Evaluating audit quality and the external auditor

On 7 June 2012, members of the European Audit Committee Leadership Network (EACLN) met in Brussels to discuss how audit committees evaluate audit quality and the auditor, among other topics. This document summarizes the key points that members raised in the discussion, along with background information and perspectives that members shared before the meeting.

Executive summary

Current scrutiny of the auditing profession by policymakers and regulators has raised the question of whether and how audit committees can use their evaluations of their companies’ external auditors to improve the audit. EACLN members explored three topics in the course of their discussion of the evaluative process, the specific criteria applied and the trade-off between cost and quality:

- **Thorough evaluations combine informal and formal elements** (Page 2)

  Members described two general approaches to conducting evaluations: an informal process that all audit committees employ in the course of their work, and a more formal process that involves tools such as questionnaires and reports. Members noted the importance of ongoing observations and assessments of the auditor’s interactions with management and other activities, but they also underscored the value of questionnaires soliciting more systematic feedback, which can provide, for example, better insight into audit quality in remote locations and makes it possible to track quality over time. Members agreed that management and the audit committee play a critical role in helping the auditor conduct a high-quality audit.

- **Audit chairs look for the ability to challenge management in a constructive manner** (Page 5)

  Members explored a variety of criteria on which they evaluate the lead audit partner, the broader audit team, and the audit firm in general. Knowledge and judgment in the area of accounting are important, as is an understanding of the company’s business and strategy. A willingness to challenge management’s positions is critical, but the manner in which the lead partner communicates and works with management and the audit committee should be constructive and open. With regard to audits in remote locations, a discussion of audit firms’ internal quality reviews yielded several specific questions to ask the auditor, involving how the staff is reviewed, for example, and what kind of training is provided to them.

- **Audit quality trumps cost** (Page 7)

  While members acknowledged that the cost of the audit is a consideration for audit committees as well as management, they agreed that quality is far more important to them. Focusing too much on cost can harm quality and deter audit firms from providing audit (rather than non-audit) services. The issue of...
cost versus quality is particularly challenging during a retendering process, when the quality that non-incumbent competing firms can provide is unclear.

**Thorough evaluations combine informal and formal elements**

At most companies, the audit committee periodically assesses the performance of the auditor, a responsibility often listed in the audit committee charter and recommended in best-practice guides for audit committees, such as the guidance from the European Confederation of Directors’ Associations (ecoDa)\(^3\) and the Financial Reporting Council (FRC) in the UK.\(^4\) Such processes may be a stock exchange listing requirement.\(^5\)

The evaluation process is of increasing interest to EACLN members because it may be an efficient means of achieving some of the objectives motivating current initiatives on audit policy. If regular evaluations of the auditor can provide assurance on issues such as auditor independence and skepticism, policymakers may feel less compelled to implement more far-reaching measures such as mandatory firm rotation.\(^6\)

The regularity of audit assessments and the techniques used vary from company to company. Members described two general approaches: an informal process that all audit committees employ in the course of their work and a more formal process that many committees use to assess the auditor more systematically.

**Advantages of informal processes: convenience and continuous assessment**

Members noted that they monitor the quality of the audit and the performance of the auditor through their regular interactions with the auditor and discussions among committee members. One member said, “Continued direct communication between independent directors and the external auditor is essential.”

Another member said, “We have, during every meeting, lunch with the external auditor to get informal input and build a relationship.” A third member added, “We have a face-to-face meeting once a year with the auditor. It is direct and candid. What are the conditions in which they are working with management? Do they have enough resources? What are the relationships with the CFO and CAO [chief accounting officer]?” Other members noted that they observe how the internal audit team, the external auditor and management engage and resolve conflicts: “I have a checklist in my head when I am observing the interaction of the external auditor and the enterprise.”

Several members mentioned the importance of continuous assessment. A member remarked, “We have six meetings with the external auditor, two with just the audit committee chair. We know what their blood pressure is. The world is always changing. [Can they cope with] different aspects and different developments? That is the key for me in judging and evaluating them.” One member expressed a desire to observe more of the auditor’s the interactions with management: “It is less clear what is happening in our divisions. We don’t see divisional CFOs that much. We need to see that interaction, too.”

Several members noted in pre-meeting conversations that audit committee members often bring experience from other boards and audit committees, so they can compare and cross-reference the performance of the external auditor. One member said, “The members of the audit committee have seen other audit firms and...”
other companies, and if they can cross-reference findings against what they’ve seen before, that’s a third line of defense.”

Advantages of formal processes: deeper and broader analysis

In addition to relying on informal assessments, many members reported that their committees have a formal set of procedures for assessing the audit. This process typically involves an in-depth annual assessment, using questionnaires that capture both quantitative and qualitative data and are completed by relevant members of management, including finance staff, internal audit and risk management. These questionnaires are sometimes provided by the audit firms themselves.

