Mitigating Increases in Audit Fees

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Executive Summary

While it may be a common perception that audit firms want to bill as many hours as possible, we find that most auditors want to work efficiently with their clients. Regardless of regulatory requirements, business structure changes, inflation in the current business environment, or other factors that can drive up audit fees, many companies are finding ways to work with their auditors to mitigate fee increases.

FERF's 2015 Audit Fee Report revealed that over 40 percent of SEC filers[1] have seen either no increases or reductions in audit fees compared to prior years. Of those filers, 15 percent were able to keep their fees down or flat for two consecutive years, and 4 percent for three years.

As a follow-up to that report, Financial Executives Research Foundation (FERF) conducted in-depth interviews with company executives who were able to reduce audit fees for consecutive years to examine the reasons for their fee reductions.

FERF also interviewed senior-level financial executives from various industries and reached out to audit partners to gain additional insights on ways to mitigate the increase in audit fees. These interviews revealed similar themes and highlighted the importance of working with auditors to find more efficient and effective ways to complete the audit.

Below are some best practices they suggested:

1. **Review current audit focus areas to identify areas for improvement:** Taking "inventory" of the audit focus areas and determining ways the process could be enhanced to resolve inefficiencies in the audit, and having "frequent touch points," were two of the areas interviewees suggested.

2. **Improve internal controls:** Improvements in internal controls are very critical. Auditors suggested "the way companies can help us reduce our procedures is to have great documentation." The 2015 Audit Fee Report revealed the median increase in audit fees of companies that disclosed ineffective internal controls over financial reporting (ICFR) was 6.4 percent, versus companies with effective internal controls that reported a median increase of 3.1 percent. Companies are beginning to recognize the importance of effective ICFR and its effects on the overall audit.

"Show me a company with weak internal controls and I'll show you an expensive audit."
Gregory Wilson, Former Deputy Director of the PCAOB Inspection Division

3. **Centralize audit footprint:** Interviewees, both auditors and preparers, shared that the more centralized the audit function, the more efficient the audit was. This corresponds with survey results from the 2015 Audit Fee Report illustrating that audit fees for centralized organizations are significantly less than those for decentralized organizations.

4. **Automation:** Preparers and auditors shared major benefits from automation. Areas where automation was mentioned include:

    a. Tools that automate and standardize account reconciliations also allow auditors to download reconciliations without having to ask the staff.

    b. Use of cloud-based solutions to automate internal controls documentation. Cloud-based systems help companies manage and execute Sarbanes Oxley documentation (including evidence), certification and reporting processes. These systems also provide auditors with necessary information to review and test a company's internal controls.

    c. Auditor platforms that allow for document sharing. Auditors are launching cloud systems that allow their clients to share information more efficiently.

    d. Auditors are also investing in more data analysis tools that allow quicker and more accurate information testing.

5. **Skilled staff:** Having a well-trained staff involved with the audit will help reduce audit fees. One interviewee suggested that a company employee with prior audit experience is critical to the success and efficiency of the audit. Because of their past experience and background, they know what auditors will expect.

6. **Audit preparedness is paramount:** Auditors emphasized the importance of clients being prepared for their audits. Not being prepared may result in auditors prolonging the audit, which translates to more fees.

7. **Review audit hours and fees, and don't be afraid to push back:** Companies that monitor the amount of hours auditors spend on a particular topic usually have the evidence to question the number of hours for which they were billed.

"Our external fees have decreased because our internal processes have gotten better…"
Director of Financial Reporting and Compliance Manager of Internal Audit

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[1] Population of 7,071 SEC Filers that filed as of Sept. 2015

Background

Reasons for increased audit fees and the impact of PCAOB inspections

As noted in **FERF's 2014 Audit Fee Survey**, the top reason for the increase in audit fees for public companies was the review of manual controls resulting from Public Company Accounting Standards Board (PCAOB) inspections and other PCAOB issues. In the **2015 report**, it dropped to second place, garnering 39 percent of total responses (second to acquisitions at 45.5 percent). Regardless, the PCAOB has had a significant impact on the way auditors perform their duties.

While the effect of PCAOB inspections was confirmed by interviewees as one of the major factors for increased fees, the degree at which this impact is felt by companies varied. For example, **William Pierce**, Senior Manager in Risk Advisory Services at Experis, noted the PCAOB has had a considerable impact on the work done by the external auditors to address findings from their inspections, which in turn trickles down to their clients.

