CANADIAN
AUDIT COMMITTEE NETWORK
VantagePoint

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Deriving maximum value from the audit and the external auditor

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading Canadian companies. 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 evolving audit committee environment.

The sixth meeting of the network was held in Toronto on March 4, 2008, with the discussion focusing on the audit committee's role in deriving maximum value from the audit and the external auditor.

This document reflects a synthesis of the key issues that emerged from the meeting. 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 this information can be disseminated to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 25 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Bill Anderson, Audit Committee Chair, TransAlta
- Gary Colter, Audit Committee Chair, Canadian Imperial Bank of Commerce
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, NOVA
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Ted Reevey, Audit Committee Chair, Aliant
- Pierre Robitaille, Audit Committee Chair, Gildan Activewear

Attending the meeting from Ernst & Young Canada were:

- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer
- Ross Pearman, Senior Client Service Partner and Leader, Asset Management Services Practice
- Rob Scullion, Area Managing Partner for Assurance and Advisory Business Services

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 comments made by Canadian Audit Committee Network members.

Executive summary

Network members were in strong agreement that an effective relationship with the external auditor is the key to maximizing the value of the audit. Creating an effective relationship means acknowledging and understanding the cultural differences between audit firms, properly understanding and benchmarking fees and scope, and dealing with regulatory matters.

- **Audit committees need to understand the cultural differences among audit firms** *(Page 3)*

  For the audit committee to have an effective relationship with its external auditor, it needs to understand the audit firm's culture and how that culture affects the lead and review partners. Unfortunately, some audit committees only appreciate differences in culture when they are in the midst of a challenging situation. Preparing early, understanding the auditing firm's perspective, and supporting transparent relationships and healthy dialogue will nurture a strong, supportive relationship between the audit partners and the audit committee.

- **The audit committee can take steps to ensure an appropriate audit fee** *(Page 4)*

  Members believe it is important for the audit committee to spend time scrutinizing the cost of an external audit, and understand how the fee was derived. It is also important for the audit committee to look at benchmarking data for fees incurred by similar companies. Additionally, members are suspicious of audit fees that seem too low as this may indicate that the audit firm lacks a complete understanding of the business, or may seek to increase fees in the future.

- **The audit committee can support an effective auditor relationship** *(Page 5)*

  Governance regulations now have a substantial impact on non-audit services that public accounting firms provide, including tax work. It is important for audit committees to be aware of the full portfolio of services that accounting firms provide and to watch out for issues of independence and conflict of interest; for the audit committee, perception matters as much as reality. Audit committees may use *in camera* sessions to get the auditor's opinion on sensitive matters, but should limit the number of issues discussed *in camera* to ensure transparency and open communication with a broader set of stakeholders.

- **Partner rotation remains a challenge for the audit committee and the audit firms** *(Page 7)*

  Regulations require that even the most effective lead audit partners must eventually rotate off the audit. Members of the audit committee must prioritize the most important characteristics of a new audit partner, and the audit firm and the audit committee should work together to manage the transition process. Interviews, reference checks, and conversations between the audit committee chair and the senior managing partner of the accounting firm are all becoming standard practice.

Audit committees need to understand the cultural differences among audit firms

In disagreeing with some observers who say audit is an increasingly commoditized service, network members describe a reality that is much more nuanced. 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. The audit committee chair must recognize those differences and manage the relationship with the auditor accordingly.

The intimacy of the Canadian marketplace also creates differences in the operating styles of the major public accounting firms. Members described executives in the Canadian offices of Big Four accounting firms as being more accessible than their U.S. counterparts, and felt they better understood how decisions were made in the audit firms.

While members recognize that all of the Big Four deliver appropriate results, they also believe *"they are quite different in their approach."* One member reported that when the member's company's account goes out to bid, *"we'll get four proposals, all with the same end result, but with different paths [to get those results]."* The paths can be different due to the nature of partner involvement, areas of focus, and different firm practices. Sometimes, those differences are more evident to some in the organization than to others: one member reported that *"there's no difference [among audit firms] from the point of view of the CEO; it's all a clear window into operations. [The CFO could], come up with [a laundry list] of differences."*

Members agree *"there are cultural differences between the firms."* Unfortunately, they observed, *"you [only] find that out when you have a problem."* In particular, members noted that accounting firms' policies and practices often diverge when difficult questions arise. Firms assert different levels of centralized control, grant engagement partners different levels of autonomy and decision-making authority, and allow clients different levels of direct engagement with technical resources.

