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Going-concern Audit Report: The Role of Audit Committee

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ABSTRACT

The objective of the study is to discuss the roles of audit committee (AC) towards the going-concern audit report issued by the external auditor. Based on the international standard on auditing that governing the auditors' works and findings from previous studies, clearly the auditor has the responsibility on the company's going-concern issues. The existence of AC as the board committee together with its strong composition seen to be a good measure to monitor the issues of going-concern that pertaining to the company's viability in future. The responsibility on this issue to AC is parallel with the guidelines in corporate governance codes as practised by most countries in the world.

Keywords: Going-concern Audit Report, Audit Committee, Auditor
JEL Classification: M442

1. INTRODUCTION

This paper aims to discuss the concept and roles of audit committee (AC) towards the issuance of going-concern audit report by the external auditor. The paper tries to discuss how the AC as a board committee can assist the company from receiving the going-concern audit report. Based on the International Standard on Auditing (ISA) 570 Going-Concern clearly stated the auditor has the responsibility to assess the entity's ability to continue as going-concern and the effect on the auditor's report. According to the International Standards on Auditing (ISA 240, ISA 315 and ISA 330), the auditor has the responsibility to assess the risks of material misstatement, whether they come from fraud or error, client's internal control system and client's business environment. Besides, the auditor also has to assess the viability of client's business operations in future (ISA 570) before he or she can issue professional audit opinion (ISA 700 and ISA 705). Meanwhile, in Malaysian Code on Corporate Governance (MCCG) 2012, under principle 5 and 6 stresses about the AC's commitment for entity's business risks including the going-concern issues. Traditionally, AC has the responsibility on the accounting transactions technically or a common term in accounting, general acceptable accounting practice (GAAP). However, lately more tasks have been assigned to AC including risk issues and this situation creates a burden of task for AC. The financial crisis in 2007 and 2008 has highlighted the importance of risk management in companies. Many investors, board of directors (BODs) and corporate governance observers have questioned the effectiveness of AC in overseeing the risk management function in the company. The public and investors also question the effectiveness of the corporate governance mechanisms; and one of those mechanisms is audit function (Bota-Avram, 2012). The audit function is strongly criticised, particularly on risk issues. This situation creates a new phenomenon about who is actually responsible for risk; whether it is the internal or external auditors, the BODs, management or others. Hence, more studies are needed on the connection between audit function, corporate governance and risk management (Porter, 2009; Yatim, 2010).

In measuring the effectiveness of AC, the composition of AC is most crucial. The composition of the AC whether in term of its members qualification, frequent of meeting and the status of its members always become an interest to the field of corporate governance. The effectiveness of this board committee relies on the characteristics that forming the committee (Pucheta-Martinez and Fuentes, 2007). The academic qualification owned by the AC members affecting their works that they are doing (DeZoort and Salterio, 2001; Carcello and Neal, 2003). They have better understanding of the auditing issues, including risk awareness and risk detection as well as they will be more effective in supporting the auditor's decision to issue going-concern opinion. The requirement for the AC members with accounting academic background also stipulated in Bursa Malaysia's Listing Requirement (Paragraph 15.09) that at least one of the AC members must be a member of Malaysian Institute of Accountants (MIA). The AC meeting is a platform to discuss the matters relating to its function and responsibility. More issues will be discussed among the members of the committee in the meeting and it will influence the quality of audit as a whole (Yasin and Nelson, 2012). The frequently meeting among the members of AC is a commitment in their jobs. In Malaysia, according to the MCCG (2007; 2012), all the AC members should be non-executive members and the committee should have at least three members. The requirement for the AC members with status as independent non-executive is to convince the stakeholders that this committee is free from any pressure and interruption from management. They have no any interest in the company and always adhere to standards that govern their profession.

The structure of this paper is organized as follows. Section 2 provides review of past literature and Section 3 discusses the issues as well as the conclusion.

