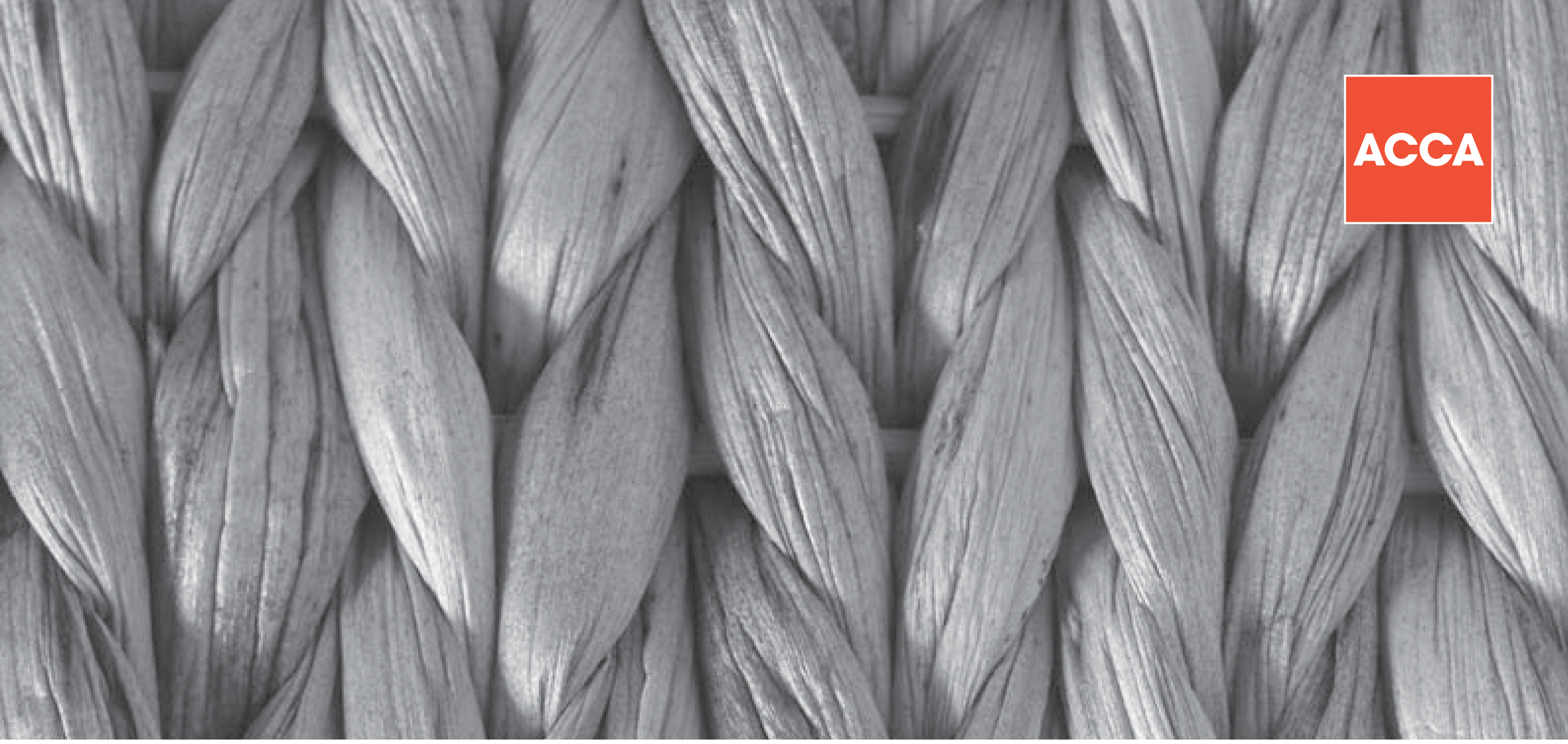

ACCOUNTANCY FUTURES

Restating the value of audit

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.

