

## Opening Remarks for PCAOB Meeting

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David Gerald J,  
President & CEO,  
Securities Investors Association

Chairman Doty, Members of PCAOB Board,

Thank you for inviting me to share my views on auditor independence, objectivity and professional skepticism. You are seeking public comment on how this could be enhanced and on mandatory audit firm rotation. At the outset, I wish to say that the views expressed in my opening remarks are entirely mine and do not necessarily reflect those of Singapore or the Securities Investors Association, Singapore. I am neither an accountant, nor an auditor but a simple minded investor so please do accept my apology. If I reflect ignorance of the practice of auditors as understood by this honorable Board.

With markets opening up in Asia, and liberalization of investing rules and markets, it's now easier for investors to do cross-border investing. Corporate Governance and accounting standards are not well developed especially in countries like China and India. Shareholder activism is also not prevalent in Asia.

### **Auditor Independence**

Auditor Independence is the key to investor confidence in financial statements. The fact that the financial statements are audited gives them a level of comfort when placing reliance on the audited statements for investing in the public listed company. But the current method of appointing and remunerating auditors have raised doubts in the minds of some investors on the independence of auditors. This is exacerbated by instances of failures on the part of auditors like Andersen in Enron. Central to this issue is the question whether there are sufficient safeguards and effective supervision of auditors are in place to minimize failures. Some investors in Singapore are of the view that since it is the audit client who pays the auditor's fee, they generally doubt that the complete independence of auditors.

Such a situation, according to some investors, threatens the auditor's independence. But they are in the minority.

Whilst some clamour for third party appointment of auditors and payment, canvassing that would be the answer to their worries, I take the considered view that so long as there are sufficient and effective safeguards to protect investors and sufficient sanctions put in place together with stringent oversight by Independent Regulators, the call for independent third party appointment and payment may not be necessary. One should continue to place faith in qualified and regulated auditors as professionals capable of exercising Integrity and Independence. Not to do so may affect the future of the profession adversely. Unless statistics support such a drastic move, status quo should be preferred. Such a move would also, I am advised, require Congressional approval. One should not paint the entire audit profession with the same brush used to paint those few who have failed. Every profession has had its fair share of shame brought by recalcitrant members. After all, to err is only human. One can never stop audit failure completely as long as humans are involved.

To date, in Singapore, there has been no real call from investors for a change in the mode of the appointment and payment of auditors because they have lost confidence in the integrity of the audit profession. In fact, on the value that external auditors bring to shareholders (stakeholder group to which the audit report is addressed), ACCA and SIAS in Singapore conducted a survey in 2010 dealing mainly with the perspectives of educated and savvy investors. It surveyed about 30,000 investors.

The key findings:

- 1) Overall, 90% of the respondents felt that the external audit, in its current form and scope, brings value to them. A minority felt it had very little or no value to them because of the historical nature of financial statements on which the audit opinion was formed.
- 2) 80% of respondents felt that audited financial statements were important to them in making investments decisions
- 3) More than 85% of respondents felt that the provision of non-financial information (such as corporate governance practices and corporate social responsibility issues) would serve their (investment) decision making purposes

Independent Audit Oversight: the question investors have asked for many years: who audits the auditor?

The expectation of investors have been met in some Asian countries: supervision of audit quality and auditors now in place but not made in China, India, Hong Kong and few others.

On auditing the audit firm – Singapore, Malaysia, Thailand and South Korea has implemented independent audit oversight by audit regulators.

Application of International Standards Quality Controls 1 (ISQC 1) ensuring certain systems in quality control is in place in these countries.

Investors in some of the above mentioned countries are becoming aware of the function of audit regulator and therefore, the comfort level is increasing.

Investors' understanding of Audit Committee – investors especially in Asia, need to understand the role of Audit Committees and need to engage the audit chairman at meetings to ensure that the committee has discharged its role adequately – Singapore Companies Act, section 201B (5) outlines the functions of an Audit Committee which is to review with the auditor firstly the audit plan, secondly the evaluation of the system of internal accountancy controls, thirdly, his audit report, fourthly the assistance given by the company's officers to the auditor etc etc. Investors need to question the Audit Chairman on these matters.

