Profile: Guy Almeida Andrade

Business Reporting through the Lens of a Mid-sized Practitioner

Observations and recommendations on business reporting from a medium-sized practitioner from Latin America

Intro

As a partner in a medium-sized accountancy firm for a good deal of his professional life, Brazilian accountant Guy Almeida Andrade is a well-seasoned practitioner with a wealth of experience, especially with respect to medium-sized businesses. In this interview, Mr Almeida Andrade provides his views and recommendations on the importance of strong internal and external audit to the governance of an organization and on how to improve professional audit services—especially those provided by smaller practices. In addition, Mr Almeida provides his recommendations on how financial statements can be made more useful for investors and other stakeholders, for example, by providing traceable, auditable, information that would show a company's ability to generate cash-flow and profit for the near future.

Guy Almeida Andrade: A brief bio

Guy Almeida Andrade is a partner at Magalhães Andrade S/S Auditores Independentes, a mid-sized Brazilian accountancy firm. In addition, he is a member of the Audit Committee of Itaú Unibanco Holding S.A., a member of the Audit Committee of Abril S.A., and a member of the Board of Directors of Companhia Müller de Bebidas S.A.

Mr. Almeida was also president of IBRACON, the Brazilian Institute of Independent Auditors, from 2002 to 2004, and a member of the IFAC Board from 2000 to 2006. He was named Eminent Accountant of 2007 by the Sindicato dos Contabilistas de São Paulo.

See also www.magalhaesandrade.com.br/.

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Boards should focus on longer-term goals

What has gone wrong in the area of corporate governance?

"One lesson that we have learned is that many of our problems have been related to short-termism within the management and boards of many companies, while, instead, we need a longer-term approach. If we go back to the Enron case in 2001, they were constantly trying to raise the market value of their shares; the short-term value of the shares has gotten too important for managers."

What should be done about that?

"Boards should focus on the longer-term goals of the company, and boards should be remunerated mainly with fixed wages or something like that, rather than bonuses, in order to give them incentive to work toward the future and not only focus on the present."

Corporate governance should be anchored by strong internal and external auditing (functions)

What do you suggest to solve outstanding corporate governance issues?

"During the 1990s here in Brazil, we started discussing corporate governance and set up codes of corporate governance and codes of conduct. Those codes emphasized the need for company boards to be more involved with the business and the business information etc. However, also during the 1990s, many companies started reengineering projects to simplify their processes. So, a lot of companies lost their internal controls and discontinued their internal audit function. Companies are working in a very sophisticated environment and dealing with sophisticated financial instruments, but they still are at risk of being cheated by dishonest people. They need to have solid controls and internal and external audits."

Do you see a reemergence of the internal and external auditing and assurance function?

"After the corporate scandals we had in the beginning of this century, companies went back to the basics. After the implementation of the US Sarbanes-Oxley Act (SOX), many companies placed much more importance on internal control. So they have gone back to some of the basic concepts."

Unfortunately, that did not prevent another crisis from happening…

"We are still trying to regain the appropriate controls. The crisis we are recovering from right now was generated due to many different issues. One of those issues was the use of very sophisticated financial instruments. Internal and external auditors were auditing investment funds that consisted of securitized papers, which were packaged, repackaged, and so on. In most cases, the auditors, as well as the traders, were simply too far removed from the underlying, hidden problems."

Auditors should not lose touch with the underlying business

What has gone wrong in the area of auditing?

"Part of the auditing problem is that modernizing the audit process to a new, virtual level has caused us to lose touch with reality. We have less of a feel for the business now. We understand the process, but we are not as in touch with the process as we should be.

"We auditors moved from a very simple way of auditing—coming to the company carrying big bags with pens and papers, trying to see many documents, and discussing operations with managers—to an environment that is very focused on IT auditing, etc. When we moved toward that new approach of auditing, we started to run our computer-assisted audit techniques (CAAT) tools inside the databases of our clients, getting hot information directly from their systems. This is of course very good, but we started to do more virtual auditing and to rely too much on technology. We stopped discussing operations, looking management in the eye, checking more documents, and checking the internal control environment."

Isn't it also a matter of how auditors use their staff in an audit engagement?

"The problem with the staff is more related to this new 'Y' generation. To train an auditor takes time, but newcomers to the profession are not willing to spend many years in the auditing profession. They want to go fast. There is a risk here for us to work with undertrained staff."