We support our 131,500 members and 362,000 students throughout their careers, providing services through a network of 80 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities. Our focus is on professional values, ethics, and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

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The role of audit is currently under heightened scrutiny. The unprecedented global financial upheaval of the past two years has seen commentators questioning the value of audit at the large public company level.

In a separate agenda, some jurisdictions have sought to minimise audit and other reporting requirements for large numbers of small businesses via the inexorable raising of the audit exemption threshold. In so doing they have equated the submission of the company to statutory audit to 'red tape', portraying the audit as a burden on small businesses from which those businesses need to be freed.

ACCA believes that, against this backdrop, it is vital for the accountancy profession to re-examine the role of audit and to question whether a sufficiently strong case is being put forward for the benefits that audit can provide to businesses, the economy and society. There is currently little published research that seeks to demonstrate the value of audit in promoting business confidence. ACCA believes that this value needs to be constantly tested against the demands and needs of users and beneficiaries of audit and assurance.

This paper is an assertion of ACCA's belief in the importance of audit and, in particular, in the skills which auditors bring to businesses, and which underpin economic stability. It is part of a global programme of activity we are undertaking, including a series of roundtable discussions and research projects, which will contribute to the ongoing debate on the future of audit.

In the preparation of this paper, we have consulted senior ACCA members and other experts around the world, and are grateful to them for their input. The contents of this paper represent ACCA's own opinions and conclusions and so do not necessarily reflect the views or policies of either the individuals quoted or the organisations for which they work.

1. Summary

- ACCA believes audit has a key role to play as a source of public confidence in the financial reporting supply chain. We do not believe the audit model is 'broken' but propose that the profession should develop approaches to larger-entity audits that pay more heed to the needs of a wider circle of stakeholders than just current and future investors, and hence meet the demands of the market. This will be achieved by extending the scope of the audit from giving an opinion on financial statements to engaging with clients on issues such as risk management, the effectiveness of corporate governance, and testing the assumptions underlying an organisation's business model and its likely sustainability. It is true that sophisticated and complex business models in the largest global companies create challenges for auditors, and there is a consequential liability issue which must be addressed, but firms should see extension of the audit as an opportunity to enhance its value , rather than as a threat.

- ACCA believes that audit skills are intrinsic to the training of a professional accountant, providing insight and experience of business models and engendering the values of professional scepticism and independence of thought that enable both audit practitioners and other accountants to advise businesses well. ACCA has strong reservations about any developments whereby auditing might become either a specialist discipline within accountancy or a quasi-regulatory function. In particular, we feel that the independence and ethical approach that lies at the heart of auditors' professional conduct help to promote confidence within the wider public domain. The audit can provide the catalyst for intervention by markets or government where it is perceived that there are clear risks in a sector, and provide evidence of issues relevant to whether a firm remains a going concern.

- Assurance is essential to all businesses to instil and maintain confidence and trust among their many stakeholders. Although appropriate forms of reporting must be used for entities of different sizes, the value of the skills of auditors must nonetheless be promoted and defended against perceptions that the audit represents unnecessary 'red tape'. At the smaller end of the market, a continued drive should be made to establish appropriate segmentation of services for the benefit of small businesses. New forms of assurance will continue to emerge, some driven by regulation and others by voluntary means and market demands. Nonetheless, ACCA maintains that the underlying essentials of assurance, consisting of an independent and quizzical assessment of a business, will continue to add value to SMEs as they emerge from the economic downturn. We also call on the profession to embrace technological developments and reporting languages as a way of delivering the audit efficiently at both the large and smaller ends of the market, and to promote approaches that enable cost-effective delivery.

- The advent of a new series of International Standards of Auditing (ISAs) will be an important step forward in increasing mutual understanding between auditors, companies and investors around the world on the purpose and practical aspects of audit. This means that any increase in audit responsibilities, as proposed in this paper, must be reconciled with the rapidly growing global take-up of ISAs. But as ISAs themselves reflect the current financial reporting regime, it is likely that they too will evolve, given the widespread view that financial reporting does not adequately explain or reflect the business model.

