

ACCOUNTANCY FUTURES

Value regained: restoring the role of audit in society

A ROUND-TABLE DISCUSSION IN BRUSSELS, 29 APRIL 2010

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 at all stages of their development. We seek to develop capacity in the profession and encourage the adoption of 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 seek to open up the profession to people of all backgrounds and remove artificial barriers, innovating our qualifications and their delivery to meet the diverse needs of trainee professionals and their employers.

We support our 140,000 members and 404,000 students in 170 countries, helping them to develop successful careers in accounting and business, based on the skills required by employers. We work through a network of 83 offices and centres and more than 8,000 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

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.

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This report summarises one of an international series of round-table discussions hosted by ACCA and designed to generate debate, new ideas and recommendations about the future of audit.

In 2010, ACCA chose 'audit and society' as one of four critical issues which it is addressing under its Accountancy Futures programme.

ACCA believes firmly that audit has a key role to play in society as a source of public confidence in financial reporting but notes that there is currently little published research which seeks to demonstrate its value. By bringing together a wide range of market participants, we hope to help establish ways in which the value of audit can be enhanced for all stakeholders.

The Brussels event was the seventh in a global series of audit-related roundtables and the first to look specifically at the small audit market.

FURTHER INFORMATION

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SUMMARY/CONCLUSIONS:

Stakeholders in the small business sector benefit from the involvement of qualified external accountants. Their interests should be protected and not neglected. And the availability or otherwise of alternative legal protections and avenues to compensation for shareholders in particular countries should be borne in mind before audit is withdrawn for small businesses.

The profession needs to make sure the value that audit-type skills bring to businesses is not lost if clients decide to move away from audit. This may be through sub-audit assurance products designed specifically for small entities.

The wide variety of practices among EU member states, which reflects different market needs, shows that a one-size fits all approach does not work and it is better to let each state decide its preference within reasonable parameters set by the EC. The fact that some states have stepped back from introducing the maximum audit threshold because of financial and economic uncertainty indicates an underlying belief in audit's value.

If audit thresholds are to rise significantly, there should be a comprehensive impact assessment on the effects taking into account the benefits that would be lost as well as the costs 'saved'. An evidence-based, incremental approach to issues like raising the audit threshold was essential. And if audit is to be removed, this should be seen in the context of a wider societal approach to checks and balances – it is necessary to understand what mechanisms exist in the system to protect not just investors but wider stakeholders.

There are important 'by-products' from audit in terms of the discipline they impose onto companies, the deterrence of fraud and comfort on going concern. If one important local company goes down, many others could be affected – so the role of audit in society is beneficial as well for as the directly audited business.

THE DEBATE

Some parties in Europe, notably the Commission, take the view that the financial cost of the audit is a regulatory burden which can be dispensed with and in the process save money for the businesses concerned. It is true that in recent years we have seen seeing a very significant movement away from the position where the audit is seen as the norm in the SME sector. The Commission is currently conducting a public review of the 4th Directive which gives certain categories of companies the right to be exempted from the standard audit requirement.

But this view dismisses the value that audit and the skills that qualified accountants can bring to businesses of all sizes. While a company may be small this does not mean it does not have stakeholders with interests to be protected. All of these companies need to borrow money, to account to their shareholders for the use of their funds, to pay the right amount of tax on their income, and to fulfil their legal obligations to prepare accounts which give a true and fair view. At a time when governments are looking to the private sector to lead the economies of Europe out of recession and into full recovery, policy-makers should not treat lightly the contribution that accounting and audit can make to the achievement of business confidence, even at the small company level.

Stakeholder safeguards

And audit/assurance must be seen in a wider context of stakeholder safeguards. In some countries such as the US, audits are restricted to a much smaller proportion of companies but stakeholders have alternative safeguards available to them. These legal/regulatory remedies will include factors such as:

- the personal liabilities of directors for their companies' debts, including tax liabilities
- the rules regarding making of distributions of capital, in particular in respect of directors' responsibilities to repay funds where they make 'illegal' distributions
- the rights of secured and trade creditors to be repaid where entities become insolvent.

Where these avenues for compensation are available to shareholders it can be reasonably argued that there is less need for a standardised audit to protect their interests. But these national contextual issues are often ignored by those who simply call for audit of small businesses to be removed. This view, that the audit has grown away from the small company sector, tends to be reinforced by the increasing complexity of auditing standards which often give the impression that they have quite a different focus than the small practitioner.