Auditors should complement modern auditing techniques with old-fashioned procedures

How could the audit be improved?

"In order to make auditing more effective, we should not avoid technological innovations, but we have to complement those with some old-fashioned procedures. We *must* go to the factory floor, we *must* check the sales force and the people who are collecting the money, because we are still dealing with people who can be greedy, who make mistakes, and who might try to avoid providing the right information. Therefore, we must not lose contact with the underlying business.

"This means we need to use a larger audit team than the one we are using right now. Therefore, we have to attract talent to the profession because we need more staff to do this additional work."

Audit fees should be sufficient to conduct a proper audit

Do you think that companies are willing to pay for this additional audit work?

"That is another challenge with respect to auditing. Auditing is a very expensive service, because audit firms need to conduct a proper audit or else they run the risk of not reaching the right conclusion and misleading the stakeholders. They would also risk being sued for malpractice. However, companies are often reluctant to spend a large amount of money on their audit. So we are dealing with a very difficult issue.

"Audit procedures are meant to provide assurance that the material audit risks are being avoided. Pressure for lower audit fees can, in the longer term, weaken the quality of the audit if, in order to stay within their auditing budget, auditors avoid the use of the more experienced people; people who know the business; people who know the controls, and who really can check that everything is OK. However, these more experienced people are more expensive.

"Auditors must be firm and fair in calculating their fees. But this can lead us to another problem: will there be another firm willing to charge a substantially lower fee in order to take the client? Of course, audit committees play an important role in guaranteeing that the external auditor is working objectively and with independence, and is maintaining a high level of quality. The right level of fees is paramount for this. But for companies that don't have audit committees, this is the role of the board. The board must be aware of the need to protect the quality, objectivity, and independence of their external auditors."

Complex audit reports can confuse the reader

Should auditors expand their communication with stakeholders through their audit reports?

"I am not sure whether that would be helpful or, instead, more confusing. Audit reports were designed to be simple, and when auditors use different words in their reports, that usually means that something is not right. So stakeholders read such a qualified report more carefully, because the auditors are trying to say something there.

"But then people said that auditors were not creative enough: that they were always writing the same things. They start reading the audit report and say the report looks like the one from last year. Therefore, we moved to more paragraphs, and now we are dividing the responsibilities in the audit report, saying: 'The management prepared the financial statements, my responsibility is only to check,' etc. The intention was good, but the result was frustrating: people no longer understand the audit report and still have the same old belief that if the report is clean, there is no fraud at any level, nor any misstatement. So, we have moved to a more complex audit report that is more likely to confuse people (see also: 'The real problem is not the audit report')."

The real problem is not the audit report

"It is just like going to the doctor who takes some blood from you for an examination. You go to the laboratory, let them take the blood sample, and after a few days, they send you this report. If you read the report, it probably doesn't make much sense to you. Therefore, the doctor will explain to you whether you are OK or not, because the doctor knows how to read such a report. We are, in this sense, like doctors, telling our clients that they are OK or that they have a fever or something like that. So the real problem is not the audit report. Instead, the problem is that people don't understand the extent of the auditor's work, and how much it would cost if the audit scope were broadened. Most of the stakeholders don't know what auditors do exactly."

Bridging the unbridgeable expectation gap

Isn't it also a matter of communication, clearly explaining what might be expected from an audit, and thus narrowing the expectation gap?

"We auditors have been trying to explain what might be expected from an audit for several years now, but the markets, the investors, the regulators, and the other stakeholders still might have difficulties understanding what auditors can and cannot do, and what they can or cannot say.

"The former chairman of the International Auditing and Assurance Standards Board (IAASB), John Kellas, wrote a paper some years ago called, *Bridging the Unbridgeable Expectation Gap* (2004). In his view, it is impossible to eliminate this gap between what people want from the auditors and what auditors can do. Maybe because of this gap, people don't understand what auditors do. So, what to do?"

Improve auditor oversight

So, how can we bridge the unbridgeable expectation gap?

"The first step is to have an independent auditor oversight body, managed or run by independent people who know exactly what accounting is, what auditing is, what auditors can and cannot do, and things like that. Such an oversight body would function as a two-way street: It would put more pressure onto the profession, but it also would protect the profession from being overexposed to unrealistic expectations.