2. The audit of publicly listed companies

2.1 VALUE OF LARGE AUDIT – BACKGROUND

It should be noted that the fundamental value of audits at the public company level has traditionally been rarely contested. A regulator's view of the value of audit was given by Jane Diplock, chairman of the executive Committee of the International Organisation of Securities Commissions (IOSCO), speaking in 2005.

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.

Periodically over the past 30 years, however, the onset of economic crisis has led to revivals of the 'expectations gap' debate. Recessions in the early 1980s and early 1990s, and the dotcom bubble of the first years of the new millennium, together with the events of the last two years have all produced examples of companies that have collapsed after receiving apparently 'clean' audit reports. In consequence, the audit profession has been placed on the defensive at various points, painstakingly seeking to point out that an audit is not a guarantee either against fraud or of future business success.

While in good economic times the issue tends to die away, a downturn such as the current one brings the argument out into the open once more. In May 2009, the UK Treasury Select Committee inquiry into the banking crisis questioned whether the audit function examines the right issues. It stated:

> *The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in 'tunnel vision', where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.*

Fundamental questions of this kind from a high-profile body demand a response from the accountancy profession, which the proposals made in this paper are intended to address.

2.2 AUDIT INDEPENDENCE

The Select Committee also went on to flag up a separate, though similarly long-standing issue: that of the potential threat to auditors' independence arising when non-audit services are offered to the same client. This issue was particularly topical at the time of the collapse of the US energy company Enron, when their auditors, Arthur Andersen, were accused of being more concerned with the sale of lucrative consultancy services than with maintaining a strong independent approach to their auditing of the company.

The UK Treasury Select Committee also stated:

> *We strongly believe that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financing Reporting Council (FRC) consult on this proposal at the earliest opportunity.*

The Committee had reached a similar conclusion in its earlier hearing into the collapse of Northern Rock.

ACCA disagrees with the Committee on the auditor independence point and believes it serves only to confuse their more valid concerns on the central question of the role of audit. The FRC, through its Auditing Practices Board, has subsequently issued a consultation paper on the independence issue which includes some important facts and figures that perhaps challenge the Committee's assertion. Prepared by *Financial Director* magazine, the figures show a dramatic decline, since Enron, of the ratio of non-audit to audit fees in listed company accounts. From a peak of 191% in 2002, the figure steadily reduced to 71% in 2008. So it may be the case that extra regulations and new ethical standards issued by the audit profession since 2002, combined with market forces, have provided an answer to the 'problem'.

ACCA does not believe a complete separation of audit and non-audit services is either possible or desirable. Some services are closely related to audit while the extra insight of the incumbent audit firm brings quality and efficiency benefits that companies would not wish to lose. There is neither visible demand among the investment community for such a split, nor have we seen evidence that the current framework, with its independence safeguards and new ethical standards, is failing in practice. We believe that quality of services offered to businesses could suffer if artificially divided in this way.

The unwelcome blanket ban on sale of non-audit services to clients, were it to happen, would also give comfort to those who have gone further still and called for audit-only firms, as a solution to concerns over independence. Such a hiving-off of audit would, we believe, be an adverse step, putting talented people off joining the profession and doing nothing to address the Select Committee's concerns over the value of audit.

2.3 CURRENT AUDIT APPROACH

A more valid approach, and one where we believe the Select Committee is on firmer ground, is to ask whether the current role of auditors reporting on the company's financial statements is still sufficient to meet stakeholders' needs. Put simply, are auditors looking at the right things?

The issue immediately arises as to whether the corporate reporting system needs an overhaul. As currently constituted, the audit is, to a degree, only as useful as the financial statements on which it reports. While the scope of this paper does not include an examination of financial reporting in detail, many would argue that a move to embrace substantially more forward-looking, qualitative and non-financial data would improve its relevance. The role of audit and the nature of audit methodology would have to change accordingly.

