

ACCOUNTANCY FUTURES

# Value regained: restoring the role of audit in society

ROUND-TABLE DISCUSSIONS IN MANCHESTER AND LONDON, 18 AND 22 MARCH 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.

[www/accaglobal.com/af](http://www/accaglobal.com/af)

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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 events in Manchester and London on 18 and 22 March were the first in a set of UK debates on the future role of audit, which in turn form part of a wider international series of round-table discussions, aimed at generating ideas and debate on the role of audit and devising recommendations to enhance the value of audit for all stakeholders. ACCA has recently published a policy paper<sup>1</sup> setting out its views to kick-start that debate.

ACCA believes that qualified auditors, whose training engenders qualities of professional scepticism and independence of thought, can add genuine value to businesses, and we are pleased that participants in the current series of round tables have attested to that value. These include 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. While governments often equate the audit with 'red tape' and seek to win favour by freeing smaller businesses from a mandatory audit, there is often too little regard paid to the importance of independent assurance.

But, as set out in our paper, and endorsed by the participants at the meetings, ACCA recognises that the role of the auditor must develop further. At the large end of the market, auditors could be responsible for enhancing the value they add to businesses 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. But it is important that the profession makes its case for the value of audit. The need for this is particularly acute, given the global financial crisis, when questioning of finance professionals is understandably prevalent. The round tables are part of ACCA's contribution to that effort.

## CONCLUSIONS

There is a growing belief that while the audit adds value to business, the current model needs to develop and ultimately include reporting on real-time information. This would be consistent with the requirements of management accounting.

Greater communication is needed in both audit and audit committee reports. While care would be needed in arrangements for opening up audit reports to wider stakeholder audiences, there is frustration with the binary nature of current reports, given the extent of work that goes into them.

The litigation issue facing auditors must be addressed as this is felt to have a serious detrimental effect on the innovation and openness which firms are willing to adopt. While some shareholders may be reluctant to lose this sanction, ultimately it is in companies' best interests for the value of audit to be enhanced.

Assuming the liability problem can be overcome, the wider role played by firms in the auditing of clients in the public sector is seen as a model for the private sector. This includes risk assessments and governance reviews.

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1. [http://www.accaglobal.com/pubs/general/activities/library/other\\_issues/other\\_pubs/2010/pol-pp-rva2.pdf](http://www.accaglobal.com/pubs/general/activities/library/other_issues/other_pubs/2010/pol-pp-rva2.pdf)

## AUDIT EVOLUTION

Participants at the London and Manchester events supported the value of audit but wanted it to evolve. Both highlighted the need to report on current information, which was considered a natural evolution for reporting. They also felt that financial reporting and audit reports had to be considered together and that development of both was required, along with the role of the audit committee.

It was suggested that the mechanisms for stakeholders to obtain other information from companies needed enhancement. It was agreed that the roles needed to be further developed, but one participant cautioned against any loss of the current openness between the audit committee and auditor, which he likened to the relationship to that of parent and teacher. The current school report is an example of valuable open information as it acts as a precursor to a private discussion between parent and teacher on the particular needs and development of that child. Just as it would not be appropriate to make this detailed school report public to the whole parent group, so a number of checks would have to be placed on any opening up of the auditor's report to wider audiences.

Banks and credit ratings agencies made clear that they placed a lot of reliance on the audit report when making decisions on lending and ratings they were giving companies. At a time of general concern about a lack of lending to businesses in the UK and elsewhere, the importance of audit in facilitating access to finance should not be underestimated.

It was of course only one source of important information. Others include management accounts, which were seen as giving current information – this point has also been raised in previous events in the ACCA global round-table series. Specific reports on different areas of the business and the more traditional 'health check' were also seen as important.

The issue here was that reporting by entities and their independent auditor needs to move with the times. It was also pointed out that the UK is seen as an example by many countries in the field of audit committees, auditing and transparent reporting. So it is incumbent on the UK to address these issues.

## COMMUNICATION

One of the participants used the amusing literary analogy contained in Douglas Adams' book, the Hitchhiker's Guide to the Galaxy, in which the ultimate answer to Life the Universe and Everything was worked out as 42. Audit reports have a similar flaw of giving the answer but without letting the reader see the workings behind the conclusion. Another called it the 'blackbox' of audit which needed to shed light on the answers.

This is a real issue for companies and for the audit profession to work on if the value of audit is to be appreciated. How much of the considerable work which goes on behind the scenes into an audit opinion should be published? Directors, audit committees and auditors must consider the risk areas, key business areas and processes to make sure they work within the boundaries set by them. The extensive amount of effort that goes into this is discussed by the auditors, audit committee and directors but is not reflected in any of the reports produced by the Company or the report by the auditor. The binary nature of audit report is no longer sufficient to meet the needs of investors, and given that they are paying for it, this is not a sustainable position.

One participant said their company had been 'really pushed' by their auditors in terms of being a going concern. Such strong challenging questioning of management should give comfort to lenders, so why was such work not being brought to the attention of investors and other stakeholders? Communication of the audit approach was an ongoing theme.

Audit committee reports were seen as particularly in need of revision – with several participants believing that such reports tended to suffer from 'boilerplate' comments, rather than meaningful communication.

An auditor posed the question of what level of detail should be reached in audit before costs began to exceed benefits. Reports need to be manageable and accessible and not over-long and full of caveats.

Others mentioned meeting the need for timeliness - to match the requirement in areas such as management accounts for up to date information. The call in ACCA's recent paper for the inclusion of more forward-looking information was supported.

