ACCA

ACCOUNTANCY FUTURES

Value regained: restoring the role of audit in society

A ROUND-TABLE DISCUSSION IN POLAND, 14 SEPTEMBER 2009

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.

FURTHER INFORMATION

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BACKGROUND

The round-table in Warsaw was the first of ACCA's global series and set the template for future events by involving a wide variety of stakeholders, all of whom have an interest in the audit debate. These included the government; the financial regulator, employer groups, CFOs, banks and auditors.

A series of questions were debated, including the following. What is the value of audit in society? Who should be allowed to audit? Is there a conflict of interest between audit and non-audit activities done within the same company by the same audit firm? Should auditors have a duty of care to broader groups of stakeholders? Should auditors shoulder any blame for their role in the recent crisis? A rich and wide-ranging discussion followed.

CONCLUSIONS AND RECOMMENDATIONS

There is a clear appetite for change from those who practise audit, as well as those who use audit. How the scope of audit evolves will need to be carefully thought through, and should not be rushed. There is unease with the way that increased regulation within auditing via increasing international standardisation appears to have lead to a continual stifling of professional judgment on the part of the auditor.

There are some clear gaps in knowledge about the state of audit in society, for example around the perceived value of audit; the economics of the audit and the actual benefits of audit. ACCA will be commissioning research around these themes in due course.

Each jurisdiction experiences audit according to its own regulatory framework and its own economic circumstances. These must be respected.

There is great benefit to be derived from a dialogue with stakeholders beyond the auditing profession as to the value of audit. Re-emphasising the role of the customer, and focusing on the needs of the customer can only be of value for the profession.

The relentless removal of audit from a growing number of companies across the EU and in other jurisdictions appears to have been done with only the slightest awareness of impact, and is seemingly driven by an ideology that equates the removal of any audit requirement with the lifting of regulatory burden. This ideological approach needs to be critically evaluated.

The relationship between the financial regulator and the auditing profession is a special one, and one where systemic links and flows of information are a necessity for the future.

Above all, there is a clear need for evidenced based research to examine what will enhance the value of audit still further for stakeholders and re-appraise the purpose of the audit function within civil society.

THE ISSUES

The value of audit in society has been questioned in recent years. A series of high-profile corporate failures has led to a growing debate on the effective role of audit. Inquiries into the recent banking crisis have sought to understand what role auditors have played in the demise of systemically important financial institutions. A series of reviews have been announced by regulators. The value of audit is once again under the spotlight – this time firmly on an agenda of wider stakeholder interest including banks themselves, businesses, employees, regulators, as well as investors.

Concerns over the value of audit have been documented in a number of contexts, ranging from declining public confidence, the falling number of trainees undergoing practical training in audit – and who see auditing as a prestigious career option – to the quality of audit and the so-called 'expectations gap' in terms of what the general public can expect the audit to guarantee.

In spite of these concerns and challenges, today's complicated business environment demands a strong audit discipline to manage the risk assurance process, uphold best principles of governance and to sustain stakeholders' trust.

The audit is rightly seen to be a central discipline within the accountancy profession. A typical view is stated below.

'Investor confidence is fundamental to the successful operation of the world's financial markets. When making decisions about capital allocation investors need to know that financial information they are given is credible and reliable. The quality of audits and audit opinions on financial reports are crucial to achieving that. Independent auditors play a vital role in enhancing the reliability of financial information by attesting to the veracity of the financial statements.

The external audit is the first external independent line of enforcement of financial reporting standards and financial reporting law. Audit is one of the vital filters that ensure that users of financial statements can have confidence in them.' (Commissioner Jane Diplock, New Zealand, 2005)

Despite the importance of the audit, it is true to say that very little research has been carried out into its value, from any perspectives: in respect of the profession itself; or of investors; or of those in the wider public domain – regulators, policy makers, or members of the public themselves.

And there have been some important recent developments in audit.