Some companies report that between 30 and 50 members of management and staff submit answers. A member said, “We ask the ‘financial community’ – the CEOs of major divisions, internal audit, risk and compliance.” The member noted a key advantage of a formal data-gathering process: “We can plot trends over time and identify two to three key issues to be discussed.” Asking management to offer their opinion on the performance of the external auditor raises the risk of a potential conflict of interest. A member remarked, “You need the point of view of management, but this is far from enough. What might please management might not please the audit committee.”

The questionnaire serves as a starting point for an actual discussion of the findings. A member noted that these discussions can reveal critical issues missed by the questionnaire, as respondents express views they are unwilling to put in writing. They can also reveal the details of how issues were resolved: “The audit committee needs to understand the push and pull that resulted in an outcome – was there a big wrestling match? The nuance of how people worked together can only be discovered in these conversations.” This member pays particular attention to the verbal responses, to judge the level of frankness and candor.

Additional sources of input

Members noted that in evaluating the auditor, they seek input from other sources besides senior management, including the audit firm itself. As part of a formal evaluation process, one member said that they ask the auditor to explain their work: “We request from the external auditor a quarterly written report – it is now about 20 pages long – on the accounts, the risks, the provisions, accounting options and the discussion with management before the audit committee meeting. The quality of the report is a key element of our evaluations.” Another member said that the audit committee should ask for an explanation of the audit firm’s quality controls: “It would help me feel more secure that there is a process.”

In pre-meeting conversations, members stressed the importance of internal audit staff, who work closely with the auditor: “My second line of defense is the internal audit team – they are my ears and eyes across the organization.”

Assessing audits in other countries

Global companies must also monitor audit quality in other countries, a concern that regulators are addressing as well.7 Understanding how the audit is conducted in remote locations presents obvious challenges. One member said, “We receive a report of the audit committee and the external auditor from all major affiliated

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companies. It is very interesting, as we are far away from them. A direct report from the local audit committee is really a plus for the corporate audit committee.”

Another member remarked that surveys could be particularly helpful for identifying problems in other countries: “We saw a loss of confidence in [a country], and we wouldn’t have known that otherwise. We changed the partner, and it came back up the next year. You can’t do it by yourself. You need some help from surveys.”

Audit quality as a three-legged stool

Some members noted the importance of assessing management’s engagement in the audit process, in conjunction with an assessment of the auditor, since the two sides must work together closely, and shortcomings on one side may reflect problems on the other side. Members also expressed an interest in understanding the external auditor’s views of the audit committee, the third leg of the stool.

A member explained that the second part of their formal survey process asks the auditor for their views on working with the company: “We ask, how good are we as an audit client? It’s completed by seven or eight of the most senior audit partners. How good are we at doing the accounts accurately? What are relationships like? Do we discuss things early? And my favorite question: Do you look forward to doing our audit? It tells you a lot about the relationship of the external auditor and management.”

Regarding the audit committee specifically, a member mentioned several questions that they would like to ask their auditors: “If you compare us to other audit committees in the world, how do we score? Where do you see we could improve? You see many audit committees and know their practices, so it’s useful to ask.” The EY partners at the meeting noted that the firm has a process for assessing prospective clients that includes an evaluation of the audit committee and its independence from management.

Are we a good audit client?

A member’s survey for the auditor aggregated the responses of seven or eight partners to the following kinds of questions:

- Do we provide a clear understanding of what we want?
- Do you have access to our business strategy?
- Do we provide sufficient access to key management?
- Do we provide sufficient access to the board of directors, especially the audit committee?
- Do we complete our draft accounts correctly?
- Does our staff understand your role, and are they cooperative?
- Do we keep them updated on the progress of our year-end work?
- Do you look forward to working on this audit?

There are other aspects to evaluating audit committee performance. See Tapestry Networks, “Enhancing Audit Committee Performance through Ongoing Candid Feedback,” BoardMatters Quarterly, September 2011, pp 10–11.
Audit chairs look for the ability to challenge management in a constructive manner

Guidance on evaluating the auditor typically specifies a number of performance criteria, and members mentioned many of the same criteria during the discussion in Brussels and in pre-meeting conversations and earlier meetings that touched on the quality of the auditor. Important performance criteria are applied first and foremost to the lead partner. They include the following:

- **Accounting and auditing skills.** Organizations such as ecoDa recommend that audit committees consider “the robustness and perceptiveness of the auditor in handling the key accounting and audit judgements identified, responding to questions from the audit committee, and commenting where appropriate on the systems of internal control.” Similarly, questionnaires shared by members ask about audit expertise and industry knowledge.

Members value both knowledge of the rules and a deeper understanding of them: “It is important to be knowledgeable about accounting principles and negotiating. Something I test in connection with the external auditor: I want him to defend his position by more than reference to the correct accounting rule. Tell me what common sense says. [I don’t want an] auditor who defends positions based on regulations but can’t defend them on philosophic grounds.”