Certainly, *"healthy transparency"* and *"open relationships"* are keys to preventing – or quickly resolving – those challenging situations. *"Access to a senior partner is important,"* one member said. Members discussed their "pick-up-the-phone" relationships with various senior partners, relationships that they believe audit firms encourage. Members pointed out that it is important to have such a relationship already in place, as it is difficult to forge one in the middle of a challenging situation: *"If you have a major problem in your company, a controversial thing, it's instructive to have access to the managing partner, to the head of the practice. As a client, you have to have that direct access and communication."*

The lead audit partner

Specific partners bring with them unique abilities and experiences. They provide the audit committee with an outside perspective on the company and can also serve as trusted advisers on selected business issues if the audit committee wants to use them that way.

Audit committee chairs' basic expectations for the relationship with their audit partner included *"good, frequent communication. No surprises. On-time delivery."* Members also appreciate partners who are proactive. Commenting on the auditor, one member said approvingly, *"We don't have surprises. If something comes up, they bring it up early. It's discussed, and the work is done."* This behaviour *"foster[s] trust,"* deepening the relationship between the audit partner and the audit committee chair and opening the door to conversations on more wide-ranging topics.

One audit committee chair regularly solicits the audit partner's opinion on the finance function, including views on *"the bench strength, people's skills, and their opinion of our key people."* Another member agreed: *"They see a lot, and what they see is important."* This audit chair added, *"I might not agree with them, but I want to hear their views."* Members value the partner's perspective because of the partner's insight into the finance organization: *"The auditor sees the depth of the team. We see two or three key people, but the auditor sees all the way down [and can tell us if we are] well spread out, and do we have enough people in line [for succession planning]?"*

Members agreed it was impractical for audit committees to assess the audit partner's leadership: *"With [our interaction being] a three or four hour audit committee meeting, it's tough to make a coherent judgment. It's hard in that limited interaction to drill down."* However, they noted *"you can see it in the results,"* as *"the ability to deliver on time speaks to the partner's ability"* to build and manage a capable team.

One member said, *"I always finish an audit committee meeting by asking the other members, 'Are we glad the audit partner was here during the meeting?' It's always a good conversation."* That conversation helps identify the value that the partner adds and helps the committee clarify what it expects from the auditors.

The concurring partner

In addition to dealing with the lead partner, audit committee chairs must maintain a relationship with the external auditor's concurring or independent-review partner. *"There's a lot of variation [between firms] in the 'extra' partner,"* one member commented. *"Sometimes they're in the committee meetings; sometimes they're never in the committee meetings. It seems like they were set up for the benefit of the profession, not for the clients."* Other members agreed that *"there's no standard approach"* to this partner's role, with members' experiences ranging from *"I know who they are, but they're rarely seen,"* to *"he's a public relations guy; he's at every meeting, and he monopolizes the conversation."*

When fulfilling the role properly, the concurring partner can act as a balance to the lead partner, providing *"a different skill set."* If the audit firm views the account as high risk, then the second partner is typically *"someone who has [significant] experience in the regulatory side of the business."* Additionally, members recognize that from the external audit firm's perspective, the concurring partner *"provides another set of eyes, a quality element"* to the work.

The audit committee can take steps to secure an appropriate audit fee

Now that companies are obligated to publish audit fees, they can also benchmark the cost of their audit against comparable companies. Recognizing that *"five or six [similar companies] are in the range of your audit fees leads to comfort"* regarding what the company is paying, one member commented. However, you must be sure that the company is *"comparing apples to apples"*; there might be reasonable differences between companies and audit fees, and one member recommended *"getting some good benchmark data and having the auditor explain any differences."*

Audit committees are suspicious of bids that are too low

At the same time, *"if a bid seems too good to be true, then maybe it is."* Members say that if a Big Four firm has made a bid that seems exceptionally low, there's a chance that *"someone doesn't understand things"* about how the company runs, what internal resources are available, or the high-risk areas that need to be audited in depth. Audit committee chairs, who rely on the external audit to provide them with assurance around the financial reporting of the firm, worry that inadequate fees may lead to a lower quality audit.

Audit committees sometimes view abnormally low bids as signaling that the external auditor may seek a significant increase in fees after two or three years. Members generally believed it was appropriate to request and receive breakdowns of fees, and detailed estimates of areas of focus from the audit firms bidding for work. One member felt that if an audit committee received that level of detail *"in the response to the proposal, then we can tell if they're buying the work."* Members agreed that *"with this level of transparency, it's easier to gain comfort"* with the audit scope and fees.

