

Getting the most out of external audit

As external auditors come under increasing pressure to make their work relevant and more valuable, internal auditors can play an important role in helping their organisations to get a useful service, argues Hanif Barma

» WHO would want to be an audit committee member these days? Their task seems only to get more and more onerous. According to many audit committee chairs I have spoken to, one of the most difficult responsibilities they have is assessing the effectiveness of their external auditor. Why is this so challenging? How can audit committees do something useful in a review of external audit? And what role can internal audit play to help them?

The responsibilities of the audit committee, including in relation to external audit, are set out in *Guidance on Audit Committees*, issued by the Financial Reporting Council (FRC) in December 2010 and updating the original Smith Guidance. It is not surprising that audit committees find their work in

relation to external audit oversight challenging. It runs to four-and-a-half pages and to twenty paragraphs – and this is the longest section in the guidance by far. (By way of comparison, there's only a page-and-a-half covering seven paragraphs describing the audit committee's responsibilities in relation to internal audit).

The audit committee's responsibilities are broad and, in summary, cover:

- Assessing the external auditor's qualifications, expertise and resources.
- Evaluating the effectiveness of the external audit process.
- Recommending the appointment of the external auditor, and approving their remuneration and terms of engagement.
- Reviewing the external auditor's independence and objectivity.

- Developing and monitoring the policy on the supply of non-audit services provided by the external auditor.

It is not an overwhelming list of responsibilities at first sight, so why do audit committees find oversight of external audit effectiveness challenging in practice?

Audit committee challenge

Some aspects of the audit committee's work in relation to external audit »

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» oversight are straightforward. For example, assessing skills and experience or confirming aspects of independence will depend on the audit committee asking the external audit firm to provide the right information, for example, about their policies, practices and how they ensure these are adhered to. Assessing effectiveness of the external audit process is more challenging.

Sometimes, audit committees think that the best route to assessing external audit effectiveness is to put the audit out to tender. Whilst tenders can tell you a lot about the cost of the audit, it's not really a gauge of effectiveness. A tender is forward looking and focuses on what you'll be paying and what you are promised you will get – but does not tell you whether you've been getting a robust and effective audit, or indeed whether what is promised is what will be delivered in future.

Effectiveness is very much in the eyes of the beholder; there's no commonly accepted definition of "effectiveness" to apply. Different stakeholders will have different views,

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needs and expectations. So, as a starting point, it will be important to be clear about what the organisation's objectives are for the external audit from the organisation's perspective. This may mean prioritising key objectives and reconciling conflicting ones.

Sure, we all want a clean audit opinion, but there are different ways of getting there (and some audits may be a less pleasurable experience than others). There are also different outputs from an external audit – do you just get an audit opinion and a few recommendations that the external auditors spotted along the way, or is there more additional and specific value added that you want, for example through robust dialogue and challenge, and sharing of good practices that the external auditors might see elsewhere?

Even if all you are looking for is a clean audit opinion, and the external audit does not discover anything, it may be difficult to tell whether this is because there was nothing to discover, or because the right questions were not asked and the right areas not probed in sufficient detail. And even if the audit has discovered an issue in one part of the organisation suggesting that good work has been done, how do you know it has been effective in all other areas?

Access may also be another issue. External audit's papers and files might provide the most tangible and visible evidence of audit work undertaken, but you can't get access to these and, without it, the technical quality of the audit may be difficult to assess.

However, the Audit Inspection Unit of the FRC is tasked with monitoring the audits of all listed and other major public interest entities, so it is likely that this will cover your external auditors – though probably not the work they do on your company given the number of audits they can cover. (Public sector audits are not included). So even if you or your audit committee did have access to your external auditor's working papers, this is unlikely to add very much to the assessment given that others are better placed to do it. Audit »

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» firms have their own internal quality review procedures too, and will be providing your audit committee with information about these procedures to inform the audit committee's view.

So while it is unlikely to be either productive or practical for the audit committee to review files to gauge how effective an external audit has been, there are useful things it can do, such as looking at different aspects of the audit, focusing on the areas where their experience and perspective can really add value. Primarily, the audit committee can look at how the audit has interacted and impacted with the company throughout the audit process.

