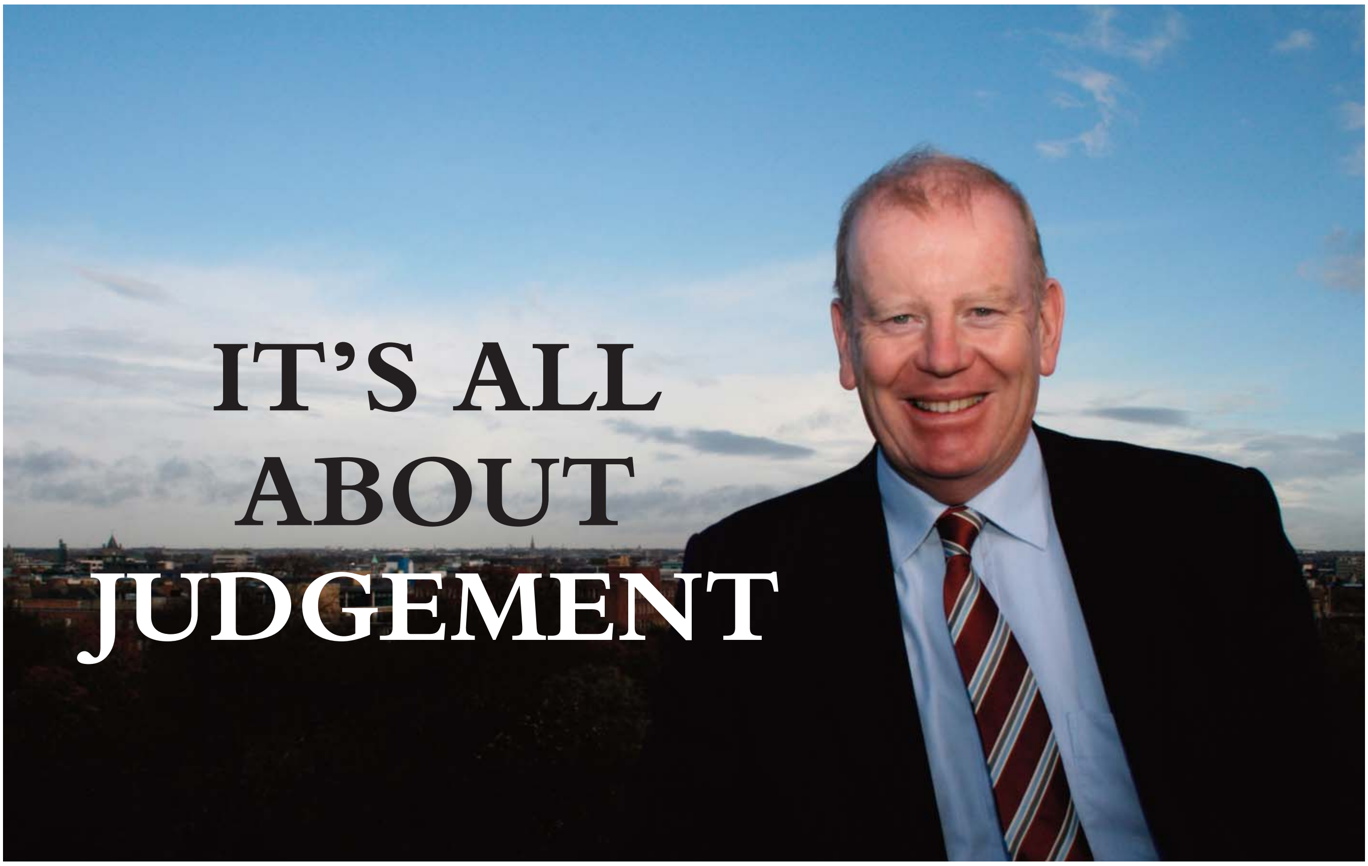
IT'S ALL ABOUT JUDGEMENT



The ability to exercise professional judgement with integrity is the hallmark of a Chartered Accountant, argues **Ronan Nolan**.

Ten years ago, writing for this journal on the subject of bias in accounting estimates I noted that, *Auditing financial statements has never been a question of a black and white, rules-based approach. In particular, dealing with the potential for bias in accounting estimates takes the auditor into a grey area where the exercise of professional judgement is of critical importance.*

I certainly believe that statement stands the test of time, and has general relevance to much of the current debate around financial reporting and auditing.

FINANCIAL REPORTING

Financial reporting, and IFRS in particular, has come in for sustained criticism, much of it in my opinion simplistic and misdirected, notably in relation to the relegation of the concept of 'prudence' from its previously overriding position.

An academic commentator giving evidence recently to the UK Parliamentary Commission on Banking Standards stated, *I think we should restore the prudence principle that enabled companies to build up buffers.* [1]

Another academic commented at the same forum, *How many people knew that the IASB was busy taking prudence out of its conceptual framework? There were all these things that were happening that stakeholders knew nothing about.*[2]

The apparent suggestion of a conspiracy to change standards in a secretive manner seems quite bizarre, but it does illustrate the level of antipathy and misconception expressed by some commentators.