There are understandable differences between the United States and Canada in fees and staffing

Audit committee chairs benchmark fees not only against similar Canadian companies but also comparable U.S. companies. Unfortunately, benchmarking against U.S. companies may highlight differences in staffing and scale. Members noted that *"benchmarking against the U.S. is difficult"* because U.S. lead audit partners travel much more frequently than their Canadian counterparts. One member remarked, *"The propensity to get on a plane is high with U.S. audit partners. In a typical [U.S.] engagement, the partner spends a high amount of time in foreign locations, in face-to-face meetings."* Another member said they understood this and valued the practice, noting that *"there's nothing like kicking the tires [in person]."*

Canadian audit committees must also consider the higher concentration of localized expertise in the United States: *"In the U.S., there are hundreds of audit partners within a one-hour flight of a company,"* a situation that is not always true in Canada. For example, a technology company in western Canada might need the expertise of an audit partner who is located in Toronto. In the United States, a deeper pool of expertise is often available much closer.

The audit committee plays a role in ensuring an effective auditor relationship

One member remarked that *"the onus is on us to communicate our expectations [to the auditor]. We need an open dialogue with the auditor; we need to be communicating what is important to the audit committee. With clear expectations, the external auditor is in a position to deliver – it's not fair to have them shooting at targets they can't see."* This open dialogue and relationship will lead to feelings of *"mutual respect"* and *"mutual trust"* between the audit committee and the external auditor.

Members felt that trust *"is a two-way thing."* The audit committee has to believe they are hearing hard truths and straight facts from the auditor, and the auditor *"has to trust they'll get a fair deal from the audit committee."* It's not an overnight process; *"it takes time"* to build up this level of trust.

The opportunities and challenges of *in camera* sessions

In camera sessions provide both opportunities and challenges for audit committee chairs. Since audit committee meetings often include the CEO's direct reports, the privacy of the *in camera* session provides an important forum for the committee to discuss sensitive personnel issues. In fact, while theoretically sessions can be used to discuss any topic of interest, many audit committee members felt that "people issues" are among the few topics that should be handled *in camera: "I can't think of a non-people-related conversation that was meaningful [in a private session],"* one member stated.

At the same time, members say it is important to ensure transparency and resist the temptation to engage in too many private discussions. *"People try and push stuff into* in camera *sessions,"* one member commented. *"You want to avoid that. Focus [in private only] on people issues, systemic issues, and critical issues."* Additionally, by avoiding discussing standard finance and accounting issues *in camera*, *"there's no game of messenger"* afterwards, enhancing communication and providing assurance that all the people who need to know something do in fact know it.

Members also recognized the difficulty in *"characterizing what was discussed [in camera] without talking about what was discussed."* One audit committee chair addressed that challenge in a novel way: *"We list the topics discussed, but not the details, and that list is reviewed by senior management [along with other audit committee materials]. They don't know the colour commentary, but they do know the topics."*

Challenges in the management of non-audit services

The restrictions against using the auditor for non-audit services is creating issues for many companies, and the management of these relationships is *"getting more complicated as the number of accounting firms is getting smaller."* In many situations, *"it's getting so that a big company is using three [of four] firms now."*

In an era when *"perception issues"* are as important as real conflicts of interest and the strengthened disclosure regulations mean that *"there's no hiding [fees] anymore,"* audit committee chairs *"have to pay [more] attention to non-audit services"* than they once did. In an attempt to address the issue efficiently, one member offered a very straightforward approach: *"You choose based on availability or prohibition. If you can't use your auditor [for non-audit services], use the next best one."* Unfortunately, many members feel that *"with every part of the audit, there's potential conflict down the line,"* especially given that an audit firm might end up auditing its own work. *"Everyone says their work is within the guidelines,"* one member said. *"My rule of thumb is, will they audit their own work? That's walking along the knife's edge. Is it even going to come close?"* However, some members noted that the external auditor may naturally tend to make more conservative judgments: *"An accounting firm [that is not the auditor] is more willing to say, 'This is likely to succeed' when they're not having to sign off on the audit."*

One member said, *"We have a tendency to ask the external auditor if they have an independence problem, but as audit committee members, we need to do our own assessment. We need to see potential conflicts."* However, audit chairs also gave examples of management engaging accounting firms for non-audit services, and the audit committee isn't informed either because the fees paid fall below the threshold requiring pre-approval, or because the firm providing the service is not the auditor. Members lamented that, *"not only don't we put the other firms through the hoops [we put our auditor through], but we only hear about the work after they're hired."* Compare this to the external auditor, who *"goes through more hoops than any other firm"* and who is monitored closely by the audit committee. *"Chapter and verse,"* one member pointed out, *"we know what we spend on the audit."* Many audit committee chairs are coming to see the importance of having that same level of information for all non-audit services provided by Big Four accounting firms.

