ACCA

ACCOUNTANCY FUTURES

Value regained: restoring the role of audit in society

A ROUND-TABLE DISCUSSION IN SINGAPORE, 2 NOVEMBER 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 roundtable event in Singapore was the second in ACCA's global series of audit debates and the first outside Europe, where the majority of the events took place. It had participants from the regulatory, commercial, investment and academic sectors as well as auditors and accountants.

The following questions set the tone of the event:

- Given the global financial crisis, did the auditors do enough to alert investors?
- Is the scope of an audit adequately defined? Is it too restrictive?
- To what extent can the assurance provided by an unqualified audit report be relied upon by stakeholders?
- Can the auditors remain independent when their fees are typically determined by the board of directors?
- Are auditors properly remunerated?
- Are auditors suitably competent to begin with?

These questions, among others, set the tone of the debate in Singapore.

CONCLUSIONS

Financial audit does add value to organisations and societies.

Greater transparency is needed from the auditing profession to demonstrate the value that is added, for example management letter comments could in the future be disclosed in the company's annual report.

Widening the scope of audit to cover such topics as the organisation's risk appetite, or its assumptions about the future was felt to be a step too far in Singapore at the current time.

Audit independence is a state of mind – auditors must not only remain objective and professionally sceptical, they must be seen to be so.

External auditors should not provide internal audit services to the same client for fear of heightening the self review risk.

The lack of enthusiasm for audit agreements including fair and proportionate limitation of liability with their clients, remains puzzling.

Concern was expressed about the audit regulatory framework tending to stifle auditor professional judgment.

An audit is a 'public good'. Careful thought needs to be addressed to the provision of other forms of assurance and whether there is a market demand for these other forms.

IS THERE VALUE IN AN AUDIT?

The general consensus of the panelists is that there is indeed value provided by an audit. From the investors' perspective, an audit lends credibility to a company's financial statements, providing comfort to investors and other stakeholders that an independent verification has been conducted and that the audited accounts can be relied upon. This is because the adherence to financial reporting and governance standards, the practice of professional scepticism and the integrity of auditors, are assumed.

There is also research evidence in support of the value of an audit. For example, companies with audited accounts enjoy lower bank loan interest rates, thus lowering their overall cost of capital.

It is worth noting that while professional scepticism is maintained and audit tests include checks on the book-keeping system, policies and procedures, internal controls, risk assessment and such like, the assurance is only reasonable but not absolute as these tests are conducted only on selected samples. This is reflected in the true and fair view opinion. An audit is different from a certification, which would require a different set of audit approaches and their associated costs.

Apart from an audit opinion, from the stakeholders' perspective, more substantial information is required from auditors in order to further enhance the value of an audit. Because of the differences in what stakeholders are looking for, and what the auditors are representing in their audit opinion, an expectation gap remains. This being the case, should the scope of audit be widened to include prospective information and underlying assumptions in order to bridge this expectation gap?

The auditors on the panel contend that the scope of financial audit is sufficient as it is currently understood.

Widening the scope will only add to the cost of the audit, without adding significant corresponding value. The failure of audit is mainly due to the negligence of auditors, and pure greed and collusion amongst perpetrators, and is not due to a narrowness of scope.

It was suggested that the four cornerstones of good corporate governance are:

- the board of directors
- management
- external auditors
- internal auditors.

Perhaps the internal audit function should be made compulsory for all public listed companies and their scope of service be increased.

It was noted that there is increasing communication between external auditors and the non-executive directors on the audit committee on matters such as aggressive accounting policies and such like, but these discussions are not directly shared with the shareholders as the current communication framework is limited. It is stressed that this needs improvement, as investors need such useful information in a timely manner. For example, management letter comments given by the external auditors to management are more valuable than an unqualified audit opinion, and these could in the future be disclosed in the company's annual report.

However, with regards to forward-looking and prospective information and assumptions, there is a limit to what auditors are able to do to assure investors and the current reporting framework is not adequately designed to address this. Auditors can only audit the assumptions of this forward-looking data and cannot provide an assurance on the outcomes arising from those assumptions. If the outcome is not what we as investors expect it to be, will we then suffer from 'hindsight bias' against the auditors? Some panellists commented that this may not be fair to the auditors as different auditors may have different interpretations and judgments on the same forward-looking information such as has arisen with fair value accounting in the banking sector.

TO WHAT EXTENT ARE CURRENT SAFEGUARDS DEEMED SUFFICIENT?

An auditor's independence is paramount even before an audit commences. Though shareholders of a company appoint the auditor, they in practice delegate to the board of directors the determination of the audit fee. Thus, this invariably creates an 'unconscious bias' towards the board by the auditors. This is especially so if the audit firm derives a significant amount of its total fee revenue from a singular client, as was the case in the recent Madoff investment fraud.

An important comment made was that independence is a state of mind, but as we cannot measure this, the proxy to this is independence in appearance. Thus, auditors must not only remain objective and impartial but must be seen to be so. In the US, there are already stringent rules concerning an auditor's independence. But they are still not sufficiently effective as they are too rule-based.

In order for auditors to remain completely independent, it was suggested that perhaps, at least in the case of listed companies in Singapore, the Singapore Exchange (SGX) could request all listed companies to contribute towards an 'auditing fund' the proceeds from which SGX could then use to pay auditors of those listed companies. It was cautioned, however, that SGX may not be in a position to assess the level of complexity of a particular company's audit and therefore of being able to set the audit fee appropriately. It was argued that the present regime of having the audit committee, comprising of independent directors, setting the audit fee suffices.