2. REVIEW OF PAST LITERATURES

2.1. AC Characteristics

Pomeranz (1997) emphasized on the new structure for AC including upgrading the AC members' qualification and composition of independent members on the AC. Although the internal audit and AC are important elements in corporate governance practices of the company, including risk management process, they have other crucial tasks that need to be performed well. They have to ensure the accounting transactions adhere to GAAP and this can be a burden on them. The effectiveness of AC in corporate governance is seen as contributing to the issuance of quality financial reporting (Wolnizer, 1995). DeZoort (1997) found that AC members should have sufficient expertise in areas relating to accounting, auditing and law in implementing the new expanded responsibility. This finding is also agreed to by Collier and Gregory (1999) that the presence of executive directors in AC and dual function of chairman and chief executive have a negative impact on the effectiveness of AC and corporate governance system.

For the committee members, the non-executive members or independent members play an important role in ensuring that the company is running an effective internal control system. In other words, independent members from outside bring a diversity of skills and expertise (Abdullah, 2004). Siagian and Tresnaningsih (2011) studied the impact of independent members on earnings quality for Indonesian companies and the result showed that the level of earnings management is reduced after the appointment of independent members. The composition of independent or outside members in the AC may help the AC to be a more effective committee without influence from top. Outside members with external sources of information and knowledge in the ACC can perform better monitoring and give advice to the BODs (Roy, 2011).

According to Ireland (2003), there are two main reasons for the modified audit opinion issued by the auditor, namely uncertainty reasons (going-concern issue) and non-going-concern issues, including disagreement and limitation on scope of audit. Ireland (2003) concluded that there are internal and external risks that contribute to the issuance of modified audit opinion, i.e., the going-concern issue related to external risk and non going-concern issue related to internal risk. In this study, the researcher intends to relate the AC characteristics with external risks or going-concern issues.

2.2. Auditing Standards in Malaysia

The auditors have to consider the entity's going-concern assumption before they issue an audit opinion. Modified audit opinion or going-concern opinion will be issued by the auditors if there are material uncertainty or risks about the client's business operations in future (ISA 570, paragraph A20 to A24). The risks or material uncertainty for the client's business operations in future might emerge from the loss of markets or customers, failure to make loan repayments or non-compliance of the legal provisions or statutory requirements (ISA 570, paragraph A2). The auditors have to respond to the risks that they are realized. They have to obtain sufficient and appropriate audit evidence through designing and implementing appropriate response to those risks (ISA 330, paragraph 3). For that purpose, the auditors have to implement some tests, such as test of control and substantive test (analytical procedures and test of details).

In terms of risks of material misstatement, the auditors have to understand the entity and its environment, including the entity's internal control system (ISA 315, paragraph 3). From the same standard at paragraph 4, the auditors have to consider the entity's business risks which affect its ability to achieve its objectives and execute its strategies. Further, according to paragraphs 15, 16, 17 and 26 of ISA 315, the auditors have the responsibility to understand the entity's process for managing risks, including identifying and estimating the actions to address those risks by the entity. The external auditor is required to issue a report on internal control over financial reporting, which includes both opinion on management's assertion and opinion on the effectiveness of the company's internal control over financial reporting (Shelton and Whittington, 2008; ISA 700); failing to detect or not investigating fraud is a liability on the auditor (Reffett, 2010). In recent years, auditors have been required to issue opinion not only on financial statements, but also on the effectiveness of internal control over financial reporting (Akresh, 2010). Norman et al. (2010) supported that external auditors must detect fraud during the audit examination period before the issuance of professional opinion.

MIA revised its Recommended Practice Guide (RPG 5, Revised 2013) that provides guidance for auditors to engage with clients on risk management and internal control statements included in the annual report. Paragraph 44 of this revised practice guide clearly states that auditors need to issue qualified, adverse or disclaimer opinion if there are insufficient or appropriate evidences relating to clients' risk management and internal control practices; or there are circumstances that are material to the inconsistency or non-disclosure of information relating to clients' risk management and internal control practices. The whole system of corporate governance should have responsibility for corporate failures or scandals, starting from the BODs, i.e., whether their monitoring function is enough to implement best practices of corporate governance, including risk management. The senior management also has responsibility for how they run the company and practice good governance. The interaction among BODs, internal audit and AC is important as each of them has different functions and different responsibilities. The BODs, through its risk management committee (RMC), is responsible for the risk profile of the company, especially on the external risk issues, whereby the internal audit is responsible for the company's internal control, including accounting transactions. All these efforts can ensure the effectiveness of risk management and corporate governance practices in the company.