Partner rotation remains a challenge for the audit committee and the audit firms

Even if an audit committee establishes a seamless working relationship with a high quality partner, that individual will eventually have to rotate out of the role. Current regulations[1] state that:

- **The coordinating or lead partner** can provide five consecutive years of service, with a five-year time-out period before serving in that capacity again.
- **The independent-review or concurring partner** can provide five consecutive years of service, with a five-year time-out period before serving in that capacity again.
- **Other audit engagement partners** can provide seven consecutive years of service, with a two-year time-out period before serving in that capacity again. This category includes lead partners on significant subsidiaries (greater than 20% of assets/revenues) and engagement partners who provide more than ten hours at the registrant/parent level, including IT assurance partners working on the audit of internal controls under Section 404.
- **Specialist partners** (e.g., those who deal with tax) who participate in certain areas of the audit have no restrictions on their length of service.
- **Partners on insignificant subsidiaries** have no restriction on their length of service.
- **Non-lead partners on significant subsidiaries** have no restriction on their length of service.

While one audit committee chair wryly noted that *"you have to hope you have good [audit partner] succession planning going on,"* all members agreed that something this critical shouldn't be left to hope and luck. *"It takes years for a partner to get comfortable,"* one audit committee chair commented. Several members commented that *"overlapping [incoming and outgoing] partners is useful,"* ideally for a period of 12 months. However, some members noted that regulations may constrain the incoming partner's ability to effect a successful transition. While audit firms are frequently concerned about *"tainting the five-year"* period for the incoming audit partner through auditor overlap, audit committee chairs are frequently willing to *"burn a year"* in order to smooth the transition.

[1] In Canada, the auditor rotation rules are effectively the same as the U.S. Securities and Exchange Commission's Rule 2-01, Regulation SX, and are set forth in the rules of professional conduct in each of the provincial institutes of chartered accountants.

In addition to planning for audit partner rotation, both the audit committee and the external auditor should be looking at the rotation plan for all the relevant audit team members. This can help prevent several key members of the audit team from rotating within a small window of time. One member learned this lesson the hard way: *"Our partner changed one year and our manager the next. That was a tough one. We lost two knowledgeable people in one year."* This problem can be compounded when the replacement is unfamiliar with the company. *"More often than not, they're not on the account already. They might be coming from [an account in] the same industry, but not this account."*

Ahead of the rotation, one member suggested that *"audit committee chairs talk to the senior partner at the accounting firm, give them a perspective on the culture of the company, a full understanding of the organization."* The goal of the discussion is to *"make sure the top end of the firm is as well informed as those down the line. It's a five-to-ten-minute discussion, and it gives a level of comfort"* to the audit committee chair and provides valuable information to the audit firm ahead of the selection process.

That process of choosing a new audit partner can follow one of two patterns. In the first, the audit firm tells the audit committee who the new partner will be, and the company has little say in the process. In the second, the audit firm proposes two or three candidates for the position, typically with one partner recommended over the others, and the audit committee and management can interview candidates and make a selection. Members strongly preferred the latter; in general, they prefer a process that requires a high level of involvement from both the auditors and the audit committee. *"The auditor knows you well, and you both want the right answer,"* one member said. While *"the firm knows their people better than we do, and the person recommended is usually a good fit,"* one member highlighted that in a joint selection process, *"everyone feels better, and there's less chance of a mistake [being made]."*

Audit committee chairs often turn to both the external audit firm and their other clients for information on the proposed candidate. *"No one [in the audit firm] is upset when they're asked why they proposed someone,"* one member stated. At the same time, audit committee chairs should still check references: *"You don't want to hear, 'They're competent, but they [lack interpersonal skills].'"*

Conclusion

Members want an open, trusting relationship and a way to sustain that trust and candor over time. Accounting firms also want a good relationship, but want to be sure they can fulfill their statutory obligation to maintain independence. Audit committee chairs face a growing number of challenges in their relationship with the external auditor, but they are also armed with experience, tools, and data to help them along. Through strong relationships, collaborative activities, and an understanding of common goals, the audit committee can derive maximum value from the audit and the external auditor.

The views expressed in this document represent those of the Canadian Audit Committee Network, a group of audit committee chairs from Canada's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.