Investor confidence in audit work could be boosted through: a) greater education/awareness about audit quality: and b) the independent audit's regulators role of auditing the auditors'. This helps to ensure the auditors follow standards and perform well in key areas, like professional skepticism which helps ensure that the corporate governance system works as it should.

### **Mandatory Rotation of Auditors**

The arguments in favor of and against mandatory rotation are well documented and publicized and will, therefore, not be canvassed here. Currently, to avoid too much familiarity between auditors and their client, the Stock Exchange listing Rules in Singapore and in many other jurisdictions require the audit partner to be rotated every five years. The International Federation of Accountants requires rotation of audit partner every seven years. Quality control reviews are also undertaken by a second partner of the audit firm carrying out the audit.

It is sufficient to say that the current practice of rotation should continue with enhanced and effective safeguards and allow the PCAOB and other regulators around the world, to monitor the effectiveness of the current practice of rotation of auditors every five years.

Moreover, the measures introduced by Sarbanes-Oxley Act pursuant to the Enron debacle thus provide important and useful safeguards. The shifting of responsibility to the Audit Committee from the management to hire auditors and oversee the engagement and the prohibition of certain non-audit services to clients should give assurance to investors but more importantly, the establishment of independent oversight of the auditing profession by the PCAOB in U.S. and equivalent bodies in other jurisdiction should increase the level of assurance to investors. The Accountants Act in Singapore, similar to those in the west, prohibits auditors from providing certain services, including internal audit services to client. There are regulations under the Act governing independence and ethics applicable to auditors breach of which, will attract sanctions.

In view of the above, it is sufficient to leave it to the Audit Committee and to the shareholders at Annual General Meetings to decide on the appointment of suitable auditors for the company and it is for the Board to decide on the auditor's appropriate remuneration.

It must also be noted that it is the shareholders who appoint the auditor at the Annual General Meetings proposed by the Board of Directors. Shareholders need to be active at meetings and query the Board on the basis for the recommendation of the auditor to be voted on, the quantum of payment recommended and the length of engagement and the issues that would be addressed by the auditors to justify the quantum.

Shareholder activism is necessary to ensure that the right auditors are appointed and paid correctly. Should the shareholders be active on these issues, in my view, the likelihood of auditors and the management of the Listed Companies acting in cahoot will be further minimized.

## **Recommendations**

### **i. Mandate full-time internal auditor**

Perhaps to enhance, not only vigilance against fraud and criminal activity, but also professional skepticism and quality of audit, Public Listed Companies should be

mandated to appoint full time internal auditors. A full time internal auditor, though engaged by the company through the Audit Committee, should report directly to the Audit Committee Chairman and the Board and not the CEO. He should report to the CEO only on operational and administrative matters. The advantage of this suggestion is that it will give the necessary assurance investors are looking for in avoiding a situation like Enron and will also minimize mistakes. As demonstrated by Cynthia Cooper. In WorldCom Case, an Internal Auditor can act quickly to bring misconduct to justice. The Internal Auditor could be the watchdog for the investors and the stakeholders of the company. In my view, this will also enhance the independence of external auditors. It will also help in the appointment and remuneration of the External Auditors. it will make the issue of mandatory rotation a moot point. This way the management will be kept in check.

## **ii. Enhance Board's responsibility**

The most effective fraud prevention is to have an effective Board that is responsible for risk governance and internal controls. The Board is now required to play a more pro-active role under these new and tough rules issued SGX (effective from 29 September 2011), the 2012 Code of Corporate Governance issued by MAS on 2 May 2012 and the Risk Governance Guidance for Listed Boards Guidelines issued by Corporate Governance Council on 10 May 2012. The Board must identify risk areas, set risk tolerance strategies and oversee implementation of risk management. On an ongoing basis, the Board needs to continually monitor and assess the adequacy of the risk management measures it has put in place, oversee the system of internal controls and ensure that management takes appropriate steps to mitigate risks.

## **Transparency of Independent Oversight Work**

I support the view that the independent oversight regulators work should be made public so that investors will be in the know. It will enable the investors, as shareholders, to make an informed decision on the appointment of auditors.

## **Conclusion**

It is the enhancement of safeguards and not changing the current model of appointment of auditors and payment to them is what is needed.

David Gerald  
President  
Securities Investors Association (Singapore), SIAS