He explains, "Auditors are being pressed for more evidence on how the external auditors know that the controls are effective and are requiring that management [their clients] do a better job of documenting the adequacy of their controls. This extends to how precise the controls are and whether the precision is sufficient to detect errors at the level that will keep them from becoming a material misstatement. This is ultimately increasing the cost of audit, or keeping the costs of the audit from going down."

A **partner from a leading audit firm** recognizes the PCAOB's action has brought a point of balance to audit firms. He explains, "The PCAOB serves a good, objective purpose to the audit process while being reasonable and balanced in their approach."

An **audit partner** from another firm believes fees have stabilized since immediately following the financial crisis. He explains, "Subsequent to the financial crisis, audit firms were scrutinized over the amount of work that was performed over testing internal controls – but I think that over the past four or five years that audit firms have been working with regulators – there is better understanding of expectations."

Areas for Improvement

Review current processes to identify areas for improvement

Interviewees suggested several ways to improve audit efficiency. For example, companies should continue to conduct timely meetings with the auditors to understand the audit scope, discuss the audit approach and procedures including risk assessment and substantive testing procedures, as well as identify significant audit areas. The company staff should exercise care and diligence in ensuring transactions are adequately supported, which makes it easier to gather information and satisfy testing procedures of audit samples. Auditors agree with many of these efforts and feel the PCAOB's efforts will cultivate better communication with companies and their auditors with reviewing audit procedures and processes.

A **chemical company VP of financial accounting** continually reassesses the audit process by filling out an "audit process efficiency template" each audit year. The VP of financial accounting explains, "Our staff fills in this template to identify audit process improvement areas and quantify its potential impact from an hours perspective." For example, the team identified areas where the auditors were spending too much time gathering information. "Once we better understood what the auditors were doing and how they were gathering information, we work with them to leverage our systems better to provide the information they need quickly."

Being plagued by a history of high audit fees as a percentage of revenue, a **senior VP/CAO of a technology firm** revisited areas of their audit for improvements and potential opportunity for reduction of fees. One area of improvement was a "collaborative operation type of thinking." Instead of making the auditors request a one-off type process, they embedded the requests of the auditors into their daily job functions. He explained, "We have now approached the audit as a process that needs to be embedded into our day-to-day activity, and how we should deal with it in the most effective and efficient manner possible," while becoming more creative in suggesting improvements.

This shift in thinking led to more efficiency such as working more collaboratively with the auditors and, "having frequent touch points with the audit partner to ensure both teams are on track with the audit plan. He explains, "Frequent touch points, which could be every day or once a week, gives a chance to reconnect and get back on the right path, both from our side and the auditor's side."

Auditors interviewed felt the current environment is ripe for dialog between auditors and their clients around improvements in audit procedures and processes.

A **leading audit firm partner** sees an opportunity in making the audit process more effective, as auditors and clients spend more time addressing issues from recent PCAOB inspections and findings.

Another **audit partner** suggested another opportunity to reduce audit fees is for clients to submit quality work in agreed upon timeframes to their auditors. For example, "Two companies that are exactly the same in terms of the scope of their operations, the nature of their business, and their geographical location. However, the differences are the quality and capabilities of their financial management staff and the quality of the documentation that supports their accounting, financial reporting and internal control judgments. You are just not going to have the same audit fee. One is going to be much higher because the auditor's effort associated with the company that has the lower quality, less qualified people, and lower quality of supporting evidence or analysis and does not deliver information on time will be greater."

Auditors also emphasized the importance of proper planning before the audit. A well-planned audit with the cooperation of both the client and auditor will definitely help reduce the audit fee.

Improve internal controls

Internal controls not only enable organizations to adapt to changing business and operating environments, mitigate risks to acceptable levels, and support sound decision-making and governance, a well-documented and effective internal control environment can ultimately decrease audit fees. Auditors acknowledge the critical importance of internal controls in overall audit improvement.

