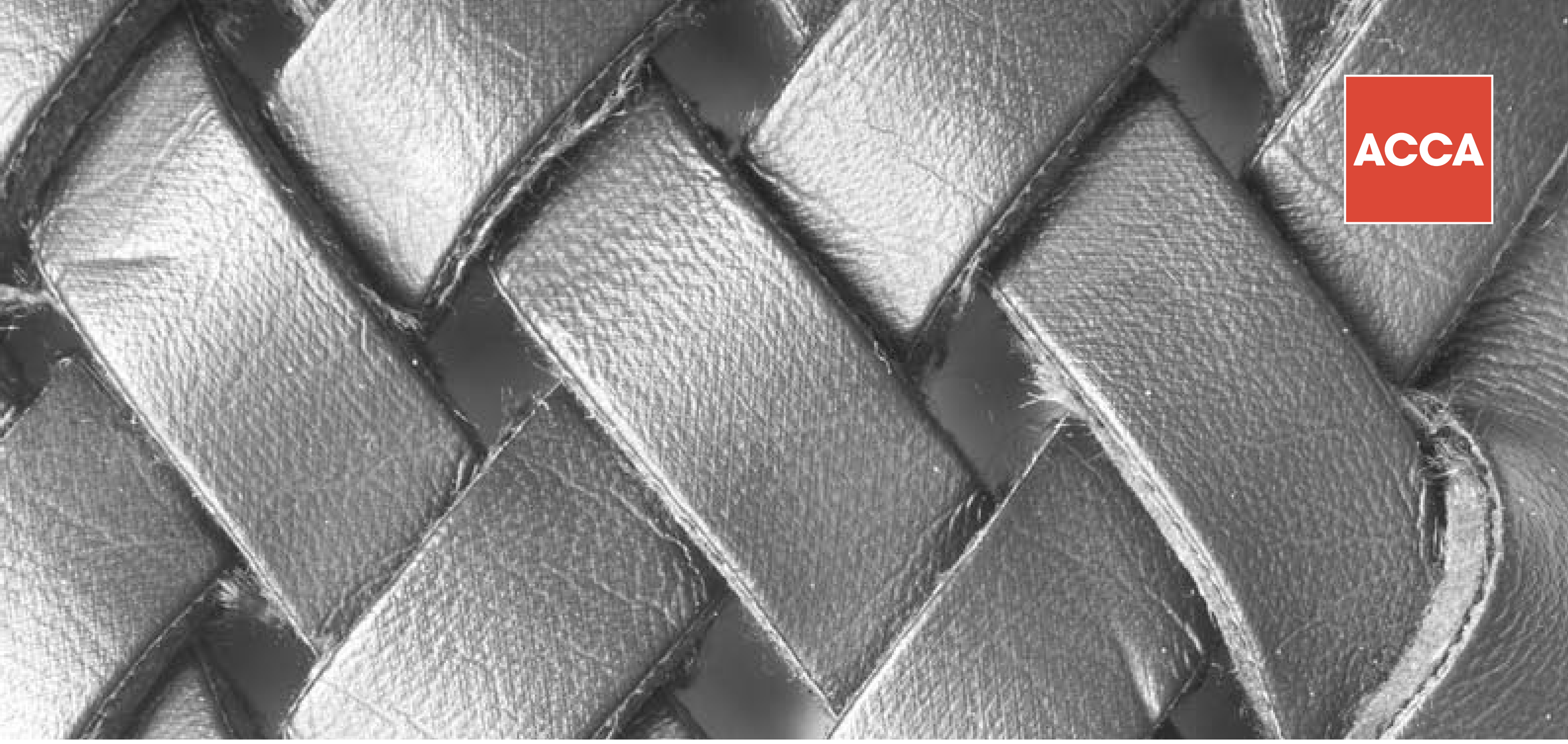
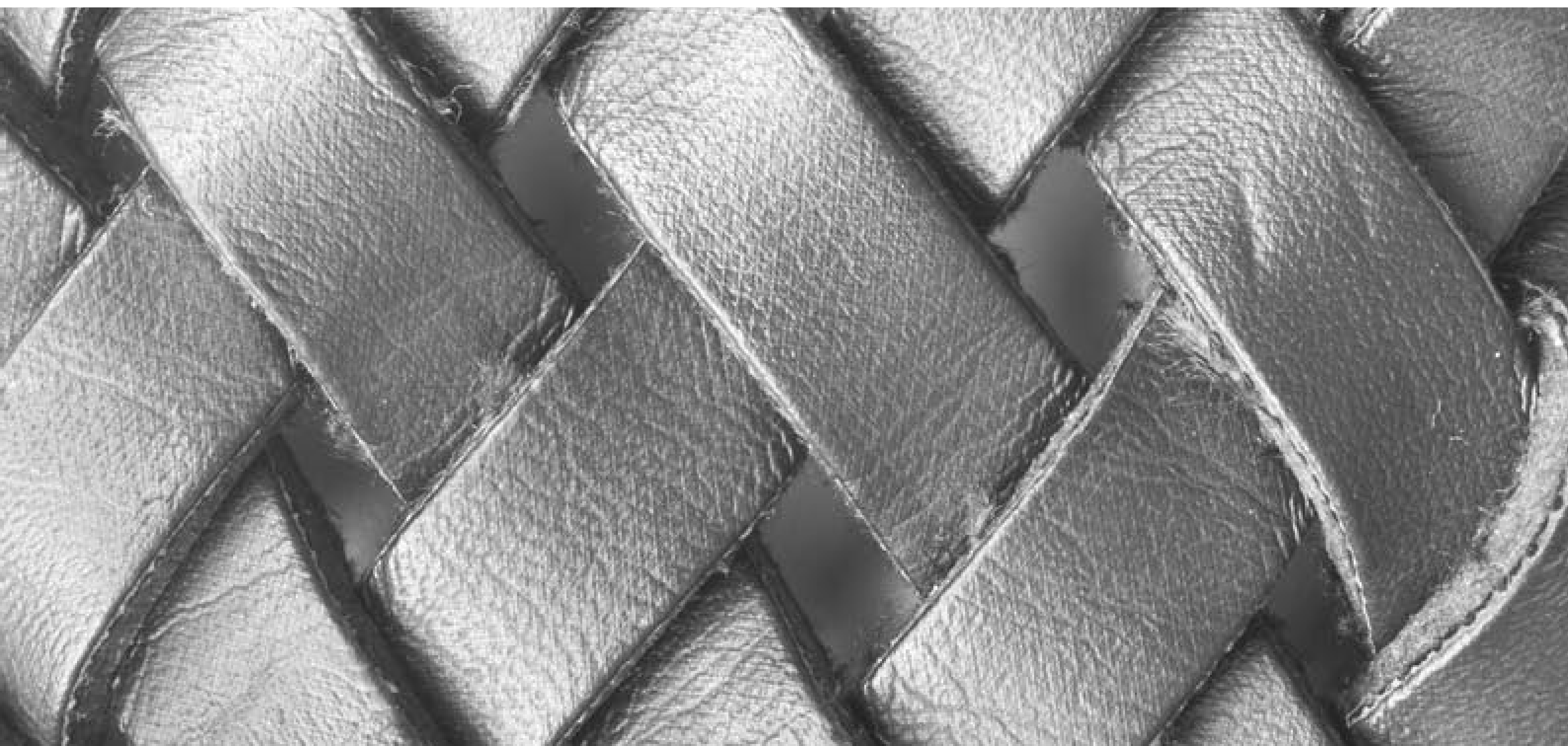