"For example, the Public Company Accounting Oversight Board (PCAOB) is now overseeing the audit profession in the US. But here in Brazil, for example, there is no PCAOB. Instead, we have a peer review system that has its merits, but we know it is not good enough. So the audit profession here in Brazil is discussing the need to create an independent body to oversee the profession.

"But we also need to educate stakeholders on the auditing function and its limitations. We have to discuss the cost-benefit of the current audit procedures *vis-a-vis* a model of a more comprehensive audit. Stakeholders need to be aware of the (additional) cost of having a bulletproof audit."

Companies moved en masse to big audit firms

Working as a mid-sized practitioner yourself, what is your view on the concentration in the audit market?

"Limited auditor choice is a real problem nowadays. In the past, a company manager hired an auditor that was advised by a colleague. Not anymore! Companies, especially the publicly listed ones, have moved en masse to the big firms. It is not difficult to understand why companies, especially the publicly listed ones, have moved to the big firms:

- First of all these big firms made the right decisions in the past: they decided to merge, to open offices in different cities, different states, and different countries and tried to bring more clients to the firm. And other firms didn't take these steps.
- Secondly, because we work in a very regulated profession and we provide a service that requires trust, companies need not only an audit, but a trustworthy brand to conduct that audit.

"Now we have the Big Four audit firms, the two runners-up, and the rest. With respect to doctors in hospitals, we have plenty of options. We can exchange one doctor for another very easily, but we can't change auditors as easily because we only have four plus two, plus the rest of the smaller audit firms. So we now have a very difficult situation, because the Big Four are much bigger than the two runner-up firms, and they are much, much bigger than the rest (see also: 'Auditor choice: 4 + 2 ≠ 6')."

Auditor choice: 4 + 2 ≠ 6

"Regulators across the globe are worried now because companies' choices are limited when it comes to choosing an audit firm. The large firms are very worried that, someday, regulators will ask them to split, so they created the Global Public Policy Committee (GPPC) of the 4 + 2 largest accounting networks in order to bring the two runner-up firms closer to them and to offer some alternatives, as if they were the Big Six."

Whoever wants to grow, must go

Is audit market concentration also a problem in your home country of Brazil?

"In Brazil, the situation is worse because there is an inaccurate perception in the market that the other firms, outside the Big Six, don't provide adequate auditing services. Companies believe that if they want to be listed, they must go the Big Four plus Two firms. They think it is impossible to continue with their previous auditor, even though they have nothing against the firm. I understand that and I don't complain, because this is the local reality. I don't know how to solve this problem, but I know what to do with my firm. We still have niches that we serve and some specialized types of services that we perform, but we are not looking for listed clients, because I know they don't want a firm of our limited size."

Enable mergers of smaller firms

How could auditor choice be further increased?

"Currently there is a small chance that some of the smaller firms will merge. Maybe in the future, the runner-up networks will come together and form the Big Seven or Eight, but that would be an enormous challenge. They will need qualified people, they will need training, they will need knowledge, they will need technology, and they will need many other things in order to instill market confidence in them."

Auditor oversight could increase trust in smaller firms

And in the meantime? What else could be done to increase auditor choice?

"In the meantime, we need to show the public and other stakeholders that the smaller accountancy or audit firms can be trusted as well. Possibly, the oversight body for the audit profession (as proposed earlier) could help in this respect. Based on its inspections, the oversight body could vouch for them and communicate to the public and other stakeholders whether or not auditors are doing what they are supposed to be doing. We need to have some kind of trusted and independent body between the auditing firms and users, not only to oversee our work, but also to provide comfort to the users of financial statements that the auditing function is doing what it should do in the smaller firms, as well as in the larger firms."

Many investors don't read financial statements

Turning our attention to actual business reporting, what kind of information should companies provide?

"The bottom line is that, having put all the things—the director's report, the balance sheet, the profit-and-loss account, the notes, the auditing report etc.—together in the financial statements, many investors don't read them, and many analysts seem to be more concerned with the press release than with the financial statements! Even banks—when deciding to grant a loan for a smaller or medium-sized enterprise (SME)—discharge financial statements, even if they come accompanied by an audit report of a small auditing firm, because they don't trust them. They prefer to rely on real guarantees rather than analysis of returns and repayment capability. I wonder, using again the US environment, who reads, for example, filing Form 10-K? I would hazard a guess that only the people from the US Securities and Exchange Commission (SEC) do, but not the market! So, companies are providing all that information, but most people really don't use that information either because they don't understand it or because they don't really care. So this is another challenge, not only for the accounting profession, but for the standard setters and the regulators as well: what kind of information do we really need to bring to the people?"