Two leading ACCA members, David Wu, a PricewaterhouseCoopers audit partner in Beijing and Japheth Katto, head of the securities regulator in Uganda, both argue that there is currently too much focus on figures, which are inevitably out of date, and not enough on forward-looking risk information, which is largely exempt from the disclosure process. Mr Katto proposes that the annual report should look more like a prospectus, telling investors what they need to know. Others have also pointed out that given the tremendous increase in computing power over the past 20 years, investors should be able to deduce more from the audited accounts about future trends than they can at present.

Nonetheless, it should also be pointed out that while the financial statements purport to be a historical record of the financial performance of the company, they do – especially when prepared on a going concern basis – incorporate fundamental assumptions about the future as well as spelling out what has happened. This is especially so regarding decisions or estimates about the useful economic life of assets, the outcome of long-term contracts, or the choice of valuation methodologies, all of which are based on assumptions about the company's future.

At the heart of that view is the company's business model. Auditors currently give no published view on that business model, although some respondents consulted by ACCA in the course of compiling this paper pointed out that communications with the boards of listed companies might include comments on important issues in this area. It becomes an even harder task in difficult economic times where the going concern status of the company becomes exceptionally difficult for the board to establish, and for the auditor to pass opinion on. In particular, an emphasis of matter in this area may lead to downgrades in credit rating with adverse consequences on a company's cost of capital.

ACCA believes that auditors should be encouraged to engage more fully with the business model, which should be made accessible to them, allowing them to test its assumptions. To facilitate this, we support the view that the Operating and Financial Review (OFR) should be revisited. Until its sudden withdrawal by the UK government in November 2005, on the grounds of cutting red tape, this had proved a valuable vehicle of broad-based and forward-looking reporting that allowed businesses to set out the risks and sustainability of their business model. If auditors engaged critically with the OFR, the value of audit could be increased substantially.

Steve Maslin, chairman of the Partnership Oversight Board at Grant Thornton in the UK, predicted that there would be a renewed focus on the OFR in 2010, given the increasing level of debate about improved information by preparers on risk management and provision of assurance concerning those disclosures.

At a recent roundtable event held by ACCA in Singapore with leading auditors, regulators, companies and investors, the point was also made that comments from auditors in the management letter should be reflected in the annual report. This, it was believed, would extend the welcome and increasing communication between auditors and non-executive directors on the audit committees to a wider audience of shareholders, and give investors more timely information that they require. It is essential here, of course, that auditors do not then tone down the management letters.

2.4 EXTENSION OF THE AUDITORS' ROLE

ACCA has consulted auditors and interested parties in major markets across the world and many agree that the time has come to consider extending the audit to the examination of, and giving a formal opinion on, the company's approach on areas such as internal controls, risk management, governance and even the business model.

At a roundtable event held by ACCA with auditors, regulators and businesses in Poland in September 2009, there was a clear appetite for well-considered change in the role of audit. One leading Polish business figure said:

> *Auditors should assess companies' business models from the point of view of the inherent risks they entail. The role would be not to evaluate the business model itself, but rather assess the possible results of a given business model.*

A potential problem with this approach is that applying formulaic tests or regulations to evaluations of business models could stifle innovation or new ways of operating within sectors. Budget airlines, for example, broke conventional market theory with a totally new business model in the aviation industry.

Our preference would be that the audit should analyse the assumptions on which the business model is based, together with their sustainability for the future. By doing this, the audit opinion would genuinely add value while not claiming to be a complete guarantee. It is important that the profession introduces only new approaches that generate more benefits to business than the costs of applying them. Not all stakeholder needs and expectations can be met, and a cost/value equation must always be considered.

