ACCA

ACCOUNTANCY FUTURES

Value regained: restoring the role of audit in society

A ROUND-TABLE DISCUSSION IN UKRAINE, 27 JANUARY 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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BACKGROUND

The event in Kiev on 27 January 2010 was the third in a series of global round tables, aimed at generating ideas and debate on the role of audit. ACCA has recently published a policy paper *Restating the Value of Audit*[1] setting out its views as a start to that debate.

Other round tables have shown the value of audit to many stakeholders such as banks and ratings agencies, which means audited companies are in a better position to access finance and to have a good credit rating. The importance of qualified auditors, with their qualities of professional scepticism and independence of thought, is recognised as adding value to businesses. But governments often equate the audit with ‘red tape’ and seek to win favour by freeing smaller businesses from a mandatory audit, which means there is often too little regard paid to the importance of external assurance.

This is not to say the audit should not evolve. At the large end of the market, ACCA has argued that auditors could be responsible for enhancing its value still further by giving an opinion on issues such as the assumptions underlying companies’ business models. The effectiveness of their risk management and corporate governance processes could be assessed. For smaller businesses, more appropriate segmentation of services could be provided, with new forms of assurance. There could be fewer checklists and more targeted focus on areas of agreed concern to the business.

Some of these points were discussed at Kiev but there were also very Ukraine-specific issues which we have focused more on, in forming our recommendations.

1. http://www.accaglobal.com/pubs/general/activities/library/other_issues/other_pubs/2010/pol-pp-rva2.pdf

CONCLUSIONS AND RECOMMENDATIONS

- Full support must be given by all market participants to Ukrainian government in full implementation of International Financial Reporting Standards (IFRS) rather than trying to develop own accounting standards. IFRS will be crucial in gaining the confidence of investors in Ukrainian economy as it continues to develop and recover after the financial crisis.

- Transparency must be increased. Audit reports should be publicly available along with company accounts. For the future, consideration could be given to more regular reporting by companies on the internet, though this would be a global rather than Ukrainian development.

- The rising technical and compliance demands being placed on audit firms by ISAs are increasing the costs of carrying out the audit. Companies and regulators have to accept that a thorough, professional audit will be more expensive to undertake. We believe that the benefits of the audit, in terms of increasing confidence in a company’s accounting on the part of its shareholders, trading partners and regulators should make this a price worth paying. But it is up to auditors to demonstrate that value.

- The state regulators must work closely with the Auditors Chamber to continue monitoring quality of work by auditors. The number of audit firms has reduced sharply since this process started and firms which are unable to produce quality audits should be kept out of the audit market. A ‘blacklist’ register could be formed for unprofessional or unethical behaviour.

- As an interim measure, it might be recommended that shareholders rather than management should appoint auditors, if it is felt that this would enhance independence of auditors and prevent the problem of ‘he who pays the piper calls the tune’. Shareholders must be confident that the auditors are there to represent their interests if they are to value the audit and be prepared to pay more for it.

- It is vital that the regulators and auditors work together but do not confuse their roles. The auditor is there to uphold investors’ interests, and the regulators are there to set the right framework for this, not to ask the auditor to produce reports for the regulator’s own purposes.

IFRS

The importance both to Ukraine and the wider world, of the advent of IFRS was universally accepted by the speakers. It was seen as crucial in creating the transparency which would allow companies to access finance. And this was where the auditors had an important role in verifying this financial information.

Volodymyr Vakht, from Deloitte called IFRS 'the driving force, the incentive for development. The key driver is the world's capital market governed by key regulators, who set the requirements to financial information, and auditors who verify this financial information.' Mr Vakht argued that Ukraine's financial reporting standards were adopted years ago, and while they were close enough to international standards at the time, the advent of IFRS around the world meant the situation had changed. 'My opinion is that Ukraine should certainly adopt IFRS as the basis of financial reporting for financial information users. There is no necessity to introduce any separate standards. We on our side, as auditors are ready to make every effort to assist regulators'.

He added: 'The role of audit is extremely important for the further development and recovery of Ukraine's economy after the financial crisis. Our businesses need operating and investment capital. It is quite difficult to obtain it within Ukraine and it is quite expensive. It is possible to obtain it in sufficient size outside Ukraine from international deals. We can reach it through business transparency and accuracy of financial information provided to investors, partners and creditors. The authenticity of this information is the role of the auditors.'

Gerry Parfitt of KPMG warned that attempts to get US conversion to IFRS posed problems because 'they are fundamentally different. US GAAP are rigid rules-based with many rules you have to follow, whereas IFRS started life as judgemental basis of accounting. By pushing the two together, I fear that we are actually going in direction of too rigid, too documented, a form of reporting.'

Mr Parfitt's theme was taken up by Lyudmyla Pakhucha, FCCA, director of audit, PricewaterhouseCoopers who warned against 'Americanization of IFRS', saying: 'Tough rules are easier circumvented than common sense. If reporting is based on prevalence of substance over form and on common sense the auditor is responsible for confirmation of authenticity of reporting. If reporting is based on tough rules, for example, filling out some forms, it is possible to comply with the rules formally but to distort the information'.