Audit, in common with much of the accountancy profession, has changed considerably in recent years. In many respects this reflects the general trends affecting business: internationalisation; technology; the need to respond to corporate failures; more complex business models; the rise of the service sector.

By the same token, business continues to demand high value propositions from auditing firms – not only in traditional areas such as compliance and control, but also in the interpretation of financial reporting standards as they apply to different markets and sectors.

Public interest continues to be at the top of the business agenda in relation to audit services. But the audit profession is also facing other trends, to demonstrate how it has a capacity to change to meet the challenges of fast-changing capital markets, market segmentation in a global environment, and the ability to adapt to the needs of complex capital market instruments.

However, there are larger trends which have affected the provision of audit too:

- the increasing complexity of International Standards of Auditing (ISAs) and the enhanced cost of applying them
- the political pressure to find new ways of de-regulating the SME sector – which has led to widespread consideration of 'audit exemption threshold' regulation, and the inexorable raising of that threshold in certain jurisdictions in the name of lifting regulatory burden
- the call for wider accountability of both companies and their managements in respect of non-financial and non-traditional areas of corporate engagement such as communities and the environment.

THE ROUND-TABLE PROCEEDINGS

Steve Priddy: Welcome to you all. Over the last weekend I noted the following stories from the UK and Polish financial press:

Ukraine hit by probe and senior resignation: a corruption probe and a top-level resignation are threatening to plunge Ukraine's central bank into turmoil, undermining Kiev's ability to pull out of a deep recession

Chen Shui-bian, former president of Taiwan received a life jail term for corruption, completing the fall from grace of the one-time human rights champion

The Gdynia and Szczecin shipyard investor has mysteriously disappeared, leaving Poland to sort out the mess

In the UK it was reported that a major accounting firm received £30.7 million of professional fees over five years, of which, apparently only £1.75 million was for audit services from the same company and its directors

What role, if any, does the auditor have in these separate stories? For me there are a series of questions which we should debate today:

- What is the value of audit in society?
- Who should be allowed to audit?
- Is there a conflict of interest between audit and non audit activities done within the same company by the same audit firm?
- Should auditors have a duty of care to broader groups of stakeholders?
- Should auditors shoulder any blame for their role in the recent crisis?

WHAT IS THE VALUE OF AN AUDIT?

From the CFO point of view, the role of audit in business is generally positive. Auditors bring best practice to business. After several years of regular external audit, a company does implement best practice. The negative side of the current situation is the existing exemption threshold of five million euros annual turnover, below which companies are not obliged to undergo statutory audit. Being subject to audit means companies are more confident when talking with creditors. They may obtain better financial facilities, when considering raising further capital. Reliable, transparent and high quality financial information might also help when seeking venture capital or expanding into new areas.

This debate raises a lot of reflections on how the audit profession can be perceived in Poland. Audit is an attestation, a confirmation of the reliability of financial information. Erroneous financial data is disclosed. An empirical study of 200 companies in Poland (the impact of financial audit on the reliability of financial statements, including compulsory audited companies and non-compulsory audited companies) showed that in over 70% of cases the P&L of those companies was restated as a result of audit. Those companies that were not audited obligatorily disclosed erroneous data on their financials. Auditors are not only looking backwards at historic financial information in the conduct of their audit.

WHAT IS THE ROLE OF AUDIT IN THE BANKING CRISIS?

Are auditors guilty of creating this financial crisis? Definitely not. The parties which may be guilty of precipitating the crisis can be many, maybe some auditors to a degree also. The crisis is not pointing at auditors, but rather at accountants in businesses, who do not submit properly prepared financial reports. What is challenging is what will happen after this crisis passes. We have to break out of discussing it among ourselves, we have to go forward to the economy, to those who run their businesses, to raise their interest in our role, go forward with the public. Auditors are perceived as 'bores' and perhaps that is a virtue!

