

ACCOUNTANCY FUTURES

The Value of Audit: Views from Audit Committee Chairmen

A RESEARCH PROJECT COMMISSIONED BY THE ACCOUNTING AND CORPORATE REGULATORY
AUTHORITY (ACRA)

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CONFIDENTIALITY

This survey was conducted on a confidential basis. Accordingly, we do not provide information on individual survey responses.

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About ACRA

The Accounting and Corporate Regulatory Authority (ACRA) is the national regulator of business entities and public accountants in Singapore. ACRA also plays the role of a facilitator for the development of business entities and the public accountancy profession.

The mission of ACRA is to provide a responsive and trusted regulatory environment for businesses and public accountants. ACRA's role is to achieve synergies between the monitoring of corporate compliance with disclosure requirements and regulation of public accountants performing statutory 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 140,000 members and 404,000 students throughout their careers, providing services through a network of 83 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.

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PURPOSE OF SURVEY

ACCA firmly believes in the value that audit brings to business and the wider economy by instilling trust and confidence in companies' financial statements. We also believe that it engenders wider 'intangible' benefits in terms of imposing discipline on companies, deterring fraud and giving comfort to other stakeholders that businesses are going concerns.

But we also believe that the profession needs to do more to promote that value – particularly at a time of economic uncertainty.

Despite some notable recent studies in this area, there has historically been a very limited body of published research on the value of financial statements' audits to investors and other stakeholders. ACCA is keen to play its part in providing evidence-based assessments which will contribute to the debate on the future of audit.

ACCA has therefore undertaken a series of international research projects that examines the role of audit, current levels of stakeholder satisfaction and the extent to which users of financial statements still rely on the assurance conveyed by audit reports when making decisions. ACCA, in its recent policy paper *Restating the Value of Audit*¹ has considered the distinct auditing issues relating to both larger and smaller businesses. This report is intended as a contribution to published research on the value of audit.

ACRA, as the national regulator of business entities and public accountants, has an interest in issues relating to the quality and value of external audits and in raising the quality of audit. There is no doubt that the value of audit is intimately connected with its quality. If the quality of an audit is compromised its value is correspondingly diminished. It is almost self-evident that a higher quality service would generate more value to a consumer of that service. To ensure high quality, however, sufficient resources must be directed to the audit by the firm.

In the debate over the value of audit, the role of the audit committee has assumed great importance internationally. The UK's business regulator the Financial Reporting Council has published several extensive guidance notes in the last two years: firstly on the formation and role of Audit Committees and then on advice for the Audit Committees on issues such as going concern and the economic downturn. Other countries in Europe are also now introducing mandatory audit committees for listed companies. And a recent study² by Maastricht University on the value of audit was based on the views of Audit Committee members and CFOs in the Netherlands, Germany, France, Belgium and the UK.

Singapore is also up to speed on developments in this area. The high level *Audit Committee Guidance Committee (ACGC)* was established by the Monetary Authority of Singapore (MAS), ACRA and the Singapore Exchange Ltd (SGX) in January 2008. Guidance³ issued by the ACGC explained the significant responsibilities and work involved: 'Audit committees play an important role in the governance and oversight of companies. They are central to establishing good internal controls and, as appropriate, risk management systems as well as delivering quality financial reporting and instituting strong processes for the proper review of interested person transactions. The growing complexities of the business environment impose even greater demands on audit committees.' All the AC Chairmen we had interviewed for this research report recognised the seriousness of the governance responsibilities they undertake.

In 2009, ACRA commissioned the Singapore Management University to carry out *A Survey on the Oversight of External Auditors through the Lenses of Audit Committee Chairmen*⁴. The survey interviewed AC Chairmen on the key factors for consideration when deciding on the appointment, reappointment and change of external auditors.

The objective of this report, a follow-up to the 2009 survey, is to inform the current debate by providing contemporary evidence on the value of the audit, against the backdrop of quality, as perceived by Chairmen of Audit Committees of listed corporations in Singapore (hereafter referred to as AC Chairmen or respondents). For this purpose, 17 interviews were conducted.

This survey is concerned with audit in the listed company market and deals with perspectives of participants in that sector.

