

VOLUNTARY VERSUS MANDATORY AUDITS

Over the past decade, Singapore has exempted more and more private companies from the requirement to have an independent audit. The Ministry of Finance (MOF) and Accounting and Corporate Regulatory Authority (ACRA) have released a set of proposed changes to the Companies' Act in June 2011. One of the recommendations was to introduce a new audit exemption criterion to address the feedback that the current audit exemption threshold of S\$5 million based on company revenue is too low.

It is recommended that the concept of a "small company" be introduced for the purpose of differentiating statutory financial reporting requirements for private companies. If a small private company fulfils two of the following three criteria, it may be exempted from audit:

Criterion 1: Total annual revenue does not exceed S\$10 million

Criterion 2: Total gross assets do not exceed S\$10 million

Criterion 3: Number of employees does not exceed 50

Currently, a private company in Singapore is exempt from an audit if:

- 1 It has fewer than 20 shareholders,
- 2 Its gross annual revenue is below S\$5 million, and
- 3 No other corporation holds a direct or indirect beneficial interest in the company

According to ACRA's *Key Facts and Trends of Singapore Public Accountancy Profession and the Market* (2008), 70% of the private companies in Singapore are exempted private companies and those with less than S\$5 million revenue are exempt from an audit.

ICPAS had commented to the Steering Committee for the Review of the Companies' Act that it is in support of the new criteria for determining audit exemption for small companies as this should lower business costs for such companies. However, it is also of the view that some companies will

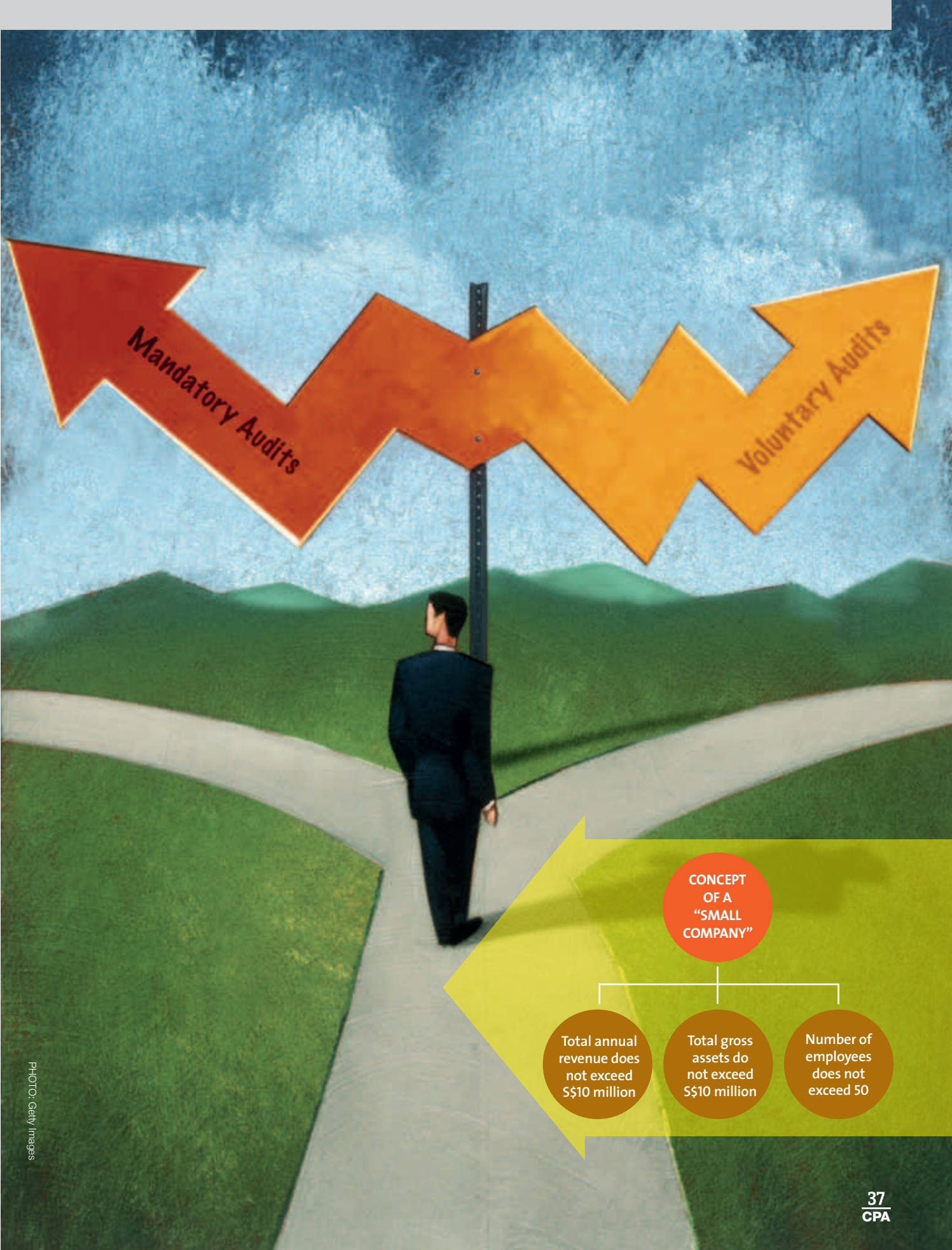
still opt to have their financial statements audited for other reasons such as obtaining credit facilities externally.

