How audit committees can assess external audit effectiveness

The audit is an important service that costs a lot of money, and companies need to get as much from it as possible. There's an opportunity here for an audit committee to add real value through its review of external audit effectiveness. The trouble is that it's really rather difficult for an audit committee to make a very rigorous assessment of external audit quality. Can it actually add anything to what the regulators and the audit firm's own quality processes are already doing?

This paper sets out to liberate audit committees. Rather than trying to do what others can do better, audit committees can add value by focusing instead on the qualitative, less visible aspects of the audit process.

External audit effectiveness? What's that?

Effectiveness is an elusive term at the best of times. Effective at what? And for whom?

Theorists can, and do, argue indefinitely about what an effective audit involves. For most of us, though, life is too short to argue about this – and if audit committee meetings aren't too short for it, then they should be.

Part of the difficulty with assessing effectiveness is that external audit is like an iceberg: what's visible to the audit committee, based on a handful of meetings a year plus what they hear from the CFO, is just the tip.

Once you've taken the plunge, it's not necessarily clear what you're looking for. If the audit doesn't uncover anything, it's not immediately obvious whether this is because there was nothing to be uncovered or because the auditors haven't turned over the right stones. And even if your external audit revealed massive fraud in the Ulaanbaatar office, this doesn't necessarily mean it's been effective everywhere else.

However, this doesn't mean that audit committees need to tear up their checklists in despair. This paper argues that audit committees can add real value by making full use of their instinct and judgement.

On a hiding to nothing?

Many audit committees say that assessing the effectiveness of their external audit is the hardest part of their job. And no wonder. When the Audit Inspection Unit checks the quality of an audit, it sends specialists to spend days poring over the audit files – which remain as closely-guarded a secret to outsiders as partner profits used to be. So how can a non-executive committee with no access to audit files add anything?

In the absence of documentary evidence on which to base their assessment, audit committees tend to go in either of two directions. Either they all but give up and content themselves with a token effort, or they do something that looks more like a review of client service than an assessment of audit effectiveness. Either way, conscientious committee members can be left feeling uneasy or exposed.

What exactly are we supposed to be assessing, anyway?

The problem arises because we tend to assume that there's only one way of thinking about audit quality, and that's the way it's been most visibly defined by the audit profession. Its central premise is that quality is primarily achieved by rigorous adherence to a clearly structured process, which is then confirmed in a documented record.

We're not suggesting that audit is a paper-based rather than a relationship-based activity – good audit partners certainly don't see things that way, and in fact the UK Auditing Practices Board's recent paper on Audit Quality is all about reaching beyond process to the "softer" things. But audit's technical (and most visible) outputs have tended to overshadow other important aspects of the process.

> The profession's usual emphasis on process and documentation has the advantage of being defensible in court, which is important in a litigious climate.
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> However, there's a respectable body of academic evidence suggesting that much of the technical side of audit is there to give the audit legitimacy, rather than for the sake of any other practical outcomes.
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> Furthermore, there's good evidence that in professions where defensibility is paramount – including audit – the documentary tail ends up wagging the dog of judgement. A "good" audit therefore becomes one which has produced a good set of files… and so producing them becomes the audit's focus.

We don't think audit committees should worry that they don't have access to much of the paperwork. Not only because the audit files don't tell the whole effectiveness story, but also because there are enough people looking at them already. This is regulatory territory, and the audit firms' own quality procedures place a very high emphasis on ensuring that the written record backs up the audit conclusions.

Even if they were to get access to the results of regulatory inspections, audit committees can't add much here. What they can do is to focus on other aspects of audit effectiveness, where their different (and unique) perspective enables them to add value.

Technical excellence, as defined in the conventional way, serves the profession's purposes but, when isolated, does not necessarily produce the best outcome for the company and its shareholders. Audit quality isn't just about rigorous process and what's in the audit files. It's also about relationships and how the audit affects the organisation.

Looking at how the audit has interacted with the company throughout the process, and what the company has got out of it, is a useful and important exercise. Far from being a cop-out, this approach is constructive and valuable – and one that audit committees are uniquely well-placed to do.

In fact, you may already be doing so. Many audit committees already look at audit effectiveness in this holistic way. We are not suggesting a fundamental shift in what some are already doing, but instead a shift in how we think about audit effectiveness and how the exercise of assessing it is valued.

A Classical approach to audit

Ever since the rules on auditor independence were changed to discourage auditors from taking their clients to the opera, audit committees have had only limited access to high culture. This is about to change… may we introduce Apollo and Dionysius, who were once Greek gods but have since fallen on hard times and are now reduced to representing two different, but complementary, aspects of external audit. In academic circles, these might be described as the cognitive and the sociological, but we prefer the Greek god terminology, which has the advantage of rather better cartoon potential.

If Apollo is the god of order and moderation, Dionysius is his alter ego, bringing creativity, emotion and spontaneity to the equation. Instinct versus knowledge, the holistic view rather than detail, people over process.