A **partner at a leading audit firm** suggested companies have the potential to reduce the time the auditor spends in the area of internal controls. "Documentation and support need to exist within a company's control environment or the lack thereof that has a direct impact on the amount of time that the auditors have to spend." He related two types of companies that he audits - those that are 'buttoned up' and those that are not. "Buttoned up companies have very strong controls. For example, an auditor will perform a walkthrough of revenue, taking a transaction from its inception to its recording on the general ledger. A company with strong controls would have controls along the way, front-end controls that will ensure that the initiation of the process is happening appropriately and various checks along the way, until they are ultimately recorded on the ledger, which means that your back-end controls are simply validating that all the information is flowing through your systems correctly and being recorded to the general ledger. This type of company will reduce the amount of time that the auditors would have to spend in that process because you have an effective system of internal controls."

In the second scenario the **partner** describes a company with heavily relied-upon management review controls at the back end of its processes. As emphasized by the PCAOB in Practice Alert 11, sole reliance on management review controls and other detective controls may lead a client to assess its ability to address the risk of material misstatement improperly. Sole reliance on management review controls and other detective controls requires increased documentation by the client, as there are no other controls overseeing the transaction and process levels.

The **partner** explains, "We have to try to get ourselves invited to certain meetings. We have to document the types of notes and the support they should have in their environment to prove that things are happening appropriately. As you can imagine, that's a whole lot of documentation effort that the auditor has to do in order to support that that control is operating effectively."

He likens this approach to "putting all your eggs in one basket" when relying solely on management review controls. "If that review control doesn't work, you are limited in your ability to point to compensating controls because there is not a suite of controls that are checking that transaction along the way. In a scenario where a company does have robust review controls, auditors expect robust documentation to that the review control is operating at a precise enough level to detect errors. This kind of support is typically documented in a way where the auditor can see the types of questions asked, answers received, errors detected and follow-up items addressed as part of the review control. It is, also, important that companies are performing procedures around the completeness and accuracy of the information used in the review control." He went on to summarize by stating, "The way that a company can help us reduce our procedures is to have great documentation."

Many companies have also figured out that the better their internal controls are, the more they can save on audit fees. For example, besides revisiting documentation, companies are centralizing the internal control functions, using a third party to test the controls independently, and standardizing templates that are pre-approved by their auditors.

The **executive VP and CFO** of a software company believes "centralizing" the function of internal controls internally and outsourcing the testing function helped reduce her fees. "In the Sarbanes-Oxley area, there is a central employee who coordinates all documents and walkthroughs. Then, we use a third party to independently test the controls on which our auditors can rely."

The **director of financial reporting and compliance of a service organization** shared that after inspections with the PCAOB and additional requirements, their organization has revisited all internal controls carefully, adding more documentation and narrative, where needed. "There has been an increase in the amount of wording and underlying documentation that is now used to support our numbers. For example, when we provide a number, we now have to document the questions surrounding it such as - how was the number calculated, are we comfortable with it, if there was a difference; is the number within expectations?"

The **senior VP/CAO** of a technology firm said they focused on improving and enhancing their documentation of internal controls by standardizing forms the company uses. The outcome was not only a benefit to the organization, it also allowed their external auditors to leverage their work. The standardized forms were used to document risk, controls testing and documentation of assessment of controls, gaps and documentation of functions that were done but not documented appropriately and agreed to by their external auditors as appropriate level of documentation. "This was a major undertaking as we are a global company, but one of the many tangible benefits for our audit firm was the ability to leverage centralized standardized documentation."

Experis' **Pierce** agrees it is critical to get buy-in from auditors around internal controls to be most successful. "Clear understanding of what controls are being tested by which groups, what control tests can be relied upon by the external auditors, and the progress being made to remediate deficiencies, if there are any, is key." He also believes private companies, even though they are not subject to internal control requirements, would also benefit and potentially decrease their audit fees by implementing best practices learned in Sarbanes Oxley compliance.

Centralize audit footprint

It is inevitable for multinational companies that much of the cost of compliance (including audit fees) is the result of auditors testing at multiple locations where key controls reside. A new trend that has emerged is centralization of the audit footprint. Whether it is through automation or strategic vision, this has helped companies decrease their audit fees with internal structure change. Auditors also favor a more centralized approach, because it can lead to a more efficient audit.

For example, the **senior VP/CAO of a technology firm** recognizes centralization of various functions is important to maintaining reductions in their audit fees. At his organization, the controls and compliance function was transformed to report to one centralized leader. This included Sarbanes Oxley work, policies and procedures, and delegation of authority. Another important element for which this function is responsible is "leveraging the work between the finance team and internal audit as well as external audit in order to enable the company to look at risk collectively as an entire organization, and determine where the company is doing their testing and what types of documentation does it need."