Looking ahead

The audit committee will get the most out of a forward-looking approach, and good working relationships are key – not too cosy such that independence issues could arise, and not so distant that frustrations creep in. A good relationship between the auditor and the company will increase the auditor's understanding and knowledge of the business and its risks – and if this information is well used, it should lead to a more focused and effective audit.

So, it would help – and here internal audit can play an important role – to define and periodically review what your business sees are the key drivers of an effective audit and to set out what you'd expect the auditors to be doing in these areas. Armed with this information, it will be easier for your audit committee to assess whether the audit has been effective. Some of the key areas to think about include:

- The annual audit plan. Is the audit plan presented in good time, well before the year end? Does it contain specifics that show proper consideration of the business, rather than generalisations and generic themes? Have the right people been involved in putting the plan together?
- Risk assessments. Has the audit committee given the risk assessment a thorough review? How does it stack up with management's own



risk assessments and can the two be broadly reconciled? Not all big risks the organisation faces need a lot of time to be spent by the external auditors, so is it clear why time is being spent where it is?

- Coordination. This is an important contributor to the effectiveness of external audit – unlike group-wide internal audit functions, external audit firms may operate on a federated or regional basis. So is information shared and is work sufficiently coordinated? And does the lead auditor spend enough time on the coordination of local teams and specialists, as well as the head office audit team?

- Robust challenge and issue resolution. Don't just wait till the end of the year to think about whether issues have been appropriately resolved in a timely manner, and whether there has been enough external challenge from the auditors. This is an area the audit committee can assess on an ongoing basis, using their experience and judgement as well as the views of management.

- Private meetings. Not everything is suitable for formal written communications. Private meetings

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are a useful means of picking up the concerns of the external auditors where, perhaps, the formal and indisputable evidence is not necessarily available. You might be surprised how frank your external auditors might be in relation to such matters when the question is posed in the right environment. (Of course, this information would need to be used sensitively as it has trust at its foundation.) So make sure your audit committee makes full use of their private meetings, not just as a formality.

And don't forget that management have a key role to play in an effective audit. From keeping the auditors informed of developments to providing them with information on a timely basis, it's important that you are a good client. It's helpful to set out in advance what management's commitment to an effective audit is, making expectations clear from the outset and holding management to account.

Looking back

At the end of the external audit, it's invaluable to look back as well to assess how the audit went – and see where the process can be improved for next year. In addition to the audit

committee's views, it's helpful to cast the net widely, and get the views of management across the business – in different business units, at head office functions, and in different locations. While an interview-based approach may get you the most insights, practicalities suggest a questionnaire-based survey when the number of respondents gets sizeable. One practical approach is to annually survey regional and local finance directors and others, whilst interviewing a few key stakeholders of external audit and having a structured private discussion at an audit committee meeting.

Practically, of course, the audit committee will not have the time (nor the inclination) to run a survey-type exercise itself. Likely candidates could be the company secretary (independent, but not necessarily intimate with the audit process) or the finance team (knows about the audit but hardly independent). So, here again internal audit can play an important role, being independent and also understanding how the external audit should work.

The benefits are clear

The benefits of reviewing external audit effectiveness are clear. There is a potentially sizeable cost attached to the exercise, so you may as well make sure you're getting something useful and what you want from the audit. Where I've worked with clients to facilitate a review, they've reported back that they've valued the assurance they've received, and seen improvements in the following year. An organisation would want to make sure it is getting value from all its other suppliers, whether contractors and consultants, IT service providers or stationery suppliers – so why not the external audit? ●

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Audit inspection

THE AUDIT Inspection Unit (AIU) is responsible for monitoring the audits of all listed and other major public interest entities. Its last report was issued in July 2010, covering 2009/10. In that year it reviewed aspects of 93 audits, including 12 follow-up reviews.

It found that a higher proportion of audits were assessed as "good with minor improvements required" in 2009/10, but reported that it was disappointed that the number and type of audits that "required significant improvements" was largely consistent with the prior year.

At the conclusion of a review of an audit, the AIU write a letter to the engagement partner with their findings, including a grading, and then suggest they voluntarily share this with the client's audit committee.

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