



Maximizing the value of the audit and the external auditor

Introduction

The Southeast Audit Committee Network held its fourth meeting in Atlanta, Georgia, on May 4, 2006. *VantagePoint* provides a synthesis of key issues that arose during the group's discussion, which focused on opportunities for audit committees and their companies to derive additional value from the audit and the external auditor.

Collectively, members of the network sit on the boards of approximately 26 large-, mid-, and small-cap public companies. Members who attended the meeting were:

- Eddie Adair, Audit Committee Chair, Tech Data Corporation
- Denny Beresford, Audit Committee Chair, Kimberly-Clark and Legg Mason
- Kermit Campbell, Audit Committee Chair, SPX Corporation
- Phillip Cox, Audit Committee Chair, Duke Energy
- Doug Ivester, Audit Committee Chair, SunTrust Banks

Other participants in the meeting included:

- Tom Hough, Southeast Area Managing Partner, Ernst & Young
- Steve Konenkamp, Southeast Area Senior Client Service Partner, Ernst & Young

In addition, several network members were unable to attend the May 4 meeting, but participated in private discussions with Tapestry Networks prior to the meeting. *VantagePoint* includes selected comments and perspectives that emerged from pre-meeting discussions with the following members:

- Jim Copeland, Audit Committee Chair, Equifax
- John Farrell, Audit Committee Chair, Fidelity National Financial
- Dean O'Hare, Audit Committee Chair, Fluor
- Jim Robbins, Audit Committee Chair, Dollar General
- Peter Wood, Audit Committee Chair, Eastman Chemical

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

Over the last few years, audit committee chairs have described what they perceive to be increasingly strained relations between external auditors on the one hand and audit committees and management on the other, resulting from a variety of causes. Recognizing that the audit environment continues to change, the network meeting on May 4 focused on ways to increase the value of the audit and the relationship with the external auditor. Discussion revolved around several important themes, which are summarized below and expanded upon in subsequent pages.

- **Communication and competence build trust and support productive relationships** (Page 2)

Members agree that trust is built on effective communication. They worry that some auditors hesitate to bring up difficult issues, leading to avoidable conflict. However, members also feel that some tension between auditors and their clients is healthy and can even be used to measure the success of the relationships. Members say auditors can and should defend accounting decisions, and they believe it is possible for auditors to support their clients without advocating inappropriately on their clients' behalf.

Members agreed it was natural to consider the strengths and weaknesses of the relationship with the audit firm when it came time for mandatory engagement partner rotation. When evaluating a prospective engagement partner, members seek not only technical and industry expertise, but also evidence of team chemistry and interpersonal skills. Members also prefer that the engagement partner live locally, but appreciate that this may present personal challenges.

- **Audit chairs want an appropriate audit scope, but audit fees are a concern** (Page 5)

Despite the relationship between audit scope and fees, members focus first and foremost on getting the scope right, not on keeping down audit costs. Members recognize that although audit fees have little impact on their companies' bottom lines, rising audit fees may prompt an emotional reaction from management and the board and may undermine trust in the audit firm.

- **Auditor evaluation practices vary widely** (Page 6)

Members agree it is helpful to evaluate the auditor on a regular basis, but describe a wide range of practice. Some companies have developed processes that elicit feedback from dozens of mid-level finance executives around the world, while others are sharing feedback more informally with senior finance leaders. Members agree that audit chairs should ask the engagement partner to share the results.

Communication and competence build trust and support productive relationships

Given the complexity of the audit process, members recognize that periodic friction between auditors and their clients is inevitable. They believe that an open, trusting relationship between the lead audit partner and the audit committee is an important foundation for effective conflict resolution. One network member noted before the meeting, *"There has to be excellent, three-way communication between the audit committee, management, and the auditor."* Another member observed that people naturally *"make more out of [friction] when they don't have trust."*



Audit committees must have confidence that the engagement partner not only has technical capabilities, but also the interpersonal skills required to bring up difficult issues in a timely manner. One member said, “[Auditors] need to avoid situations that create surprises for audit committees ... Usually they occur after the external auditor has been aware of these things for a while ... I think [the problems] could be fixed, like most things in life, by better communication.” Describing himself as a “strict constitutionalist,” one member said clearly defined roles and responsibilities were also critical.

Some tension can be healthy

While recognizing the value of trust, members were clear that some tension was not only inevitable but quite often desirable. They feel the audit committee needs to foster a spirit of healthy tension and ensure that they are challenging the auditors enough. As one member noted, “There needs to be a certain amount of tension, but always with the goal in mind that everyone’s going in the same direction.” Another member said, “We want it to be a cooperative, yet challenging relationship. We don’t want to be at each others’ throats, but we don’t want to be cozy either.”

Members also said that tension could be used as a measure of the success of the relationship. One member said it was important for the external auditor and the audit committee to experience a “mild” amount of tension; in contrast, the auditors’ relationship with management should involve “modest” tension. This disparity allows the audit committee to adopt a “sage” role, working with the external auditors and management to identify “what is best for the whole [process].” Another member confessed, “I like to have management call me once in a while to complain about the auditors,” though that member remarked that he did not want the complaints to be about the auditors’ service. If, on the other hand, management complains that the auditors are being too conservative, he said, “That doesn’t bother me too much.”