As a counterpoint on the same day, a third witness commented, *Another solution … is to go back to the idea of building up buffers, having general provisions, which somehow or other attempt to smooth out the ups and downs of the economic cycle… We could go back to that, but I would not advocate it … It may well not simply smooth out the bad and the good, but may often, in some cases, hide losses as much as profits.*[3]

A comment in a recent letter to *The Financial Times* neatly summed up my own view of the matter: *In the great blame game that has followed the financial crisis, the oddest culprit to be singled out is International Financial Reporting Standards. This is like blaming a tape measure for obesity.*[4]

I find it hard to believe that anyone would prefer to go back to a regime which lacked transparency, encouraged secret reserving, and in fact did not require the financial statements of financial institutions to show a true and fair view!

And, finally, by way of setting the scene as regards financial reporting, no less a person than Sir David Tweedie, former Chairman of the International Accounting Standards Board and, more recently, President of ICAS (2012-13), offered these comments to the UK Parliamentary Commission, *I have heard it said that the IFRS got rid of prudence. It didn't. It got rid of the title 'prudence', but the way the IFRS operates is that standards come first.*

..prudence is written all through them...We had a long discussion about where prudence fits in with neutrality ... being neutral means trying to get the right answer without bias, and if you bring in prudence you are biasing it. The idea therefore was, let's put in the standards and make them as prudent as we want them to be; then, we want people to try to get the right answer thereafter.[5]

In other words, exercise professional judgement with integrity!

AUDITING

Auditors have also been subject to criticism, and indeed to regulatory and legal actions in the aftermath of the economic crisis.

In Ireland, the Nyberg Report (March 2011) under the heading "The Silent Observers: External Auditors" observed: *Auditors are also required to assess whether a bank will remain a going concern for the next year; this seems to require them to make a judgment on at least the short term sustainability of the bank's business model and strategy. The auditors clearly fulfilled this narrow function according to existing rules and regulations. They did not, however, generally report excesses over prudential sector lending limits to the FR ... Auditors, therefore, did not feel that commenting on the implications of such business model problems fell within their proper remit... As a result of the global financial crisis several initiatives are under way to explore ways of making audits conform to the "watchdog" expectations which are both in the market and among the public.*[6]

This reference to an 'expectation gap' finds an echo in many other commentaries including that of EU Commissioner Michel Barnier in the draft Green Paper which asserted that, *auditors are the dog that did not bark during the crisis, and their role has been called into question*.[7]

The canine theme was also picked up by John Griffith-Jones, who currently heads up the UK's Financial Conduct Authority, who noted that audit reports have become *less and less useful to the world at large...In the period up to the crisis.... the perceived wisdom for closing the audit expectation gap was to lower the expectation rather than to expand the scope. And the result? The dogs did not bark. Why? Because it was not their responsibility to do so.*[8]

And returning to Professor Sikka, *Auditors have been the real weak link in the banking crisis....Nowhere in the Companies Act does it say that auditors are not required to provide any warning about a company not being a going concern.*

Sir David Tweedie, again at the same hearings, balanced the foregoing as follows: *The minute you put a going concern qualification on a bank, there will be an immediate run. So a relationship between the auditor and the regulator is required. I think that that was missing at the time.*

This comment highlights two interesting issues – the limitations of a binary audit report, and the importance of the auditor's relationship with the Regulator in the case of regulated entities.

I should note that in his interesting article in the June edition of this journal Mark Kennedy also picks up on some of Sir David Tweedie's observations on audit reports.[9]

And finally, in the context of audit, the APB issued a very thought provoking paper on Professional Scepticism in March 2012[10], which noted that Auditing Standards define professional scepticism as, *an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence*.[11]

This is obviously of critical importance in determining how professional judgement should be exercised.

Key issues addressed in the APB paper include the need for auditors to offer a robust challenge to management assertions, and the nature of the auditors' mindset – whether it should be neutral, inquiring or challenging. The conclusion reached is that a sceptical audit requires a mindset towards the challenging end of the spectrum, appropriately tailored for the particular circumstances. In an earlier APB paper this was characterised as 'presumptive doubt', though this precise term was dropped from the final paper. The paper offers useful suggestions as to how audit firms can foster this type of approach in their culture and among their people.

BETTER COMMUNICATION

One constructive idea emerging from this debate is the need for better communication, both in the financial statements themselves, and from the auditors.

The financial statements already include a mass of information – indeed all the data required to understand the financial position of entities which subsequently got into difficulties was included in the disclosure notes – but not necessarily in a context which facilitates interpretation.

This point was well made in the letter to *The Financial Times* already referred to above; *The rapid build-up of assets – loans and trading instruments – was clear to see. So was the suppression of equity, which left banks short of loss-absorbing capacity. Since the crisis, regulators and others conducting post mortems have used numbers reported under IFRS to demonstrate the dangerous increase in leverage.*

Published accounts contained much other information that should have prompted questions about the vulnerability of asset values to a downturn in house prices, or a more general recession. After all, banks are cyclical – or did those who complain now believe then that boom and bust had been abolished?