The technology firm also centralized its audit footprint. This included consolidated information by region rather than by country or multiple business units. As a result, their auditors were able to go directly to the regional centers and test rather than dispatching auditors to each country or business unit within a country.

The **chemical company** centralized their enterprise resource planning (ERP) systems. "We used to have two or three ERP systems and then went to one, which drove audit efficiencies."

Explaining that the audit fee is also multifaceted, some audit partners expressed how a company is structured has an important impact on the audit fee. "There are a number of companies that have multiple divisions that have different ERP systems, and in some cases, 50 to 100 different IT packages. This type of structure will require us to go and audit the system or at least understand the controls over the many systems at the important locations; whereas, other companies are designed much more efficiently where they have one or a few number of instances of a global ERP. Another example is the company's legal structure. We see hundreds of legal entities scattered throughout the world, which can lead to greater statutory audit requirements."

Automation

Interviewees have implemented various systems to either centralize the process or make work papers more accessible to their auditors. Auditors are also open to improving a good relationship with their clients. An audit firm, in fact, has even implemented new systems to help with their audits and to enhance their auditing capabilities.

In addition to transitioning from a global ERP system to a single centralized system, the **chemical company VP of financial accounting** also experienced efficiencies through the implementation of a new global account reconciliation tool. He explains this cloud-based tool is a depository for account reconciliation noting, "This allows auditors to download account reconciliations without having to ask us. This transition is a major time-saver from our previous manual process. Before where we had to track down who is reconciling the account and where the information was. Now, it is easy for the auditors to access the reconciliation directly which saves both us and them time."

The service organization **director of financial reporting and compliance** says they expect to improve their audit fees by automating their internal controls. The new system allows all documents to be centralized into one database, and it is expected to help with their future audits. "Before, we were using Excel, Word and a flowchart-based system, and all three documents were brought together and handed off to the auditors. Now, using the automated internal controls system, these documents are linked to each other, which make changes easier and quicker. Also, our auditors have direct access to these documents as well."

A **VP of accounting policy at a financial institution** shared that automating their internal control documentation not only helped with the improvement of documentation, but also resulted in a decrease in audit fees. The automation of this function has reduced the time spent in connecting matrices with narratives to the respective flow charts, in addition to, reducing the amount of time spent capturing the walkthrough information.

Another **audit partner** says any type of automation is helpful to the audit process. Manual processes are more difficult to audit and auditors can spend more time performing a review. "When it comes into scope for us, if you have a manual process, then the amount of work that we have to get comfortable with that process is much more than if the company actually scaled that and made the process automated."

Another benefit of automation is with shared interfaces. "Where I also see automation driving efficiencies in the audit is with systems a client and auditor can use to communicate. Systems that monitor deliverables, including when a deliverable is not met, are helpful. Some include red flags that automatically occur. For these systems, the right people will get notices in the organization prompting the right attention on the deliverables."

Automation facilitates a smoother audit. One **interviewee** reported his audit firm launched a tool that allows them and their clients to share information on a real time basis. He explains, "We can see what we have asked for, what has been provided, and what's behind schedule."

In addition to platforms that allow sharing of data, the audit profession is piloting certain audit tests that may mitigate future fee increases and provide greater insights. An **audit partner** explains, "Automation of audit testing can help auditors to more identify and test those potentially more risky transactions by being able to analyze a much larger population of data and set of transactions."

Hire skilled staff

Having the right staff involved in the audit process also helps decrease fees. Staff with an audit background is more aware of the auditor's needs, which in turn, can expedite the information provided. For example:

The **executive VP and CFO of a software company** hires staff who are former auditors. "They know what the auditors are looking for. Our corporate controller is a former Big 4 and scrutinizes all areas auditors review to determine which ones can be improved, and then works with auditors to make sure they understand what the scope is and what it should be so that they don't go out on tangents. Because of his background, he was also able to streamline all financial reporting necessary to get the tax provision and footnotes. In addition, he has come up with schedules and worked with auditors to determine where the most significant areas of the tax provision are."