Apart from these safeguards to independence, is there a 'rule-of-thumb' ratio between audit and non-audit fees from the same client to the same audit firm, beyond which an auditor's independence may be compromised?

Past research findings are inconclusive in this regard. A recent US survey showed that the increase in the provision of tax services equates to increased audit quality, simply because information arising from one area of professional work shed more light into another area of work for the same client. Such information gathering opportunities from other non-audit services can help an auditor manage the audit risk of a particular client.

As a general rule, panellists felt that external auditors should not provide internal audit services to the same client for fear of heightening the self-review risk. In order to mitigate this, audit firms use a different audit team for its financial and systems audits on the same client.

It was proposed that a 1:1 ratio may well be the industry-wide acceptable ratio for now.

DOES THE AUDIT ENGAGEMENT PAY FOR ITSELF?

While companies do get value from an audit, this is not properly reflected in the fees paid to auditors. Companies must realize that the value derived from an audit is not just the audit opinion per se. Companies that are willing to fairly remunerate their auditors do receive good practical business advice in return.

It was observed by panellists that auditors in the US are generally paid at higher levels than is the case in Singapore. While this may be so, it may be because auditors in US operate in a highly litigious environment, and therefore have higher insurance premiums to contend with.

Bigger audit firms in Singapore are generally well paid but not so for the other smaller audit firms.

While research has shown that audit quality improves when exposure to legal liability increases, there is general consensus that this liability needs to be proportionate to, and commensurate with, the audit fees earned. Failure to do so may deter talent to enter the audit profession. Furthermore, unlimited liability could drive another Big Four accounting firm out of the market, thereby damaging choice.

Another school of thought is that with an unlimited liability exposure, auditors may end up performing additional audit tests that may not add value to audit, thereby reducing the value proposition. Perhaps a 'defence fund' can be set up for audit firms to address this matter?

The auditors presently report to the shareholders. Should auditors' reporting obligations be extended to other stakeholders as well?

According to the law of tort in Singapore, the legal liability of auditors is to the company and not to the shareholders. Shareholders thus do not have a direct recourse against the auditors of the company. They will first have to seek recourse from the directors of the company, and the directors may or may not then seek further recourse from their auditors.

The present line and scope of reporting is generally deemed sufficient for now.

DO AUDITORS HAVE ENOUGH SPACE TO EXERCISE PROFESSIONAL JUDGMENT IN THE CURRENT REGULATORY FRAMEWORK?

While current financial reporting standards are principles-based, further refinement of these principles will eventually lead to a more prescriptive and compliance-based set of reporting standards. As a result, the space to exercise professional judgment is being slowly eroded. To some extent, this removes the uncertainty of interpretations of auditing standards and perhaps will also reduce the unlimited liability exposure of the auditors since more prescriptive reporting standards are being followed.

However, it is worth noting that while a compliance-based regulatory framework seeks to remove ambiguous professional judgment, the mechanistic process of 'form over substance' was not able to prevent the recent failures of major financial institutions. So there is a need to draw the line on the extent of further refinements of the current regulatory framework.

With regards to the comment on the failure of financial institutions in recent months, is there any evidence to show that audit deters bribery, money laundering, corruption and such like?

A fraud investigation would need a different scope of engagement as compared to a financial year-end audit. Nevertheless, some commentators do see the financial year-end audit as providing some form of deterrence to such activities. In the event that a fraud is detected, and if the burden of responsibility of reporting to the authorities is required of the auditors, then this would serve as a better deterrent of fraud. In the US, for example, auditing standards require the auditors to actively consider if there has been any evidence of fraud.

It is certainly imperative for public listed companies to be audited as this provides assurance to passive shareholders that the accounts are true and fair. For all other privately-held companies, the shareholders are typically very actively involved in the operations of the company. Thus, an audit would be of less relevance unless it is requested by external parties, for example, when the company is applying for a banking facilities, or when due diligence may be required as part of a merger or acquisition. A company that has subjected itself to external audit provides a positive 'signal' and level of comfort to their stakeholders.

Setting different audit exemption thresholds very much depends on the commercial dynamics of individual countries. It was observed that in some countries, there is no demand for an audit, unless it is required by statute. Thus, a concern raised is that if the audit exemption thresholds are set at too high a level, this may lead to the closure of smaller audit firms, finally leading to reduced choices for companies who wish to be audited.

It was also suggested that though it is paid for privately, an audit is a 'public good'. Thus this raises the question: Do other stakeholders in non-listed companies have the right for an audit to be done? Or, in place of a regular financial audit, would the market accept a more limited form of assurance?

IFAC is still canvassing opinion on this proposal of a variety of limited forms of assurance but it is very difficult to narrow this down to several template formats that can accommodate the global business community. What the business community demands depends on many factors such as market size, business culture, intention and such like.

A limited form of assurance may well cost less, but the market is still unclear as to whether this is useful. Perhaps, it is not a case of needing more variations to the level of assurance already in existence, but rather, how can the auditors better communicate with the users of accounts on these differing levels of assurance and what they mean?

THE PARTICIPANTS

ACCA would like to thank the following individuals for their participation in this event:

Chairman

- Mr Brendan Murtagh, President, ACCA

Regulators

- Mr Devanesan, Bursa Malaysia
- Retail investors
- Mr David Gerald, SIAS
- Commercial sector
- Dr Ng Boon Beng, FD, Oracle Corporation Malaysia
- Accounting body
- En Nik Mohd Hasyudeen Yusoff, VP AFA, Past President, MIA

Academia

- Professor Tan Hun-Tong, NTU Professor of Accounting
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