In the US, one Big Four auditor argued that audits already generally report on weaknesses in the internal controls environment, a practice designed to address the risks identified in the risk management function. And in the Middle East, a senior Big Four auditor recommended that firms should provide a separate report on risk and internal controls. The current audit report is already too long, in his view, and a special report would be something the audit firms would be happy to prepare.

Leo Lee, director, finance and administration at the Securities and Futures Commission in Hong Kong, felt that a view on internal controls should be part of the published audit report. In Africa, Japheth Katto supported the idea of extending the audit in this way, although accepting that a wider approach might require a change in accountancy training or the co-opting onto audits of experts from outside the profession.

Others consulted by ACCA questioned whether auditors were equipped to do this. Some believed that regulators were in a better position than auditors to know about the business models and their potential weaknesses and risks. The UK Financial Services Authority's increasingly intrusive examinations of banks in the light of the financial crisis were given as an example of this approach by one respondent. The Dubai Financial Services Authority also floated the idea of expanding the audit committee's mandate to include risk. And it must always be made clear that even if the auditor's role is expanded to incorporate reporting on, and highlighting weaknesses in risk management, it remains firmly the responsibility of the company to inform shareholders of any issues in this area.

2.5 INTERNATIONAL STANDARDS OF AUDITING

The implications of a fundamental extension of the auditor's role would have to be carefully thought through, particularly the training requirements, but it would be a genuine move towards addressing the current criticisms. A major issue is that such a move might require legislative change, and at the least would have to be reconciled with International Standards of Auditing (ISA), which are being used by an increasing number of countries. ACCA supports the development of the current ISA standards, although we note the concerns expressed at the recent roundtable in Poland that increasing international standardisation must not lead to an emphasis on rules and regulations at the expense of professional judgement, as this is where the value of audit can best be demonstrated. ISAs would, however, have to be adapted to accommodate any major expansion of the audit role.

Of course, the issue of unlimited liability would also have to be addressed but firms should not see such an expansion of scope as a threat. Rather, they should view it as a genuine chance to enhance the value of audit and a way in which the expectations gap can begin to be addressed.

Concerns about the extension of audit scope may be assuaged when it is remembered that when auditing public sector bodies, firms readily agree to carry out work on a wider basis. Rather than giving only an opinion of financial statements, UK firms will also cover aspects of corporate governance and arrangements by the institution to secure 'value for money' (a requirement of the UK Audit Commission) for the taxpayer. The wider remit in the public sector has arisen because most public bodies provide services rather than making profits, which means the financial statements give only limited information about their performance. Nonetheless, for similar fees firms are willing and able to provide assurance on a far wider basis for public sector bodies – to the point where external audit in that sector is viewed as an essential part of the process of accountability for public money and the governance of public services.

It should, however, be pointed out that firms are generally at less risk of litigation in the public sector, and so can price their audits more competitively. Until more companies and their auditors can reach agreement on taking advantage of legislation that allows for fair and proportionate limitation of liability around the audit assignment, this will continue to be a problem.

3. The audit of non-publicly listed bodies

3.1 VALUE OF SMALL AUDIT – BACKGROUND

Just as there is pressure on the audit firms at the listed end of the market to prove that audit adds value to business, so the regulatory and political backdrop at the smaller end is similarly challenging. In recent years, governments in several parts of the world, notably Europe, have repeatedly raised the turnover threshold below which businesses can exempt themselves from statutory audit. At £6.5m turnover, or £3.9m in gross balance sheet total assets, in several member states, this represents a significant swathe of businesses.

Perhaps understandably, the vast majority of eligible businesses choose not to spend money on a voluntary audit. This may partly be a reflection of the problem of over-complexity of financial reporting – which for small businesses is even more of an issue than for large companies. If small entities' reporting regimes are not suitable for that market then the auditing of those financial statements will not add value, and would explain why many perceive no value in small audits, and equate them with 'red tape'.

