An international perspective on improving the audit

<u>The Audit Report Must Provide Value</u>

Everyone knows if there has been a bad audit - it is all over the press! No outsider, however, knows if there has been a good or an outstanding audit.

Audit is seen by some companies as a necessary commodity – a burden that has to be endured as a result of seeking capital from investors. The audit opinion is an on/off switch – is it a fair presentation or not? Even that opinion can be hard to find. When I qualified as a Chartered Accountant the UK audit report was 3-4 lines long. You could tell at a glance if the opinion was qualified by its length. Sadly, since then, the expectation gap buried the opinion in boilerplate verbiage concerned with ‘who is responsible for what'! Much of that boilerplate language, if deemed necessary, could easily be referred to on a website as for example can be done in the UK. I have to add however that not all firms have decided to take advantage of this approach. Ultimately, the audit report should only contain information which informs investors and actually adds value. The audit report is the principal output from an activity costing considerable sums of money and therefore must add value to its recipients – the investors. As the PCAOB stated in its Release No. 2013-005:

“Many investors have indicated that they would benefit from additional auditor reporting because they do not have access to, or may not be aware of, much of this information. Additionally, many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the reports more relevant and useful.”

Instead of meeting this basic need of “adding value” at present the report appears to be one of limiting responsibility rather than giving investors what they might want. The statutory monopoly, the payment model and pressure from management do not encourage the auditor to innovate. But the profession now has a wonderful opportunity provided by the PCAOB's exposure draft to start to end the notion of the audit being a necessity and begin to make it a vital part of investment analysis. The PCAOB must also be cognisant that developments have already taken place in other jurisdictions such as France and the UK and the US profession does not want to fall behind on what is now emerging as best practice in the area of auditor reporting. Also, the International Auditing and Assurance Standards Board (IAASB) is also currently developing a revised auditor reporting standard. It would be of great benefit if the PCAOB and IAASB could, as far as is possible, agree to as much consistency between the two final standards as is possible. Such an approach will help those investors who invest in companies in different jurisdictions around the globe. Whilst I accept that there will be differences due to US specific jurisdiction issues, other differences, including terminology should be minimised as the end goal for both standard setting bodies has to be the same – a more informative audit report for investors which provides them with greater insight on the company's financial performance and financial position.

I would have liked the PCAOB to go further than what it is proposing. I do understand the concerns to avoid confusion about the responsibility of the auditor, management and those in charge of governance. The proposal, however, could have been based on the notion that investors want auditors to ask themselves what is it that, if they were investing in the company, they would want to know and for the auditors then to highlight or provide that information.This would allow investors to identify quickly the key areas in the financial statements. Additionally, of course, investors would like to know what concerns the auditor has about the company ('What keeps him awake at night?').

Positively, the proposed new report and the introduction of auditor commentary on critical audit matters does deal with many of the requests of investors. Critical audit matters are those matters addressed during the audit that :
(1) involved the most difficult subjective, or complex auditor judgments;

(2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or

(3) posed the most difficulty to the auditor in forming the opinion on the financial statements.

However, the audit report could be further expanded to deal with other matters of interest to the company's investors , namely management judgements and estimates, accounting policies and practices and the identification of where significant matters are disclosed in the financial statements. Such an expanded report would put pressure on management to avoid creative accounting techniques and poor disclosure (but only if the auditor is truly independent). The proposed change to the audit report is a critical step in increasing the usefulness of the audit but more needs to be done to enhance auditor independence.

The financial crisis led to criticism of the author – why didn't he warn us what was about to happen?

Some will still argue that the auditor should simply restrict himself to the expression of an overall opinion on the financial statements. If evidence is sought that the audit report should be more expansive, it can be found in the PCAOB papers for March 2011 in which Calpers noted that the auditor's report for 2008, 2009 and 2010 for one of the many companies that were the recipients of TARP funds was 'word for word exactly the same' with the 2008 report costing $119 million and the 2009 report costing $193 million. Clearly the 2009 audit was of an entirely different intensity than that of 2008 – where was the emphasis? The investors paid an extra $74m to learn what? – that once again the financial statements gave a fair presentation – nothing else! Wouldn't the investor have wanted to know what had troubled the auditor? The audit profession is a noble one – it oils the wheels of the capital markets. Enron, WorldCom et al all show what happens when the markets fail to trust the auditor. But, as I suggest above, the auditor can do much more in drawing attention to vital information/

assumptions / estimates in the accounts and explain the concerns that had to be assuaged before the auditor could accept that a fair presentation was shown.

Internally the Audit Committee in well-run companies already receives reports from the auditor such as I have suggested. Some argue that the Audit Committee itself should report on the issues discussed – it could - but the auditor will have lost the opportunity to show how useful a good audit can be.

Going Concern

Auditors struggle with the giving of going concern opinions as the issue of such a view can precipitate the collapse of the client but they could do more. The auditor could comment on his reasons for accepting the validity of the going concern assumption. One of the major UK casualties of the global financial crisis was Northern Rock. Its accounts revealed that almost three quarters of its liabilities were short term while these funds were lent for periods up to 25 years. The liabilities did not largely consist of deposit accounts but of funding from the wholesale markets. The assumption behind the going concern assumption was that these markets would always stay open - as they had done until the liquidity crisis struck! The initial assumption was therefore quite reasonable but perhaps if it had been brought to investors' attention some may have decided that a risk of the markets closing was one they were not prepared to take.

