Relationship between the audit function and effective governance

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Introduction
At a conference on international trends in corporate governance you might well wonder why I have chosen the ‘exciting’ topic of auditing regulation for my keynote this morning. Looking at the program I can see there are a few accountants in the audience but most of you are specialists in related management fields and I suspect most of you have no interest in auditing and are already grabbing your ipads or iphones for something else to do for 50 minutes. I have to confess that as an accountant I too have always found auditing particularly uninteresting. Auditing is like going to the dentist: it is expensive but necessary to have regular check-ups because occasionally we find a problem, decay, that needs corrective action, a filling. Like your annual dental health check-up annual audits of financial reports have long been part of the governance system of incorporated entities. As early as 1200 A.D. incorporated guilds in the United Kingdom (UK) required annual audits by a committee of members (Watts et al. 1983). The historical evidence suggests that the audit function evolved as an effective monitoring and bonding technology (Watts et al. 1983) that today consists of an international profession fulfilling regulatory requirements for assurance services.

Despite auditing’s long history we might well ask, in the light of financial frauds such as Enron and the demise of their auditor Arthur Anderson, and the recent global financial crisis, does the modern audit function enhance effective governance? Is the audit function relevant to contemporary corporate governance structures? Today I want to use my keynote speech to tell you about recent developments in audit reporting and regulation that excite me about the role of auditing both as a governance researcher and as an accounting professional.

Audit Report of Rolls-Royce
First let us look at a specific example: the case of Rolls-Royce Holdings. Chances are that many of you flew to this conference in an aircraft powered by a Rolls-Royce jet engine. The business model for jet engine suppliers like Rolls-Royce and its larger rival General Electric is that they retain ownership of the engine and lease power plants to the airlines. Thus you are relying on both the airline and its engine supplier. By flying in a Rolls-Royce powered airplane you effectively risk your life based on the reputation of the Rolls-Royce jet engines as well as the company and the management team that supplied them to the airline. Would you fly if the engines were manufactured by a company at risk? By risk I mean both financial and operational risk because they are intertwined. How do we determine the riskiness of a company like Rolls-Royce? You might think that the Independent Auditor’s Report in the annual report is a good place to start when assessing the risk of flying in a Rolls-Royce powered airplane. The Independent Auditor’s Report is a public attestation by a professional independent auditor assuring amongst other things that the financial report is properly prepared and that the firm is a ‘going concern’, an accounting concept that means financially viable.

If we look at the 2012 annual report of Rolls-Royce we find the one page audit report by
KPMG (one of the ‘Big 4’ international audit firms) located towards the end of the annual report (Rolls-Royce Holdings PLC 2012, page 129 of 133). By hiring a ‘Big 4’ auditor Rolls-Royce is a signaling to users of the report that its financial information is higher quality. The extensive audit quality literature finds ‘Big N’ auditors (N has varied over time and across markets) conduct higher quality audits, partly due to industry specialization possible only in larger firms and the superior competency of larger ‘Big N’ office sizes, providing greater assurance of high financial reporting quality (DeFond et al. 2014). The layout and content of KPMG’s audit report in Roll’s accounts is typical of most audit reports. The audit report follows a boiler plate wording and essentially states that the financial statements give a true and fair view of the state of affairs, that they have been properly prepared in accordance with the relevant regulations, and that the firm is a going concern (Rolls-Royce Holdings PLC 2012). This is a ‘clean’ audit report in that the auditors raise no concerns about the reporting, the information they received from management or the ongoing viability of the firm.

So you can relax and jump on your return flight assured by the reputation of the auditor KPMG that Rolls-Royce is financially sound that there are no risks in the company. Or does it? The Chairman’s statement in the same annual report in 2012 notes that there are issues with corruption in some foreign markets specifically:

As previously reported, the Serious Fraud Office (SFO) asked us, early in 2012, to investigate allegations of bribery and corruption in Indonesia and China. In response to its request we asked a leading law firm to conduct a wide review which has raised matters of concern in these and in other markets. We have now referred a file to the SFO. (Rolls-Royce Holdings PLC 2012, page 5)

The audit report is ‘clean’ but the Chairman’s statement raises some concerns about litigation and ethical risks in the firm. Nevertheless the Chairman goes on the state that Rolls-Royce has appointed an independent expert to review the firm’s compliance procedures and report to the ethics committee. The Chairman’s statement affirms that the Board ‘will not tolerate improper business conduct of any sort’ and that the firm ‘will take all necessary action to ensure compliance (Rolls-Royce Holdings PLC 2012, page 5). On the surface the governance by Rolls’ Board seems to be effective at investigating and reporting to authorities corruption issues and that it has appropriate structures in place with an ethics committee and consulting expert going forward.