- **Knowledge of company strategy and risks.** Members highlighted the importance of knowing the company and its problems and risks. An incumbent auditor with several years of experience at a company should have an in-depth understanding that informs its audit. A member said, “One thing we measure is to listen closely to the auditor when they explain the problems of the company. How thorough are they? How knowledgeable? I want to know if they are more knowledgeable than other members of the company because they have a global view and a view of the whole company.” Another member said, “The external auditor has insight from their deep dives into the business, but unless they understand the strategies and business models around the world, that insight could be useless.”

- **Independence and professional skepticism.** Auditor independence is critical to audit quality. Guidance from organizations such as ecoDa stresses the importance of annual evaluations of independence against specific, measurable criteria, such as the financial interests an auditor might have in a company and the nature of additional services the auditor provides to the company. One member’s audit committee asks the auditor to describe the steps the auditor has taken to assure independence, an approach also recommended by the FRC in the UK.

Members are also interested in behavioral aspects of independence, such as how the auditor resolves issues with management. Is the auditor able to resist pressure from management? In what areas did management follow the auditor’s advice? It is extremely important that the auditor not hide behind what is technically acceptable in order to approve questionable positions. A member described how his audit committee addressed a situation in which the auditor approved increasingly aggressive accounting positions: “We now have a simple measure of audit quality: how many times do they differ from what management proposed? I count the number.”

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10 European Confederation of Directors’ Associations, Audit Committee Guidance for European Companies, page 32.
11 Ibid., page 29.
The members noted that “if management says the external auditor is not flexible, that is a good thing.” A red flag for the audit committee, on the other hand, might be the discovery that the auditor is not discussing with the audit committee important topics it has discussed with management.

**Partner temperament.** In pre-meeting conversations, several members highlighted the importance of the lead partner’s character and emotional intelligence, as reflected not only in the partner’s willingness to stand up to management, but also in the approach taken. A member explained, “It’s the same thing as being a board director. We are critical, evaluate management deeply, but how you express your evaluation is important – are you disempowering or empowering? You need to be constructive. For a director or an auditor, you try to get the organization to move in the right direction.”

Members also emphasized the virtue of a proactive, energetic lead partner: “Do they make sure they have the best people on my account? How willing are they to travel and see the business? What are they seeing across the audit firm and bringing to us? What are they doing to improve efficiency?”

At the meeting, members mentioned the general ability of the auditor to maintain strong relationships with the company. A member noted, “I am concerned about the ability of the external auditor to deal with different professionals in the company. Do [those professionals] know the auditor? Does he talk to them? He needs to mix with them.” Members mentioned the importance of chemistry and fit between the audit partner and the company’s culture.

**Communication and reporting.** Evaluation guidance and the questionnaires shared by members highlight a number of criteria related to the communications from the auditor, such as their timeliness, clarity, consistency and insightfulness. A member elaborated in a pre-meeting conversation: “How do they communicate, how do they highlight issues, what were the main issues and how were they resolved? How often did the auditor contact the audit committee chair about issues discussed with management?”

**Global capabilities.** For a global company, the capabilities of the auditor in specific countries are a key issue. Are partners in far-flung jurisdictions also competent and independent? How do these partners communicate with the lead partner? A member said, “We need to know that the lead audit partner knows what is happening in other countries.”

### Questions to ask the auditor about auditing in other countries

The discussion touched on the extensive internal quality-review processes employed by audit firms, yielding several questions that audit committees could ask of the external auditor to help evaluate the quality of audit work being conducted outside the home country:

- Do staff from outside the country go in and review the work?
- Does one partner take responsibility for all global partners on the account, ensuring that they have the right skills and are following the right procedures?
- Does the firm have global training, with additional training for local market variations?
- How is the performance of the local partner measured?
The importance of disclosure
Guidance from organizations such as the FRC suggests that at least some disclosures about evaluation criteria are advisable. The FRC states that “the audit committee section of the annual report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors.”

Members broadly endorsed the idea of disclosure, recognizing the sensitivities that could be involved. One member said, “I write the disclosure myself. I am sensitive to the issues, but companies are too cautious in their disclosures. Institutional investors give credit for openness. I talk about the areas of focus from the survey results and what is improving.”

Audit quality trumps cost
Members discussed the cost of the audit and its relationship to quality. In pre-meeting conversations, some members suggested that price is a factor for the audit committee as well as management. A member remarked, “At the end of the day, you’re looking at money, and the trade-off between cost and quality.” Speaking of a decision to retender, a member said, “Part of the catalyst was that an audit committee member suggested it – let’s do a soft bid to see what happens on pricing.”