2.3. Corporate Governance and Risk

In Malaysia, the Finance Committee on Corporate Governance (FCCG, 1999) recommended the establishment of a governance code leading to the first MCCG in 2000; and amended in 2007, to make some improvements to suit the current corporate environment; and again in 2012. Brown et al. (2009) suggested that the governance structure should have a separate RMC, i.e., the separation of risks and risks under the control of the AC to be monitored by this new committee. The risks under the AC are related to accounting transactions, including the internal control system. The governance structure should consider the risk and risk management agendas for corporate decision-making processes as the risk management philosophy advocates communications across the whole organisation. It includes the BODs, senior and middle management as well as ordinary employees, where compensation and budgeting normally are in the scope of this work.

Technical skill is very crucial for AC members. The creation of a risk management sub-committee of the AC can be considered, but the members of the AC must have adequate skills, competencies and experience, since these sub-committee reports to the AC. Brown et al. (2009) also suggested for the creation of a separate board level RMC to concentrate on the broader scope of risks, especially non-financial risks. The members of this committee must come from various departments, including marketing, production, human resources, finance, research and regulatory departments, and representative/s from the AC itself.

In term of risk, client-related risk can be classified into audit risk and client's business risk. Audit risk is the risk when the auditor fails to draw attention to a material misstatement, deficiency, abuse or other unacceptable matters in an audit, leading to the issuance of an incorrect audit opinion (Elder et al., 2009); whereas client's business risk is "the risk that the client's economic conditions will deteriorate in either the short- or long-terms" (Johnston, 2000). For client's business risk, there are several types of risks faced by the companies, such as market risk, competition risk and political risk that affect the companies' operations and external environment as well as product risks. Audit risk can be divided into three components: Inherent risk, control risk and detection risk (Martinis et al., 2010). Inherent risk is the perceived level of risk that a material misstatement may occur in a client's financial statement in the absence of internal control procedures. Control risk is the perceived level of risk that a material misstatement in the client's financial statement will not be detected and corrected by internal control procedures. Detection risk is the perceived level of risk that a material misstatement in the client's financial statement will not be detected by the auditor (SAS No. 107, AICPA, 2006). Inherent risks and control risks lie within the company while detection risk lies with the auditors (Law, 2008).

3. DISCUSSION

The composition of AC is an important element in BODs structure whether in term of its members qualification, frequent of meeting and status of members. Based on the previous studies and auditing standards that governing the auditor, AC has important role for the issues of entity's going-concern. It's has the oversight function as a board committee and to ensure the entity has viability for future business. It consistent with as prescribed in MCCG 2012 for the AC to have strong composition. However, the existence of separate RMC will less burden of tasks for AC. Yet, the existence of this board committee is voluntarily in nature and no mandatory requirement as for AC. The job profile of RMC is to execute the tasks involving the risks for the company as a whole including the internal and external risks. This condition practically reducing the burden of tasks for AC which traditionally responsible on accounting transactions.

4. CONCLUSION

To ensure for the effectiveness of this board committee, the qualification of the AC's members should be measured seriously. They should have accounting and finance academic qualification as argued by Carcello and Neal (2003) and also supported by DeZoort and Salterio (2001). To ensure the entity's issues pertaining to going-concern issues be discussed effectively, the AC meeting should be held frequently. More issues can be discussed and solved if the AC meeting is held frequently during the financial year. Lastly, the quality of individuals who serve on the AC is an important indicator for effective monitoring of risk matters. The AC is seen to be more efficient if the members come from the outside or are independent members because they have the incentive to develop their reputation as experts (Fama and Jensen, 1983). This argument has been supported by Pucheta-Martinez and Fuentes (2007) in their study that they found a significant influence between AC with more independent members and receipt of qualified audit report. As the conclusion, the composition of AC is a best measure to ensure the effectiveness of this board committee.

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