Surprisingly the Independent Auditor’s Report has no comment on this significant business risk or the possible future financial impact of any litigation or sanctions and fines. The audit is ‘clean’. So what does the typical ‘clean’ audit report tell us? Essentially audit opinions are a binary signal where a ‘clean’ or unqualified report signals that there is no material or significant issues with the preparation of the accounts or the ongoing viability of the business. This contrasts with a ‘qualified’ option that identifies areas where the auditor has significant concerns either about the information supplied, methods used or the ongoing viability of the firm. Carson et al. (2006) document that about 85% of audit reports in Australia are ‘clean’ or unqualified with less than 4% of audit reports being qualified. The remaining 11% are unqualified but the auditor’s report is modified. Typically in Australia the modification is minor with the auditor noting that they concur with the
additional disclosure by management that following an accounting standard would be misleading and hence additional note disclosures are included (Carson et al. 2006). Thus effectively over 96% of all Australian audit reports are unqualified.

How can this be effective governance? The binary pass/fail signal of ‘clean’ audit report for 96% of firms, like Enron’s and other failed firms’ clean audit reports, potentially masks a wide range of underlying issues that have implications for the stakeholders’ assessing firm risk and value. This evidence draws into question the effectiveness of the auditing function as a governance mechanism given the limited communication within audit reports. Yet the historical emergence of auditing was to address accountability of agent managers by providing an independent monitoring mechanism reporting to stakeholders (Watts et al. 1983). The monitoring role of auditing is just as important today given the highly publicized corporate frauds of WorldCom, Enron and the like, the high levels of earnings restatements and documented earnings management by firms (Cohen et al. 2004). Arguably the recent global financial crisis could have been averted or at least not been as severe if the auditing functions of the key players in the sub-prime mortgage industry had provided earlier information on the risks of the underlying business model (Sikka 2009; VanDenburgh et al. 2008).

Auditing and Governance Mosaic
So how does auditing contribute to the governance mosaic of firms? The broader governance literature is replete with many definitions of corporate governance that will be debated throughout the conference. Locally the Australian Stock Exchange (ASX) defines corporate governance as:

> “the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized. Good corporate governance structures encourage companies to create value (through entrepreneurship, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved.” (ASX Corporate Governance Council 2003)

Broadly speaking the various corporate governance codes and guidelines issued around the world address four key governance areas: (1) board and management structure and processes; (2) corporate responsibility and compliance in the organization; (3) ownership structure and exercise of control rights; and (4) financial transparency, information disclosure, auditing (or assurance) (ASX Corporate Governance Council 2003; OECD (Organization for Economic Cooperation and Development) 2004; UNCTAD (United Nations Conference On Trade And Development) 2006). The scope of this presentation is limited to the accountability and control systems that address the financial transparency, information disclosure, auditing aspects of governance. Given the reporting and auditing focus I will draw on the seminal work of Cohen et al. (2002, 2004, 2008).^1

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1 For broader discussion of corporate governance see Dewji et al. (2013).
Cohen et al. (2004) outline the corporate governance mosaic that models the interplay between the various stakeholders that impact the governance of corporate entities. An adapted version of their model is presented in Figure 1.

**Figure 1: Corporate Governance Mosaic**

Adapted from Cohen et al. (2004)

The governance mosaic consists of two levels of corporate governance. Firstly the market level governance stakeholders are the parties external to the firm. They include the formal regulatory bodies and processes of the legislature, legal system, stock exchange operators and market regulators. Market regulators include bodies that regulate and monitor security markets and professional institutions that regulate and monitor financial reporting and auditing processes. External governance is also exerted by market participants such as financial analysts and stockholders. There is a complex interplay between all the external governance stakeholders from the humble beginnings of providing protection for investors and national economies to today’s internationally interrelated market governance systems. As we know from the recent global financial crisis the system of governance within countries and across markets benefits the world as well as local economies. A key outcome from the external governance processes is quality financial information for all market participants. These reports facilitate performance monitoring at the individual investor or security level right through to the macroeconomic level. It is well documented, following the seminal work of Ball and Brown (1968, 2013), that accounting information impacts security valuation and hence wealth in financial markets. More recently researchers have focused on the impact of information quality or information risk on financial markets. The evidence suggests that poor accounting quality or high information risk is economically costly and is associated with less timely price adjustment and higher cost of debt and equity capital (Aldamen et al. 2013; Callen et al. 2013; Easley et al.
2004; Lambert et al. 2007). So both new information and information risk are priced in financial markets.