It is important to make sure clients have the right people to analyze complex transactions. Another partner explains, "It is extremely helpful when the client has a deep understanding of accounting for the complex transactions, as well as auditing."

A **former VP of corporate finance at a financial institution** acknowledges that while most finance professionals recognize the need for experienced and competent staff to oversee functions like the audit relationship or complex transactions, it is challenging to fill these roles. The demand is high for these individuals, and recruiting and human resource functions may not have the domain expertise to identify top talent in an employer's market. To help maintain a pulse on up-and-coming talent, hiring managers should remain engaged with local professional organizations like AICPA, SEC Professionals or CPA societies to continually develop their network of qualified professionals. This provides a network and pool of resources when staffing needs arise.

Audit preparedness is paramount

From an auditor's perspective, clients that are prepared for their audit are more likely to see a decrease in audit fees.

Timeliness of client deliverables is "paramount" to audit success and cost reduction as an **audit partner** explained. "If work is not provided by the client in a timely manner, the audit firm will need to shift its staff, and perhaps subject the company to a new audit team that is not that familiar with the client's organization. So you can imagine that creates both inefficiencies because of the learning curve and that they don't have the experience as staff that have been on the engagement before."

Another auditor agreed, "The better the client is prepared and to that extent, the better we are prepared – that will streamline the efforts on both sides – and to the extent that we are prepared together, there is a synergistic effect."

Review audit hours and fees, and don't be afraid to push back

There are two critical components of the audit fee - the hours and the hourly rate. If items mentioned above have all been addressed, this may help the hours. Almost all interviewees suggested companies keep track of the hours audit firms spend on a particular area, and challenge the reported total if it is not correct.

The **director of financial reporting and compliance** has deployed an internal tracking of hours the company spends on particular areas. This becomes helpful when the auditor's time is estimated to be much higher. For example, while implementing the COSO Framework, their auditors originally estimated that the company will spend over 1,000 hours. However, because; the company had a solid framework to start with, they only spent 400 hours. "They [auditors] originally had estimated the implementation would be a six-figure process. But since we tracked the time we spent internally, we ended up well under half of that amount and are able to push back in other areas."

Another variable to consider is the hourly rate charged. The **executive VP and CFO of a software company** explained she goes in armed with data to support the market fee for her industry and revenue range. "The biggest part of it is the hours, and an even bigger part is the hourly fee, which is a little bit more of an art. I use my own market knowledge, and refer to the FERF **Audit Fee Report**, to push back on the audit fees." Another approach she shared is not accepting overruns from the auditors unless they are communicated before they occur. "I do not take overruns unless they come to me before, so I reject the payment."

A final suggestion from the interviewees was to consider whether the audit firm currently being used is just not the right size. An **executive at a mid-tier company** suggested that even though their auditor was great, they were just too "big" for what they needed. "We decided to go with a middle-tier firm, which ultimately had lower rates. However, there is still work that needs to be done, even at a mid-tier audit firm, to keep the fees lower."

The increase in audit fees should be determined on a case-by-case basis, as an audit partner explained. If the company is growing, there is likely a need to increase fees as growth typically adds complexity and increases internal processes. The ultimate goal is for companies to be more self-sufficient through avenues such as taking on more activities on our behalf or automating more of the process." This should ultimately decrease the time the auditors spend at the engagement.

"I think there should be a continued focus on the mix that audit firms have to serve clients. If an operating environment has greater controls, if they are focused on automation, that should have a direct correlation to the mix that audit firms have on the job and the amount of time engagement teams are spending on the audit."

Conclusion

There will always be upward pressure on audit fees, due to changes in regulation and organizational structure. But there are opportunities to mitigate these fee increases, or even to reduce fees, including:

- **Revisiting audit areas to find more efficient ways to provide data to auditors;**
- **Reviewing internal controls to ensure key controls are working effectively and processes are well-documented;**
- **Using a central hub for information to minimize travel time for auditors;**
- **Automating those aspects of the audit that can help expedite the transfer of information; and**
- **Reviewing and understanding the basis for both the number of hours that are billed and the hourly rate.**

While some of these tasks may be easily attainable, others may require more thought, and some may require a capital investment. However, just as our interviewees said that their changes made a difference, it behooves senior financial executives to implement whatever is possible. At a minimum, they should plan their audits thoroughly and obtain buy-in from the auditors on required documentation before the audit starts.

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