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

² <http://www.maastrichtuniversity.nl/web/Main/Sitewide/News1/NewReportFromMARCValueOfAudit.htm>

³ <http://www.acra.gov.sg/Publications/Guidebook+for+Audit+Committees+in+Singapore.htm>

⁴ 'A Survey of the Oversight of External Auditors through the lenses of Audit Committee Chairmen', by See Liang FOO, Yang Hoong PANG, Luck Pia NG, Kwong Sin LEONG, ACRA, 08/2009.

KEY FINDINGS

1. The external audit is regarded as extremely valuable by AC Chairmen, predominantly for the assurance it brings them that the financial statements prepared by management present a 'true and fair' view of the company's financial position and results to its shareholders. They see audit as an essential part in the financial reporting value chain which provides them with comfort that the company's own internal accounting staff, processes and systems are generating reliable information. It therefore assists the AC Chairmen to meet their corporate governance responsibilities and statutory duties under the Singapore Companies Act.
2. Almost all AC Chairmen were of the opinion that the most important criterion for the selection of the auditor was the engagement partner's expertise and knowledge of the company's industry and business; and an informed audit team with international reach.
3. Overall, AC Chairmen indicated that their auditors currently met all their key expectations and had no issues with the quality of audits. Almost all felt that their auditors had a good understanding of the company's business, which allowed them to carry out an effective audit, although one did question whether the full complexities of the business were completely understood.
4. AC Chairmen want auditors to be independent and 'speak their mind'. This is where the real value is. Audit provides an invaluable independent perspective on the numbers generated by management. Challenging questions from auditors and subsequent responses by management give AC Chairmen confidence that the figures are reliable for financial reporting purposes. AC Chairmen say the auditor is well-placed to bring to their attention any current or potential problems.
5. Auditors' knowledge of new accounting standards and drawing the attention of AC Chairmen to the impact these will have on the company's financial statements was seen as very valuable. Given the increasing complexity of Singapore Financial Reporting Standards (FRS), AC Chairmen valued this insight.
6. AC Chairmen are willing to pay reasonable fees for quality audits, especially those which add value to the corporate governance role to be discharged by the AC Chairmen, and keeping them as low as possible was not a principal objective for them.
7. The management letter, in which auditors outline weaknesses in internal controls, was particularly important to AC Chairmen, who might not otherwise be informed of these weaknesses.
8. There are important additional intangible benefits generated by the audit. AC Chairmen find auditors' feedback on areas such as the quality of the management's finance team and the competence and co-operation of staff, particularly those in foreign locations, to be useful. These and other insights would be lost without the external auditors.
9. Liability is a key problem and needs to be addressed. AC Chairmen thought auditors had become risk-averse to offering professional views that would be useful to the company but was not required within the scope of the statutory audit nor specifically requested for. This meant that the full potential value of the audit was not being realised. This reflects similar findings from ACCA research in other international markets.
10. Most AC Chairmen did not expect auditors to advise them on business strategies and preferred auditors to focus on core assurance services. But they did believe audit firms and the accountancy profession at large had the expertise and skill-sets to potentially provide a range of specialised non-audit services, having regard to applicable independence rules.

Auditors of large entities will have to work harder as business becomes more complex and international. Analyzing the assumptions underlying the business model – as called for by ACCA in *Restating the Value of Audit* – will be important in this context. With Singapore setting out an agenda to position itself as a regional centre of excellence in accountancy, such developments in the scope of audit would benefit from being addressed: innovation and developments in the provision of audit services, within the overall context of a quality framework as set out by ACRA could do much to establish a leadership position internationally. The range of specialised non-audit services identified by the AC Chairmen suggests that audit firms will have the skill-sets to develop their role.

TERMS OF REFERENCE

This report presents the results of a research project on the value of audit commissioned by ACRA and conducted by ACCA. It is based on responses provided by AC Chairmen of listed corporations in Singapore. The following five themes were explored in this research:

- *Value of audit* – frank assessments by AC Chairmen of the value of the audit of financial statements in today's complex environment
- *Expectations and engagement* – reviews of the expectations of AC Chairmen on the level and quality of engagement they expect from auditors
- *Quality of audit* – assessments by AC Chairmen of the quality of audits and the competency of the audit team
- *Current audit approach* – critical assessments by AC Chairmen of the changes that could be made to the current audit environment and practices to enhance the value of audits

and

- *Future potential for the profession* – assessments by AC Chairmen of the expertise and skill-sets of the Singapore accounting profession at large and its potential to undertake wider areas of assurance and the provision of specialised non-audit services, having regard to applicable independence rules.