Historic financial statements still have value

What kind of information do we really need to bring to the people?

"Many managers, investors, and other stakeholders during the 1980s and 1990s started saying that the financial statements are too backward looking and that they need more current and forward-looking information. They also moved from looking at the bottom line profit number to looking at EBITDA.[1] So they were more interested in cash-flow generation than the ability of a company to generate profit."

Isn't that a legitimate complaint that financial statements are predominantly retrospective?

"For sure, the financial statements show information of yesterday—not of last year but of yesterday. But what we have to have in mind is that a company can be measured through a set of information: revenue growth, profitability, returns, liquidity, and other ratios. More than that, based on a company's performance over a series of years, cross-competitor analysis, and market and economic trends, one can forecast the future cash flow, balance sheet, and income statement of any company."

Information in the financial report should be traceable and auditable

How can we meet the stakeholder demand to receive more forward-looking information?

[1] EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization

"We need something in the financial statements that would be traceable, auditable, and that would show unquestionably whether or not a company has the ability to generate cash-flow and profit for the near future. For example, it could be interesting if companies could inform their stakeholders in a more precise way, how much money they are spending in research and development (R&D), or how many patents they are generating from their R&D activities, and more importantly, how much cash-flow these patents from their R&D are generating. So this is traceable information that can be attached to the financial statements and that can be attested by external auditors. This could help the stakeholders to better understand not only the current environment but also the odds for future viability and success of a specific company."

Some investors and other stakeholders might take an additional step back and look at the strategy behind the R&D program.

"True, but factual information, such as R&D and its results, can easily be put in the financial statements and audited. To include information about the strategy is more of a challenge, because the strategy is only talk and, therefore, much more difficult to audit. In my view, it is better to let the facts speak for the strategy (see also: 'Facts/results speak louder than words')."

Facts/results speak louder than words

"As an auditor, you can check the amounts paid for R&D, and you can assure a company is spending that money in real projects, trying to generate profit for the future. So, in their financial statements, companies can not only show that they are spending money on R&D, but also show how successful they are by disclosing both the patents that they have registered, and the cash flow and profits that they have generated with these patents. With this traceable kind of information—starting with R&D costs, leading to patents, leading to cash-flow, leading to profits—companies can show part of their strategy, as well as the results of their strategy to the stakeholders. This information can be easily checked by the auditors.

"This is not an exercise in futurology. We are not trying to say: 'Considering this, the future will be blue or red.' It is not that. Instead, the financial statements say: 'We are expending this amount of money, we have these patents, and we are generating this amount of money from the patent.' So this kind of factual, quantitative information is easily traceable and easily audited. Of course, companies will have to disclose what projects didn't go well and were discarded, and how much money was expended in those failures, but this is part of the disclosure process."

Guidelines around management commentary should be developed

What are your views on management commentary?

"First of all, until now there have not been many guidelines regarding management commentary. There should be some guidelines developed around what management actually should disclose in their commentary: for example, management commentary should be based on actual facts. If we don't standardize management commentary, we risk companies only commenting on the positive things. But if we standardize too much, we are going to force companies to say the things that they don't want to say, and give away too much about their strategy. So we have to strike a balance.

"Management commentary is a kind of compromise. It is not a forecast, predicting: 'We are moving in this direction,' or 'We are moving in that direction.' We also have to take care, because most companies do not intend to clearly divulge their strategy in their external communications."

So what should management commentary say?

"In their commentary accompanying the financial statements, management should evaluate why the performance of the company was good or why it was not, and what they are intending to do in order to improve the situation, to pay the bills, to invest in different projects and different markets, and things like that. But they should do so in a way that we can audit what they say because there is no value in information that is not auditable. And, of course, if I am saying that, I am saying that the auditors must audit that narrative information that the company's management is providing.

"If management is explaining some failure, then auditors can attest if the explanation is reasonable and true or not. For example, if the figures were not so good this year, we would probably want to know why. But on the other side, if the performance was good, management should explain why it was good although the scenery at the beginning of the period was not so beautiful. So again, we need a way for someone to say that they are telling the truth without putting the auditor at risk. So we need to have a set of information that can be traceable and auditable, not just a piece of paper that nobody believes or reads but something that is useful for decision making."