Volodymyr Bogatyr, Deputy Minister of Justice said that 'implementation of IFRS is a priority for the Ministry of Justice. The Ministry produces annual recommendations on bringing legislation of Ukraine in accordance with EU legislation on accounting. We also carry out monitoring of implementation of Ukraine legislation developed in accordance with EU law. Financial reporting issues were reflected in Ukraine-EU Association agreement, which puts obligations on Ukraine to bring its legislation in accordance with international standards. Together with Ministry of Finance we will explore the possibility of translating IFRS for SMEs into Ukrainian, which would increase transparency of reporting of Ukrainian SMEs and improve investment attractiveness for foreign investors.'

ACCA is strongly supportive of the full implementation of IFRS, whilst acknowledging the reasonable concerns raised by Mr Parfitt. We have repeatedly warned of the dangers of countries or regions (including the EU) trying to 'carve out' sections from the IFRS standards which they do not like, before translating them into national law. The whole point of trying to secure one set of global standards, which will allow true cross-border comparability and ease the flow of capital is threatened by such actions.

It is true that fair value has been the source of controversy in many countries. But we believe that the accounting issues raised by Lehman's use of 'repo' financing, which were allowed under US GAAP, but which would almost certainly not have been under IFRS, which demands that the substance of a transaction is more important than the form, have showed the value of principles-based accounting.

ECONOMICS AND VALUE OF AUDIT

Mr Vakht raised a very important point in terms of the viability of the audit profession.

'One of the most serious risks for the auditor is effective downfall in demand. It reduces fee rates. What are the results? The auditor does not earn enough money to invest in work quality improvement procedures, or to invest in employee development. The good news is that the cadre of high qualified professionals was preserved in the downturn.'

If better financial reporting, in the form of IFRS, is accepted as being important to Ukraine's economic development, then the importance of verifying of those figures via the audit should equally follow. But to justify higher fees, it can be fairly argued that auditors need to demonstrate their value to company shareholders. Have they done so?

Gerry Parfitt conceded that the profession had not done enough in reducing corruption and ensuring transparency. He said that auditors and accountants should have done more to stop the world investment banking crisis where assets were parcelled up and sold onto unwitting investors.

Other speakers also raised concerns about quality of audits.

Viktor Suslov, Head of State Commission on Regulation of Financial Services Markets of Ukraine, revealed: 'There were 1300 certified auditors (of non-banking financial services firms) as of 1 January 2009. Now there are 958, and a quarter of auditors have left the market. The reason is simple – we started controlling the assurance of obviously false reports by auditors, and coordinated closely with Auditors' Chamber of Ukraine'. He added that out of 40 insurance companies that were recently excluded from the register due to insolvency, all of them had positive audit reports.

ACCA fully supports action to remove auditors who are not capable of providing a high-quality service from the audit market. We are encouraged, not discouraged, by the Chamber of Auditors and the regulator working together to clamp down on poor audit work, and agree that a register or blacklist of poor auditors, as suggested by Angela Prigozhina, Senior specialist of financial sector, World Bank in Ukraine, is a good idea.

But she also argued that it would be impossible for Ukraine to climb out of the crisis, without strengthening its transparency and its competitiveness and that 'Quality of accounting and audit are the key elements of transparency and competitiveness.'

Ms Prigozhina went on: 'There are countries which do not have resources – neither oil, nor land, nor grain. But these countries are competitive, because they play by the rules of the game. The first step on the way to improving competitiveness – is to become open and transparent. It is naïve to assume that the market in Ukraine will increase the quality of audit and financial reporting – as market itself conceals information, in order to participate in unfair redistribution of private resources in times of crisis'.

None of the speakers underestimated the importance of auditing and financial reporting. Their only criticisms were on how it was being carried out. ACCA agrees that it is crucial for the audit profession to commit itself to quality, ethical auditing. Only by doing this and proving that it adds value will it convince shareholders to pay more for its services and in turn be able to re-invest in quality training and service improvements.

Mr Dmytro Oleksienko, representative of the Ukrainian Federation of Professional Accountants and Auditors, said that one of the problems with the audit profession was the low entry barriers to the market. He referred to the World Banks' ROSC study which suggested audit should be separated from other advisory services with high-level requirements for providers of mandatory audit. ACCA would support action to restrict audits to qualified auditors for suitably qualified and trained auditors.

INDEPENDENCE OF AUDIT

Another criticism of auditors that came up at the event concerned their alleged lack of independence from company boards.

Mr Suslov said: ‘The one who pays is the one who calls the tune. When shareholders rather than their agents (the board of directors) commission the audit, then it will be more reliable. It is not always the case when management is commissioning the audit – as management wants to look better before the shareholders, and selects an auditor accordingly.’

He added that ‘maybe we should think about a change of fee payment procedure to avoid economic incentives for confirmation (by auditors) of non-authentic reporting’.