## INNOVATION

The fear of litigation among auditors and company directors was raised, with many believing that this was having a serious adverse effect on possible innovation in reporting. Reports too often made few positive comments and the current audit report design was highlighted as being negative. Some asked how could anyone tell what was a good audit report and a bad one, although a believer in the free market did feel that this should give room for a non-Big Four firm to challenge the current hegemony by offering something different in their audit approach. Others stated that audit committees and directors reports lacked the detail and insight that users required.

But there was support for the idea raised in the ACCA paper of auditors commenting on the assumptions underlying the business model of companies. Northern Rock was given as a good example of how that would have been useful, as their model was ultimately unsustainable. Comment should be made, it was suggested, if the model changed significantly or was very different from a company's peer group.

It was noted this could be difficult but would be useful information.

This point has particular topicality as the Treasury Select Committee, in its inquiry into the banking crisis, published two reports containing criticisms of the auditing profession, one of which focused on Northern Rock and the other which referred to it. The Committee's report said this episode and other banking failures 'caused us to question exactly how useful audit currently is' and whether auditors were looking at the right things. The London panel effectively gave its backing to the sort of overhaul the Committee had been calling for.

Such developments would inevitably be challenging but there was clear support for change and an end to the current binary audit report based purely on historic financial statements.

## SMALL AUDIT

In Manchester, it was agreed that audit gives confidence and the reduction in the number of companies being audited in recent years has had an adverse effect on perceived quality and reliability of reports. This situation was exacerbated by abbreviated accounts being filed for smaller entities.

One participant pointed out that where there were no shareholders an audit was probably not essential. In some cases, such as with sustainability investment funds, more specialist forms of communication may be more appropriate to target key clients and stakeholders, although there may still be a role for auditors to play.

Banks, while valuing audit, would also need their own due diligence to give them comfort that security is in place for loans to be repaid. But while finance providers can call for more expensive reports to be undertaken, it was suggested that this was an expensive option only open to a select few and so audit should fill the gaps on behalf of other stakeholders. Looking at future projections and giving an opinion on these figures was seen as important. This supported the call in London for forward-looking information to play a larger part in the audit report.

## PUBLIC SECTOR

The public sector played a greater part of the Manchester discussion. The wider role played by private sector auditors when auditing public sector clients, as outlined in ACCA's paper, was noted.

Apart from financial statements, 50% of the work involved was typically a Value for Money assessment. One council, for example, required risk assessments over its strategic objectives. The risks are broken down and then auditors assess the risk frameworks and the work done in this area. This involved internal and external auditors bringing together different professions to review and report on activities, risks and achievements.

Some of the public sector reports were highlighted as successful as they provided an assessment of the effectiveness of the service, which could be communicated to stakeholders. Public sector auditors have greater power than in the private sector and a framework involving themes such as value for money, Governance, Managing Resources, and Accountability framework, which makes it easier for the auditors' value to be demonstrated.

This can be shown by the fact that local authorities are sometimes unhappy about the wide scope of audit and its comments on their performances and failures in some areas. It is unquestionably audit as a force for good in bringing about public service improvement in the public interest. And with the Audit Commission setting clear rules of engagement there is no chance of the auditors designing the rules to suit themselves.

The current work undertaken by internal and independent external auditors relies crucially upon the openness and confidentiality of discussions. Auditors and the audit committee work together to define the areas of risk and share findings. The independent external auditor assesses risk and tailors the work they undertake to ensure they have appropriate evidence to meet their audit objective.

## THIRD SECTOR

The role of audit in the co-operative and fair trade sectors were also addressed and participants highlighted areas where reports and internal governance supported the key ethical aims of a business. Reporting on the company, its controls and aims on fair trade and the ethical behaviour and the rules the organisation set itself was seen as very important. This was particularly so in the case of joint ventures in developing economies, where the internal audit function had a responsibility in checking whether that children were not employed illegally and that materials were ethically sourced.

The external auditors could assess the financial aspect of these joint ventures though one participant questioned why, given the risk of reputational damage to the organisation if mistakes were made on the ethical sourcing, auditors should be restricted to verifying only the figures. Once again this is an example of auditors not being free to contribute the maximum value of their professional skills.

As with London, the Manchester participants believed that more up-to-date information was needed with monthly figures being available for scrutiny, and possibly quarterly figures being audited, although it was conceded that the people who needed this information would have the ability to access it anyway.

Delegates said that the true value of audit was that it was an independent non-political assessment of process and figures. It takes place against an agreed framework and standards and, if it was not there, what would replace it? The audit provides reassurance, although one participant posed the question of whether auditors were able to instigate change, other than simply report what has taken place.

The issue of liability was also seen as important but reputation equally so for both auditor and auditee which made improved reporting a key goal. Once again the role of the audit committee was seen as crucial.

The issues of limiting liability for auditors, increasing communication between auditors and audit committees and quality of disclosure needed by investors will be taken forward by ACCA in our ongoing debates.

### THE LONDON PARTICIPANTS:

- Mick Champion, Barclays
- Frank Curtiss, Railpen Investments
- Stephanie Fitzpatrick Corkin, Fitzpatricks
- Tim Goodman, Hermes Equity Ownership Services
- Jonathan Hayward, Independent Audit
- Andrew Hobbs, Ernst & Young
- Andi Lonnen, PHP
- Giles Mullins, Grant Thornton
- Robert Stenhouse, Deloitte
- Martin Williams, Graydon Credit Agency
- Glenn Collins, Tracey Johnson, Steve Priddy, Ian Welch, ACCA

### THE MANCHESTER PARTICIPANTS:

- Brian Devlin, RBS and Natwest
- Rebecca Hamilton, The Co-operative society
- Mark SurrIDGE, Grant Thornton
- Steven Tolley, Jones and Palmer
- Anita Williams, Northwest Regional Development Agency
- Glenn Collins, Susan Greaves, Steve Priddy, ACCA

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