Financial statements should be published online

How should business reporting develop over the next 5–10 years time?

"Here in Brazil, listed companies must publish their financial statements in all newspapers. This is very expensive, because the statements take up three or four pages of the newspaper. And although the financial statements are available for everybody, this method is not useful. The way forward would be to make this information available via a website. If necessary, you could send the financial statements to investors and other stakeholders through email.

"In the past, companies published their financial statements in very nice booklets. I think that they still do that, but the PDF format is the rule right now and I think it will be for the next five years. I see no substantial change in that. Of course, you can find the information on the websites of the CVM or the Bovespa here in São Paolo,[2] but I believe the main point of reference to look for that information should be the company's website."

Drastically reduce the number of compulsory footnotes

[2] CVM or Comissão de Valores Mobiliários is the Brazilian security commission; Bovespa, or Bolsa de Valores de São Paulo, is the Brazilian Stock Exchange.

And if we look at the content of financial reports, what changes would you recommend?

“In terms of the balance sheet, income statement, and cash flow statement, there is no need to make a change. Most people can read and understand this information. But footnotes, those are tricky things, because there is no need to explain the footnotes. We have to include relevant information in the footnotes, regarding the liabilities, contingent liabilities, and information about future cash flows, especially the money that we need to pay in the near future, but there are many other details that I think are unnecessary.

“In Brazil we are moving toward the implementation of International Financial Reporting Standards (IFRS), and one big difference between these and our current reporting standards is regarding disclosure: the enormous quantity of additional information we have to bring to the notes. Who is going to read this information? Are the stakeholders really interested in that information? We are demanding much additional information, without knowing if people are reading it or not. Therefore, we have to discuss this more with regulators, investors, analysts, and the whole group of other stakeholders.”

Fix the roof when it is sunny; not when it is storming

What can we learn from the accounting debate that followed the latest financial crisis?

“Currently, we are discussing fair value concepts worldwide, and this discussion probably does not involve the right people. It involves people who believe that the damage of the latest financial and economic crisis was caused by fair value measurements and not because of poor management decisions. And not many people are countering these false arguments because they don’t understand fair value.

“If we try to discuss accounting subjects in a time when the economic climate is calm, we are not going to bring many people to the table because they consider the subject too complicated or too technical. If we try to discuss accounting in a chaotic and highly impassioned climate like during the recent financial and economic crisis, we will bring to the table people who are very angry and who believe the problem is not caused by them, but by the accounting standards. So that is not going to help. You have to find a way to discuss the subject when the economic climate is calm and with the right people, and we are not yet being successful in doing that.”

Key recommendations from Guy Almeida Andrade

1. Companies should focus more on their longer-term goals, and remunerate their boards accordingly to encourage them to work toward the future and discourage short-termism.

2. Corporate governance should be anchored by strong internal and external auditing functions to ensure that companies have the appropriate controls in place (and that boards receive the information they need).

3. Auditors should complement modern, technology-based auditing techniques with old-fashioned procedures, such as reviewing and discussing operations, checking the internal control environment, and looking management in the eye, in order to stay in touch with the underlying business.

4. Auditors should be firm and fair in calculating their fees to be able to maintain an adequate level of audit quality. Audit committees (or boards in the absence of an audit committee) must be aware of the need to protect the quality, objectivity, and independence of their external auditors. The right level of fees is paramount for this.

5. Audit reports should be simple so that qualifications are clear and easy to understand and interpret by all stakeholders.

6. To narrow the expectation gap, the audit profession should continue its efforts to explain what auditors can and cannot do, and what they can or cannot say.

7. An independent auditor oversight body should be created as it would benefit the public interest, protect members of the accountancy profession from being overexposed to unrealistic expectations, and increase the credibility of smaller accountancy firms.

8. Companies should be required to provide stakeholders with traceable, auditable, and well-balanced management commentary that shows the companies' ability to generate (future) cash-flow and profits. Auditors should be prepared to audit and attest this commentary.

9. To satisfy the mandatory publication requirement, companies should be allowed to publish their financial statements (and other business information) solely in electronic format.

10. The relevance of additional disclosures should be discussed with the various stakeholders, as these requirements inflate the length of financial reports exponentially.

We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief survey.