In general, however, audit chairs are much more worried about quality. As one member put it, “We have to be conscious of the costs, but the quality of the audit comes first. If we are driven only by cost, we are not doing a good job for the company.” Members cited several reasons that focusing too much on costs was not a good idea:

- **You get what you pay for.** A member remarked, “If you pay less, you get less. The scope will come down. All the audit firms’ businesses operate the same way. The only way to reduce fees is to reduce effort.”

- **Audit fees are not hugely significant.** As a member put it, “Relative to turnover, audit fees are a small proportion. It’s not really a cost issue, but management driving for what they want from the auditor.”

- **Price pressure could reduce competition.** Speaking of past tenders, a member noted, “If we focused too much on cost, some firms were asking not to be selected, as they didn’t want to give up non-audit work.”

13 Ibid., page 13.
How the retendering process differs from the evaluation of ongoing engagements

While the trade-off between cost and quality comes into play when evaluating an ongoing engagement, the issue may be particularly challenging during a retender for the simple reason that it is more difficult to judge the quality of competing firms’ work. As a member put it in a pre-meeting conversation, “If you are retendering, it’s hard to assess fees against quality – you don’t know how good someone will be.”

A tender process differs from the evaluation of an ongoing engagement in other respects as well:

- **The process is more complex and time-consuming.** An obvious and key difference is that the company and the board are evaluating several firms, and the process is more likely to involve several stages. These stages might include initial meetings with candidate firms, evaluations of written proposals, presentations by all the candidates or a few finalists and the final assessment and decision. One member recently managed a six-month retendering process. Another member likened the process to overseeing a major outsourcing project.

- **Management is more closely involved.** Management input goes beyond responding to a survey. Key members of management and the board will meet with the prospective auditors. A member said, “The CEO, CFO, board chair and I had separate interviews with the proposed lead partners to see if they could meet our requirements and whether they could act effectively within their firms.”

- **Additional evaluation criteria come into play.** A member noted that the challenges of switching from one auditor to another make it very important to consider such factors as the ability to “get up to speed quickly and build relationships quickly.” The member commented, “Most people underestimate the enormity of building all those relationships and getting all those tentacles into the company. It puts a premium on the capacity to get into an organization quickly.”

Conclusion

At the meeting in Brussels, a member remarked, “If we want to fight against the regulators, we will need to have a formal evaluation of the external auditor.” To that end, EACLN members explored various aspects of conducting an effective evaluation of audit quality and the external auditor. They considered the benefits of formal tools such as periodic surveys distributed to management and other company staff, but they also noted the value of ongoing, informal assessments and the need to understand the company’s role in achieving a good audit. They listed a range of evaluation criteria that take into account not only the technical skills and knowledge of the lead partner but also elements of temperament that make it possible for the lead partner to challenge management constructively. For most audit chairs of large public companies, audit quality far outweighs cost as a factor in the evaluation of both incumbent firms and firms competing in a tender.
About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organised and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisors as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of ViewPoints lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive ViewPoints are encouraged to share it with others in their own networks. The more board members, management and advisors who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants

The members of the network participating in the meeting sit on the boards of about 20 large-, mid- and small-capitalization public companies. Network members participating in all or part of the meeting included:

- Mr Ángel Durández, Audit Committee Chair, Repsol
- Mr Phil Hodkinson, Board Director, BT
- Mr Lou Hughes, Audit Committee Chair, ABB
- Mr Daniel Lebègue, Audit Committee Chair, Technip
- Ms Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Mr Kees Storm, Chairman of the Board, Anheuser-Busch InBev
- Dr Bernd Voss, Audit Committee Chair, Continental AG
- Mr Mario Zibetti, former Internal Control Chair, Fiat Group

The following EY partners participated in the session:

- Mr Christian Mouillon, Global Vice Chair, Assurance
- Mr Mark Otty, Area Managing Partner, EMEIA
Appendix 2: Discussion questions for the audit committee

- How do you approach evaluating the auditor and audit quality? What tools and techniques do you use? How often do you carry out these evaluations?
- How do you assess the auditing of your company’s operations in other countries?
- What aspects of your approach work well, and what aspects could be improved?
- How forthcoming is the auditor with feedback on management and the audit committee?
- What evaluation criteria do you use? Which are most important?
- Which evaluation criteria are the most difficult to apply? What techniques are helpful?
- What kinds of disclosures should the audit committee make about the evaluation of their external auditor?
- What kind of problems have you discovered in your evaluations? In what other ways have problems emerged?
- How were these problems resolved? What kinds of disclosures are made about problems and their resolution?
- If you have ever gone through a tendering process, what were the reasons for it?
- What should the process be, and who should be involved? How much time should be expended by the audit committee?
- Which evaluation criteria are the most important? What are the challenges in assessing audit firms against these criteria? How should cost be evaluated and balanced against quality?
- What information should be disclosed about the tender process and the final decision?