The raising of the thresholds, together with increasing interest from regulators in audit quality and the nature of services offered by small firms, has led to a serious contraction in the number of registered audit firms in the UK and elsewhere. In the five years 2003–08, the UK's audit capacity reduced by more than 25%. This has inevitably raised fears that audit will become a specialist function, similar to insolvency.

ACCA does not wish to see such a scenario become reality by default. This is not a protectionist stance – the great majority of these firms have re-invented themselves and are providing business advice and services to clients. We believe that such an ongoing reduction in audit capacity would have a detrimental effect on the wider economy and society. Audit is currently at the core of training for many student accountants and it provides unique insight and experience of business models: knowledge that serves accountants and hence their SME clients throughout their careers. If trainee accountants are unable to gain experience of audit outside a relatively small number of large audit firms, this insight will be lost and business as a whole will suffer.

While supportive of efforts to remove needless burdens on business, ACCA firmly believes that audit (and the preparation and filing of proper accounts) does not fall into this category. Full accounts and an independent audit will often bring real economic benefits to SMEs, through the help they offer to businesses, not only by aiding effective financial management, but also by satisfying lenders, investors and suppliers when the firm seeks to raise finance and credit. A measure of accountability in respect of its financial affairs is, we believe, a reasonable and necessary corollary of a business's enjoyment of the benefits and protection of limited liability.

The positive effects an audit can have were shown by a 2007 survey by Marleen Willekins in Belgium, where 1,332 relatively small companies were analysed. She concluded:

> *We find that auditing does make a difference. First, earnings management is lower in audited companies. Second, tax regularisation disclosure is higher in audited companies. Third, we also find that overall financial performance is higher in companies that are audited.*

This was only one survey, and some of the issues were analysed in only a sample of very small firms. Nonetheless, governments and decision makers have ignored such findings, and have preferred, especially in a difficult economic situation, to win favour with business by focusing on reducing 'burdens'. The European Commission is actively campaigning for its proposed directive on the exemption of annual accounts requirements for micro-entities, as part of a pledge to cut 25% of administrative costs from EU legislation by 2012. Policymakers have produced little in the way of evidence to support their approach.

It should, however, be noted that many accountants have doubts about statutory audit for SMEs. Leo Lee in Hong Kong claims it is of 'limited value' at the smaller end of the market and it is more important that the accountant gives businesses good advice on accounts preparation and advice. Ivan Paule, a Horwath audit partner in Bratislava, Slovakia, also argues that an audit is unnecessary until a business has grown to the point where it has external shareholders and a division between owner and management. ACCA agrees that it is these ownership characteristics, rather than arbitrary financial quantitative criteria, that should determine the presence or absence of audit. So how should the profession respond to this challenge?

3.2 SEGMENTED ASSURANCE APPROACH

There is clear evidence that creditors and suppliers are increasingly concerned to establish the going concern status of a company and to obtain independent assurance on the accuracy and completeness of accounts, especially in the areas of cash flow management and cash flow projections. This would appear to indicate that external assurance *is* an important concern and that it can be driven by market demand as well as by statutory force.

Given that the statutory requirement for audit has been removed for most small businesses in several EU member state jurisdictions, ACCA believes that the profession needs to promote strongly the benefits that the skills of auditors bring in enhancing business confidence, which itself provides part of the broader assurance of security and integrity in business that society expects. This has to be done on a value-added service basis, rather than one that relies on force of law.

Qualified accountants, whom surveys have consistently shown are the most trusted advisers to SMEs,[1] can bring great value to smaller entities and the users of the accounts by using audit-type skills. For the audit-exempt sector, if businesses do not choose voluntary audits, then advisers might consider offering some agreed procedures to add value to their business. 'Unbundling' the audit product from its lengthy checklists, where appropriate, could be a key to providing assurance and business confidence in areas of particular concern or risk, according to the needs of the individual company. Procedures could be agreed with audit-exempt businesses that would add value by exploring areas of concern or risk to management. Businesses may value the audit-type skills and approach that qualified accountants can bring, even if they believe the audit process itself is of questionable value to them. Certainly, by quantifying the underlying assumptions of the business model and helping to create sustainable performance, auditors can add value to these businesses.