Are auditors to blame for the financial crisis? It is a very complicated situation – investors could be blamed, owners, managers, accountants, or auditors – that's a good question. Even governments and regulators for not heeding the warning signs. The answer would be: 'not only auditors are to blame'. Rather say that thanks to auditors, the financial crisis in the world was disclosed. But where were the auditors that were auditing the big financial sector's annual statements for 2007? They did not disclose any problems in companies, that went bust in 2008. They did not warn shareholders of companies that were about to go bust. Foreseeing the future is very difficult, because the future is unknowable. We can say the following: 'Thanks to the fact that we are such a great profession, thanks to us this crisis was identified and noticed very quickly'.

Auditors are not easy – they are not a 'soft touch', even if they are perceived as boring.

Many banks right now are in a very difficult situation, and people from banks learned much from audit but auditors also have to learn. There is a conflict of interests: if you provide audit services, you should not provide other services.

In some cases there is a lack of standards in audit circles. Talking about the banking system, which is very heavily supervised, auditors and supervisors do not have the same interpretation of some phenomena in the books. Each auditor has sometimes different interpretation of the same economic events or transactions. Changing the auditor sometimes means changing the past. The role of audit is to fill in the gaps in information on the market. Who is paying auditors and who is selecting auditors is an important question. Should external audit be paid by the company being audited? Or maybe part of the cost should be shared by government supervision body or by clients of the bank? And the rule books for auditors are not without ambiguity – sometimes they are like the Bible, and open to interpretation.

Auditors cannot release themselves from blame for the crisis. It is important not only to look at historical data, but also auditors should be looking more at areas of risk. The independence of auditors is very important, as well as their professional scepticism, but also it is important to ensure rotation of auditors working for the same company for long period of time. The Financial Supervision Commission, started talking more to auditors over the recent times, so that the quality of financial statements is the best. A committee, aimed at increasing cooperation between the Commission and auditors has been established, regular meetings are held to debate different topics of mutual interest to auditor and regulator thereby seeking to satisfy the public interest.

Small and medium sized enterprises are not especially interested in role of audit in society. In Poland for the SME sector the most crucial issues are the quality of finance professionals within businesses, the quality and clarity of tax law, value added by auditors to business, and professional ethics. No regulation can replace ethics of audit. Training and education of the finance professional is very important – though over the last 20 year tremendous progress has been made. Training is not provided at the adequate level. Quality of law, particularly tax law – is an institutional barrier which leads to higher payroll costs. The role of auditors is viewed differently by business, depending on the size of a company. Unfortunately, companies often do not see the value added by auditors. For example, SMEs are not prepared to pay more to auditors but they would, if they could see more value in the work of the auditor – such as in risk identification.

Auditors in their work are focusing on the historical data, but the value of assets and liabilities may also depend on assumptions about future events, there are always some assumptions about the future in the financial statements. Should the auditor rather look harder into the long-term business model of the company? Should they be looking into the long-term future of the company, rather the foreseeable future? Should auditors be working more closely with boards and with owners of companies? Standards and law are quite interpretative, but very clear regulation – is it possible?

Steve Priddy: There are no audit firms in Poland doing only audit. So what do we know of the economics of auditing – what might incentivise the market to focus on audit-only assignments? Empirical research should be done on the economics of audit – it is clearly being said by some that they lose money, yet others claim they are profitable.

CAN THE BUSINESS MODEL BE AUDITED?

In respect of the audit of the business model, many business models are naive to start with. The person whose business model started in a garage is now the richest person in the world. Auditors are, however, secretive about valuation models in the banking sector, at least. Auditors have for some time now become very cautious, as if cautiousness is a virtue. But is over-scepticism good? Perhaps not, as it does not provide for the fair view on financial statements. What hypochondriac would write on his gravestone: 'Yes, I was sick after all!'