In the past, some clients expected auditors to advocate for their position when dealing with complex or controversial accounting issues. With the post-Sarbanes-Oxley shift in rules and regulations, many auditors have been reluctant to advocate their clients’ decisions, fearing it would compromise their independence.

Members said auditors do not need to play an advocacy role, but should instead work with management to understand all the potential courses of action. Management must then decide independently what accounting treatment is most appropriate. If the auditors agree with management’s position, the auditors should “be prepared to defend it because it’s the right thing to do.” As long as the auditors believe management’s position is correct, a public demonstration of support “was proper [in the past], and it’s proper today.”

National offices impact relationships with the engagement partner and the client

Accounting firms’ national offices are staffed by senior level accounting and financial control experts who spend much of their time reviewing complex client accounting issues. They are also a firm’s primary interface with regulatory and rule-setting bodies, including the PCAOB, SEC, and FASB. Although some audit committee chairs have described accounting firms’ national offices as a “black box,” this perception is an unintended consequence of firms’ need to ensure independent review of difficult issues.



During a meeting held in March 2005, one accounting firm leader asserted that a lack of clarity from regulators was interfering with the firms' ability to provide service to their clients: "There is a lot of second-guessing in the system. The level of stress is at its highest in over 30 years. The National Office people become very conservative, and they second-guess the engagement team, so they [in turn] second-guess the client beyond the natural skepticism we are trained in, and the whole system becomes dysfunctional."¹

Echoing these comments, some audit chairs are frustrated that accounting firms sometimes appear to take decision-making authority away from the local engagement partner, requiring instead that difficult decisions be approved by staff at the national office. Members worried about the impact this practice has on the engagement partner's credibility and the timeliness of the audit process. One member said, "*The most damaging thing I've seen is when local partners are countermanded by upstairs.*"

Partner rotation presents new challenges

The mandatory five-year partner rotation point presents an opportunity for audit committees and audit firms to step back and reflect on the quality of their relationships. Many such rotations are due to take place in 2006 and 2007. One member suggested that this might be a natural time to reconsider the relationship, noting that it would be unnecessarily disruptive for the company to change audit firms after going through a partner rotation. Other members agreed it could be an option.

Members said when a new partner is assigned to lead their audit, they "*want to be assured we've got the 'A' team.*" Given the rise in audit fees, members said it was an absolutely necessary for new engagement partners to bring top-level industry expertise to the job. Members also seek to understand a partner's motivations in accepting the new assignment. They sometimes question why the partner has been assigned and whether he or she is able to commit enough time to the work.

Members agree that local presence is valuable, yet recognize that it is increasingly difficult to achieve. As one member observed, "*Being on the ground, being accessible, impacts the quality of the work [and] how fast issues get addressed.*" However, firms may not always have specialized expertise in a given market, and "*for major client handlers, more times than not it includes a move.*" Unfortunately, many dual-career families are unable to relocate, and members say that balancing work and personal lives in different cities is "*really hard ... It ultimately translates into issues at work.*" At a certain point, they worry that it will be difficult for audit firms to retain good people, because "*if you tell [audit partners] you'll have to move every five years, that really becomes unattractive.*"

Capabilities are an issue when changing audit firms

Members said that a decision to change audit firms is typically motivated more by capabilities and interpersonal chemistry than by fees. Said one member, "*[In changing auditors], we're not necessarily thinking we're going to save fees.*" Instead, companies seek "*the right team,*" with relevant expertise and authority at the local level. Member said it was important to "*look at who's doing the work – do they have the skill set that's necessary?*"

¹ Audit Committee Leadership Network, "The future of the accounting profession," *ViewPoints*, April 22, 2005, 3.



Audit chairs want an appropriate audit scope, but audit fees are a concern

Although the external auditor is clearly responsible for developing the audit plan, the audit committee is responsible for understanding and approving the scope of this plan – and may choose to argue for increasing the scope in accordance with the company’s risk identification process and the committee’s own concerns and interests. One member said the auditors should engage in *“a thorough corporate risk discussion with the audit committee and management each year prior to any detailed planning of the audit.”*

At the same time, audit committee chairs are anxious to avoid crossing the “bright line” that separates the audit committee from management. One member said prior to the meeting, *“The best plan is one that is in enough detail [that] the audit committee members get a sense of what is going on, [but] not so many trees that you miss the forest ... Ten or twelve pages as opposed to one or two pages, or a hundred or two hundred pages.”*

Members recognize that audit scope must influence cost, and not the other way around. They broadly agree with the member who said, *“Let’s get the audit scope right, then talk about what it’s going to cost.”* However, some members say it is also helpful for the audit committee to understand the relationship between cost and scope, especially if they are asked to prioritize alternatives or make value-based choices: *“If it costs this, that’s what you get.”*