METHODOLOGY

This research survey was conducted through confidential, face-to-face, discussion-type interviews of 17 AC Chairmen of corporations listed on the Singapore Exchange (SGX). These corporations were mainly audited by the 'Big Four' accounting firms.

Private interviews allow qualitative analysis of issues and a far greater understanding and insight into the respondents' rationale than surveys. Being a far more direct and personal form of research than questionnaires, these interviews allowed us to obtain in-depth and unmoderated information from AC Chairmen.

Audit committees are generally charged with oversight of a company's external financial reporting communications. They also play an important role in reviewing the health of the company's internal financial control and risk management systems. When discharging these responsibilities, AC Chairmen and their committees have regard to the work of the external auditor. AC Chairmen are therefore uniquely positioned to assess the value of audits as they are directly involved in the financial reporting value chain and generally possess a high level of financial literacy.

Interviewees were selected across different sized organisations and types of business (eg services, consumer, manufacturing, financial services etc). Statistical techniques were not used.

Each interview lasted for about an hour and questions were fielded by at least two interviewers. Responses from interviewees were then consolidated to highlight themes and issues in this report.

The report uses unattributed direct and paraphrased quotations from respondents selectively, to illustrate various themes and opinions.

TERMINOLOGY

For the purpose of this survey report, the term 'audit' refers to the external audit of a company's financial statements required by statute and 'auditor' refers to the external auditor.

The term 'management letter' refers to the letter prepared by the auditor and addressed to management, outlining internal control weaknesses and other related issues, together with management's responses, based on discussions the auditor had with relevant management personnel during the audit.

ISSUES

IS THERE VALUE IN AN AUDIT?

The most significant value derived from the external audit related to the traditional rationale for the audit ie to provide assurance and comfort. This was confirmed by almost all respondents. There was broad consensus that the value of external audit was in the assurance it provided to AC Chairmen of the reliability of the financial statements prepared by management. This was variously described during the interviews as ‘assurance’, ‘protection’, ‘comfort’ and more imaginatively: ‘ability to sleep at night’. This assurance was considered extremely important to the AC Chairmen.

The respondents were of the view that the statutory audit provided value to the company in the following ways:

- a. The opinion on the statutory financial statements provided comfort to the Audit Committee that the financial statements provided by management are ‘true and fair’ and can be presented to shareholders.

*‘...they assure us that everything we present to the shareholders, the numbers, we can present with confidence’
AC Chairman*

- b. Challenging questions posed by the auditor from an independent perspective and subsequent responses by management gave Audit Committees assurance of the thoroughness and completeness of the company’s financial reporting and internal audit processes.

‘One has to ensure that one is not seduced by management.’ AC Chairman

- c. Issuance of the management letter by the auditor gave Audit Committees valuable feedback about operations on the ground.

‘The auditors are my eyes and ears on the ground...’ AC Chairman

AC Chairmen derived significant value from the auditor’s management letter, which outlines internal control weaknesses and responses from management. One AC Chairman believed that the management letter was in fact of more practical value than the auditor’s report. The management letter, it was felt, brought pertinent issues to the attention of the Audit Committee, which may not have otherwise been dealt with at that level.

- d. AC Chairmen found feedback on the management’s finance team useful; including issues relating to their competence, level of co-operation and assistance; and any understaffing conditions that the auditors have noted.

‘The skill of an auditor is not so much in reading the books but more about reading people.’ AC Chairman

- e. AC Chairmen found input from their auditors, on foreign operations and international practices, useful. Identification of issues relating to subsidiaries in emerging economies or regions was considered particularly useful.

‘...it is not sufficient to just know that the auditor has respective firms in those places. What is [important to me] is that I want to know what is happening in those places.’ AC Chairman

- f. AC Chairmen felt that the value obtained from the external audit complemented the value derived from internal audit.