There is nothing inconsistent between neutral reporting of the figures and a 'true and fair' view.

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Accounting involves the exercise of judgment (if only it were as easy as box-ticking), and … investment professionals … prefer that judgment to be unbiased.[12]

Notwithstanding the above, there is clear scope for the enhancement of accounting disclosures in relation to the key areas of estimation and the related judgement decisions taken. Matters such as claims reserves in insurance companies, loan loss reserves in banks, and the valuation of work in progress in development companies, for example, could be addressed in more helpful commentaries which could include such useful information as sensitivity analyses which would enable readers to test the impact of changes in the key assumptions being adopted.

Auditors also have a role in communicating the financial position of entities. One aspect of this which is relevant to banks, insurance companies and other regulated entities is the importance of open dialogue with the regulators. As noted above, this has been widely commented on as having been sub-optimal in recent years, and measures have now been taken in many jurisdictions, including our own, to remedy this.

The other key aspect is communication between the auditors and the company and its shareholders, the most visible aspect of this being the published audit report. This is not to downplay the importance of the auditor's communications to the audit committee, which is an important element of governance, and in respect of which strong guidance is in place. Audit committees themselves have a role in reporting more clearly the content of their dialogue with the auditors. But, I believe, auditors themselves really need to grasp the nettle directly and be much more open and less defensive in what they say in their published report. While I understand the constraints on auditors in this regard very well, the current compliance orientated model has passed its sell-by date.

Auditors have lots of interesting observations to make on many of the financial statements they audit, and I believe these can be made without damaging the entity or exposing the auditor to undue risk. The auditor's comments on the key areas of focus for the audit, and on the major judgments underlying the financial statements would be extremely valuable to users in understanding the results. Such innovation has just recently been introduced for audit reports on listed entities. It will be interesting how this is received in the coming years.

In the majority of cases such comments would be entirely supportive of the views of the directors, and users would come to see the audit report as adding real value to their analysis of the position.

I was particularly taken by an illustration of this point, again from Sir David Tweedie's evidence already referred to, *One of the things about the crisis in America that shook me is that the 2008 audit report of one of the companies in receipt of the troubled asset relief programme funds cost $119 million, and in 2009 it cost $193 million and yet the audit report was, word for word, the same. So you had no idea what a totally different audit was actually undertaken. There was clearly an emphasis on different aspects of that audit, but an outsider would not know. I think all that should be brought out, which would be very useful for financial analysts and for the general public; it would give us warnings… I would want them to disclose the going-concern assumptions. What makes you say it is a going concern? In what areas did you have disputes with management? What areas were you concerned about? On what areas did you spend a long time in the audit? What are the big estimates that are involved in the audit, because there are always estimates in the accounts? Which are the ones that you had to look at very carefully, and which ones were pretty significant?*

Finally, I believe auditors should be prepared to discuss these matters with shareholders at the company's AGM. This would help demystify the audit for ordinary shareholders, and should enhance the general perception of the value of audit.

> "CHARTERED ACCOUNTANTS HAVE A WELL DESERVED REPUTATION FOR EXPERTISE AND INDEPENDENCE. WE NEED TO UP OUR GAME, BOTH AS PREPARERS OF FINANCIAL STATEMENTS AND AS AUDITORS, IN COMMUNICATING THE REAL BENEFITS WE BRING TO SHAREHOLDERS AND THE WIDER STAKEHOLDER COMMUNITY THROUGH THE EXERCISE OF OUR PROFESSIONAL JUDGEMENT."

CONCLUSION

Chartered Accountants have a well deserved reputation for expertise and independence. We need to up our game, both as preparers of financial statements and as auditors, in communicating the real benefits we bring to shareholders and the wider stakeholder community through the exercise of our professional judgement. There are several encouraging initiatives in progress at present, but we all need to encourage speedy and constructive outcomes!

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[1] Prof. Prem Sikka, Centre for Global Accountability, University of Essex, January 16th, 2013.
[2] Prof. Stella Fearnley, Bournemouth University Business School, January 16th, 2013
[3] Prof. David Cairns OBE, visiting professor, University of Edinburgh, January 16th, 2013
[4] Jane Fuller, Chair, Financial Reporting and Analysis Committee, Will Goodhart, Chief Executive, CFA Society of the UK- FT 23 December, 2012
[5] Sir David Tweedie, President Institute of Chartered Accountants in Scotland, January 28th, 2013
[6] *Report of the Commission of Investigation into the Banking Sector in Ireland*, March 2011
[7] European Commission, *Proposal for a regulation on the quality of audits of public-interest entities and proposal for a directive to enhance the single market for statutory audits,* November 2011.
[8] Speech at London Mansion House, October 2012
[9] Mark Kennedy "Debating the Future of Statutory Audit", *Accountancy Ireland*, June 2013.
[10] APB *Professional Scepticism – Establishing a common understanding and reaffirming its central role in delivering audit quality*, March 2012.
[11] ISA (UK and Ireland) 200, paragraph 13
[12] Jane Fuller and Will Goodhart, *loc cit.*