The audit profession has a predominantly Apollonian view of the world: analytical, rule-driven, structured and rigorously formal. It's on this side that there's already plenty of attention to audit quality, and where the audit committee feels hamstrung by lack of access to audit files.

But just as audit committees don't have access to audit files, so regulators and audit firm quality reviewers will always have the outsiders' view. So while the audit committee can look from the Apollonian angle as far as is practicable and useful, it should augment this with its own uniquely Dionysian view.

Apollo and Dionysius may have diametrically opposed characters, but this needn't lead to disharmony. In fact, they can be complementary – and the ancient Greeks didn't consider the two gods rivals. Engineers and architects can be seen as Apollonian and Dionysian respectively, but it takes both working hand-in-hand to create wonderful buildings.

It is also important to emphasise that we are not suggesting that auditors are purely Apollonian, and audit committees Dionysian. (Auditors sometimes go to the pub after work, while audit committee members usually turn up to meetings on time and sober...) We are simply illustrating two different concepts of audit, both of which are valid – and both of which are necessary to see the full picture.

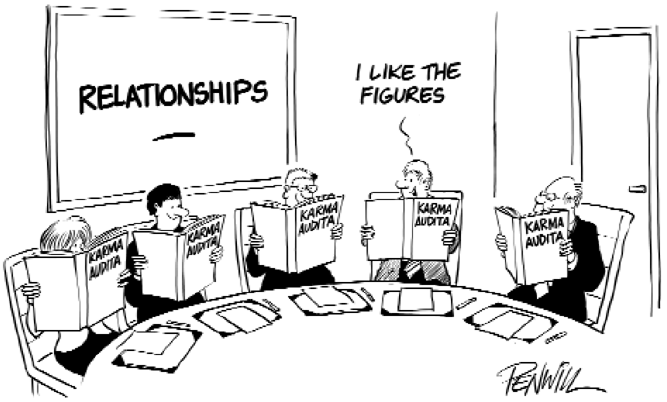
There are lots of checklists around to help audit committees assess external audit, all of them firmly from the Apollonian point of view. Within their limitations, some of them are pretty good. (We give top marks to the one produced by the Institute of Chartered Accountants of Scotland, even though to our bitter regret none of us are members of that august body.) We aren't going to try to outshine them. Instead, the rest of this paper contains a few practical thoughts to help you add Dionysian depth to Apollonian analysis.

Getting the most out of it

Getting an effective audit includes making the most of your auditor's experience, benefiting from their different perspectives and their interest in the company, and tapping into their knowledge of best practice and benchmarking.

Purists (who tend to be of an Apollonian persuasion) may argue that this kind of thing is extraneous to the audit. Don't let them put you off – from the wider Dionysian perspective, this kind of interaction is central, and firmly within the audit committee's scope.

Taken to extremes, wider relationships can stray into cosiness or other impairments of the auditors' independence. But, tempered by sound judgement, a good relationship between company and auditor doesn't just make it more likely that the audit process will run smoothly and on time. It also increases the auditor's knowledge of the business and its risks. If that knowledge is used well, the audit work will not only be more focused (and more efficient) but the audit process will deliver value as it goes along, through the stimulus that it gives to different parts of the organisation.



A Dionysian approach is also useful when it comes to assessing auditor independence and objectivity, another audit committee responsibility. Here, what really matters is practical and emotional independence – and this tends to be revealed in the tone, as much as in the substance, of interaction between auditor and company. Audit committees, for example, will typically look at how issues arising from an audit have been resolved; but they will also learn a lot by looking at the manner and tone of the issues' emergence and escalation, and the negotiations that led to resolution.

The right-first-time approach: looking ahead

Not surprisingly, we have yet to see an audit committee report along the lines of: "The audit committee evaluated the effectiveness of the external audit and concluded that it had been ineffective. Nevertheless, the committee considered that the accounts could be approved for issuing to shareholders."

It's in no-one's interests to declare an audit ineffective after it's been done. So increasingly, work on accounting policies and material judgements is done early, often before the year-end. This makes the audit committee a helpful part of a right-first-time process. It's a good idea: the audit committee's role shouldn't just be to look back after the event, but to look for opportunities to help things run well from the outset.

The audit plan is a good place to start. Auditors will always present the audit committee with their audit plan, but there are plans and there are plans. Often they come too late – sometimes even after the year-end – and it's not unknown for there to be pages and pages about the audit approach which could helpfully be condensed to "We will comply with auditing standards". Audit committees often need to be more assertive, and ask for a practical plan in plain English well before the fieldwork is due to start.

When you have this, you should look particularly closely at the auditor's risk assessment. If the Board's own risk monitoring and assessment processes are working well, and if the non-executives have a decent understanding of the strengths and weakness of the business and of the management, the audit committee should be able to make a useful critique of whether the right amount of the right sort of audit effort is going to the right places.

And look for what's been left out, as well as at what's been highlighted. The plan is unlikely to say, for example, that the CFO's a poor delegator and so there's more risk of accounting errors as the business grows. If the audit committee suspects this might be a risk, it needs to find out whether the auditor is aware but being discreet, or is in the dark.