- g. From a strategic perspective, at least one respondent believed strongly that audits are essential for capital markets to function properly.

Overall, the audit also makes a valuable contribution to the AC Chairmen in the discharge of their corporate governance responsibilities.

WHAT DO AC CHAIRMEN EXPECT FROM THEIR AUDITORS?

According to AC Chairmen, the 'second opinion' provided by auditors on the financial statements provided an invaluable independent perspective on the 'numbers' generated by management. The independence of the auditor was considered paramount.

'What we value most is their independence; we do not want them covered by management.' AC Chairman

AC Chairmen said that in dealing with their auditors they:

- a. expect the engagement partner to be experienced and confident with relevant industry experience. Among those that appointed 'Big Four' audit firms, AC Chairmen felt that the calibre of the engagement partner was usually considered more important than the choice of audit firm
- b. expect the engagement partner to be substantially involved in the audit. Some respondents demanded to know the amount of time that the engagement partner intended to spend on the audit, when reviewing the audit plan. They would express their concern if they considered the amount of time to be insufficient with respect to the scope of work planned
- c. expect the audit firm to have deep expertise in the relevant industry
- d. expect the audit firm to have access to technical resources and consultation within its international network
- e. expect member firms to transfer international technical and industry expertise to the local engagement partner. A number of AC Chairmen noted that expertise was not transferred effectively. One AC Chairman expects that for significant new client engagements in specialised industries, for which the firm has no local expertise, knowledge transfer should be committed by having 'warm bodies', referring to foreign experts, to be located in Singapore and not just merely access to an international technical helpdesk

- f. expect auditors to 'speak their mind' and ask relevant and challenging questions that would bring pertinent issues to light. In this connection, they appreciated fresh questions under changing conditions

'We want a partner that speaks his or her mind if there is something not right or if there is a disagreement. They don't have to be rude or offensive but they should tell us if they don't agree or if he or she sees something which may cause a problem maybe not now but in the near future.' AC Chairman

- g. expect the engagement partner to set the tone for the audit team with regards to the quality of the audit, the level of professional scepticism and engagement with the client

'... [the] emphasis on tone at the top was a key focus in terms of quality.' AC Chairman

- h. expect to deal with the same engagement partner and team during the audit. In other words, the engagement partner, presented during the selection process of the audit firm, should be retained as the audit engagement partner and not replaced with another partner who is not able to demonstrate the same level of technical competence or capability as the earlier selected partner after the firm has been appointed auditor to the company

- i. value auditors that can provide early warning on new and proposed financial reporting standards and provide an analysis of their impact on the company's financial statements

'...we want firms to tell us ahead of time if there is a new accounting standard or potential issue. We don't want surprises.' AC Chairman

- j. expect significant closing journal entries to be reviewed by an experienced senior member of the audit team. This should not be delegated to a junior member who is not experienced to identify irregularities arising from management override
- k. value audit team members who are able to include a practical perspective when checking for compliance with the financial reporting standards by the company
'[The auditors] must not just look at the standard per se but understand the rationale, the intended accounting impact, the result and the consequences. If the intention is here and the results are there, and they do not reconcile, something is wrong!' AC Chairman
- l. prefer the same firm or network firms to audit foreign subsidiaries (as far as is practicable) and the parent company auditor to visit foreign entities and subsidiary company auditors on a regular basis. One respondent also suggested the use of video-conferencing to communicate with foreign auditors
- m. expect auditors to address risks and concerns when dealing with subsidiaries in emerging countries in group audits. Audit work should be designed to increase the likelihood of the identification of material misstatements in the financial statements arising from non-compliance with laws and regulations, particularly in emerging economies
- n. expect auditors to be comfortable and knowledgeable about IT systems and networks
- o. prefer management letters not to be too moderated and 'watered-down'. AC Chairmen want to have a comprehensive and accurate report of operations on the ground and face-to-face discussions on the issues identified in the auditor's letter
- p. expect the audit plan to be discussed with the Audit Committee, the fee to be determined based on the scope of work discussed in the audit plan; and a realistic fee estimate to be given upfront
- q. expect auditors to be consistent in their technical views. It would be helpful if auditors were to explain clearly the reasons for changing or reversing technical decisions or opinions
'Sometimes you get situations where auditors have taken one view and later on changed their position. And that is a big issue for management because it could change the reasons why we would do certain things.'
I don't know if it's an overruling of position being taken in Singapore or by global. I don't know whether it is really a change of mind internally through the technical partner's interference or intervention. And I don't know whether it's because somebody got it wrong in the first place. What I do know, though, is that I'm experiencing this more often these days than before.' AC Chairman
- r. found a discussion session with the auditors, in the absence of executive management, was considered very important and useful
- s. felt that a confrontational approach towards management was not constructive. AC Chairmen believed that scepticism should be expressed in a professional manner.