Audit under fire: a review of the post-financial crisis inquiries



ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 147,000 members and 424,000 students in 170 countries, helping them to develop successful careers in accounting and business, and equipping them with the skills required by employers. We work through a network of 83 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote the appropriate regulation of accounting. We also conduct relevant research to ensure that the reputation and influence of the accountancy profession continues to grow, proving its public value in society.

ABOUT ACCOUNTANCY FUTURES

The economic, political and environmental climate has exposed shortcomings in the way public policy and regulation have developed in areas such as financial regulation, financial reporting, corporate transparency, climate change and assurance provision.

In response to the challenges presented to the accountancy profession by this new business environment, ACCA's *Accountancy Futures* programme has four areas of focus – access to finance, audit and society, carbon accounting, and narrative reporting. Through research, comment and events ACCA will contribute to the forward agenda of the international profession, business and society at large.

www.accaglobal.com/af

Throughout 2010 and 2011 the role of audit has been the subject of a number of high-level inquiries in several jurisdictions. This paper outlines ACCA's position on the key issues that have been raised in those inquiries.

CONTACT FOR FURTHER INFORMATION

Ian Welch, Head of Policy, ACCA
tel: + 44 (0)20 7059 5729
email: ian.welch@accaglobal.com

Executive summary

Audit has never had such a high political profile. In the UK, Brussels and the US the global financial crisis has sparked a series of high-level inquiries into the role and effectiveness of audit, while in Singapore, among others, regulators are actively engaging with stakeholders to assess how audit can be enhanced.

The European Commission's wide-ranging Green Paper on audit will be debated in Brussels throughout 2011 and will eventually lead to legislation covering the European auditing profession. Michel Barnier, the EC's Financial Services Commissioner, has already warned, at a high-level summit in Brussels in February, that 'the status quo is not an option'.

In the UK, the House of Lords Economic Affairs Committee has conducted a highly critical inquiry into audit competition, which has led to a referral to the Office of Fair Trading on the basis that the complexity of the issues covered requires that they be fully examined by a better-resourced body than a Parliamentary committee .

Meanwhile, in the US, the Public Company Accounting Oversight Board has been examining the need for changes to the current auditor reporting model and has consulted a variety of stakeholders. The US senate has also undertaken a hearing, in which regulators and standard-setters have been called to give evidence, into the role of the accountancy profession in preventing another financial crisis.

ACCA firmly believes in the value that audit brings to business and the wider economy by building trust in corporate reporting. In our 2010 papers *Restating the Value of Audit*[1] and its follow up, *Reshaping the Audit for the New Global Economy*,[2] which was based on the findings from an international series of round tables held by ACCA in 2010, we have made the case for the role of audit to be extended to meet stakeholder needs more effectively.

Nonetheless, we accept that policymakers and regulators have every right to ask tough questions on the role of audit in the global financial crisis and that the profession needs to respond appropriately.

Several of these issues, including audit competition, have been examined in inquiries in more than one jurisdiction and this paper sets out ACCA's thinking on some of the central questions in the international debate.

AUDIT CONCENTRATION

In order to increase audit competition, ACCA believes policymakers need to take action on restrictive covenants and particularly on auditors' liability. The use of covenants is a directly anti-competitive measure, while easing the burden of potentially catastrophic litigation will encourage new entrants to enter the large audit market.

AUDIT INDEPENDENCE

ACCA rejects calls for the banning of non-audit services and for mandatory rotation of firms. We believe that joint audits are ineffective but are the lesser of two evils, compared with rotation. Fuller disclosure by audit committees of the basis of their choice of auditor is recommended. ACCA backs an enhanced role for audit committees, though warns against over-reliance on them.

EXPANDING THE ROLE OF AUDIT

ACCA argues that audit should be enhanced to take on areas such as risk management, corporate governance and testing of the assumptions underlying companies' business models. This would meet stakeholder needs more effectively, address criticisms of the narrowness of the audit role and so help to bridge the 'expectations gap'.

1. *Restating the Value of Audit*, ACCA, 2010, http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/pol-pp-rva2.pdf

2. *Reshaping the Audit for the New Global Economy*, ACCA, 2010, http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/pol-af-rtf2.pdf

AUDIT COMMITTEES

ACCA agrees that audit committees, acting independently from executive directors and management can do much to provide additional confidence in the integrity of the accounting and auditing processes. But we caution that recent inquiries may have invested too much reliance in audit committees – they are usually small groups with limited resource and not everyone on them are technical experts.

GOING CONCERN

ACCA would support reform of the current 'all or nothing' report to allow a more graded approach. Ways must be found to break the logjam whereby any modification to a clean audit report can trigger immediate loss of confidence in a company by investors or credit providers.