Some concern over fees is understandable. As one member said before the meeting, *“The fees have gotten ridiculous ... If you are running a company, and your [audit] fees go from \$10 million to \$30 million a year, you have a right to ask questions.”* Another member noted that dramatic fee increases erode relationships with the auditor: *“When you pay for anything begrudgingly, that impacts the relationship.”*

Furthermore, in discussions prior to the meeting, some members said the balance of power has shifted. In the past, *“management used to have all the cards.”* Now, *“[audit] firms ... feel they have the chance to negotiate on fees for the first time in several decades, and the audit committees are the unhappy ones, feeling as though they don’t have any negotiating power anymore.”*

Members don’t know how to determine if they are getting a fair deal. *“It’s hard to compare the fees we are charged against others’ fees, and ‘standard’ versus ‘discounted’ smacks of used-car sales negotiations.”* While audit scope must address a company’s specific risks, one member said they benchmark the audit fees their competitors pay as a percentage of sales, assets, and income. The reasoning was simple: *“We’re all struggling to get productivity. Audit firms ought to do that too.”*

While audit fees may frustrate management and audit committees, one member said, *“As a practical matter, we make too much out of fees.”* Cost containment is important in principle, yet for most companies the audit fee has no meaningful impact on the bottom line, and *“it’s not that big a deal.”* As one member said, *“I wouldn’t want to be on an audit committee that put [a request for proposal] out, and the first thing you look at is fees.”*

Members also noted that the internal audit was not designed as a mechanism to reduce external audit fees. One member said, *“[Internal audit is] a piece of the control system that management puts in place to ensure systems operate the way they are intended.”*



Auditor evaluation practices vary widely

How often should audit committees evaluate their external auditor? The Conference Board Commission on Public Trust and Private Enterprise recommends that they evaluate the auditor “at least annually.”² Audit chairs can use these annual performance appraisals to help maximize the value they receive from the audit and the external auditor. One member suggested that more formal evaluation is a growing trend, driven in part by shareholder advocacy groups.

Typically, the auditor evaluation is completed before developing the next year’s audit plan or embarking on the fee negotiation. One member said prior to the meeting, *“I tell you where we do have discussion directly with auditors ... when we talk about the engagement for the next year. That’s where we go through the issues. [They are] not always monetary, sometimes style, quality, people.”*

Members report a wide range of practices:

- **Formal evaluation conducted by management.** One company distributes an extensive auditor evaluation form to the local controller at about 50 sites around the world. Controllers are asked to rate the auditor on a 1-7 scale across 15 different dimensions. Results are aggregated at the corporate headquarters and are used to evaluate the overall relationship as well as identify service problems in selected locations. *“The CFO and controller do that themselves and then sit down with the audit committee chair and say, ‘This is what we’ve come up with,’ and ask if it’s what we would expect. Once we’ve agreed on the particulars, we sit down with the CEO of the audit firm [and/or] the engagement and regional partner[s], and we just talk things out.”*
- **Formal evaluation conducted by a third party.** Audit firms sometimes engage outside parties to conduct telephone or Web surveys of management and audit committee members: *“Some of the audit firms have used an outside service, and that service calls you and says, ‘Look, not for attributing purposes...’ They go through very direct questions, and some of the answers that have come back have been very telling and aren’t just peaches and cream.”* Members said audit firms do not always proactively share results of the independent feedback process; they agreed it would be helpful to ask the engagement partner to share feedback with the audit committee at a subsequent committee meeting.
- **Informal evaluation.** One member said they begin the evaluation process with the *“give and take”* of an informal discussion, which they later formalize. The auditors know the discussion is coming, and prepare accordingly. Another member said prior to the meeting, *“Unfortunately, we do not have a formal process ... but we do go through [an evaluation] very seriously among ourselves and management, [asking,] ‘Are you pleased with the service; are you pleased with the attention you’re getting?’ But it’s not quantified in quite the same way as a board or audit committee [evaluation].”*

Before the meeting, one member described a two-way process in which the auditor also evaluates the audit committee *“in comparison with other audit clients they work with.”* This member said, *“[We] plan on making modifications based on what they’ve said.”* Another member agreed, saying, *“I like their feedback ... and we expect them to be open and candid enough to bring us something directly. If the audit*

² The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations, Part 3: Audit and Accounting* (New York: The Conference Board, 2003), 35. The complete text is available at <http://www.iasplus.com/resource/confboard.pdf>.



committee is horrible, the auditor has a duty to consider it a material weakness of the company.” However, one member said auditors were reluctant to share candid feedback: “We ask for feedback from the [audit] firm, but don’t get it. [The auditors are] not going to say much unless they are painted into a corner.”

Conclusion

Although the relationships between auditors, management, and audit committees are defined by law, regulations, and common practice, there is ample room for the personal touch that makes a difference for all parties. While audit chairs require that auditors demonstrate technical competence and industry expertise, they also measure an auditor’s value in terms of trust, chemistry, and interpersonal skills. How can audit committees maximize the value of the audit and the external auditor? By approaching the relationship with their auditor as they would any other professional relationship, seeking to identify and minimize the structural and personal barriers by judicious application of the personal touch.

About this document

The Southeast Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Southeast 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.

The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more board directors, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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