ACCA

ACCOUNTANCY FUTURES

Evolution of the audit function: better understanding of the audited entity

CONCLUSIONS OF A ROUND-TABLE DISCUSSION IN POLAND, 26 MAY 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.

FURTHER INFORMATION

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AUDIT AND SOCIETY

ACCA has identified the future role of audit in society as a key driver of change within the profession in the coming years. As part of this initiative, ACCA has hosted a series of round-table discussion events around the world to explore what the concerns are about the value of audit and to arrive at a series of recommendations designed to address them. At these events, a wide range of stakeholders has addressed the key issues facing audit and the audit profession in an open and frank manner.

One of the first in this series of events was held in Poland on 14 September 2009. That session considered fundamental questions such as the value of audit to wider society, the accountability of auditors to stakeholders, and the relationship between the auditor and governments and regulators.

That first session generated such interest that a follow-up meeting was held on 26 May 2010. This time, one specific theme was identified for the event, namely the contribution that audit committees can make to the enhancement of business stability and corporate governance in the wake of the global financial crisis. This was regarded as highly topical given the decision taken by the Polish Government in 2009 to make it compulsory for public companies to establish audit committees.

This second event, like the first, was attended by representatives of the business community, audit firms, the National Chamber of Chartered Accountants (KIBR), the Financial Supervision Commission, the Union of Polish Banks, the Polish Institute of Directors, the Polish Confederation of Private Employers and representatives of the Polish media, as well as individual ACCA members.

SUMMARY

The decision of the Polish Parliament to introduce a legal requirement for the country's public companies to establish audit committees promises to be a crucial step forward in terms of improving corporate finances. The decision will have a major impact since, before it was made, more than half of the companies affected were operating without an audit committee.

The change is timely since the uncertain situation in the global economy obliges public and private enterprises alike to take a more responsible and prudent approach to the management of their finances. Introducing audit committees to large private sector companies, and encouraging them to work closely with their external auditors, will help in this process.

If audit committees are to have a positive impact in terms of enhancing the integrity of companies' financial reporting processes, they will need to retain their independence from the executive board and management. At the same time, the executive and management will need to understand and respect the audit committee's independence and functions.

Audit committees can make a positive contribution to improving corporate governance but they can not succeed in isolation. Committees and auditors should work constructively with each other while respecting each other's independence. On a wider level all the key players involved in the process of governance, including the CFO and the company's shareholders, should accept their responsibilities to make the process work in the interests of the company as a whole.

In the light of the financial crisis, auditors must do more to demonstrate the value their services bring to business and ensure they always maintain and demonstrate their independence.

RECOMMENDATIONS

The following recommendations emerge from the meeting:

- companies need to view the introduction of audit committees as an opportunity to enhance their governance and reporting processes, not as a threat to the executive.

- companies need to support the members of their audit committees by making available suitable training to them and providing them with the resources and facilities they need.

- companies should be encouraged to approach their accountants or auditors for advice on managing their finances before the situation becomes so bad that the audit report must inevitably be qualified or negative.

- larger companies and financial institutions need to give the risk management function the status necessary to ensure that companies do not take grossly irresponsible commercial risks.

- companies should acknowledge the importance for effective governance of sound ethical practices. Attention needs to be given to incorporating concerns about ethical behaviour at the recruitment stage and within the corporate culture.

ISSUES RAISED AT THE ROUND TABLE

The role of audit committees in corporate governance

Before trying to identify the particular contribution that the audit committee makes to the process of corporate governance, it is first necessary to establish the aims of corporate governance itself. Those are, essentially, to enhance the confidence of investors (and also of regulators and government) in the way that an entity's affairs are being controlled. In particular, corporate governance seeks to enhance the quality of decision-making within an entity by seeking to ensure that decisions are made by competent individuals, after due process and consideration, and while minimising the risks associated with conflicts of interest of various kinds. The greater the degree of trust and confidence in the way that an entity's affairs are being run, the more likely it will be that the markets and regulators will look upon that entity as being a credible investment option. Glenn Collins, head of advisory services at ACCA, told the meeting: 'It is vital that principles of good governance in business are developed as they ultimately enhance business trust, promote competitiveness and improve growth.'

