

# Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.



## The value of financial statement audit

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The biggest change in audit arguably since the profession was created and certainly since the auditing standards were given the force of law is the introduction of the new long form audit report applicable to all audit reports for periods ending 31 December 2016 designed to:

- Increase transparency with the disclosure of Key Audit Matters (“KAMs”) where applicable
- Enhance the disclosure of material uncertainty over going concern where relevant
- Increase the clarity over Other information and
- Reduce the expectation gap through enhanced disclosure of the roles and responsibilities of both the auditor and those charged with governance.

A key part of the discussion of the value of the new long form audit report is the disclosure of KAMs in the report and whether they are required for all audit reports, which they are not, they are only required for listed entities. As direct result of the change in the form of the report a more substantial question is being asked of the profession, does a financial statement audit report still have real value particularly if it does not include KAMs which remains likely to be true for most audit reports issued for periods ending 31 December 2016?

### **Audit Reports with or without KAMs?**

The auditing standards remain common to both general purpose and special purpose accounts, and so while the form of the report may differ between listed entities and other audit reports with the inclusion KAMs the evidence required to conclude and the reasonable assurance provided to the users of the accounts by the audit report is the same.

Therefore the more pertinent question given the quality of the assurance is the same whether KAMs are included or not, is what value does a financial statement audit provide to



a business, in particular a small or medium sized entity ("SME") beyond meeting the compliance requirements under the *Corporations Act 2001* where relevant?

## **What value does an audit provide?**

Stepping back from the headlines of the change in the form of the audit report and whether to include KAMs a financial statement audit continues to provide:

- An independent examination of transactions, processes and controls
- A tool to facilitate access to the broader capital markets
- A tool to facilitate business growth and interaction on the global stage and
- A tool to help owners extract the value from their business.

All conducted by an experienced professional who can share their knowledge and experience as a partner to the business.

## **An independent examination – Start as you mean to go on**

Starting early in the business cycle with a financial statement audit improves the accountability of the company, prepares them for the requirements imposed on larger businesses as they grow, and assists in the development of an appropriate internal control environment.

As businesses grow there is a transition point when the directors and owners become less involved in the day to day operations of the business and a level of management is introduced.

Growing businesses become subject to increased regulation such as lodging financial statements with ASIC under the requirements of the *Corporations Act 2001*, including the requirement to keep books and records. Clients who have operated for a number of years without an audit who then have to prepare for their first audit often find the process lengthy and involved, usually with numerous changes to the financial results as a consequence of errors, mislaid records and inappropriate accounting treatments. The accounting standards are being regularly changed at present and a SME may have started treating a transaction correctly but unless they are current with the accounting standards, in subsequent years they may no longer be accounting for it correctly. Examples of standards currently being revised are:

- AASB 9 *Financial Instruments*
- AASB 15 *Revenue from Contracts with Customers*
- AASB 16 *Leases*

While these standards are designed to provide greater clarity and transparency of the transactions, the changed accounting treatments may substantially impact the reported result for a business. The impact of the changed accounting treatments can be widespread and influence key items such as bank covenants, tax or profit, which in turn may impact access to capital or the ability to exploit an opportunity. Therefore good governance or simply sensible ownership values the rigor of the audit in ensuring that the reported position



is materially correct.

During a financial audit, the auditor is required to obtain an understanding of internal control relevant to the audit. While no opinion is expressed on the effectiveness of the company's internal control, the observations from the understanding gained is an opportunity for the auditor to share insights with those charged with governance. As an experienced professional this can be a great opportunity for the auditor to share knowledge and build their relationship as a trusted business advisor, opening up a window of opportunity for the auditor to continue to help the business as it grows.

## **Growing businesses**

Emerging SMEs are being fostered in the suburbs and countryside of Australia and the rest of the world, and as they grow many will need to define or measure just how successful they actually are in order to continue growing.

It is current and emerging small and medium sized entities (SMEs) which will drive innovation and growth in the economy as they aspire to follow the path of other landmark institutions which commenced life as SMEs. The potential of SMEs should never be underestimated - take Broken Hill Proprietary for example, a small rural miner which evolved into BHP Billiton, or Nintendo, which started out as a playing card manufacturer and is now the owner of "Pokemon Go".

Growth of a business brings new challenges in addition to the day to day operational requirements. There reaches a point where SMEs need to consider:

- Accessing sufficient capital to sustain the company and support growth
- Corporate governance
- Extracting value from the business.

## **Access to capital**

"Cash is king", an oft used phrase in business, and with good reason, as it relates to having sufficient working capital.