But the regulatory efforts of the market level governance only serves to frame the financial information process for firms. The second level of governance is the firm’s particular set of systems and processes and these are more directly involved in the reporting process. It is the micro level interplay between the firm stakeholders within the firm’s governance system that directly impact the quality of the firm’s financial information and hence the riskiness of information to markets. Historically management manages the firm but also manages the reporting of their performance creating an agency conflict. The role of the Board of directors is to set strategic direction but also to monitor management on behalf of shareholders, that is both strategic and financial control (Hendry et al. 2004). The board also engages external auditors to provide an independent opinion on management’s reporting of performance (Watts et al. 1983). From the extant governance research we know that board constitution (size and independence) as well as separation from management (duality) contribute to effective governance. While the jury is still out on whether these factors positively impact firm performance there is fairly consistent international evidence that an independent board and audit committee does improve financial reporting quality (see meta-analyses by García-Meca et al. (2009) and Lin et al. (2010)). There is also some evidence emerging that independent-financially qualified audit committee’s improved firm performance and reporting during periods of financial crisis (Aldamen et al. 2012).

The roles of the audit committee and the internal and external auditors are intertwined to impact the financial reporting quality of the firm. The audit committee is a sub-committee of the board of directors that assists the board to fulfil its corporate governance and oversight responsibilities. Many jurisdictions mandate audit committees and require firms to appoint suitable financial experts to the committee (e.g. see ASX Corporate Governance Council (2003)). An audit committee monitors the company’s financial reporting, internal control systems and risk management systems and interfaces with the internal and external audit functions (Turley et al. 2004). A quality internal audit function operates under and reports to the audit committee (Duncan et al. 2014) and is responsible for monitoring and identifying material internal control and system weaknesses (Lin et al. 2011). Firms with quality internal audit functions exhibit higher financial reporting quality and lower earnings management (Prawitt et al. 2009). The work of the internal audit function is also an input to the external audit and they will place greater reliance on the work of the internal auditor if they perceive the internal audit to be of higher quality (Duncan et al. 2014).

Recent evidence suggests that the internal corporate governance environment has improved considerably. Cohen et al. (2010) find that audit committees are substantially more ‘active, diligent, knowledgeable, and powerful’ and Beasley et al. (2009) find audit committee members ‘strive to provide effective monitoring of financial reporting’ rather than being ‘ceremonial in nature’ and simply providing ‘symbolic legitimacy’. However, management continues to be a major corporate governance actor with control over recording on its financial accountability. The external auditor’s core role is to examine and form an opinion in relation to the financial reports produced by management. In the process the auditor interfaces with management to obtain and test the underlying financial evidence, examines the work of the internal auditor and discusses concerns and issues with management and the Audit committee. In essence the independent audit report is a
negotiated outcome between management and the external auditor usually via the audit committee (Francis 2011; Gibbins et al. 2010). The outcome of the auditors extensive investigation and negotiation is then reduced to a binary signal: a ‘clean’ or qualified audit option. By definition a lot of information is lost when it is combined and reduced to a binary signal and arguable some of the information external auditors develop during the course of their audit would be useful to stakeholders.

Proposed Audit Disclosure Regulation
Cases like Rolls-Royce, Enron, WorldCom and the global financial crisis have stakeholders questioning the monitoring and governance effectiveness of the audit function (audit committee, internal and external audit). In response to these issues the International Auditing and Assurance Standards Board (IAASB) released a discussion paper in 2011 on the audit implications of the evolving nature of financial reporting. The core message from stakeholders was that financial reporting is increasing in complexity, involves more judgment and qualitative disclosures, and users want more input from the auditor to help them understand the complex financial reports (International Auditing and Assurance Standards Board 2011). We know from the research evidence that the auditor’s opinion is valued as a key part of the corporate governance mosaic but as Prof. Arnold Schilder, Chairman, International Auditing and Assurance Standards Board (IAASB) put it recently:

‘users want to hear more from the auditor – more pertinent, and more tailored, information about the specific audit performed on an entity’s financial statements. There is symbolic value in the current report, but little communicative value – and users see the potential for the auditor to provide more value and more transparency.’ (Schilder 2013)

One avenue to improve transparency is for auditors to disclose more about the insights they gain in the process leading to their final audit opinion. An audit report that is less of a boilerplate document, such as the Rolls-Royce ‘clean’ report, is likely to be more meaningful to users particularly if the auditor is able to tailor a more entity-specific report.