The way that the authorities in any country go about identifying what governance rules or principles should be followed by entities within their jurisdiction will often vary in terms of detail: there is no 'one size fits all' assumption in this area. But pronouncements on corporate governance are generally built on a set of basic principles. The best-known international governance framework is that laid down by the Organisation of Economic Co-operation and Development (OECD): it has identified, as fundamental governance principles, responsibility, transparency, accountability and fairness. The challenge faced by most countries is how to translate such a high-level, principles-based framework into guidance which will be meaningful and relevant in their own markets.

The audit committee is designed to be a key organ of corporate governance in large public-interest entities in that it addresses the specific issue of the integrity of a company's financial reporting process. The audit committee seeks to ensure that investors and prospective investors, as well as regulators and governments, can have trust and confidence in the image of the entity's financial position and performance as set out in its financial statements. The committee sets about this task by giving specific attention to the accounting policies that are appropriate for the entity to adopt and by helping to ensure, in various ways, that the auditor is free to carry out an objective, independent audit of the entity's accounts.

Audit committees can play a significant role in protecting shareholders' interests by identifying and mitigating the risk of error, omission and manipulation of financial information, particularly at the year end. In doing this the committee can not only help to ensure that the financial statements amount to a fair presentation of the entity's performance and position but help to pre-empt any criminal or civil actions that the entity might otherwise face.

The establishment of audit committees in Poland

When businesses collapsed during the peak of the financial crisis, many in Poland questioned the work of the auditors of those companies, and in some cases the value of the audit itself. This was especially so where the companies concerned had collapsed after having received 'clean' audit reports. It was considered vital that steps be taken to satisfy stakeholders that their financial interests were being protected.

The decision to introduce the requirement for public companies to set up audit committees was one important response to these concerns. The free market solution in this respect had not succeeded – best practice codes, which recommended the establishment of audit committees, had been adopted by less than half of listed companies.

ACCA itself has shown an active interest in promoting the integrity of financial reporting systems and processes. In the 2007 revamp of its examination syllabus, it featured significantly more emphasis on ethics, governance, risk management and internal audit – all areas in which there had been widespread failings in the run-up to the financial crisis. The meeting also heard how *ACCA Poland*, led by Waldemar Majek FCCA, has worked with the Polish Institute of Directors to produce best practice guidance for the setting up and running of audit committees. This guidance document has now been published on the web site of the Warsaw Stock Exchange.

There was broad agreement at the meeting that the audit committee was, potentially, a very useful tool for enhancing the integrity of the financial reporting process in Poland. The committee and the auditor could, moreover, perform their respective functions to their mutual advantage. The committee could certainly help auditors in carrying out their work by respecting and supporting the auditor's independence and by itself being independent of executive management.

But it was important to remember that the audit committee exists within the corporate structure. For it to be able to fulfil its potential and to become truly effective, there must be a willingness on the part of the company to support the committee and to allow it the resources and the freedom to do its job properly. Merely establishing audit committees, appointing individuals who do not have the required expertise or experience and without providing them with the tools they need to do their job, will not in itself achieve the goal set for them.

Not only this, but good governance should not be seen solely as the responsibility of the audit committee or the supervisory board alone: all actors in the company – auditors, audit committees, CFO, shareholders and supervisory boards – need to work together to achieve the goal of good governance.

The audit committee as a tool for helping the auditor

If the value of the audit is to be maintained and enhanced, it is important that auditors are able to find out as much as they can about what is going on within the client entity. They need to understand the client's business, the drivers of its performance, and its various internal control procedures. They will also want to be aware of any known weaknesses in those control procedures, potential problems with particular offices or individuals within the company, and any concerns that the committee may have about particular accounting policies or practices favoured by management. The audit committee can represent a source of crucial information in these respects.

It was also argued strongly, however, that while the audit committee can act as a useful source of contact and communication, the relationship between the committee and the auditor must not be allowed to become too close - the quality of an audit will always depend heavily on the independence of the auditor. Pawel Cyganski of the Polish Confederation of Private Employers said that auditors should always keep their distance from the client, whether or not it has an audit committee. Auditors needed to retain their independence in all cases, and should not be afraid of losing clients for reasons of lack of independence or for being too honest in their opinion of the client's commercial viability. On the latter point, he claimed that auditors were often told by clients 'don't be too tough in your audit opinion or it will weaken us further'.