There is already an established market for 'non-audit' assurance services in the SME sector. Although they have been slow to take off in the UK, a number of such products have been developed or are in development in a number of countries (to take Europe as an example: Denmark, Estonia, France, Germany, Ireland, Italy and Switzerland, according to a recent report by the European Federation of Accountants (FEE)[2]).

ACCA believes this drive to establish a variety of non-audit assurance services that are more suited to SMEs than the traditional full audit will represent a valuable contribution to business confidence. New value propositions that are driven by market demand will be more enduring than those that cling on to regulatory or statutory backing for their existence. There should not be the current audit-style level of 'regulation' or standardisation of these offerings as this risks making such services insufficiently flexible for the needs of different entities. Instead, regulators should seek to share, across borders, best practice in respect of new service offerings.

The profession should, however, be wary of confusing the small business market with 'alternative audit' vehicles that, in reality, constitute limited assurance reviews rather than high assurance audit services. ACCA believes that SME demand for properly segmented and tailored assurance work from qualified accountants will hold up. Any offerings that have the appearance of being more for the benefit of accountants than their clients will, rightly, be rejected by the market.

In respect of the current audit, standards-setters should establish clearer and more practical 'small entity' standards and procedures to open up a new quasi-audit service stream for the smaller end of the market. Continuing from her 2005 statement quoted in section 2 (i) above, IOSCO Commissioner Diplock went on to say that 'an audit is an audit at all levels of activity – regardless of the size and complexity of the entity that is being audited'. ACCA believes this assertion must now be seen as wanting, especially given the sophistication and complexity involved in the audits of large global companies.

Stratification of the type of work that goes into an audit or assurance report is both inevitable and appropriate, given the different needs of organisations according to their complexity, sector and size. Public policy should make a clearer distinction between small and large entities. Successive failures of big business mean that the focus of politicians and regulators is inevitably on high-profile collapses, and the role of auditors in that context. This cycle adds ever-greater complexity to the audit process, rendering the single-form audit product inappropriate for smaller entities and increasingly difficult for small accountancy firms to carry out for such clients.

1. *Lifting the Barriers to Growth in UK Small Businesses*, Federation of Small Businesses, 2006.

2. *Survey on the Provision of Alternative Assurance and Related Services Across Europe*, FEE, July 2009.

4. Conclusion

ACCA is firm in its belief in the value of audit as a source of confidence in published accounts. Nonetheless, we also strongly believe in the need for evidence-based assessment and global research to demonstrate and provide better understanding of the value of the audit to all stakeholders and society in general. ACCA is committed to playing its full part in this process of identifying ways in which the audit might develop for the future, on the basis of an understanding of needs rather than on a presumption of value. The expectations gap needs to be closed, and the requirements of shareholders, preparers and the wider public must be reflected in the service offered, ensuring that value is maintained.

One answer might be an extension of the current role of audit, at the larger end of the market, with formal inclusion of risk and internal controls, as outlined in this paper. The debate should start now, as the profession seeks to respond to concerns raised during the recent economic conditions.

Consistent promotion of the value of audit skills to stakeholders is essential. For SMEs, this should include unbundling of the key audit product from lengthy checklists and agreeing procedures that are of value to each business. Continued development of appropriate non-audit assurance services must be a priority for the profession.

ACCA will continue to champion the skills of auditors, who bring best practice to business. The audit approach is both a positive contribution to business success and, as an attestation of the reliability of financial information, a crucial tool in promoting confidence and trust in business. Audit may also be capable of fraud detection, although this is not its primary function. But it can be a valuable part of promoting a safer and fairer business world and society, with more equal participation in the economy, by helping to identify cases of, for instance, tax evasion and mistreatment of suppliers. A world without audit would be poorer.

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