It was acknowledged that the AC Chairman had an important role to play in setting the tone of the interaction with the auditor. In fact, it was noted that the value of audit was modulated, to some extent, by the nature and quality of interaction between the Audit Committee and the auditor.

WHAT DO AC CHAIRMEN THINK OF THE QUALITY OF AUDITS?

Respondents did not raise any significant concerns about the quality of the audit, which were conducted mainly by the 'Big Four' accounting firms.

Almost all respondents were of the view that auditors generally have a sufficiently good understanding of the company's business to perform the audit.

'I think most auditors understand the business that they are auditing; although they may not necessarily understand some of the complexities.' AC Chairman

Most respondents were of the view that their auditors showed the correct balance between professional scepticism and co-operation. One respondent said that they 'had a healthy alertness' and another said auditors took an 'independent stand' on issues.

The consideration of fees is important to AC Chairmen but it was not the most important consideration. It was essential for AC Chairmen to ensure that a reasonable fee was determined to ensure that audits were carried out in an efficient and effective manner. It was felt that fees should be reasonable to ensure that the audit team is highly motivated to perform the audit to high standards.

WHAT CAN BE DONE TO ENHANCE THE CURRENT APPROACH TO AUDIT?

More than one respondent felt that auditors have become more risk-averse in recent years due to various developments in the legal and regulatory frameworks. As such, it was felt that auditors were not realising and companies were not receiving the full potential value of the audit. One respondent suggested that the auditor's liability be limited to provide auditors more leeway and room to be forthcoming in the provision of unsolicited opinions and professional views during the audit on a variety of matters that would be useful to the company.

'Threat of litigation is an obstacle to the value of audit.' AC Chairman

Some respondents felt that the periodic rotation of audit firms could bring benefits to the company. A fresh perspective on the financial statements, related systems and procedures would be obtained as well as ensuring the independence of the audit. However, they stopped short of specifying any pre-determined tenure, preferring instead for management to exercise judgment on the appropriate timing. A few respondents expressed some concerns that a proper understanding of the business may be hampered if rotations are executed too frequently.

AC Chairmen said that they valued auditors providing more information on impending financial reporting standards and their impact on the company's financial statements. Such a proactive approach is appreciated as financial management of companies may need significant lead time for implementation.

FUTURE, SUPPLEMENTARY AND SPECIALIST AREAS FOR THE ACCOUNTANCY PROFESSION

Certain non-audit services that were closely related to the financial reporting and audit processes were thought to be particularly suitable for the audit firm to be engaged in, having regard to applicable independence rules. They included the following:

- a. Tax compliance work was thought to be the natural preserve of audit firms. Tax advisory work and restructuring advice were also thought as useful extensions to the provision of audit services.
'Provision of tax services is a natural complement to audit services.' AC Chairman
- b. Advice on cash and liquidity management was seen to be another area where the profession could contribute.
- c. General and forensic investigations relating to financial reporting issues and internal controls could be carried out by those in the profession.
- d. Advice on corporate governance structure and processes were welcomed by some respondents.
- e. Many respondents felt that the profession would be appropriately placed to advise management on the effectiveness of their risk management system and/or risk concentrations.