The role of the auditor in the financial crisis

Representatives of the audit profession agreed that it was essential that auditors safeguarded their independence and called for the understanding of the business community in helping them do this. Barbara Misterska-Dragan of KIBR said it would not be fair if auditors were blamed for giving qualified or negative opinions on clients and if those opinions led to a further deterioration in the trading positions of those clients. She stressed that, in some cases, giving a qualified or negative opinion was the only option available to the auditor. She argued that many businesses that find themselves in this unfortunate position could have pre-empted insurmountable financial problems by approaching their accountant earlier for advice on how to better manage their finances – accountants were ready and willing to offer such advice and there were no ethical restrictions on their doing so. Jerzy Malkowski of the Union of Polish Banks suggested that the audit process itself should assume the character of a medical examination, whereby the auditor would not only diagnose the problems facing the client but also suggest restorative action.

How should the audit committee operate?

Marta Rejman FCCA, ACCA's representative on the International Federation of Accountants (IFAC), said that the experience of Poland so far is that supervisory boards are opting for the easiest solution and appointing to the audit committee the only person on the board who happens to be a qualified accountant. It is highly desirable that experienced accountants be represented on audit committees – that is, in fact, a requirement of the EU's Statutory Audit Directive. But that should not be the sole criterion. In order to truly fulfil the task attributed to it, the committee should be a strong, professional and independent body, as well as comprising individuals who are competent to sit on it. Members should ideally be experienced in business and have sufficient character to constructively challenge the executive where necessary. It would certainly be an advantage of they understand the principles of accounting and audit. The chair should be a strong leader and sufficiently experienced and qualified to understand and evaluate the financial implications of the company's plans and activities. This will help the board overall to weigh up risk properly so as to avoid taking unnecessary or unwise risks. The committee needs to have an open dialogue with the company's management and auditors so as to properly inform the supervisory board and therefore to protect the interests of shareholders.

It is crucial for the auditor to be informed about the risk practices and the business model of the company. The committee can help the auditor in this regard. Ultimately, though, it is for the company to decide on its approach to risk and it is not for the auditor to interfere with its decisions. But auditors can contribute the knowledge and experience they have acquired and committees should be prepared to listen to any comments which auditors may wish to offer on the merits of the company's policies and practices on risk.

The value of audit to SMEs

The meeting also returned to an issue which had received attention during the first round-table meeting in 2009, namely the audit of SMEs. Marta Rejman FCCA informed the meeting of the initiative taken by IFAC to adopt a 'think small first' policy with regard to the framing of new standards. This policy was welcome, she said, and was especially important in countries like Poland where the overwhelming majority of the businesses were small and medium-sized entities (SMEs). Marta Rejman said 'audit should be simple and bring an added value to give owners more control over their businesses. Standard setters should look through the prism of SMEs and make standards which are relevant to the circumstances of those businesses.'

The importance of ethics in business

On a wider governance point, Jerzy Malkowski stressed the importance for businesses of adopting a robust and ethical approach to the management of risk. He said that, in the run-up to the financial crisis, many banks had come under severe commercial pressures to undertake high risk ventures. Where risk managers had advised caution in such circumstances they had often been overruled. We should draw two lessons from these experiences, argued Mr Malkowski. First, the status of risk management, especially within financial institutions but also commercial companies generally, needs to be increased so that the voice of responsible risk management is heard and heeded. Second, businesses need to aim to recruit and train people who can be relied upon to behave ethically when faced with business decisions and opportunities. Lack of ethics on the part of individual staff can sometimes be traced to a lack of training, so investment in this area should be seen as being essential corporate investment. These comments are echoed by ACCA's report *Risk and Reward: Tempering the Pursuit of Profit*, published in June 2010 (http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/tech-afb-rar.pdf).

CONCLUSION

The consensus of the meeting was that the introduction of a mandatory requirement for Poland's largest companies to set up audit committees was a necessary step, given the low levels of adoption on a voluntary basis, but one which offered opportunities for enhancing the effectiveness of financial reporting, corporate governance and external audit. For the potential of audit committees to be achieved, however, companies and their shareholders need to understand and respect their purpose and functions and work constructively together.

LIST OF PARTICIPANTS

ACCA would like to thank the participants at the event:

- Glenn Collins FCCA, head of advisory services, ACCA (moderator)
- Waldemar Majek FCCA, managing partner of BPP Poland
- Barbara Misterska-Dragan, KIBR (National Chamber of Statutory Auditors)
- Marta Rejman FCCA, ACCA representative on IFAC
- Jerzy Malkowski, Union of Polish Banks
- Pawel Cyganski FCCA, Polish Confederation of Private Employers.

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