However, the question remains: Should small private companies be forced to have an audit or should they be allowed to decide for themselves whether they wish to be audited?

The primary economic argument for requiring companies to have audits is that auditing is a "public" good. A public good is a good that is difficult to exclude someone from using, even if he/she has not paid for it, and one person's use does not deny another the use of the good. Auditing is a public good because the benefits of reliable audited financial statements are not restricted to the persons who pay for the audit. For example, the audited information may be used by potential shareholders to understand the financials of the company or by financial institutions in their assessment of loan or credit facilities to a company. Because audits provide benefits to these external stakeholders who typically do not pay for the service, there is a danger that a voluntary audit regime will result in too few audits being purchased ("too few" from a societal point of view). Similar arguments are made against having voluntary markets for other types of public goods such as street lighting.

While the public good argument is compelling, there are two reasons to believe that it may be better for auditing to be voluntary. First, the public good argument does not hold if there are few individuals who benefit from an audit but who do not contribute towards the cost. In this situation, it is better to allow shareholders to decide for themselves whether or not they want to pay for their companies to be audited, that is, the free market works best.

The second argument against mandatory auditing is more subtle and therefore more interesting. This is, that a mandatory audit requirement suppresses valuable information about the types of companies that would voluntarily choose to be audited. For example, if



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Voluntary Audits

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In The Know

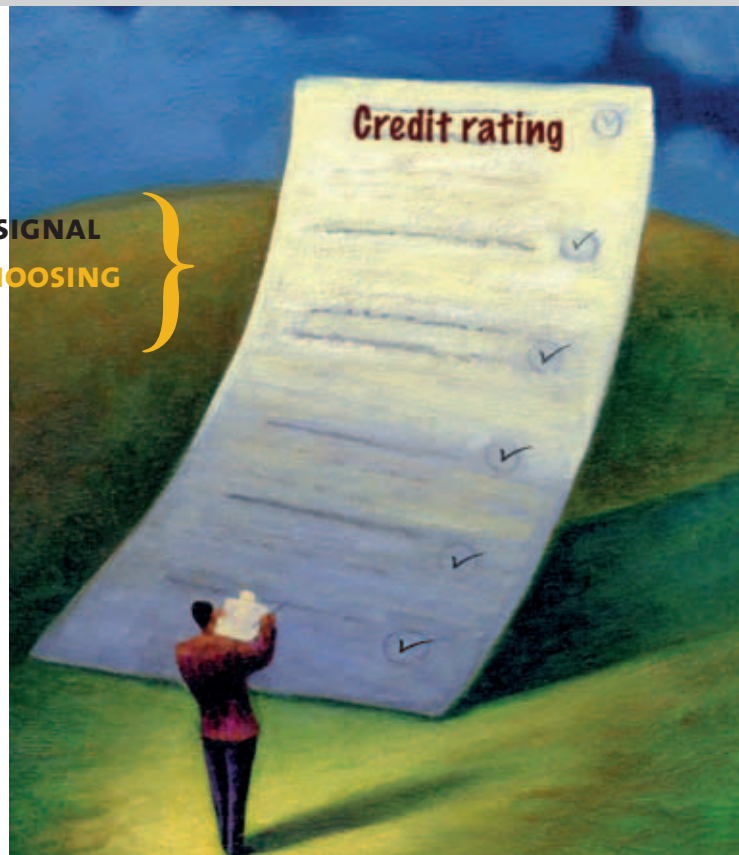
COMPANIES TRANSMITTED A POSITIVE SIGNAL ABOUT THEIR CREDITWORTHINESS BY CHOOSING TO BE AUDITED VOLUNTARILY