There was also a general opinion that the following services could be provided by audit firms to non-audit clients, taking into account the expertise and skill-sets that the profession is perceived to have:

1. Corporate finance advisory and other services were cited by some respondents. Although investment banks have a good historical record in this area, allowing them to command fees at a premium, AC Chairmen believed that the expertise in the profession currently and the growing successful track records allowed accountants to deliver similar services at more cost-effective market rates.
2. A number of respondents also thought that the profession had the required skill sets to advise management on mergers and acquisitions; and to perform the relevant due diligence reviews.

But AC Chairmen in this study generally did not expect the profession to advise them on their business strategies. There was a general opinion among them that the profession should focus on core assurance services to fully maximise their core competencies, maintain independence and avoid distractions. These core services constituted the 'cake' that AC Chairmen benefited from; non-audit services were considered just 'icing'.

'Being able to audit the company is different from being able to run the business...We challenge them in their area of expertise; not in running the business.' AC Chairman

Nevertheless, at least one respondent was of the view that the company could benefit from the auditor's review of the assumptions used in their business model. The scope of the activity was therefore limited to reviewing verifiable facts and estimates; and did not extend to making a business judgment.

CONCLUSION

The assurance that the financial statements prepared by management were ‘true and fair’ was the most highly valued benefit from the external audit. The responses from this survey therefore clearly confirm that the most significant value that AC Chairmen receive from external audits is a benefit that is generated from the traditional audit model. To this extent policymakers may conclude that the traditional audit model is not broken and continues to fulfil a critical role in the financial reporting value chain and the corporate governance framework. External audits occupy an important niche in the corporate governance eco-system and the removal of the audit would therefore spell disaster to capital markets and consequently to the wider economy and society.

The value derived from the audit is also a function of its quality. This quality can only be achieved when audit firms devote sufficient amount of time and effort to ensuring that the audit is carried out in accordance with the many demanding requirements in the relevant standards.

It is important to note that the audit report is only but one element of the value derived from an audit. For example, a good audit will normally uncover issues and learning points that are useful for a company, including, for example, the improvement of risk management, strengthening of corporate governance and challenging of underlying business assumptions.

AC Chairmen valued industry expertise in their auditors. This not only facilitates communication between management and the audit team but also, more importantly, was critical to ensure that auditors identify relevant risks. Generally, AC Chairmen were satisfied that their auditors had a good knowledge of the client’s business and the level of technical competency required for the size and complexity of the audits. They had no significant concerns about the quality of the audit, conducted mainly by the ‘Big Four’ accounting firms.

Growing risk aversion among audit firms was thought to be a significant impediment to realizing the full potential value of the audit. This has significant policy implications for law makers and regulators. Various jurisdictions have already instituted some form of limitation of the auditor’s liability or are thinking of implementing such measures. So far, there has not been any public debate or consultation specifically on limiting the auditor’s liability in Singapore, for example, in terms of introducing a proportionate liability regime or capping the liability relative to the audit fee . This may need to be addressed as the audit role evolves or possibly expands, as is being debated internationally.

With regards to the evolution of audit firms, most AC Chairmen recognise that these firms, as a group, are repositories of unique skill sets and talent concentrations. Given these resources, they believe that there is potential for the profession to develop products and services that are relevant to non-audit clients in the marketplace.

These include, in particular, services and products relating to Corporate Finance; Enterprise Risk Management services; and Transaction Services, including services relating to due diligence as well as mergers and acquisitions. No doubt, many other services could be provided by the profession, but these were specifically mentioned by respondents in this survey.

This survey covers large corporations only and thus most AC Chairmen generally did not expect the profession to advise them on their business strategies in view of the size of their companies. One AC Chairman also commented that for large corporations, it is generally expected that business strategies would be well taken care of by a competent management team. However, at least one AC Chairman responded enthusiastically to the benefits that the profession can bring as business advisors to small and medium-sized enterprises. It would be interesting to explore the views of the Board and senior management in this area to assess what role the profession can play.

In the final analysis, the value of audit cannot be assessed in a vacuum. Some respondents have commented on the difficulty of understanding increasingly complex and lengthy financial statements, prepared under the Singapore FRS. Since the audit is performed on these financial statements, the perceived value of external audit is to some extent dependent and intertwined with the perceived value of these financial statements. There is therefore merit in combining assessments of the value of audit with a wider examination of the fitness for purpose of the corporate reporting regime.

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