In Poland, audit is coming increasingly into the sphere of public finance. Municipal finances and their audit are entering financial markets, and public sector bodies in turn have to undergo external audit. There is also the question of prestige, having the presence of external audit at municipal finance level. With regard to conflict of interest between audit and non audit service provision, the opinion was expressed that if you don't audit your own work then there is no conflict of interest and also that if the law required audit-only firms then audits would be much more expensive. In terms of the rotation of auditors – the view was expressed that only the key auditor of the company performing audit should be changed, but that the audit firm could be the same. Otherwise it will imply bigger cost burden for company audited. With regard to business models, auditors should assess companies' business models from the point of view of inherent risks they entail. The role would be not to evaluate business model itself, but rather assess the possible results of a given business model.

PARTNER ROTATION?

A key question is who should be the audit partner and how long should they be partner? It is the supervisory board that hires audit resource. Any conflict of interest disappears if both the supervisory and management boards knew what exactly services are provided by audit, and how much they cost. Audit committees are entering the companies' corporate governance agenda and they are supposed to be looking at external auditors' work. A new joint ACCA-Polish Institute of Directors initiative on preparing lists of highly-qualified audit professionals to become candidates for audit committees in companies will help improve governance. Self regulation is better than external regulation – there should be no more than a dozen rules/principles. Members of audit committees should be well-remunerated, as the audit committee is likely to perform 70% of supervisory board's work.

Steve Priddy: Does it help this discussion to move beyond the pure investor perspective to consider a wider range of stakeholders?

WHAT DOES THE AUDITOR DO?

Generally, a point is being missed about what it is to be the auditor. Many people can talk about this profession, how to limit it, who can do this, and so on. But sometimes those people don't know what the work of an auditor is, and how hard and responsible it is. Looking at the overall picture, what's going on around the auditor, how external markets perceive auditors, what is auditor's prestige, liability, the constraints around the auditor, and what knowledge auditors should have, there are doubts about whether the profession is sustainable in the long term. Where can audit skills be learned, and where will they be learned in the future? Auditors specialize in different areas, not only in accounting – one has to know tax, IT systems. And their knowledge of specific companies is what is important. A single person cannot have this specific knowledge. Auditors often consult with their colleagues from other departments. It is a lot of work.

AUDIT AND THE EXPECTATIONS GAP

With regard to the audit expectations gap the complexity of businesses today creates a need for an audit team with specialist skills. On the question of widening the scope of audit, the profession should define, materially, what the scope should be. What is also expected in reading the audit report is cases of infringements of law, and errors, so that the supervisory function can be effective. Both supervision authority and auditors should have a goal of bridging this gap. The Financial Supervision Commission is very much interested in what is written in the audit opinion and report, but also it is right want to share supervisory observations, supervisory views.

The conflict of interest issue is underestimated. The independence of auditors – is like the independence of the judiciary (which has to be accountable at the same time), it depends on standards. Rules, standards, are written within the audit community. But at the end of the day the view was expressed that the auditor does not have liability.

The challenges will be after this crisis is over. The auditors have to start talking to those who purchase their services. There is an expectation gap which can be bridged by looking in each others' (regulators) reports. There are different objectives. Auditors are not looking specifically for errors, but for facts, for evidence that confirms the correctness of financial statements. But the supervisor has other objectives; they are looking for things that are not in line with the law. For several years there has been an obligation – to also be looking at 'symptoms' of corruption, but this is a by-product of audit. This difference in expectations between institutions and recipients of reports is quite big. A discussion like this makes the gap smaller, but it will never disappear.

SIMPLIFY THE LEGISLATION IN POLAND, PLEASE!

Steve Priddy: To summarise our discussion: the expectation gap is a key issue. It touches on auditors vis a vis the regulator, the companies audited, the banking sector. More needs to be done on the value added by auditors to business, and I am grateful to KIBR for pointing me in the direction of recently published research. The tension between ethics and independence remains real. The economics of audit are not transparent. Regulators need a more systemic dialogue with auditors; auditors need to listen more closely to their customers. Thank you, once again, for your time and contribution to this discussion.

THE PARTICIPANTS

ACCA is grateful to the contributors of this round-table discussion and is pleased to list them here. Views expressed are those of the individuals, not necessarily the views of the organisations they represent. Any errors or omissions remain with ACCA.

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