Sara Harvey, for ACCA, argued that the profession should start to think about introducing a scaled-down version of the full audit which is quicker and cheaper than the full audit and involves agreeing procedures with the business to provide assurance on the areas of risk which are of most importance to them? ACCA's recent paper *Restating the Value of Audit* outlined this 'segmented' approach to the assurance for smaller entities, in which lengthy audit checklists could be 'unbundled' for smaller clients and other assurance services developed. The paper pointed to a survey by the European Federation of Accountants (FEE)¹ which showed there had been a range of 'non-audit' assurance products launched successfully in Europe, although they had had little take-up in the UK.

She asked if it was right that a company which meets the accounting tests has no obligation to consult its shareholders, particularly minority shareholders, before becoming exempt from the audit? There is a good argument for saying that the agreement of shareholders is a more valid criterion to govern audit exemption than an arbitrary accounting threshold.

There are other options she said that might be considered. At present, a high proportion of new companies become insolvent and fail within three years. Is it right that new companies in this high risk situation should benefit from audit exemption from the outset, or should they have to undergo a probationary period of, say, three years before being trusted with audit exemption? Alternatively there could be a higher entry level, with increased capital requirements, before limited liability incorporated status is granted.

Two-tier stakeholders?

There is a danger that Europe could move to a 'laissez-faire' solution for information (audit and accounting) which would create a two tier system of stakeholders - those who are powerful and those who are not.

The influential parties can put pressure on a business and can extract or have made available to them the information that they require. There are some benefits to such an outcome - businesses choose who to deal with and know the requirements that will be placed on them. Big companies like Tesco and Rolls Royce can get information on areas such as accounting, credit ratings and cash flow from suppliers and in some cases the businesses who supply them. Banks and other providers of finance can also obtain the current information they desire.

The disadvantage of the two tier approach is that those who do not have the statutory power or business clout to ask for more information are disadvantaged. The information they can access is declining in all member states. In the UK, abbreviated accounts are an example. Less powerful stakeholders could do business with an entity without knowing the true risks, or decline business they would undertake if they had the full information. Can this situation be justified?

Current European situation

The European Parliament announced in March 2010 that it agreed with the conclusions of the Stoiber High-Level Group which had decided that micro-entities should be spared from having to publish accounts, and that it should be for each member state to decide their requirements for this sector. Edmund Stoiber, who was charged with bringing in cuts in red tape of 25%, believes his plans would save 1.7bn euros and would remove a considerable burden from affected businesses.

Moving up the scale, the EC felt that International Standards of Auditing, due to come in via the Statutory Audit Directive, would be burdensome for SMEs. Commissioner Barnier was due to pronounce on the subject later in 2010. The EC also felt there were problems of definition of SMEs – could a five-employee business which was also the holding company of a multinational company really be classified as SME?

1. *Survey on the Provision of Alternative Assurance and Related Services Across Europe*, FEE, July 2009.

The EC breakdown of businesses in Europe is:

- 91.8% micro (includes 30% of employees in Europe)
- 6.9% small (includes 20% of employees)
- 1.1% medium
- 0.2% large.

These are quite startling statistics – they mean that 98.7% of businesses and 50% of employees in Europe do not face an annual audit. (The number which opt for a voluntary one is believed to be small, though one of the practitioners on the panel said in his experience quite a few businesses did so) This is by any standard a major reporting deficit. And given the proven deterrence to fraud caused by the presence of an audit, it is a matter of legitimate concern.

The EU with its periodic upwards move in audit threshold is moving closer to the US approach of only listed companies having statutory audits. Currently there are 1.4m audits in Europe each year and 300,000 in the US.

Audit or advice?

It was suggested that IFAC had agreed that SMEs most needed advice from accountants rather than audit. Several participants believed banks only valued the name of the accounting firm which put its name to the accounts rather than checking their actual audit work. This was the key to accessing finance, not the audit itself. Even with relatively large accounting firms many clients are increasingly in a position to opt for voluntary audit or another in the suite of assurance offerings. The value of independent experts checking the books in terms of boosting confidence in the finances was key, whatever the format of the work.

But Steve Maslin, a senior UK audit practitioner at Grant Thornton, observed that in his experience, a ‘professional review’ or such like often ended up costing almost as much as an audit but lacked the full benefits and rigour of an audit.

Others agreed that SMEs wanted advice from their external accountants, but this was on top of, not instead of, the audit – that was a given, they felt. The advice was needed because SMEs lacked the resources to do things themselves and so wanted their advisors to give all the services together. There was no ‘one’ view on micros and some auditors present disputed that clarified ISAs would be too complex for SMEs. They are ‘scaleable’, clear and robust, the participants said.

Differences among EU states to audit threshold

There is a wide variety of current practice across Europe when it came to the audit threshold.

Eleven countries used the maximum threshold, 8.8m euros turnover. These are Austria, Belgium, Germany, Ireland, Italy, Luxembourg, the Netherlands, Romania, Slovenia, Switzerland and the UK.

Three others – Greece, Poland and Spain – adopt a turnover figure of between 5m to 5.7m euros.

Four – Czech Republic, France (except SA), Lithuania and Portugal – have a figure between 2m to 3.1m euros.

Two – Estonia and Slovakia – have a figure between 1m and 1.8m euros.

Five – Bulgaria, Denmark, Finland, Hungary and Latvia – have a maximum figure of 1m euros.

Five others – Cyprus, France (SA), Norway, Malta and Sweden – have no threshold figure. In other words all businesses must be audited.

This wide divergence of approach to the audit threshold among member states reflects different country experiences and views of stakeholder needs. Estonia used a professional review instead. Finland had intended to use the maximum threshold but when it looked into the situation more carefully, believed that audit would simply be replaced, in practice, by tax audits, which were distinctly less appealing. So it actually reduced its existing threshold. One auditor however pointed out that there had been similar fears in the UK when the audit exemption started being introduced in the 1990s – but that in reality tax audits had not taken over.

Sweden too, had recently decided on a half-way house. It believed that given current financial/economic uncertainty, a full threshold would be dangerous. Given the strength of official feeling towards increasing the threshold, this is a notable step by Stockholm.

This is an important point. In a difficult economic environment, where fraud and white-collar crime traditionally rises, the best time to increase still further the number of businesses not having an audit? It is interesting that when it came to the decision, the Swedish government decided against such a move. Change should be viewed in the context of the economic cycle, and a serious economic downturn, where access to finance is harder for SMEs to obtain, is not conducive to alleviating the need for assurance. Lenders across Europe and further afield currently require more not less assurance.

Fee's stated view is that if audit thresholds are to rise significantly, there should be a comprehensive impact assessment on the effects. Others agreed, saying it was important that impact assessments on audit took into account all the benefits that would be lost as well as the costs 'saved'. An evidence-based, incremental approach to issues like raising the audit threshold was essential rather than a 'big bang' large hike in the threshold. The divergence of member state approach indicates the Commission should tread carefully before raising substantially the EU-wide threshold.

Benefits of audit

Steve Maslin argued strongly for the value of audit, which he said made companies accountable for the statements that they make and the comfort they give shareholders.

It was important to remember, he said, that there were also important 'by-products' from audit in terms of the discipline they impose onto companies, the deterrence of fraud, comfort on going concern. All this would be lost if there were no audit. And it should be remembered that if one important local company goes down, another 50 could be affected – so the role of audit in society is beneficial.

The current 'binary' audit is useful enough – and there had been plenty of research on the value of audit at the top end of the market from the likes of the FRC, Ipsos, Mori, University of Maastricht, ICGN – but shareholders are also looking for information on risks, controls, business model and management estimates. His and ACCA's conclusion is

that the audit role should be extended to take in giving an opinion on areas such as the assumptions underlying the business model, rather than just the historic financial statements. The more information is being given out by companies in an era of greater demands for transparency, the more auditors have a role to play in verifying it.

But he said there was little research at the smaller end of market except for a 2007 study by Marleen Willekens in Belgium. This study of 1,332 small companies found that audit had made a positive difference. Earnings management was lower, tax regularisation disclosure was higher, and overall financial performance was superior in those businesses which had been audited.

It was agreed that it is important that firms have time to communicate change if they are moving away from pure audit to alternative options such as the 'unbundled' approach outlined in ACCA's paper, where a risk-based set of procedures could be agreed between auditor and client. As noted above, change must be seen in the context of the economic cycle and the clear value put on assurance by banks and other stakeholders in terms of access to finance. If audit is to be removed, this should be seen in the context of a wider societal approach to checks and balances – it is necessary to understand what mechanisms exist in the system to protect not just investors but wider stakeholders.

The initial findings of a new study, unveiled at the event did not appear to back up Willekens' conclusions on the positive effect of audit on the financial performance of small companies. But no causality was established by the new report and it was possible that without the audit, the performance in these categories would have been even worse. It was also true that due to high tax rates in Belgium there was even more incentive for businesses to minimise their profits for tax purposes. Of course, the study was carried out a time of economic recession, not a benign environment as Willekens' had been. More study is, as ACCA has said, urgently needed.

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- Sara Harvey, chairman of ACCA's Auditing Technical Committee (moderator)
- Jean-Phillippe Rabine, of the Audit Unit, DG Markt
- Hilde Blomme, director of practice regulation, FEE
- Steve Maslin, chairman of the Partnership Oversight Board, Grant Thornton UK
- Prof Dr Joel Branson and Prof Dr Diane Breesch, Dept of Accounting and Auditing, Vrije Universiteit Brussles

More than 20 delegates also attended and put questions to the panel.

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