Company A chooses to be audited voluntarily while Company B chooses not to be audited, then this choice signals a difference between the attitudes of each company. For example, a lender may infer that Company A is more trustworthy and more deserving of external finance than Company B, given that Company A is voluntarily submitting to an audit. By forcing both companies to be audited, the mandatory regime suppresses this valuable signal about the relative creditworthiness of each company.

The alleged signalling benefits of voluntary audits motivated my colleague Professor Jeff Pittman at the Memorial University of Newfoundland and myself to conduct an academic study. To test the signalling theory, we gathered information on 5,139 small private companies in the UK. This research setting was chosen because data are more readily available for private companies in the UK and it allows Singapore to learn from the UK experience. Before 2003, every company in the population had to be audited, but due to a change in the audit exemption regime in 2004, they were given a choice. Of the 5,139 companies in this sample, 3,440 companies (67%) kept the audit in the first year of the voluntary regime (that is, 2004), while 1,699 companies (33%) chose to become unaudited as soon as this option became available.

We first looked at the credit ratings issued to the 3,440 companies that continued with the audit in 2004. For these companies, there was no change in audit assurance because the companies were audited in both 2003 when audits were compulsory, and 2004 when audits were voluntary. We predicted that these companies transmitted a positive signal about their creditworthiness by choosing to be audited voluntarily in 2004. Consistent with this prediction, we found that companies experienced an improvement in their credit ratings if they continued with the audit in 2004. This finding remained the same even after controlling for other factors that affect credit ratings such as changes in the macroeconomic environment and changes in the company's characteristics between 2003 and 2004 (for example, changes in the company's size and performance).

We then looked at the credit ratings issued to the 1,699 companies that dispensed with the audit in 2004. For this group, we predicted a drop in credit ratings for two reasons. First, there was a reduction in audit assurance because the



companies were audited in 2003 but not in 2004. Second, these companies transmitted a negative signal about their creditworthiness by choosing to dispense with the audit in 2004. Consistent with our prediction, we found that the opt-out companies experienced a significant deterioration in their credit ratings in 2004.

In addition to credit ratings, we examined the audit fees that companies were paying during the final year of the mandatory audit regime. Among the 1,699 companies that chose to become unaudited in 2004, the average audit fee in 2003 was just £4,270 (approximately S\$12,000). In comparison, the average audit fee in 2003 was £5,680 (approximately S\$16,000) among the 3,440 companies that retained the audit in 2004. This difference remained highly significant even after controlling for other important factors that affect audit fees such as size of company and audit firm.

Overall, the findings for audit fees suggest that the opt-out companies were intent on minimising the costs of the audit during the mandatory regime. These companies minimised their costs by paying comparatively low audit fees whereas the companies which genuinely wanted to be audited paid higher audit fees.

This article was written by Prof Clive Lennox, Division of Accounting, Nanyang Business School, Nanyang Technological University. The full research article, "Voluntary versus Mandatory Audits", was published in *The Accounting Review* (Fall 2011), Vol 86, No 5, 2011, pages 1655 to 1678.