AUDITOR/REGULATOR DIALOGUE

Regulators should build relationships with auditors that promote collaboration rather than separate working. Mutual trust and understanding are important drivers of effective communication, which is key to the achievement of each party's objectives

AUDIT OF SMALL ENTITIES

Ways of auditing small and medium-sized enterprises (SMEs) need to be revised to ensure direct relevance to those entities. An internationally agreed range of assurance services for businesses not subject to audit is needed. But policymakers should not conflate audit with 'red tape'. Audit adds value to businesses' financial statements and makes it more likely that they will raise finance effectively.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

ACCA rejects claims that the IFRS regime has led to a lessening of prudence or judgement in audit. While prudence as an accounting concept is not central to IFRS, the system demands that companies present their position and performance fairly. Criticisms of the accounting standards on this issue have been misplaced and their perceived effect on audit mistaken.

1. Audit concentration

The Big Four's dominance of the audit market was the direct focus of the Lords' inquiry and one of the key issues in the EC Green Paper. The 'systemic risk' posed by such an oligarchy and the fears of what would happen if four turned into three drove both inquiries to seek answers.

Solutions are hard to find. The Financial Reporting Council (FRC), the UK City regulator, set up a Market Participants Group of investors, companies and audit firms in October 2006 and a year later published 15 recommendations intended to allow the audit market to work more efficiently and, in the medium to long term, to increase audit choice in the UK. The recommendations included supply-side measures intended to encourage non-Big Four firms to offer audit services to large public-interest entities, and demand-side measures to make boards more accountable to shareholders and reduce the perceived risks to directors who choose a non-Big Four auditor.

Yet in its fifth annual Progress Report in June 2010, the FRC admitted that 'to date there is limited evidence that the recommendations have had a significant impact on market concentration and the risks arising from that concentration'. In fact, the FRC admitted that concentration had actually increased.

ACCA agrees that more competition in the market would be beneficial. As we saw in the banking sector, the existence of institutions that are 'too big to fail' can never be healthy. We agree with the Commission that measures are needed to overcome the barriers that prevent smaller firms from taking on large audits, which we outline below. But we do not agree with the idea originally floated of downsizing or restructuring those firms that the EC Green Paper referred to as posing a 'systemic risk' because of their size. We do not believe that regulatory action of this kind is appropriate, and nor indeed is artificial intervention into the market, such as putting 'caps' on the number of audits that any one firm can carry out. Companies have a right to appoint whomever they want and regulatory intervention of this kind, which tries to 'buck the market', cannot be supported.

While we share the Lords' frustration at shareholder apathy and lack of involvement in the companies they own (although this is being addressed, at least in UK, by the advent of the Shareholder Code, which increases their responsibilities), the only long-term answer must be persuading them that their best interests are served by a healthy competitive audit marketplace, rather than an oligarchy. Although the largest global companies will inevitably require the services of large global firms, directors and shareholders of other listed companies should consider whether other audit firms could service them as effectively.

We believe action in two areas in particular could help to boost competition and remove barriers that deter or prevent non-Big Four firms from taking on large audits.

(A) RESTRICTIVE COVENANTS

The first proposal is that restrictive covenants should be outlawed. In the UK, the government has asked the Office of Fair Trading to examine how widespread the problem is – a move that ACCA welcomes. The top six firms stated in a joint submission to the OECD in 2009 that: 'in certain countries including the USA, UK, Germany, Spain and Finland we have encountered clauses or requirements in contractual agreements between companies and their banks or underwriters that state that only Big Four audit firms can provide audit services to the company'.

Mid-tier firm partners also went on record in their Lords evidence that they have personally come across such agreements.

Such artificial barriers to competition must be eradicated, on the grounds not only of equity, but also of pragmatism. If there were to be a failure of one of the Big Four, restrictive covenants would prevent companies from using other audit firms, which would leave only three to choose from, Given that the OFT is now extending its remit to look at audit competition more widely, we would hope that lenders and shareholders in all countries not only reject such covenants, but think more creatively about their auditor requirements in general.

(B) LIABILITY

The other key issue is liability. Auditors, like other professional advisers, will normally owe a duty of care to the entities that they audit. This will involve a responsibility in law to carry out their work with the skill and competence that society, and end-users, should be entitled to expect. Where this duty exists, and where the work is not carried out to the standard required, those end-users will have the right to take legal action against the auditor to seek compensation for any loss that his negligence has caused them.

This exposure to liability is usually seen as a good thing, since it concentrates the minds of advisers and drives quality and 'customer care'. If advisers were not motivated by the prospect of retribution for poor quality work there might be a danger that they would fail to exercise the right level of skill and care. For this reason we do not advocate freeing auditors from liability for their mistakes and sub-standard work, although we do think the example of Andersen, which collapsed after the Enron scandal ruined its name, shows that reputational risk equals financial risk as an incentive to give the best advice possible.

Nonetheless, ACCA does believe that, in some cases, rules on auditors' liability can be unreasonable and lead to undesirable consequences. We refer here, in particular, to the basis of joint and several liability that exists in the UK and many common-law-based jurisdictions around the world. Under this system, a person who has been owed a duty of care, and who claims to have suffered loss, can sue all or any of the parties alleged to have caused that loss. The key point here is that where one of the parties is considered to be better off, and hence more likely to be in a position actually to pay the damages claimed, the plaintiff can choose to sue just that party, with the others being effectively let off. Because auditors must have professional indemnity insurance, they have often been regarded as the best targets – so-called 'deep-pocket syndrome'.

This state of affairs is likely, in our view, to have at least two unfortunate results. First, if auditors are so constrained by the threat of being sued, they will be reluctant to get involved in innovative work that might actually produce real benefits to stakeholders. In fact, the auditing profession has been accused regularly over the years of being too conservative and of couching reports in defensive, legalistic terms because of the concern to avoid litigation. At this time, when stakeholders and regulatory bodies are increasingly looking for auditors to provide assurance on new areas, such as the effectiveness of companies' risk management, we need auditors to be willing to expand the scope of their work, which will not happen without the removal of the threat of litigation that could destroy them.

Second, and directly relevant to the issue of competition, the threat of being sued on an unlimited basis is likely to be a disincentive to smaller firms to get involved with the audit of large companies. Even if a firm considered itself to have the skills, experience and resources to take on the audit of a large company, it might well be forced to refrain from tendering for such an engagement if the financial risk associated with audit failure would be sufficient to wipe out the firm.

It should be noted that countries that have some form of statutory restriction of liability have succeeded in increasing the pool of audit firms operating in the listed company sector. A good example is Germany, which has had a cap since 1931 (currently 4m euros) – while the biggest companies are all Big Four clients, 34% of smaller listed companies are audited by firms outside the top eight.

The EU issued a formal Recommendation to member states in 2008 to encourage them all to limit liability for audit work – this followed a review which concluded that there was no evidence that limitation of liability, either by statutory caps or other means, had any detrimental effect on the quality of audit work.

Getting the right sort of liability regime is not easy. In 2006, the UK government moved to allow contractual limitation of liability agreements, but these have proved almost unworkable in the listed company sector, partly because shareholders have been very reluctant to give up their rights to sue auditors, but also because US authorities have been hostile to the practice, viewing it as a threat to audit quality.

Since the year 2000, Australia has reformed the whole basis of its federal law on civil liability. In the wake of a national crisis over the availability and cost of professional indemnity insurance (which saw audit firms' premiums rise by up to 400% in some cases), it has replaced the principle of joint and several liability (at least in cases involving economic loss and damage to property) with a general assumption of 'proportionate' liability, in which the plaintiff is entitled to sue each wrongdoer who he considers bears some responsibility for the loss he has suffered, and each wrongdoer will only be liable for that share of the plaintiff's loss which arises from his own negligence, as decided by a court. This new system applies to the work of company auditors via changes made to the federal Corporations Act.

The introduction of proportionate liability in federal civil cases is in addition to legislation already in force in some Australian states, which allows for the statutory capping of professionals' liability. In New South Wales, for example, the liability of an auditor is capped at ten times the audit fee for the assignment concerned.

No system is perfect, but on balance ACCA is attracted to the concept of proportionate liability as offering a solution which reflects the reality of the auditor–client relationship but which still allows a plaintiff to recover the whole of his claim where the defendant is solely at fault.

Although such action in the area of liability is not a panacea for an intractable problem, we do believe that, together with moves to eradicate restrictive covenants, it would facilitate greater competition from non-Big four firms. These firms have publicly stated in their submissions to the Lords and EC that lack of money is not what restricts them from tendering for large audits – rather it is the belief that as things currently stand they would be unlikely to be successful, and so they avoid the time costs of tendering. This also means that the supposed 'solution' of amending rules on ownership of accountancy firms and generating external investment is not the answer.

Many other problems and potential solutions have been raised in the current debate and we assess them here.

2. Audit independence

The EC Green Paper and the subsequent discussions in Brussels have concentrated in particular on three interlinked issues to do with increased audit independence.

The first is the provision of non-audit services by auditors to clients, the second is mandatory audit rotation and thirdly, joint audits. It seems that while many of the initially large number of possible areas of action have now gone, these three are still the likeliest sources of proposals for legislation.

(A) NON-AUDIT SERVICES

For many years politicians and other commentators have been exercised by the issue of auditors' provision of additional services to their audit clients. In the recession of the early 1990s, there were claims that firms 'low-balled' – ie cut their audit fees in order to get a foot in the door for more lucrative non-audit work. Then in 2001, following Enron and the demise of Andersen, the argument came up again. How could firms possibly perform properly independent audits when their eyes were fixed on the bigger consultancy prize? The introduction of the Sarbanes–Oxley Act ('Sarbox') in the US in 2002, which established the Public Company Accounting Oversight Board (PCAOB), was the result.

In 2007, as the credit crunch began, a UK Treasury Select Committee into the failure of Northern Rock bank referred to this issue and then in 2009, another Select Committee into the banking crisis, declared: 'We strongly believe that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the FRC consults on this proposal at the earliest opportunity.'

The FRC's Auditing Practices Board (APB) did just that. And its discomfort was clear in its report, which observed that the Select Committee's recommendation was based on the views of 'certain representatives of the investor community' and 'particular commentators', none of whom were named but who included at least some who could reasonably be described as 'frequent critics of the audit profession'. The APB lamented the lack of evidence used in the arguments – 'these views are based predominantly on the perceptions and opinions that different stakeholders hold, and not a proven track record linking audit failures with a lack of objectivity'.

Yes despite that report, the Lords have now come out with a similar conclusion to the 2009 Select Committee. Although they were 'not convinced that a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit is justified' the Lords nonetheless recommended that auditors should be prohibited from providing internal audit, tax advisory services and advice to the risk committee.

The US is the only significant jurisdiction, so far, to act in this way – nine services are on a prohibited list, under Sarbox, although 'pre-approval' can get round this on occasion. It seems very likely that the EC will go the same way and establish a list of such activities, although it will not simply import from Sarbox.

ACCA's view is closer to the APB's. Policy decisions must be based on evidence, not assumptions and in fact, the figures, courtesy of *Financial Director* magazine,[3] show a dramatic decline, since Enron, of the ratio of non-audit to audit fees in listed company accounts. From a peak of 191% in 2002, the figure plunged to 71% in 2008. For a subject where the debate too often generates heat rather than light these are telling figures.

3. 1. http://www.financialdirector.co.uk/financial-director/analysis/1744271/pounds-sense-fds-audit-fees-survey-2009

ACCA does not believe a complete separation of audit and non-audit services is either possible or desirable. Some services are closely related to audit, and the extra insight of the incumbent audit firm into the business brings quality and efficiency benefits that businesses would not wish to lose. The ability of small accounting firms to offer wide-ranging services as business advisers is of proven value to small and medium-sized enterprises (SMEs), a view supported by research.

While we do accept that there is a strong case for external auditors to be excluded from internal audit work – and we would be happy to examine other areas on a case-by-case basis – we do not believe that tax advisory work should be included on any prohibited list. Most companies would be rightly aggrieved at having to take on another firm of advisers to do tax work, as this seems costly and unnecessary.

There is also a wider point here. We believe audit training is a crucial part of being an accountant and a blanket ban on the provision of non-audit services to audit clients would start to position audit as a specialist activity, rather than a central part of business governance that adds wider value to business leaders. This would not help bring talented people into the profession.

Nonetheless, the non-audit issue has always been a difficult case for the profession to make to a sceptical audience – and the financial crisis has stripped away any inclination the EC had to give auditors the benefit of the doubt. Sometimes realpolitik is too strong and it seems that a Sarbox-type list of prohibited services will be replicated in Europe, but the outcome must not be the drastic option of 'audit-only' firms, which would lead only to a serious reduction of talent entering the profession. That simply has to be avoided.

(B) MANDATORY ROTATION

In evidence presented to the Lords' inquiry, several headlines were generated by the fact that the average tenure of one of the Big Four firms is an eye-catching 48 years. This was deemed to be clear evidence of the need for change. Although it is hard to argue that a firm can be external auditor to a company for 30 years without becoming part of the 'organogram' of the company, ACCA does not agree with mandatory rotation of firms after a set number of years.

The problem is that, unless the wider problems surrounding competition can be addressed, merely insisting on a change of audit firm will probably lead to one Big Four firm replacing another. And quality could be needlessly threatened if a short number of years was fixed – given the scope and complexity of modern international businesses, especially banks, the necessary knowledge built up by the audit firm would be lost too soon.

We believe it is better to stick with the existing rules on audit partner rotation – if the lead partner has to change reasonably regularly, it should help to prevent threats to auditor independence. Companies already sometimes complain when the lead partner changes too often and continuity is lost, although a suitable balance has to be struck.

The Lords – while rejecting mandatory rotation – nonetheless proposed compulsory tendering every five years, with at least one non-Big Four firm involved. The audit committee would have to give detailed reasons to shareholders for their choice, which is a proposal currently being pushed by the UK FRC, as part of its general exhortation for audit committees to play a bigger role in governance.

ACCA strongly supports the idea that audit committees should explain their thinking to investors in this way – the committees are there, after all, to protect the shareholder interest. This is far better, ACCA believes, than the idea, floated in the post-mortem of the crisis, that regulators or other third parties should appoint auditors. Appointing auditors is a key part of the governance of the company and it should be the company's audit committee, who have knowledge of the company, that makes the choice and is accountable for it. This also prevents any allegations of corruption, which could arise if a third party determined which firm gets the work. Detailed disclosure of the reason for the choice would also help to prevent the unwelcome spread of so-called 'restrictive covenants', mentioned earlier. Auditors should have to demonstrate their superior service, rather than this simply being assumed.

But it would nonetheless be wrong to assume that mandatory tendering will be a panacea. Non-Big Four firms are already reluctant to take on the considerable costs of tendering, knowing they are unlikely to oust one of the Big Four. So without other more effective measures to boost competition, compulsory tendering may simply add costs with no benefit.

(C) JOINT AUDITS

Joint audits are another idea being floated in Brussels – but at the EC's two-day conference on audit and accounting in February 2011, it was noticeable that loyalties divided sharply along national lines. French firms and regulators praised the use of two firms as being a success in France – both on the basis that 'two pairs of eyes are better than one' and because the system allowed smaller firms to get exposure to listed company audits. UK and German speakers, on the other hand, condemned the approach as costly and ineffective. It can be argued that there is some logic in giving a smaller firm at least some experience of larger companies by allowing it to audit the subsidiaries while a bigger audit firm does the consolidated group accounts. There is, however, a danger that this could be a tokenistic development while the real power remains in the larger hands.

ACCA would, on the whole, agree with the Lords, who were not convinced that joint audits would be better but argued that they would increase costs and bureaucracy. We also believe there is a real danger that either work would be duplicated or would fall between the cracks with both auditors leaving it to the other. The Parmalat case in Italy showed the potential risks of joint audits. Nonetheless, as some mid-tier firms have argued, something has to be done to overcome 'Big Four' dominance and there are no easy answers, as we have already seen.

Joint audit and mandatory rotation may appear to be unconnected issues, but the EC does seem to think that one of them should be introduced to increase competition. If the EC or a major policymaker insists on a substantial change, then joint audits would at least be preferable to mandatory rotation.

3. Expanding the role of audit

Both the Lords and the EC have questioned whether the role of audit should be expanded. ACCA has been arguing since 2008 that although the role of audit is not 'broken' and still adds real value by enhancing trust in financial statements, audits could achieve much more. We believe audit needs to evolve not just to take into account the historic financial statements but also to give an opinion on more forward-looking, qualitative and non-financial data. Less attention should be given to out-of-date figures and more to risk information.

ACCA argues that auditors should consider incorporating into the standard audit report a clear statement of responsibilities for reviewing and/or reporting on companies' risk management and corporate governance arrangements. We also believe that the auditor is well placed to assess and report on the client's business model, or at least on the financial assumptions underlying that model. In our 2010 round tables this idea was considered to be a potentially very valuable addition to the range of auditors' responsibilities, given the experience, during the financial crisis, of banks that pursued strategies that would not at the time have attracted any specific attention from the auditor, even though in retrospect and when considered in isolation they may appear to be highly risky.

By taking on such a radical enhancement of their role (which would have to be matched by appropriate action on liability) auditors will respond to the demands of stakeholders who want auditors' views on the general economic and financial outlook of the company. The issue of how and when 'red flags' can be raised by auditors on behalf of investors when they can see problems looming – rather than behind the scenes raising of concerns with management or even regulators – needs to be addressed. Such a development – which would focus on business risks rather than just the risks of material misstatement of the financial statements – would, in our view, help genuinely address the so-called 'expectations gap", rather than continuing the long-standing, and futile attempts to 'educate' the public into the limitations of audit.

We accept that the auditor should not be asked to communicate to a company's stakeholders more frequently than the company itself does, but demands for more regular interim reporting will definitely grow. Increasingly, finance providers are demanding monthly management accounts, ideally with external assurance. It is not necessarily the case that audit fees would rise if the above approach were adopted, because the work would be done throughout the year. A move closer to 'real-time reporting' might go a long way to meeting stakeholders' needs and avoiding the problem of an annual binary audit report.

The Lords report backed ACCA's approach on expanding the role of audit and the current US and EC debates suggest that the status quo will not be an option. To explore the issue of extending audit reports, ACCA has commissioned expert research from the Maastricht Accounting, Auditing and Information Management Research Center (MARC) to assess what form such reports might take. This report will be published in early July 2011.

The potential expansion of the role of audit outlined here, which ACCA believes is necessary, is contingent on two other factors. The first, liability, has already been covered in this paper. The second is whether investors would be willing to pay for the increased audit costs involved. While there has been little direct research carried out to date on this point, ACCA believes there is enough evidence that users value the role of audit to suggest they would be willing to consider it.

MARC's 2010 study, *The Value of Audit*,[4] which surveyed 171 financial analysts in Europe, concludes that they found the auditors' work valuable as it increased their confidence and reliance on financial statements. MARC's interviews with CFOs and audit committee members indicate a desire for the audit model to be reshaped to give 'a more comprehensive approach that additionally offers a broader, more holistic view of the business'. This issue is also being addressed in the report of a survey of investors carried out by *ACCA Singapore* in conjunction with the Securities and Investors Association of Singapore, which will be published in July.

4. *The Value of Audit,* University of Maastricht, 2010, http://www.maastrichtuniversity.nl/web/Main/Sitewide/News1/NewReportFromMARCValueOfAudit.htm

ACCA's 2010 round tables also suggested that shareholders would at least be willing to discuss the issue. In several jurisdictions, such as Singapore, Ukraine and Malaysia, there was concern that audit fees were too low to allow sufficient re-investment in the profession and in Malaysia representatives from asset management groups urged companies not to be obsessed with reducing auditors' fees. The other side of the coin was that firms had to avoid commoditisation of work or fees, and price according to the complexity of the assignment. None of this is conclusive – but it does appear that audit users are prepared to pay for services that prove their value.

4. Audit committees

Since the financial crisis, regulatory inquiries have shown much interest in the potential strengthening of the role of audit committees (ACs). These comprise members of a company's board of directors who are allotted special responsibilities to supervise the company's financial reporting and audit processes and to ensure that those processes are undertaken properly and with integrity. Most countries around the world now see ACs as an essential element in the process of corporate governance and expect larger companies/public interest entities to establish them, whether by law, regulation or good practice guidance.

To ensure the effectiveness of ACs, they are required to consist exclusively of directors who are 'independent' of management. This will mean that members should not be part of the executive team and should have no personal interest in the company that might affect their judgement when carrying out their functions. The independence of the AC from management and the rest of the board of directors is important in order to ensure that the auditor can speak to them on matters that he or she may not wish to share with the other directors.

It is also, usually, a feature of legal or regulatory provisions that one or more members of an AC should be qualified or otherwise experienced in accounting and/or audit matters. In fact, a research report by ACCA in Singapore, commissioned by the Singaporean regulator ACRA, showed that AC chairs greatly valued auditors' comments on many parts of the business. The chairs appreciated the auditors' expertise on accounting matters and the fact that they brought issues to the AC's attention of which they might not otherwise have been aware . It is important that this good working relationship is maintained.

The EC Green Paper asked whether ACs need to play a more active role in ensuring that a company's accounts give an accurate picture of the company's financial state. The UK FRC now sees the AC as being the pivotal body in the process of corporate governance. Specifically, ACs in the UK now have an enhanced responsibility to review the independence of the company's auditors and to consider whether any additional business services that the auditors may offer to the company would have a detrimental effect on their independence as auditors. In a discussion paper issued in 2011, the FRC has gone further, proposing that the AC should report to shareholders on how the auditors have carried out their work, setting out:

- the key areas of risk, including any risk associated with accounting policies of which readers of the annual report should be aware, and
- any matters of material significance that the company's auditors have identified and communicated to them,

The AC should also report on its own performance:

- the steps it has taken to assess the effectiveness of the audit
- the policies that the AC has adopted to ensure that the auditor's independence is not compromised by the provision of any non-audit services
- the reasons why it has recommended that the company's auditors be re-appointed or not.

ACCA very much supports the concept of the AC and agrees with the EC and the FRC that the AC, working effectively and independently from executive directors and management, can provide additional confidence in the integrity of the accounting and audit processes. If the AC can become a trusted arbiter of the company's auditor's 'independence', and whether or not it is wise for the auditor to provide additional services to the company, then this may alleviate the need for legal intervention on those matters (something that we would prefer to avoid if possible).

We do, however, caution against relying too much on the AC's ability to secure the complete integrity of either process. The company's procedures for preparing accounting information, for setting up internal controls, and for preparing and approving the accounts, are the responsibility of the board as a whole, although much of the day-to-day work associated with these matters will in practice be delegated to management. Further, the AC is usually a small group of people and not all their members will have a background in the complex technical issues that they must address. Not without reason is membership of an AC increasingly referred to as a part-time job with full-time responsibilities.

Given that both the board as a whole and the external auditor will remain responsible for their own specific functions, it will be important not to assume that the AC can guarantee that either will perform those functions entirely correctly. Rather, the AC should come to be seen as playing a uniquely useful role as the pivot between the board of directors and the external auditor, and in the process do much to inspire the trust and confidence of report users in the company's reporting processes.

5. Going concern

'Going concern' has been one of the biggest issues facing auditors since the onset of the global financial crisis in the second half of 2007. Financial statements normally have to be prepared on this basis, which assumes that the entity will be able to continue in business for at least a defined period after the reporting date. If the business intends to cease operations soon after the reporting date, or if there will be a need to do so, then this will invariably have an effect on the value of the entity's assets and liabilities, and an alternative basis of accounts preparation will be required. Under auditing standards, auditors are required to assess whether the going concern assumption is appropriate for the presentation of financial statements that comply with the relevant accounting framework.

In the audit context, however, the requirement for accountants and auditors to address the issue of going concern is often misunderstood and is closely linked to the 'expectations gap'. Concerns are invariably raised when companies fail within a short time of the balance sheet date. Accusations may be made that the auditors should have been aware that the company would fail and that this should have been taken into account in considering whether or not the company was a going concern.

In November 2009, the UK FRC provided guidance on addressing the exceptional risks to going concern and liquidity which were facing companies and their auditors at the height of the credit crunch, and are still taking evidence as part of an inquiry launched in March 2011 into this issue, as proof of its ongoing potency despite the stabilisation of credit markets since 2009.

The auditors' responsibility as regards going concern does not, in fact, require them to give any guarantee that the company will survive for the foreseeable future. Auditors need only assess whether the going concern assumption is appropriate as a basis for preparing the current financial statements. They must consider whether any events or liabilities (contingent or otherwise) might threaten the company's solvency but the responsibility does not require them to make any assessment of the company's financial health beyond an assessment of the company's prospects in so far as they affect the chosen basis of reporting.

Given that the audit report, and the accounts on which it is based, are drawn up to a fixed date, there cannot be any realistic expectation that auditors can predict the future. Nonetheless, because this area is a key concern for stakeholders it is likely that any changes now made to the structure of the audit function will involve some modification of the responsibilities of preparers and auditors in relation to 'going concern'. This could happen if, for example, auditors take on new and wider responsibilities to report on the effectiveness of the company's internal controls and/or risk-management arrangements. The assessments auditors would make about such matters would in turn probably affect their opinion as to whether the company could be classed as a going concern.

The Lords devoted a lot of time to the issue of going concern in the audit of banks and the particular issue of whether auditors should have allowed their judgement about going concern to be clouded by signals from government that taxpayer funding would be available as a last resort. Their report also raised a wider issue of whether an auditor can responsibly risk a run on that bank by giving any sort of qualification to the audit report.

This does not just affect banks. Auditors of all companies during and since the financial crisis have faced this conundrum – the very act of giving anything other than a clean audit report can incite jumpy investors and lenders to abandon a generally healthy business.

ACCA is attracted to the concept of moving from the current 'all or nothing' paradigm to a graded report where an auditor makes a categorisation of the relative performance of the company – in the same way that a ratings agency does. In principle, it should be feasible to include more information in the audit report provided it was clearly distinguished from material that might be regarded as a modification. The key would be frequency – if such material were included on a regular basis, the markets would begin to see that there was in reality no such thing as a 'clean' audit report and we believe this would do much to remove negative perceptions. Considerable work needs to take place on this issue but it seems to us a promising approach.

6. Auditor/regulator dialogue

The Lords were particularly concerned about the deterioration, in recent years, of the traditional dialogue between bank auditors and regulators. In one of their report's most eye-catching phrases, the Lords called this a 'dereliction of duty' by the two parties.

Financial institutions, such as banks and insurance companies, are generally subject not only to audit but also to supervision from an industry regulator. The role of the regulator is determined by the law in a particular jurisdiction but usually includes monitoring compliance with the law and regulations affecting a particular industry. The purpose is to reduce the risk to society that financial institutions will themselves commit fraud on their customers or, in the case of banks, fail to maintain appropriate resources to remain financially stable. During the credit crisis, the performance of bank regulators received considerable scrutiny.

Although the role of auditors remains primarily to report to shareholders, each year, on the truth and fairness of the financial statements, they may also be required to make further reports direct to the regulator. These may relate to regular data returns to the regulator or to ad hoc communications on matters that have come to the auditor's attention and appear serious enough that the regulator should be notified.

During the hearings, Lord Lawson, one of the driving forces on the Lords committee, was especially indignant that the regular dialogue between auditors and regulators envisaged by the 1987 Banking Act, which he had introduced when UK Chancellor, had lapsed under the 'light touch' regulatory regime of the past 15 years. The Bank of England, which is reclaiming regulatory prominence from the Financial Services Authority, has recently been having meetings with the audit profession that will lead to the restoration of this dialogue.

ACCA, which was one of the voices calling for change in the way the regulator uses audit and auditors when meeting its own statutory obligations, welcomes the move. We called for the regulator to build relationships with auditors that promote collaboration rather than separate working. Mutual trust and understanding are important drivers of effective communication, which is key to the achievement of each party's objectives. Engagement should be regular and at an early stage in relation to each year's audit.

ACCA also encouraged trilateral meetings between the regulator, auditor and audit committees of major institutions, as the failure of, for example, a large bank can have significant consequences. We noted that by creating an ethos of working with the regulator, audit committees could themselves be motivated to be more robust in their work on behalf of shareholders.

Nonetheless, the distinct roles of regulator and auditor should never been confused. Auditors should never be seen as agents of the regulator – this would change the relationship between auditor and client company to the detriment of both.

7. Audit of small entities

All the issues covered above have concerned audits of large companies, especially banks. This is inevitable, given that the performance of bank auditors during the financial crisis has been the focus of the regulatory and political inquiries in several jurisdictions.

Even so, no audit policy paper would be complete without addressing the concerns of 99% of businesses – ie SMEs. It worries ACCA greatly that governments and policymakers continue to equate audit with 'red tape'. The Lords report calls for a reduction in the audit requirement for smaller companies in order to 'lower regulatory costs'. And the EC Green Paper, while acknowledging the importance of audit to SMEs in enhancing the credibility of their financial statements, goes on to add that the process is potentially burdensome. It adds that 'where member states want to maintain some form of assurance' a new form of service might be needed. In Europe, businesses with turnover of up to 8.8m euros do not need to have audits – and there are regular calls for this threshold to be raised. The UK government has urged the Commission to consider a dramatic hike up to 28m euros, in the name of cutting 'red tape'.

ACCA is no supporter of needless burdens on business. And we would agree that new procedures need to be introduced to make sure that SMEs are getting the best from audit – in our paper Restating the Value of Audit we made the case that 'unbundling' the core audit product from lengthy checklists and focusing on areas of particular concern or risk might add more value. 'Stratifying' the audit to the appropriate scale and complexity of the business makes sense.

Although the clarified ISAs issued by the International Auditing and Assurance Standards Board (IAASB) have been a positive step, there would be, in the long term, no bar to revising them in order to adopt a 'think small first' basis, which would demonstrate more clearly their direct relevance to SMEs. We have also been encouraging the IAASB to update its existing non-audit standards and consider how they may be used in conjunction with 'hybrid' engagements to provide an internationally supported range of engagements that enhance the credibility of financial reporting by businesses not subject to audit. These engagements, which rely on the expertise of professional accountants, are of value to users because they can rely on the quality of accountants' work. Such engagements, which vary from simple preparation of the accounts through to a 'review' based on a more limited level of work than an audit, would benefit from internationally agreed standards, which would, for example in the EU, help cross-border trade.

