management.”*

Another member said that because auditor independence rules had become so restrictive, such that it is not possible to switch the audit to an accounting firm that has recently performed non-audit work, it is important to keep one accounting firm completely independent (or *“pure”*). This member’s committee requires that services provided by any public accounting firm be cleared through the audit committee. None of the other members described such an explicit “purity” policy, though they did recognize the potential benefits.

⁴ <http://www.law.uc.edu/CCL/SOact/soact.pdf>. Section 201 is found on pp. 27–28 of the document.

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.



The audit committee's role in negotiating fees varies widely

The auditor's reporting relationship with the audit committee is described in Section 301 of the Sarbanes-Oxley Act: "The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."⁶

Should audit committees actively negotiate audit fees?

Members describe varying degrees of involvement in the fee-setting process. Most members said management negotiates audit fees, which are then presented to the audit committee for discussion and approval. However, one member argued that this practice was inconsistent with the audit committee's obligations under Sarbanes-Oxley: "[Sarbanes-Oxley] says the audit committee retains the auditor. If you don't negotiate fees, how can you say you retained the auditor?" It should be noted that while some members were intrigued by this practice, nearly all members believed it was appropriate for the auditors to conduct the initial fee negotiations with management.

Another member pointed out that fee negotiation is not simply a matter of multiplying the number of hours by an hourly rate. In order to set fees, auditors and their clients also need to clarify roles and responsibilities and must agree on processes that contribute to audit effectiveness and efficiency.

An academic study undertaken in 2001, before the implementation of Sarbanes-Oxley, found that active and independent audit committees tend to drive up audit fees. The study stated, "Audit committees comprised solely of independent directors that meet at least four times annually are significantly, positively associated with audit fees. This evidence is consistent with audit committee members' taking actions within their span of control to ensure a higher level of audit coverage, as well as facilitating auditor independence."⁷ At least one member felt this finding was consistent with his experience: "I agree strongly that an active audit committee drives up fees ... frankly, we want to cover [ourselves]."

Audit committees sometimes separate discussions of audit scope and fees

A few members said that while auditor compensation is related to audit scope, it is sometimes helpful to "separate project management and scoping activities from fee discussions, because the fee discussion generates such [emotional] energy."

Members said they often pre-approve a preliminary fee early in the year in order to allow the auditors to begin work (e.g., 70% of the prior year's fee). The final fee might then be agreed upon six to eight months before the fiscal year end.

⁶ <http://www.law.uc.edu/CCL/SOact/soact.pdf>. Section 301 is found on pp. 31–33 of the document.

⁷ Lawrence Abbott, Susan Parker, Gary Peters, and Kannan Raghunandan, *The Effect of Audit Committee Characteristics and Non-Audit Fees on Audit Fees* (New York: Social Science Research Network, 2001), 2. The full text of this paper is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=275808.



Integrated audits are still evolving and have not yet yielded optimal efficiencies

In a November 2005 report describing some of their findings from the inspection of audits performed for 2004, the PCAOB wrote, “Some auditors did not integrate their audits of internal control with their audits of financial statements. Consequently, the amount of reliance placed on controls in establishing the nature, timing, and extent of financial statement audit work was limited. The Board expects that auditors will better integrate their audits in the future.”⁸

Members say their audit firms have made progress in integrating the audit activities, but believe there are opportunities to make this integration more effective. In a discussion prior to the meeting, one member said, *“We’ve made good progress toward an integrated audit. In the first year, we were at a ‘one’ [out of 10]. In the second year, we got to a five or six. Eventually, with the better-managed companies, it’ll be a routine thing, [and] we’ll be at an eight or nine.”*

Members believe that no best-practice benchmarks have yet emerged by which audit committees can measure the effectiveness or efficiency of an integrated audit. They also recognize that a truly integrated audit may require not only changes in the audit process, but also changes in processes employed by the company and the internal audit department. As a result, some members believe that discussions about audit integration should include the audit committee, finance staff, and both internal and external auditors.

Conclusion

Network members shared quite a number of innovative practices for deriving greater value from the audit and the external auditor, but none comes without a certain cost. In many cases, the financial cost is minimal. Rather, for the audit committee, the real cost is typically time: time for informal meetings to exchange perspectives and build trust with auditors, time in committee meetings to discuss risk issues in depth, time to take a more active role in fee negotiations, time to oversee non-audit service procurement more closely.

Similarly, audit partners must play their part in maximizing the value of their services. This requires a willingness to initiate discussion with management and the audit chair, a mind-set that seeks out opportunities to add value, and partnership with the client in building trust.

The views expressed in this document represent those of the North Central 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.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.

⁸ 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. 2005-23, November 30, 2005, 2. The full text is available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf.