ACCOUNTANCY FUTURES

Reshaping the audit for the new global economy

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.

www.accaglobal.com/af

ACCA held a series of ten international round-table discussions on the value of audit over a 12-month period from September 2009 to September 2010. 'Audit and society' is one of four critical areas that ACCA is addressing under its *Accountancy Futures* programme.

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

Introduction

ACCA held a series of ten international round-table discussions on the value of audit over a 12-month period from September 2009 to September 2010. 'Audit and society' is one of four critical areas that ACCA is addressing under its *Accountancy Futures* programme.

The events were held as part of ACCA's efforts to increase the amount of publicly available global research into the value of audit, which is relatively thin, given the central role that audit plays in business. ACCA firmly believes in the value of audit as a source of public confidence in financial reporting and hence in increasing trust in business and the wider economy. By bringing together a wide range of market participants, including businesses, finance providers, regulators, auditors, ratings agencies and other interested groups, to hear their views on audit, we aimed to gain further first-hand knowledge of the issues and to draw conclusions on how the value of audit could be enhanced for its stakeholders. This focus on value was the key driver for the series, rather than regulatory or professional oversight issues.

The individual round-table reports are available to download from ACCA's global website.[1] This paper aims to summarise and take forward some of the key findings of the events, which took place in Belgium, Malaysia, Poland, Singapore, the UK, Ukraine and Zambia. Many of the participants were senior figures in business or key regulators in their countries and we thank them for their contributions.

Table 1: List of round-table events

1. Warsaw, Poland	14 September 2009
2. Singapore	2 November 2009
3. Kiev, Ukraine	27 January 2010
4. Manchester, UK	18 March 2010
5. London, UK	22 March 2010
6. Cardiff, UK	23 March 2010
7. Brussels, Belgium	29 April 2010
8. Lusaka, Zambia	24 May 2010
9. Warsaw, Poland	26 May 2010
10. Kuala Lumpur, Malaysia	22 September 2010

1. . http://www.accaglobal.com/af

We were pleased to discover that, for all the issues and concerns raised in the various events, the importance of audit itself was rarely questioned. In several reports, the headline comment was that there is a strong belief that audit adds value to businesses. Participants in several round tables questioned whether auditors had carried out their roles sufficiently effectively in their countries in the run-up to the financial crisis, and a keen debate unfolded as to whether the role should be revised, but only at the smaller end of the market was there any serious questioning of whether audit itself was necessary.

Banks and ratings agencies made clear at several events that they valued the audit and said it was an important aspect of the financial information on whch they relied. So the value to businesses in accessing finance should not be underestimated in today's market, where credit is tight. In Poland, a banker advised companies to make full use of their audit for obtaining expert advice and improving the business (while respecting the ethical rules on auditor independence) rather than treating it as something negative to 'get through'. At several events, participants referred to the lower costs of capital for audited companies – an assertion supported by the European Commission in its current Green Paper on audit – while the first Poland debate referred to an empirical study of 200 companies, which showed that 70% of these had had their Profit & Loss accounts restated by the directors of the company as a result of discussions with the auditor. This suggests that those businesses not subject to audit could be disclosing erroneous data in their financials.

These findings indicate what audit can achieve. Audit increases trust that financial results are accurate and hence enhances confidence throughout the wider economy. This was borne out by an authoritative study by Maastricht University[2] in March 2010, in which 200 CFOs, analysts and audit committee members were asked their views of audit and one of the principal conclusions was that audit strongly increases confidence in, and reliance on, financial statements.

But there was also a strong feeling of frustration that while audit as currently constituted adds considerable value to business, it could do a lot more. Stakeholders' needs would be better protected if auditors could report more on risk and other forward-looking information. The audit needs to be expanded and to evolve, and its findings must be communicated more clearly. For this to happen, solutions need to be found to the liability issue, and financial reporting will need to evolve, in keeping with investors' needs.

Table 2: The key issues discussed at the round tables

1.	Expanding the scope of the audit
2.	Real-time reporting
3.	Auditors' liability
4.	Communication
5.	Did auditors do a good job? Economics of audit
6.	Independence of auditors
7.	Role of audit committees
8.	Small audit – stratification of audit.
9.	Rules stifling professional opinions
10.	Relationship between auditor and regulator

2. Maastricht Accounting, Auditing and Information Research Centre (MARC), *The Value of Audit*, Maastricht University, 2010.

1. Expanding the scope of the audit

The very serious financial consequences of the global banking crisis have called into question the continuing effectiveness of the existing models of both financial reporting and auditing. It should be noted that the various reviews undertaken in the aftermath of the crisis have not unearthed any strong evidence to the effect that auditors have systematically failed in their professional responsibilities. Nonetheless, delegates at all the ACCA events understood the concerns of many in the business world that the audit function had not succeeded in forewarning stakeholders of, or preventing, the corporate failures that had occurred. Audit had not, apparently, been able to provide any indications to stakeholders about the serious problems affecting the viability of the companies concerned.

Participants at the round tables accepted that these concerns were legitimate. They considered, however, that the real issue that the profession had to address was whether the scope of the audit needed to be reformed, with the objective of providing more information relevant to the needs of management and shareholders alike. The round tables supported the idea that the scope of the audit should be expanded to ensure that it remained practically useful to companies and their stakeholders.

As for how this could be done, a number of options were discussed. There was general agreement that the profession 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. Round-table discussion participants also showed interest in the idea that the auditor should assess and report on the client's business model, or at least on the financial assumptions underlying that model. This particular idea was considered to be potentially a very valuable addition to the range of auditors' responsibilities, given the experience, during the financial crisis, of banks' pursuit of strategies which – while in retrospect and when considered in isolation may appear to be high risk – would not at the time have attracted any specific attention from the auditor.

In its paper *Restating the Value of Audit*, published early in 2010, ACCA had made the case for the inclusion of more forward–looking, qualitative and non-financial data in the field of financial reporting, which would in turn change both the role of audit and the audit methodology. Many of the experts spoken to in the compilation of that report said there was currently too much focus on out-of-date figures and not enough on risk information. In the UK round tables, this inclusion of forward-looking information was warmly welcomed as part of a general evolution of financial reporting and auditing.

In Malaysia, in the final round table, shareholder representatives made it clear that they wanted more information on risks from the auditors, even if that information had to go, in the first instance, to the audit committee chairman. This point will be looked at further below under section 4 on greater communication of audit findings.

There was also support for the point raised by ACCA in the above paper that firms auditing public sector clients took a much wider approach, including issues of corporate governance and 'value for money'. Bodies in this sector often depended on the expertise of external auditors, although the reduced chance of litigation, addressed in section 3 below, was acknowledged.

In Singapore, concern was expressed about the possible future involvement of auditors in commenting on forward-looking or prospective information, given the inherent unpredictability of such data. Delegates there took the view that auditors should be expected to provide only limited comfort on these matters, as well as on assumptions made by directors and the likely outcomes of those assumptions.

Another key point made at the events concerned the skills that would be needed to implement any reforms that might be made to the scope of the audit. Reforms of the kind referred to above would have implications, in due course, for both the pre- and the post-qualification training of auditors. From June 2011, ACCA is relaunching its own professional qualification, with the current P1 *Professional Accountant* paper being replaced by *Governance, Risk and Ethics*, which will contain an enhanced focus on risk, in light of the acknowledged role that failures in this area played in the origins of the financial crisis. It also covers the complex issues, particularly the ethical and behavioural aspects that must be addressed by management and auditors to mitigate the culture of excessive risk-taking in pursuit of often-unsustainable rewards. But if the role of audit is expanded in future then, where auditors cannot be expected to provide the necessary expertise themselves, they will need to consider whether to appoint appropriately qualified staff to their firms or to buy in those skills from outside.

It is also clear that the whole field of corporate reporting will develop, with companies putting more emphasis on narrative reporting, and with the issues of complexity and information overload that research studies show have dogged it to date[3] being gradually overcome. Integrated reporting will also become more widespread, with the G20 summit in 2011 expected to give its support to a standard in that field. With more narrative reporting, there will be more demand for assurance and verification of these 'front-end' of report statements. So external developments are set to lead to an enhancement of auditors' role.

3. *Hitting the Notes, but What's the Tune?,* ACCA and Deloitte, 2010.

2. Real-time reporting

ACCA believes that in addition to the expansion of audit to take in the areas outlined in section 1 above, the issue of more timely reporting needs to be addressed if audit is to generate increased value for stakeholders. The round-table events made it clear that the current audit model must develop and, ultimately, include reporting on real-time information.

More timely reporting helps companies improve and maintain strong credit ratings. By gaining a good reputation for voluntarily making Monthly Management Accounts (MMAs) available, including information on areas such as cash flow and key risks, businesses will be providing exactly the sort of information for which ratings agencies, banks and other credit providers will be looking. In a tough credit environment, this will inevitably place them in a better position to raise finance than their competitors.

In the UK, one participant said a leading high-street bank was pressuring one of his clients to provide MMAs as a condition for continued financing. While this may be a temporary requirement caused by the banks' stricter criteria for lending during the economic downturn, it also suggests that the provision of such information will become the norm. If so, auditors or reporting accountants will have a key attestation role to play.

In Ukraine, participants (including partners from Big Four accounting firms) called for MMAs to be available online and verified by auditors. This would lead to a major increase in transparency in comparison with, for example, just issuing a private report to banks to facilitate a loan. A representative from the World Bank agreed, saying that markets should have wider access to such reports. Regulators should 'name and shame' those companies that do not put MMAs online. Too much information is available only to certain parties and not to general stakeholders.

In the UK, delegates agreed that reporting by both entities and their auditors needed to evolve. Filing of delayed accounts months after year-end was no longer considered sufficient – MMAs verified externally would be of more use. It was also recognised that to achieve real-time reporting, auditors may need to restrict the scope of the report, or report on just some of the key risk or performance areas of the business rather than on the entity as a whole. There would need to be a combination of robust company systems and embedded analytical software to look at current and predicted performance, including order books. A clear engagement letter agreeing the scope of the work to be undertaken would be necessary. Current real-time information was also seen as being potentially very useful in the not-for-profit sector.

In Malaysia, too, shareholder groups wanted to see more interim reports and auditing so that 'red flags' could be raised for investors if the company started hitting problems. Behind-the-scenes raising of concerns by auditors to management was no longer sufficient.

It is important to note that external verification of MMAs throughout the year would not mean that auditors would generate vastly increased fees. The work involved in annual audit should be substantially reduced if regular attestation was taking place over the course of a year.

3. Auditors' liability

The caveat to the expansion of the audit outlined in sections 1 and 2 above was a requirement to solve the issues it would raise in terms of auditor liability.

Like all professional advisers, auditors are very conscious of the risk they run in providing their services to business clients. They expose themselves to very large potential liability for negligent advice on any areas where they are involved, and so any material expansion of the audit would add to these concerns. Another significant factor in any move to expand the format of the audit is the highly concentrated market for audit services, within which most multinational companies are audited by one or other of the four largest audit firms: this means that the disappearance of any one of these firms would pose serious problems for the regulation of the corporate sector on a global basis.

There was general agreement across all the ACCA events that, while expansion of the scope of the audit was, in principle, a good thing, it could not happen in practice if auditors considered that they would thereby be exposing themselves to an unreasonable level of liability that exceeded the business benefit of performing the audit. Therefore, it would be essential that a debate on the optimum framework for auditor liability take place in parallel with the debate on the future scope of the audit.

It should also be noted that not all claims against audit firms allege that the auditors have been uniquely at fault in failing to detect or give warnings of imminent corporate failures. The 'deep pocket syndrome' under which auditors – who are required to have professional indemnity insurance – are targeted following company collapses, irrespective of their level of culpability, has long been a thorn in the side of the profession.

Some of the round tables discussed current domestic developments in the law on liability. In the UK, company law had been reformed in 2006 so as to allow auditors and their client companies to enter into bi-lateral agreements to limit the auditor's liability in respect of specific audit assignments. There had, however, been comparatively little use made of this new option, largely because of the difficulty of gaining shareholders' approval for the agreements but also owing to the adversarial position of the US market authorities, which see agreements of this type as being direct threats to audit quality. UK companies with US interests appear to have been discouraged by this. The meeting in Singapore expressed great interest in the UK reform, and surprise at the limited use being made of it in practice.

It is also worth noting, given concerns over the alleged lack of audit competition in many markets, that countries that have legislated for some form of statutory restriction of liability have succeeded in increasing the pool of audit firms operating in the listed sector. Germany is probably the most favourable example. It has had a statutory limit on auditors' liability since 1931: the current cap for the audit of listed companies is 4 million euros. While the top 20 companies are all audited by Big Four accounting firms, there is significantly higher involvement of mid-tier firms among smaller listed companies – in all, 34% of all listed companies there are audited by firms outside the largest eight.

4. Communication

Linked with the extra transparency outlined in the MMA issue (section 2, above), several round tables called for increased communication of the auditor's input – including an end to the current 'binary' audit report. Only the audit committees and the boards get to see the full extent of the additional letters and reports, discussions and enquiries, with other stakeholders merely receiving a 'yes or no' outcome. In the UK, a participant urged that what he called the audit 'blackbox' should be opened up if the real value of extensive audit work were to be appreciated by shareholders; and as they are paying for it, that is not an unreasonable demand. Another delegate at the same event used an amusing literary analogy: in Douglas Adams' book *The Hitchhiker's Guide to the Galaxy*, a computer reveals the answer to the ultimate question of Life, the Universe and Everything to be 42 – but without giving any indication as to how it arrived as this figure. (Using a rather more scientific approach than Adams' computer, the aforementioned Maastricht University project gave audit a value rating of 7.3 out of 10. Respondents were asked to judge the usefulness of audit, on a scale from 1 to 10, where 1 = no value and 10 = excellent value.)

Like the computer in *Hitchhiker,* audit reports show an answer, but without letting the reader see the working behind the conclusion. This is unsustainable given the current questioning of the audit role, and needs to change.

One view expressed was that the contents of the management letter should be made available more widely. In one of the UK round tables, one participant said that her company had been 'really pushed' by the auditors on the question of 'going concern'. Such challenging questioning of management should give comfort to lenders and other stakeholders that the financial statements are robust, so why was this work not being brought to their attention? This illustrated the current difficulties for the profession in being able to demonstrate the value that audit can bring to enhancing business confidence.

Similarly, in Malaysia, a Big Four auditor agreed that there was a frustration that a two-page audit report, giving a clean opinion and mostly devoted to spelling out the auditors' responsibilities and using technical language, gave 'no reflection of the effort and judgement that goes into the audit'. But once again he saw the problems involved both with litigation and the issue of whether companies would be prepared to pay the extra costs associated with extending the points made in the management letter into a format suited to a wider audience. Another participant pointed out, however, that banks received long-form reports that were much more detailed and valuable than the two-page audit report, so Malaysia was 'not alien to the concept of making the management letter go beyond the management of the company'.

There is, however, another side to the story. One UK senior auditor cautioned against any loss of the current openness between auditor and audit committee, which he likened to the relationship between parent and teacher. The school report acts as a useful precursor to a private discussion between the two, but it would not be appropriate to open this up to the whole parent group. Similarly, a number of checks would have to be placed on opening up of work that the auditor undertakes to wider audiences.

In Singapore, it was stressed that the current communication framework was limited and needed improvement as investors required information in a more timely manner. Given the widespread view that the information in the management letter is more valuable than an unqualified audit opinion, it was suggested that the former could be put in the annual report. It would be essential, if this were to happen, that auditors did not then tone down their comments to management, as a subsequent research report by ACCA in Singapore,[4] commissioned by the Singaporean regulator ACRA, showed that audit committee chairmen greatly valued auditors' comments on many parts of the business.

4. *The Value of Audit: Views from Audit Committee Chairmen*, ACCA Singapore, 2010. http://www.accaglobal.com/af/audit

One of the benefits of looking to improve communication would be that fears of the growth of a 'two-tier' system of stakeholders would be diminished. Several round-table participants observed that influential stakeholders such as banks had the power to ask management for specific information – for example current, real-time and targeted reports – to meet their needs. Those stakeholders who lack such power rely on the audit for their assurance and information. With shareholdings increasingly dispersed, the role of audit in corporate governance should not be downplayed, especially given the failings of governance in financial institutions and the role these played in the financial crisis.[5]

At the Brussels event, it was noted that the information that less powerful stakeholders could access was declining across Europe. The UK's abbreviated accounts regime was given as an example, where such disadvantaged stakeholders might do business with an entity not knowing the true risks, which they were not in a position to ascertain. Policymakers need to appreciate that all stakeholders, businesses and suppliers of credit and finance need information. The continued development of a two-tier system could effectively create a business 'underclass' in Europe.

In the UK, practical questions were raised about the cost/benefit ratio of increasing communication. What level of detail should be given out before costs start to outweigh the benefits? There was a lack of agreement on what should be communicated to shareholders. Should they have to specify when banking covenants come to an end, for example? These discussions revealed the practical issues involved in trying to develop the audit approach.

Audit committee and directors' reports were specifically mentioned as being, too often, full of 'boilerplate'-type comments, which were not as useful as they could be. It was also emphasised that much of the good work undertaken by audit committees is not revealed to external stakeholders. This includes work on which the external auditor may have relied. In Poland, a full understanding by all stakeholders of the role of the independent audit committee was seen as vital for future open and transparent reporting by the business.

On audit reports, the current report design was seen as too negative, although this was partly a problem of litigation (see section 3), which has to be addressed before other issues can be resolved. In the UK event one participant asked how, with the current design, anyone could tell a good audit report from a bad one. But another retorted that this surely gave auditors a chance to differentiate themselves in the market by offering something innovative and different.

5. Paul Moxey and Adrian Berendt, *Corporate Governance and the Credit Crunch*, ACCA, 2008.
http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/cg_cc.pdf

5. Did auditors do a good job? The economics of audit

At the Ukraine and Zambia events there was a widespread belief that auditors had serious questions to answer. In Zambia, the deputy governor for administration at the Bank of Zambia said that in the 1990s auditors had signed off clean reports on companies that had subsequently collapsed, even though (at least with hindsight) the warning signs had been there. And the same thing had happened again in the current financial crisis. Where were the auditors? Were they sufficiently robust in standing up to clients or were they more concerned with keeping lucrative audit and non-audit assignments?

In Poland, too, when businesses collapsed at the height of the financial crisis, many commentators questioned the work of the auditors and, in certain cases where corporate failures had been preceded by clean audit reports, the audit role itself. It was agreed that auditors had to do more to reassure shareholders that their interests were being upheld and that audit had value. There was a strong view that audit committees, which have recently become mandatory for listed companies, would play a big role in helping in this respect (see section 7 below).

In Ukraine, the financial services markets regulator said that there had been many false audits and over 3,400 audit firms had now left the market altogether. Volodymyr Vakht of Deloitte conceded that there was a real issue with fees, which were not high enough locally for the firms to be able to invest in quality improvement procedures and employee training and development. In Singapore, too, there was concern that fee levels, especially for non-Big Four auditors, were not high enough and that clients got a very good deal, not just for audit but also for business advice, in return for what they paid. The profession, it was felt, was providing a higher level of value to business than was being fully recognised.

This concern was repeated in Malaysia, where fears were expressed that firms were not getting high enough fees to pay sufficiently attractive salaries and hence were losing talented people from the profession. Representatives from asset management groups were aware of the problem and said that they urged companies not to be obsessed with slashing audit fees – if one pays low prices one cannot complain if quality is not good. The other side of the coin, however was that auditors had to be sharper when it came to pricing their work according to risk – firms had to structure themselves better and not commoditise either work or fees. Pricing should be based not on time but on risk and the complexity of the assignment – firms that failed to do this could not complain of being undervalued by their clients.

There was clear concern expressed about auditors' need to demonstrate ethics, scepticism and independence. It was essential, participants agreed, that auditors applied the spirit, not just the letter, of standards and stood up for what was morally right. Of course, this applied equally to professionals within companies but the regulatory oversight of the auditing profession is a principles-based system, and such regimes depend upon ethical behaviour. The *ACCA Rulebook* stresses the central importance of members' demonstrating the highest standards of ethics and professionalism, and supports a principles-based approach over one centred on large quantities of rules. There was concern expressed by one participant that there was not enough regulatory deterrence to bad auditors and if this is the case in any system, then it needs to be addressed.

In Poland, warnings were given that auditors who were brought in only when it was too late should not be blamed for their client companies' troubles. Let's not shoot the messenger! The auditors should also not be blamed if the only verdict they could report was a qualified or negative opinion and that in turn led to further problems for the business. But a banker in Poland pointed out that the audit process should be compared to a medical examination, where a good doctor would not only diagnose the problems but also suggest restorative action. Companies should use the expertise of the auditor and not see audit as something negative, to 'get through'.

ACCA wholeheartedly endorses this view of the value that a skilled auditor can bring to the business, although of course the audit itself would have to be carried out with regard to ethical standards of auditor independence.

Looking more globally, Gerry Parfitt of KPMG Ukraine conceded that not enough had been done by auditors in reducing corruption and ensuring transparency. He said bank auditors should have done more to stop 'toxic' assets being parcelled up and sold on to unwitting investors by investment banks.

It is encouraging that auditors themselves are candid enough to accept that improvements could have been made on bank audits. But the overall conclusion from the round tables is that audit is effective and fees charged for audit work must reflect properly the work involved in carrying it out. Pressure to reduce fees may, some say, have the unwanted consequence of compromising the quality of an audit; quality must remain the fundamental driver of audit work. It would not be in the interests of audit quality or the public interest if firms were motivated to drive down their fees to a level incommensurate with the cost to them of carrying out the audit. We believe that company audit committees and shareholders should bear this in mind when considering the cost of the audit.

At the same time, it is also essential that the audit must seek to ensure that demonstrable value is delivered to the client. As an investor representative in Malaysia put it: 'boilerplate reporting, standardised, is not sufficient. We want more from you'.

6. Independence of auditors

The concerns about audit performance, examined in section 5 above, are also reflected in the issue of auditors' provision of non-audit services to audit clients and the implications that has for independence. Concerns over this issue were expressed at some of the round-table events, although not by investor participants.

ACCA's view remains that there should be no overall ban. Some services are closely related to audit, and the extra insight of the incumbent audit firm brings quality and efficiency benefits that companies would not wish to lose. There is no apparent demand among the investment community for such a split. We have also seen no evidence that the current framework, with its independence safeguards and new ethical standards, is failing in practice. Buyers of professional services are sophisticated and in a prime position to know the needs of their companies and it seems wrong to deprive them of the option of benefiting from economies of scale and the increased understanding that incumbent auditors have of the business.

Financial Director magazine has produced figures that 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 steadily reduced to 71% in 2008. So it appears that extra regulations and new ethical standards issued by the audit profession since 2002, combined with market forces, have provided an answer to the 'problem'.

ACCA is also concerned about smaller enterprises. The importance of an all-round cost-effective service for SMEs, which would not be able to afford to employ several advisers, should also be borne in mind by policymakers. It is important that issues of relevance to larger companies do not get inappropriately forced onto smaller businesses.

Nevertheless, concerns over the provision of non-audit services by auditors remain widespread and it should be noted that influential bodies such as the UK Treasury Select Committee have recommended a ban on such provision and have asked the City regulator to consult on it. The EC Green paper on auditing, released in October 2010, also raises the issue. Some of the round tables also revealed an element of market unease on perceived threats to audit independence, which suggests that audit firms would be wise to proceed cautiously, especially where non-audit fees become higher than audit fees. In Zambia and Malaysia, large non-audit fees were regarded as a threat to auditor independence, while in Singapore, participants suggested a 1:1 ratio of audit to non-audit fees was acceptable but no further. But they also pointed out that knowledge gleaned from other parts of the business often meant that auditors who did non-audit work for the client could then do a better audit.

The Singapore event also concluded that auditors should not perform internal audit for fear of reviewing their own work. ACCA also believes that independence could be threatened if the audit firm either made management decisions' on the basis of any internal audit work it has performed or placed reliance on its own work. We support the UK FRC's decision (ahead of its full review of non-audit services) to write directly to major firms suggesting that they be 'cautious' before entering into arrangements 'which stretch the internal/external audit boundary, not least because it could prove to be inconvenient and/or costly to change such arrangements should the outcome of the FRC's work be that the Ethical Standards are changed in a way that affects the provision of such services'. Audit firms and audit committees should be very careful how investors and the wider public perceive such agreements.

The Singapore participants also observed that while the US had stricter rules regarding auditors' independence, like any rules they could become gradually subject to a 'box-ticking' mentality. The Singapore round table did suggest that to improve perceptions of independence, consideration could be given to a system whereby the Stock Exchange pays auditors, with all listed companies contributing towards an 'auditing fund'. The problem was that the Exchange may not be in a position to assess the complexity of a particular audit and so it was deemed better to leave it to the audit committee, who were in a better position to set fees.

In Poland, participants questioned whether some of the cost for audits of banks, for example, might come from clients of the bank, or a government supervisory body. In Ukraine this issue also came up and it was suggested that to underline the point that auditors were supposed to be working for shareholders rather than management, the audit fee should perhaps be disbursed by government or the regulator.

Nonetheless, ACCA would agree with the Singapore conclusion: that it is very difficult for an outside body to give a view on what the fee at a certain company should be, and that this should be the role of the audit committee.

7. Role of audit committees

The importance of the audit committee was mentioned in several round tables, reflecting the rising number of countries where such committees are being mandated for listed companies. It has also become the subject of a separate study by ACCA in Singapore – the first of its type in this global audit programme – commissioned by the regulator ACRA (see section 4 above). Audit committees are increasingly seen as critical to ensuring that the organisation has strong and effective processes relating to independence, internal control, risk management, compliance, ethics, and financial disclosures.

Given the scale of the financial crisis, it is apparent that many companies failed to assess and manage their risk properly. It is therefore clear that the oversight role of the audit committee will continue to expand and to grow in importance. It is often stated that audit committee members have a part-time job with full-time responsibilities. Audit committees need to be independent and must review management decisions with healthy scepticism. This process necessarily includes a close analysis of the way companies assess and manage risk.

Poland, where the requirement for audit committees is still new, was particularly keen to explore ways of enhancing the effectiveness of the regime. It was agreed that if such committees are to have a positive effect on the integrity of companies' financial reporting, it was essential that they retained their independence from executive board and management.

The ACCA report mentioned above also made clear the importance of a strong working relationship between auditor and committee. Audit committee chairmen wanted auditors to be independent and 'speak their mind' and valued the external perspective they brought, which often allowed committees to challenge management more effectively on the figures. They also appreciated the extra expertise auditors could bring through their knowledge of new accounting standards and insights into the internal controls weaknesses of which chairmen might otherwise be unaware. They also valued 'intangible' benefits relating to feedback on areas such as the quality of the management's finance team. Generally the extra confidence and assurance that the audit brought was regarded as extremely important and allowed audit committee chairmen to do better jobs.

To fulfil its responsibilities, an audit committee should use all available tools, including the company's internal audit function, external auditors, and, if necessary, the retention of outside counsel and advisers. Each of these tools serves a key function.

If the scope of the audit and/or the reporting framework is expanded, then ACCA would also expect the role of the audit committee to change, especially if new areas of reporting are introduced. At this stage, however, ACCA would consider it more appropriate to take steps to encourage audit committees to fulfil their potential in the governance and reporting processes that currently exist. This means ensuring that knowledgeable and independent-minded individuals are appointed to audit committees and that they develop an aptitude for asking the right questions, both to their external auditor and their internal accounting staff.

8. Small audit – stratification of audit

For smaller businesses, should the profession start to think about introducing a scaled-down version of audit that would be quicker and cheaper than the full audit and would involve agreeing procedures with the business to provide assurance on the areas of risk that are of most importance to them? In ACCA's recent report, *Restating the Value of Audit,* the authors outline this 'segmented' approach to assurance for smaller entities, in which lengthy audit checklists could be 'unbundled' for smaller clients and other assurance services developed. It was pointed out in the Brussels round table, which was the only one to look specifically at the smaller audit market, that there had been a range of sub-audit assurance products launched successfully in Europe (a survey by European accountancy body FEE which shows this development appears in the ACCA paper) although they had had little take-up in the UK.

The debate in Europe has been dominated by the view that the audit is a regulatory burden with which smaller businesses can safely dispense, saving them money. The Commission, which aims to save administrative costs on business by 25%, is currently conducting a review of the Fourth Directive, which gives member states the right to exempt small entities from audit. The threshold is almost certain to rise again.

Yet this view dismisses the value that audit and the skills of qualified accountants can bring to business of all sizes, in addition to the wider trust in the economy, which we have already addressed. The fact is that there is a wide variety of current practice across Europe – 11 countries use the maximum threshold, but 19 others use different figures or have no threshold. This disparate approach reflects different country experiences. Sweden and Finland backed away from using the maximum threshold owing to the current economic uncertainty, which they did not feel was the right background for a reduction of audit in the economy.

The decision by Sweden and Finland is understandable. A difficult economic environment, in which fraud and white-collar crime traditionally rises, does not seem the most appropriate backdrop for a measure which would increase still further the number of businesses having no external verification of their financial statements. 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, even if this may need to be achieved via an alternative assurance approach aimed specifically at SMEs. The profession should address the current multiplicity of products aimed at this sector and look to agree a common standard for auditing SMEs, which should be less complex than that for larger companies.

Also, 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 such as raising the audit threshold is essential. There is a good argument for saying that the agreement of shareholders is a more valid criterion for governing audit exemption than an arbitrary accounting threshold. And if audit is to be removed as a requirement, 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.

Ultimately, it could be argued that stratifying the audit, and tailoring the product to the needs of different types of business, according to their scale and complexity, is more important to the future of audit than debates on thresholds. The profession needs to rely on demonstrating its value – and the wider context of good governance - than relying on legal mandate.

That value was reaffirmed in Brussels, by one senior auditor who pointed out the important 'by-products' from audit: the discipline they impose on companies, the deterrence of fraud, and comfort about going concern issues. If one important local company goes down, another 50 could be affected – so the role of audit is beneficial in society as well for as the directly audited business.

9. Rules stifling professional opinions

At several events, the issue of whether judgement was being replaced by rules in the auditing and accounting industry came up, particularly with regard to current convergence efforts by standard-setters to harmonise IFRS with US GAAP. In Poland, unease was expressed that increased regulation and international standardisation of audits had stifled auditors' professional judgement. In Singapore, too, participants felt that while IFRS standards were principles-based, these would eventually lead to a more prescriptive and compliance-based set of standards. In Ukraine several speakers warned that against 'Americanisation' of standards in the sense that this meant that rules would override judgement.

The upsides were seen as increased certainty of interpretation of standards and also a possible reduction in lawsuits against auditors, who would increasingly be able to point to adherence to standards as a defence. But mechanistic rule-following is not what ACCA believes audit should be about and it does not add real value to business. A partner from one of the Big Four firms in Malaysia observed, however, that as business has become more complex, so has accounting – particularly with the fair value debate in recent years – and there was, in his opinion, more subjectivity in audits now. The judgements in the annual reports were perhaps not being looked at carefully enough by the investor community.

Once again it comes back to the litigation issue. It was clear from the UK round tables that in the public sector there is more satisfaction with the audit process, which is broader and more comprehensive than in the private sector, often taking in value-for-money assessments and corporate governance reviews, and assessing performance outcomes. In a paper comparing audits in the two sectors[6] prepared early in 2010, ACCA concludes that the 'wider scope of public sector audits allows them to be more progressive and innovative than audits conducted in the private sector'. As an example, the paper takes the issue of 'use of resources', under which the auditor:

> *focuses on whether an entity has sound and strategic financial management; robust strategic commissioning arrangements and good management of natural resources, assets and people. This approach is on a risk basis and draws on cumulative audit knowledge and evidence, which means that the audit is proportionate. An organisation that is efficient can expect to have less audit work undertaken on 'use of resources' than poorly performing entities. It means that at any one time the auditor has a good all-round understanding of the organisation and can identify early the managerial, governance and financial risks. 'Use of resources' is possibly the most progressive audit framework in the world.*

And yet it is the same firms who are carrying out audits in both sectors. This suggests it is the lessened fear of litigation in the government sector that enables more innovative thinking and approach. The profession, governments and policymakers must find a way of breaking the legal logjam that is proving such a dead weight on innovation in the audit market.

---

6. Gillian Fawcett, *Enhancing External Audit: Learning from the Public Sector*, ACCA, 2010. http://www.accaglobal.com/pubs/general/activities/library/public_sector/ps_pubs/papers/tech-tp-gf05.pdf

10. Relationship between auditor and regulator

Participants in several round tables have said there is no longer sufficient dialogue between auditor and regulator. Some said there should be a regular flow of information between the two. The lapsing in recent years of a general protocol under which auditors can raise concerns to regulators is seen as a weakness.

In emerging audit markets such as Ukraine there was a clear desire for the two sides to work together to strengthen the role of audit in the economy. But in Wales, too, concern was expressed that there was no longer sufficient dialogue between auditors and regulators – this was seen as a particular problem for the Welsh Assembly and other public sector bodies, which rely heavily on expert audit reports when dealing with public money.

Clearly further developments will need to occur – and there may well be a role for audit committees and auditors directly or via professional networks to liaise openly with regulators on key industry trends and risks.

ACCA sounds a note of caution here, however, as there could be dangers to auditor–client confidentiality if the auditor were seen as an agent of the regulator. It is important that auditors and regulators build good working relationships but vital that there is no confusion among other stakeholders over their respective roles. The auditor is there to uphold shareholders' interests and the regulator to set the framework and enforce rules. It is not the auditor's job to produce reports for the regulator's own purposes and, even where the actions of auditors are determined by a legal duty to report to the regulator, the objectives remain different. The regulator should not only understand the danger of an 'expectation gap' but should communicate with firms and other stakeholders the position that auditors are not an extension of the regulator.

Conclusions

The ACCA global round table series proved above all else that participants see value in audit. Banks, analysts and other players wanted more, not less, assurance of company figures and prospects in the economic downturn. The investment community looks to a clean audit report before advising clients where to put their money. And small and medium-sized companies, where the value of audit is most often questioned by commentators, can be assured from our findings that having their books checked by reputable firms of accountants puts them in a healthier position for securing finance. In an era of reduced lending this benefit should not be underestimated.

And yet there is a sense of frustration in all the markets where ACCA held round tables, because so much more could be achieved. The role of audit, while proven to be valuable in giving reassurance as to the financial figures, could and should be expanded into other areas. 'We want more from you – give us more. What do you think of the company?' said one investment representative in Malaysia, referring to risk assessment. It is clear that the current restrictions on the role of audit to giving only a binary opinion on the financials is no longer enough to satisfy stakeholder needs.

A way has to be found to increase and widen communication of audit findings. A quiet word with the audit committee or a management letter restricted to a select few is not enough. When a company is hitting problems investors need to know. They are, after all, paying for the audit. And a report published three months after the year-end looking back at last year's figures is also of limited value – the profession has to come to terms with real-time reporting. Externally verified monthly management accounts available online may be the future. The audit must develop and be targeted at the needs of different sorts of business depending on their scale and complexity. And financial reporting itself has to reform because audit, as currently constituted, is only as useful as the financial statements on which it reports. If these are over-complex or not suitable for their audiences then the value of audit will not be appreciated.

Another key problem raises its head. At every round table the spectre of liability hung like a dead weight across discussion. More proactivity and opinions expressed on different areas equals more potential for litigation. In theory, the market should find a solution. In reality governments must step in and end the logjam by giving auditors the reasonable protection that will enable them to break free from the boilerplate language of which so many participants complained.

And should this happen, it will then be up to the profession to meet the challenge, demonstrate the value it can really add and seek further innovation, as it is doing in the public sector. Already, developments in corporate reporting such as integrated and narrative reporting are going to mean more dependence on auditors. And, in the wake of the banking crisis, with inquiries into the role of audit taking place among regulators and policymakers across the world, there is no going back. Auditors are firmly under the spotlight and are going to have to deal with questioning of their professional scepticism and independence. Our round tables have shown there are significant numbers of doubters. Controversial issues such as what is an acceptable level of non-audit fees will have to be addressed, not batted away.

On smaller enterprises, the challenge for the profession, in the face of regulatory pressure for scrapping reporting requirements, will be to establish successful scaled-down audit procedures for SMEs. Assurance (and regulatory approach) should be 'stratified' so that it is appropriate for the scale and complexity of the business in question. In the European Union, a great variety of non-audit reports have sprung up, which has led to both a degree of confusion about what these reports contain, and a lack of cross-border standardisation. ACCA believes that the involvement of practising accountants in providing focused assurance services to SME clients has great potential for adding client value, and ACCA encourages the development of such services. Our suggested approach would be to standardise non-audit reports on the basis of the International Federation of Accountants' classification of, and standards on, review engagements, assurance engagements and compilation engagements, and to agree upon procedures.

But for all sorts and sizes of client, auditors must demonstrate judgement and not be tempted to hide behind standardised rules. ACCA has always campaigned for common international auditing and accounting standards as a way of reducing the costs of doing business and increasing transparency and comparability. They must not be used, as some believe, as a lowest common denominator. The global round-table series has shown there is, overall, a positive view of what audit can bring to business. It is essential in the years ahead that the profession, policymakers and other stakeholders set out a pathway for overcoming some of the issues this series has identified.

POL-AF-RTF2

ACCA 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / +44 (0)20 7059 5000 / www.accaglobal.com