It is important that policymakers recognise that audit is uniquely able to build trust in businesses' financial statements. Now that lack of bank lending to SMEs is a real concern, ACCA believes from the evidence of the 2010 round tables that those businesses that opt out of audit will lose credibility with finance providers and will find it more difficult to secure finance – which is not what governments want. Policymakers must appreciate that there is a downside to removing checks on small businesses' finances. Audit should not be so lazily linked with 'red tape'.

8. International Financial Reporting Standards

While this paper does not cover financial reporting, the Lords and US inquiries have brought IFRS into the scope of their investigations and so we address it briefly here. Given the widespread criticisms that the 'mark to market' regime under IFRS received during the global financial crisis, it is perhaps not surprising that the Lords took the chance to address accounting standards, but they surprised many by coming down firmly on the side of the critics of IFRS. More surprisingly still, the Lords concluded that IFRS had a directly adverse effect on audit by 'limiting auditors' scope to exercise prudent judgement'.

The Lords agreed with witnesses who criticised the supposed loss of prudence in IFRS, which they described as much more rules-based than UK GAAP. These witnesses argued that under IFRS auditors were led to place conformity with standards above trying to establish if the accounts were 'true and fair'. Form had apparently replaced substance and professional judgement had been subordinated to slavish compliance with whether technical rules had been adhered to.

ACCA has a degree of sympathy for the critics. The 'fair value' regime had its flaws, revealed during the crisis, when there were frequently no liquid markets to mark against. And the Lehman case appeared to show the problems caused when auditors follow rules rather than stepping back and assessing more deeply whether they were genuinely protecting the interests of shareholders. Some of the participants in ACCA's 2010 series of round tables also questioned whether standards had become too rules-based and whether on occasion auditors were guilty of following the letter rather than the spirit of standards.

Nonetheless, we do not agree with the overall conclusions of the Lords' report. As several expert witnesses confirmed during the sessions, IFRS includes an overriding requirement that the financial statements should present the position and performance of the company fairly. As one said: 'the requirement in IFRS to present fairly is not a different requirement to that of showing a true and fair view, but is a different articulation of the same concept'.

In terms of audit, we believe the Lords may have confused 'prudence', in its conceptual accounting usage, with a wider meaning. The IFRS system does not have prudence at its heart – the whole point is that deliberately choosing the safest, or lowest, value for, say, an asset is inherently biased – and IFRS instead increases transparency and allows the neutral facts to emerge more quickly. The system is based on this very lack of bias. Prudence is not the underlying purpose of accounts.

By arguing that 'prudent scepticism' needs to be re-established at the heart of audit, the Lords' report is confusing two concepts. No one could dispute that 'prudent scepticism' is the basis of good auditing – but this does not require prudence in accounting standards. Prudence needs to be ensured through effective supervision.

ACCA also does not believe that IFRS contributed significantly to the credit crunch. Although some have argued that it increased volatility and pro-cyclicality in company figures, the fact remains that countries such as Australia whose banks used IFRS did not suffer greatly, while some of those that did not – such as the US – experienced great difficulties.

9. Conclusions

It is right, given the scale of the global financial crisis and the extent of taxpayer bailouts of banks in several countries, that the role of auditors and accountants should be questioned. Despite the inquiries, no one has argued that audit itself is unnecessary, at least not for larger companies.

The crisis and its aftermath have not dented ACCA's belief in the importance of the role of quality audit for building trust in company statements. We believe the role needs to expand, as we have argued consistently since 2009. This would be much more pertinent an answer to the issues of the expectation gap and lack of competition than some of the solutions proposed by other parties, which we have covered in this paper and which would amount to little more than re-arranging the deckchairs.

We also believe the biggest audit firms are well placed to innovate to meet market needs and would be willing to take on an enhanced role, particularly if the corresponding liability issue is addressed. The defensive mindset often attributed to the profession, pre-crisis, is being replaced by an acceptance that change is necessary and desirable. As this paper was going to press, PwC announced the creation of its first-ever head of reputation, as a direct response to criticisms it had endured in the Lords report. The firm said: 'the debate on reputation and regulation of the profession is likely to be one of the most significant challenges PwC faces'.

As the international debate on the role of audit continues in the second half of 2011, ACCA will be publishing more research and evidence to strengthen and inform that debate.

Timeline

May 2010
University of Maastricht publishes important report, *The Value of Audit,* http://www.maastrichtuniversity.nl/web/Main/Sitewide/News1/NewReportFromMARCValueOfAudit.htm

October 2010
European Commission publishes a Green Paper on audit reform, *Audit Policy: Lessons from the Crisis,* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1325&format=HTML&aged=0&language=EN&guiLanguage=en

December 2010
UK APB tightens ethical rules for auditors, http://www.frc.org.uk/apb/press/pub2470.html

January 2011
UK FRC publishes discussion paper, *Effective Company Stewardship* (containing proposals for new reporting responsibilities for the auditor and the audit committee), http://www.frc.org.uk/publications/pub2486.html

March 2011
House of Lords Economic Affairs Committee publishes report, *Auditors: Market Concentration and their Role,* http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/publications/

March 2011
UK FRC announces new inquiry into going concern assessments by auditors and companies, http://www.frc.org.uk/press/pub2531.html

March 2011
UK Department for Business announces it will make further cuts to audit rules for small companies and will lobby for audit exemption to be extended to medium-sized companies, http://www.bis.gov.uk/news/topstories/2011/Mar/Government-bins-business-red-tape

April 2011
Deadline for comments on IAASB's draft strategy and work programme for 2012–14, ttp://www.ifac.org/Guidance/EXD-Details.php?EDID=0151

April 2011
Inquiry by US Senate Banking Housing & Urban Affairs Committee on the role of the accounting profession in preventing another financial crisis, http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_id=0f533e5b-dc43-4fc2-a415-5df2ae8806da

November 2011
Scheduled publication of the EU's proposals for revising the EU Directive on Statutory Audit.

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