It should be pointed out that the issue of auditors being, in reality, appointed by boards rather than shareholders is a common criticism in many countries. Commentators have argued that the role of auditors in reporting to company shareholders is compromised by the fact that their payment comes from the boards, on whose goodwill they depend for re-appointment. They feel, as suggested by Mr Suslov, that it would be more appropriate for regulators or governments to levy or disburse the audit fee.

ACCA’s view is that management have been designated the role of day to day running of the company by shareholders and appointing auditors is one of those responsibilities. It seems to us difficult to argue that an external body, with no knowledge of the relationship between a company and an audit firm, should make the decision for it.

Nonetheless, if in the particular situation of Ukraine, if this would help restore confidence (even if only in perception) in the independence of auditors then it might be a move worth considering in the short-term. We would hope that in the long-term auditors would have demonstrated their value to shareholders and such a move could be repealed.

If regulators were to be responsible for disbursing the fee to auditors, it would be even more crucial that the distinct roles of auditor and regulator were understood.

Mikhail Krapivko, Vice president of the Union of Auditors of Ukraine, said that regulators had blurred the roles: ‘ The owners of the company need a report prepared not according to regulator’s requirements, but according to requirements of auditing standards. The regulator wants the auditor, instead of appraising the quality of financial information, to copy the figures, the size of authorised capital and value of assets. More attention is paid to that than to quality of opinions. It is a serious problem.’

It is essential that all market participants understand that the auditor is there to uphold investors’ interests, and the regulator is there to set the right framework for this, not to ask the auditor to produce reports for the regulator’s own purposes. Angela Prigozhina urged the two sides to work together closely to improve banks and other companies’ reporting.

‘The auditor should not perform the role of the regulator but they should combine their efforts. The regulator should remain the regulator and control the conformity to its requirements by banking and non-banking institutions and the auditor should issue additional statements – either assurance or conformity or point to shortcomings.’

Ivan Nesterenko, Head of the Auditors’ Chamber, argued that the role of the auditor in Ukraine had been unnecessarily restricted by having to meet the requirements set by regulators and that they needed to be ‘set free’.

‘I understood and I understand today that it is true that the auditor should express his opinion only on the annual financial reporting. I think that this restriction within financial reporting hinders the audit opinion users. Probably, the customer accepts it. But I will tell you that it is abnormal and leads to the situation when investors or other shareholders or users of financial information do not correctly estimate value of the assets.’

Under IFRS there would be fair value of assets and while both Mr Nesterenko and Mr Parfitt pointed to the problems caused by inaccurate appraisals, which had caused problems in many countries by exaggerating debt and causing volatility, there is a clear role for the auditor in giving an opinion on the accounting procedures used. Hence IFRS frees the auditor to use his judgement on behalf of the shareholders.

Mr Nesterenko also argued that there should be greater transparency which would help cut too-close ties between auditors and regulators. The Auditors Chamber, he said, supported making audit opinions and conclusions public, along with the company reports.

'Everybody should see them to avoid the situation when the commission gets one version, the issuer gets another version and the shareholder gets the third version', he said. ACCA would endorse that view.

TRANSPARENCY

The issue of transparency was taken up by Mr Parfitt who argued that one important role for the audit profession was to increase business transparency generally rather than just issuing a private report to banks to facilitate raising finance for a company, important though that is. He compared the situation to that in the UK where every business has to file its accounts with Companies House, the official registrar of companies. Anyone interested in a particular company could check those accounts on-line.

He said that in the internet age businesses should be reporting monthly, and the auditing profession should verify those figures.

This theme was followed by Angela Prigozhina, who said with reference to the banking industry, that the market should have access to reports disclosed by financial institutions. Regulators should punish those who delay or fail to publish monthly or quarterly reports on their websites. Too much information is available only to international investors, creditors or regulators but not the wider public, she argued.

Although monthly/quarterly reporting could increase short-termist investor pressures on listed companies, ACCA is supportive of measures to increase transparency. We would favour audit reports being expanded to take in comments currently in the management letter. There is no reason why investors and other stakeholders should not be party to the considerable work that goes into a good audit, rather than just seeing the final opinion.

In recent UK round-table events this has been referred to as the audit 'blackbox'. It is by expanding the scope of the audit and revealing the depth of work that goes into verifying the company's financial statements that the profession might start to restore confidence in the role of audit, which the Kiev event showed is much-needed.

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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- Mykhailo Krapivko, Vice President, Union of Auditors of Ukraine
- Ivan Nesterenko, Head of Auditors' Chamber of Ukraine
- Dmytro Oleksienko, Member of the Board of the Ukrainian Federation of Professional Accountants and Auditors (UFPAA), Head of the Audit Committee
- Lyudmyla Pakhucha, FCCA, Director, Assurance Services, PricewaterhouseCoopers
- Gerry Parfitt, Audit Partner, KPMG in Ukraine
- Angela Prigozhina, Senior specialist of financial sector, World Bank in Ukraine
- Viktor Suslov, Head of State Commission on Regulation of Financial Services Markets of Ukraine
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