Late in 2013 the International Auditing and Assurance Standards Board (IAASB) issued an exposure draft setting out proposed new and a number of revised International Standards on Auditing (ISAs) aimed at improving the auditor’s report on audited financial statements. It is beyond this presentation to go into the minutia of the exposure draft. However there are three core areas of improved auditor communication: (1) prominent placement of the auditor’s opinion in the auditor’s report; (2) auditor reporting on “Key Audit Matters” which are those matters most significance in the audit of the current period financial statements; and (3) auditor reporting on going concern, the appropriateness of management’s use of the going concern basis of accounting and a statement as to whether any material uncertainty was identified that may cast significant doubt on the entity’s ability to continue as a going concern (International Auditing and Assurance Standards Board 2013). Such a richer information set, particularly in relation to key audit matters and going concern risk, would allow stakeholders to judge finer gradations in information risk and financial reporting quality and
mitigate the information asymmetry between external stakeholders and management. As part of the IAASB project to improve audit quality it issued a Framework for Audit Quality (International Auditing and Assurance Standards Board 2014) that aims to: (1) raise awareness of the key elements of audit quality; (2) encourage key stakeholders to explore ways to improve audit quality; and (3) facilitate greater dialogue between key stakeholders.

Paralleling these international efforts the Financial Reporting Council in the UK issued its own version of the audit reporting standards requiring the audit report to contain: (1) a description of the risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall strategy; (2) an explanation of how the auditor applied the concept of materiality; and (3) an overview of the scope of the audit, including an explanation of how the scope addressed the risks of material misstatement (Financial Reporting Council 2013). The United States is also considering regulation to enhance audit informativeness.²

Unshackled by prior boiler plate binary audit report regulations, in 2013 Rolls-Royce’s auditor KPMG penned a very informative six page audit report (Rolls-Royce Holdings PLC 2013). The New York Times commented that in the past audit reports were seldom read but that stakeholders are now reading the new audit reports with interest (Norris 2014). The first line KPMG’s audit report for Rolls-Royce says it is an unmodified or a clean report. Most of remainder of the extended report identifies the risks, response and findings in relation to eight contentious areas: (1) basis of accounting for revenue and profit in the Civil aerospace business; (2) measurement of revenue and profit in the Civil aerospace business; (3) recoverability of intangible assets and amounts recoverable on contracts primarily in the Civil aerospace business; (4) accounting for the consolidation of Rolls-Royce Power Systems Holding GmbH and valuation of Daimler AG’s put option; (5) liabilities arising from sales financing arrangements; (6) accounting for risk and revenue sharing arrangements; (7) the presentation of ‘underlying’ profit; and (8) bribery and corruption. The level of detailed discussion makes the audit report very informative about the business, its governance and financial reporting. For example the half page dealing with bribery and corruption first notes that a large part of the business involves significant contracts with governments for which the procurement processes are via commercial intermediaries that are ‘highly susceptible to the risk of corruption’(Rolls-Royce Holdings PLC 2013). The report states that the company is under investigation in both the UK and US. The report then details the auditor’s testing of controls over the selection and renewal of intermediaries as well as investigating management’s response to the risk. The section concludes by assuring the disclosures the firm made and that it is too early assess the consequences including fines associated with the ongoing investigations and hence it is not possible to provide for any future loss.

While the level of disclosure by KPMG is commendable not all audit reports evidenced non-boiler plate company specific discussion. Norris (2014) notes that some audit reports issued by other UK Big N audit firms evidences boiler plate discussion of risk, materiality and scope issues.

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² The Public Company Accounting Oversight Board (PCAOB) in the United States (US) has its own ‘Auditor’s Reporting Model’ project that amongst other things seeks to enhance auditor discussion of ‘critical audit matters’ and the evaluation of other information for material misstatement.
Implications for Industry and Research

While international audit disclosure regulation and practice is in a state of flux it is quite clear that many parties in the process are pursuing more informative audit reports that enhance the efficiency, transparency and quality of corporate reporting. Can we therefore expect that financial fraud and earnings management will be eliminated with comprehensive audit disclosure? Unfortunately that is unlikely because human nature will find a way around any process but hopefully the incidence and impact will reduce. What is likely is that the additional disclosure by auditors will provide governance stakeholders an insight into the negotiation process between management and the auditors in finalising the accounts through the auditors disclosure of issues and their resolution or otherwise. Until now this has been somewhat of a black box where the only signal is the binary audit report signal. The potential disclosures like Rolls-Royce’s six page audit report means the availability of a much richer data set upon which to formulate assessment of financial, operational and information risk of the firm. The disclosure will also provide some insight into the financial statement negotiation process between management and auditors. For researchers this new database of disclosures is exciting as it will allow us to explore and a multitude of new hypotheses including the markets assessment of information risk and the impact on investor decision making and judgement formation, audit judgement and financial analyst forecasts. Finally a benefit of the more informative auditor discussion is that it will highlight the many assumptions and estimates that are included in the financial results highlighting that a range of permissible profits and assets that could be reported. While accountants understand this it may be somewhat of a revelation to many investors.

References