From information from the PCAOB's own meeting in June 2011, I learned that none of the top ten Troubled Asset Relief Program (TARP) recipients received going concern opinions before receiving $295 billion from the US Government. Out of the ten largest bankruptcies during the crisis, only two had going concern opinions. In the year prior to their collapse, the market capitalisation of the eight companies without going concern opinions declined from a collective $75.5 billion to just under $700 million at the time of filing – a 99% loss in investor value. The link between regulator, auditor and the investing public was broken.

Auditor Independence

Will the auditor have the courage to use the opportunity given by the new report? He may have little choice. The calls for mandatory rotation or retendering stem from two sources – a good one that a pair of fresh eyes can find things that the existing auditor takes for granted or – a bad one that the auditor/company relationship is too cosy!

If I were an Audit Committee chairman I would want the toughest auditor I could hire to prevent the company – and me – from being the subject of front page articles in the WSJ or the FT. Demonstrating a fierce independence through the medium of the audit report could make it difficult for a company to fire an auditor – and with a good audit committee chairman – evidence to resist a change of auditor and rebut charges that the relationship is too close. If there are genuine concerns about the auditor's independence more could be done to increase the auditor's power and improve audit quality: namely – removing the annual appointment and extending the appointment until the next proposed date of retendering so the auditor has time to demonstrate how good his audit is – and is not subject to constant pressure of being fired; - making the removal of an auditor during the appointment subject to a shareholder vote after both sides put their case – incompetence or excessive fees would obviously be cause for dismissal – complaints from management that the auditor was tough would not! Even if tendering does take place price should initially be removed from the decision – the audit committee should be required to pick the audit that it deems is of the highest quality and then ask for a price. If the committee believes that another auditor offers a better cost – benefit then it should be required to explain to investors that it would have chosen a different auditor if the sole criterion were quality and disclose the savings made.

Reposition the Audit

Personally I would like to see the audit repositioned in the financial reporting architecture. As stated above, I would like to see a much closer link between the investor and the auditor. Expanding the audit report to meet the requests of investors is the key to this enhanced relationship. The new report proposed by the PCAOB is a beginning. I would like to see more. In addition, a significant change in the existing relationship between the company and the auditor is essential if the investor is to be well served by a more useful audit. Long term audit appointments, increasing the difficulty of firing the auditor, making it harder for the audit committee to appoint the auditor on the basis of a lower price would all help. Some audit committees seem to believe a major part of their job is to force down the audit fee and, on the basis of the PCAOB's own evidence of reduced audit fees after tender, it seems that many audit committees have succeeded in achieving such an objective. This behaviour puts into jeopardy the whole financial reporting model. If audit fees are too low, the auditing firms will struggle to attract highly qualified graduates -the expert auditors of tomorrow. Furthermore, to retain key partners by maintaining their income, if fees are cut the firms may try to make the audit profitable by reducing partner time and thereby audit quality.

The audit report is proposing that, in addition to critical audit matters, the report gives the background to the audit (all of which I would put in an appendix to the main audit report or on a website to avoid obscuring its central message).
The auditor is to:

- confirm that the firm is public accounting firm;
- state when the auditor began serving as the company auditor;
- give details of the basis of opinion;
- outline what the audit includes.

I would add another disclosure to sound a warning about the potential dangers of a lower quality audit caused by falling audit fees, namely, time spent on the audit analysed into time spent by partners, managers and junior staff.

<u>Reporting by Auditor on Other Information contained in Annual Report</u>

I also support the PCAOB in enhancing the role of the auditor’s responsibility in relation to other information published in the annual report. Such information is widely used by investors and more needs to be required of the auditor in relation to such published information.

Signing of Audit Report

As you will gather from above I would like to see the auditor even more independent of the company, looking to the investors to be his supporters for re-appointment because of the excellent job he had done for them. As I stated in previous correspondence with the PCAOB I would also like to see the auditor sign the report in his own name on behalf of his audit firm so everyone is aware of who is responsible for the stewardship of the audit (which I believe improves audit quality).

Relationship between Auditor and Regulator

Finally, although it is not a subject of this exposure draft, but as a marker for the future, I would like to see a closer relationship between the regulator and the auditor highlighting the auditor's public duty and assisting the regulator in his mission of serving investors or ensuring financial stability.

Concluding Remarks

Audits in the USA should not be different from audits anywhere else in the world; and we should not risk confusing investors by having auditors performing to different standards of behaviour and reporting depending on where they are conducting the audit. International standards are critical in all aspects of the financial system whether that be accounting, auditing or valuation. I am, therefore, delighted to witness PCAOB's openmindedness in inviting overseas commentators to its panels.

Audit is at tipping point. Its worth to investors and society as a whole is seriously underestimated – here is a wonderful chance provided by the PCAOB to demonstrate to the public the worth of an audit until now hidden behind the phrase ‘fair presentation/true and fair view’ There is more that could be done but this is an excellent initiative.