All businesses require working capital to start and sustain the business. It's often said that a financial audit is "key to the efficient working of the Capital Markets", however, the phrase 'Capital Markets' is usually enough to make many SMEs tune out as it is generally synonymous with listed entities and publicly issued debt. However, taking a broader view of what a Capital Market is i.e. sources of capital, SMEs access to the capital market is most often through debt finance from the major financial institutions.

Investors and Banks see audits as a cornerstone of confidence and comparability in evaluating their business decisions. Most financial institutions place a high degree of reliance on audited financial statements as part of their risk assessment of a loan application, or as part of covenant compliance and will ask for them as a matter of course. The impact of having an audited set of financial statements can range from:

- Being able to obtain finance at all
- The bank withdrawing finance



- The range of institutions willing to lend and
- The rate of interest may be influenced by having audited financial statements.

Accessing the pool of capital is critical to the success of any business and having audited financial statements can facilitate this. Whether the business needs cash to buy a new machine, acquire a competitor or develop a new product, these opportunities are usually time critical and so waiting to have audited financial statements prepared on an ad hoc basis rather than having the annual audited financial statements to hand can mean the difference between seizing an opportunity or missing out on an opportunity.

### **New markets and growth opportunities**

In the increasingly global marketplace goods and services move across the globe at a dizzying rate such that SMEs are transacting across borders just as frequently as the largest businesses.

It's not just investors and banks who value audited financial statements. When building new working relationships with other businesses, depending on the nature of the transaction, having audited financial statements can assist in obtaining letters of credit or better payment terms, or facilitate the creation of a new business relationship because of the additional credence given to audited financial information.

### **Corporate Governance**

The financial statement audit is a key contributor to the governance process.

The landmark institutions have processes, manuals, internal auditors, and implementation teams larger than the head count of many businesses in order to ensure they fulfil their corporate governance requirements. For major changes, initiatives and projects these internal teams are then typically supported by consultants too - an overhead that is beyond the needs and means of most SMEs.

While an emerging SME may not have all these formal processes and support functions in place, effective corporate governance is still a critical requirement for the directors as part of their fiduciary duties and owners. Having the processes that the business does have subject to an independent examination can be vital in avoiding issues, or improving the efficiency of the business.

### **Extracting maximum value from the business.**

Audited financial statements are one of the key ways of determining what a business is actually worth.

SMEs are often tightly held and when it's time for an owner to exit, options can be limited. An owner finding out as they are looking to close a deal to sell or exit their business that the valuation is not what is hoped for is a difficult experience, however, if the client has audited financial statements the likelihood of an unpleasant surprise in a due diligence process is reduced substantially.

### **Time to reconsider?**

So, perhaps it is time to reconsider how we describe an audit? Imagine the positive outcomes if we were to stop underselling an audit as a compliance burden and think of it as



a key partner in the ongoing success of a business from start to finish, allowing owners and management to focus on what they do best?

So while the audit report you sign for your client may or may not have KAMs documented in it, the long form audit report and the discussion it has generated is perhaps a new platform to rethink the discussions you have with your clients about the value of an audit and what underpins the audit report and how it supports them do business?

Are your clients:

- Planning to acquire a new business or enter a new relationship, locally or overseas? Consider how the audited financial statements can facilitate the building of a relationship based on a sound financial footing with both parties knowing the substance of the other.
- Planning to access more funding or to change their funding agreements or provider? Consider how with audited financial statements, their business can illustrate its value and financial strength.
- Planning to exit the business through retirement or sale, list or change its ownership structure or composition, depending on their intentions more than one year's audited financial statements may be required or may be advantageous in maximizing the value of the business. Consider how audited financial statements present a common understanding of the business and therefore its real value for sale or other transaction.
- Preparing for the new accounting standards, both the impact on their results but also the impact on their accounting systems and staff? Consider how the auditor obtains an understanding of the systems and business to see where and how new accounting standards may impact the business.
- Considering what their financial statements will look like under the new accounting standards and whether they need to discuss any impacts with their financiers particularly if there are covenants with ratios or asset levels etc?
- Considering their internal control framework and its adequacy in relation to their business today? Many business's internal frameworks have not evolved as their business grows, an audit can represent an opportunity to highlight areas of development to management and those charged with governance.
- Considering whether the internal control framework is sufficient for the directors to meet their legal and fiduciary obligations? As businesses grow the directors need to ensure that they continue to meet their obligations which increase with growth an audit can provide valuable insight into the current state of the internal control framework and its suitability.

All of these represent an opportunity to illustrate and discuss the value of the audit to your clients with their business decisions, far beyond the traditional view of compliance.