Audit firms like to present themselves as seamless organisations, but the reality can be rather different. Geographically, they tend to be federal rather than integrated. And it's often the case that specialists such as IT and tax come from different bits of the firm and aren't terribly well co-ordinated with the core audit team.

The best audits will overcome these internal barriers, usually by means of good relationships and informal communication within the firm. This takes time and travel, and is often among the first things to be cut if the audit fee is squeezed too hard. So the audit committee should probe not only whether the central team has a good grip on specialist and subsidiary issues, but also whether the lead partners are spending enough time on holding the whole worldwide audit team together.

Properly robust challenge over the whole of the year will show how well things have been thought through, reveal underlying tensions and indicate how firmly the audit partner has stood his or her ground on tricky issues. And the committee can get a lot out of the private meetings with the auditor, probing who's setting the agenda and what were the most difficult things to resolve with management.

Taking stock: looking back

Ensuring audit effectiveness is a year-round role. But there's also a need to take stock and learn from experience so as to make improvements for next time. This is the formal, after-the-event, annual review.

Audit committees can do quite a bit on their own. But most will also want to understand what went on in different parts of the company. This means gathering information from outside the boardroom, covering matters ranging from relationships and attitudes to practicalities such as whether the partners and managers put enough time into it and if the rest of the team knew what they were doing. The wider you can cast the net, the better.

There are no hard and fast rules about how best to collect information. Questionnaires involve less time and cost, and can be applied more widely. However, they need to be carefully prepared so that they are not read as crude checklists. And the results can be hard to interpret, especially when it comes to subjective, potentially sensitive, matters such as relationships.

Our grateful thanks to the clients and others whose advice helped to shape this paper, and especially to Professor Michael Power of the London School of Economics.

Being a good client

No successful relationship is one-sided: both parties have to work at it, and external audit is no different. Here are some of the areas that audit committees can consider to see whether their company is keeping its side of the bargain:

- **Doing a decent job.** Pretty obvious, but often overlooked. If the company gets the accounts right in the first place, there is more room for the auditors to add value, rather than merely fixing problems. And if the auditors get the information they ask for on time, the audit is more likely to run to schedule.

- **Making expectations clear.** Remarkably often, problems between client and auditor arise because auditors aren't actually telepathic. The company should establish what it thinks would constitute a good service and go through it with the auditors so they know what it expects. There's no point grumbling behind closed doors.
- **Drawing the right boundaries.** Boundaries and cooperation need to be sensibly balanced. You don't want the auditor to ask for every number ever analysed since the company was incorporated, or to rack up fees in the pursuit of interesting but irrelevant enquiries. But nor do you want them to be blinkered. Make sure their scope is such that they can see the big picture.
- **Making it interesting.** Auditors may be known for their high boredom thresholds, but actually they're like the rest of us: they perform best at things that are interesting, varied and challenging. If things are too straightforward, their attention can drift. We're not suggesting that you create exciting diversions to keep your auditors on their toes, but rather that you keep this psychological factor in mind when thinking about non-audit services. Sometimes you'll get a better audit if you are able to get your auditors a bit more engaged.

Who should the audit committee ask to help with it?

The company secretary is often the most independent internal resource, but doesn't usually have the necessary technical expertise. The CFO is probably the best-informed assessor, and it's quite common for audit committees to leave the effectiveness review largely in his or her hands. This is understandable, but really doesn't seem a good idea. It's too easy for a critic to ridicule the idea along the lines of "asking the burglars to evaluate the police".

The internal resource with the best combination of relative independence and know-how is usually internal audit (though, even then, they may have a close working relationship with the external auditors). We think it's better to involve them than to leave it entirely to the finance function.

It is still relatively rare to involve an expert third party, either alone or working jointly with internal audit, but it's becoming much less so. There is an increasing take-up of third party services for internal audit effectiveness reviews, and there are signs that external audit effectiveness is heading the same way. Independent assessment gives the most objective view, but can cost more (although probably not as much as you think, especially if you properly cost internal resources).

An external reviewer needs to be chosen with care: clearly, it has to be someone who knows about external audit, but – not unreasonably – most audit firms get a bit twitchy at the idea of a direct competitor poking around their patch. (For the record, we don't do financial audits.)

It's worth the effort

The way to stop the review of external audit being an annual chore is to recognise that the audit process is many-faceted. Audit committees can shine more in some facets than in others. So, while not neglecting the overall picture, you should focus on the things that the audit committee can do better than others – and then do them well.

Independent Audit Limited supports audit committees in assessing (and, where relevant, selecting) their external auditors. More widely, we help boards strengthen their strategic leadership and control. We assess board and committee effectiveness, advise on governance mechanisms such as audit or risk management frameworks, and help with narrative reporting.

If you would like to discuss any of the ideas contained in this paper, or would like additional copies, please contact **Jonathan Hayward** or **Hanif Barma**.

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