Profile: Ernest Kan

Sincere and Steady Wins the Race

Over a long career and numerous engagements, Dr. Ernest Kan has accumulated a wealth of experience in corporate governance, financial reporting, and the audit of financial reports. In this interview, he shares some of his opinions in the typical fashion of an exemplary auditor: sincerely and steadily.

Intro

“The financial crisis hit the United States (US) particularly hard, but it also produced a hugely negative ‘ripple effect’ in countries around the world,” says Singaporean auditor, Dr. Ernest Kan. The crisis especially impacted countries that heavily export their products to the US. For example, many companies from China had to close because 90% of their output was exported to the US, and there was no longer a demand for their products. Some of these companies were Dr. Kan’s clients, so he witnessed the effects of the crisis firsthand. In this interview, Dr. Kan provides his recommendations on what can be done to further improve corporate governance, financial reporting, and the audit of financial reports in order to make financial reports more useful.

Control systems should take a wider perspective

Can you point out some governance lessons from the financial crisis?

“Before the financial crisis, companies overly focused on a financial controls-based monitoring framework, driven by the US Sarbanes-Oxley Act (SOX). However, what the financial crisis highlighted is that many of the risks that have the greatest impact on a business may be derived from the external operating environment.

“Moving forward, control systems should take a wider perspective, considering that organizations exist as part of an open system of dynamic variables. Perhaps we should look at new tools, such as business intelligence systems to help gather valuable information for the business and to produce alternative views and models. Business intelligence systems today have a lot of capability, such as combining data from internal information systems of an organization and integrating data coming from the particular environment e.g., statistics, financial and investment portals, and miscellaneous databases. In order to react quickly to changes in this dynamic market, organizations need business intelligence systems that
make it possible to conduct cause-and-effect analyses of organizations themselves and their environments. Thus, such systems are meant to provide adequate and reliable up-to-date information on different aspects of enterprise activities, which aids in management decision making.”

**Good financial controls can prevent companies from failing**

*Yet financial controls are no less important, correct?*

“Certainly, financial controls continue to be important, and I have a good example to highlight this point. One of the listed companies I know of went down last year due to a lack of good financial controls. They grew very rapidly since they listed. They had a very good business model, but poor cash flow management. In accounting terms, we call that overtrading. They overcommitted themselves.

“We told them repeatedly that they need to strengthen the financial control measures around the handling of their cash flow. We pointed out all the financial control issues to them. In year one, year two, even up to year three, I saw very little progress. Don’t get me wrong, there was no fraud. However, they did not get themselves up to speed in this area. And, indeed, when the crisis came, the fact that they did not properly manage the controls around their cash flows crippled them; they got trapped by a shortage of cash and did not have enough to run their operations. So the bankers came in to seize the company, because the company defaulted on its loan covenants. Had they put in a few more financial controls, some of the negative signals would have surfaced earlier. And an earlier intervention could have prevented the violation of certain ratios.

“Earlier we discussed the business intelligence system, which can also be useful from an internal control perspective. If you notice that something is moving unexpectedly, you can zero in on that area and try to find out what the problem is.”

**A balanced system of self-regulation and monitoring strengthens control without stifling management**

*How can companies implement better risk management and controls?*

“To increase the supervision of executive management, the board of a company should look at the concentration of power within the entity. The board should consider taking steps to strengthen the powers of the risk management and internal audit functions, without stifling management’s ability to take decisive business decisions and actions.

“To better integrate governance into the business model, one needs to study the monitoring mechanisms of the business units and consider self-regulation. This means instead of adopting a purely functional approach, the internal audit and risk management departments’ staff would monitor the company’s business units. We could see the business units reporting on themselves in relation to their contributions toward the entire organization, which instills in them a collective mentality in the conduct of their business activities.”
Regulators should empower the independent director

*If you don’t have adequate protections for the rights of minority shareholders, it is difficult to encourage them to increase their participation in the capital markets. Is representation of minority shareholders an issue in Singapore?*

“It is not a prevailing issue in Singapore, but sometimes there are problems that surface, and in those situations, minority shareholders have made statements that they wish the independent directors had spoken out a little bit more. The protection or clarification of the duties of the independent director is something that the law may have to address further. For example, are independent directors expected to act for all shareholders, or to focus on the interests of the minority or retail investors?

“Typically on a board, you have a mix of independent and non-independent directors, and the independent directors should provide an independent view. Under our current law, one-third of the board of publicly held companies needs to consist of independent directors, so they are always in the minority. For small- and medium-sized enterprises (SMEs), the challenge is generally more severe as the segregation between supervision versus executive function within the board may not be so clear. If those companies are family owned—and in Singapore we do have quite a few companies that are family controlled—it is of course always more difficult.

“In order to make these independent directors speak out a little bit more, you need to empower them. Otherwise, though they know they’ve been appointed as such, they will be reluctant to take a more independent view. I believe that is probably not quite properly addressed in the current Company Act. Moving forward, under new proposals to strengthen the corporate governance of financial institutions here by the Monetary Authority of Singapore (MAS), banks and big insurers in Singapore will have to fill more than half the positions on their boards and key board committees with independent directors, instead of the minimum one-third now."

Increased regulation and oversight of financial players likely

*How should regulators deal with the consequences of the current crisis and avert future crises?*

“What we witnessed during this financial crisis is that regulation failed to keep pace with developments in the financial services industry. Regulators may feel that it is time to redress the balance. The financial crisis points to possibly under-regulation of some financial industry players, such as hedge funds, investment banks, and other players in the world of shadow banking.¹ The market needs to be studied in areas that have gone wrong, and I believe that will lead to more regulation and oversight.

“The under regulation of financial products has often been cited to be one of the main reasons that led to the financial crisis. This is a very simplistic view. There was a compendium of reasons converging at the same time. You could say, ‘the perfect storm.’ The ingredients for the brewing of the perfect storm included easy credit conditions, the US housing bubble, sub-prime lending, financial innovation and complexity, incorrect pricing of risk, the commodities boom and over-leveraging, which also created the boom and the subsequent collapse of the shadow banking system. These firms in this shadow banking

¹ According to the (US) Financial Crisis Inquiry Commission, the shadow banking sector includes investment banks, off-balance-sheet entities, money market funds, and hedge funds, as well as some affiliates of traditional banks. It is some $8 trillion in size and is almost as large as the traditional banking sector (in the US).
system had a lot of money going into them and then suffered ‘runs.’ Examples include Bear Stearns and the infamous Lehman Brothers. Paul Krugman—the Nobel Prize (Economics) laureate—bravely described the run on the shadow banking system as ‘the core of what happened’ to cause the crisis.

“It is not entirely clear if the world economy is out of the woods yet. The European public debt contagion is very much in sight, and we can see the effect it has had on the Euro and the Pound Sterling. Nerves have calmed in Asia as we have seen strong economic growth in Singapore recently. The strong balance sheets of the Asian economies played an important role in helping to contain the effects of the crisis, unlike what happened during the Asia Financial Crisis in the late 1990s.”

**Balanced regulation should prevent excesses without deterring innovation**

*Is there anything that the wider global community can learn from your national oversight body, the Monetary Authority of Singapore (MAS)?*

“Our government here in Singapore generally feels that you need to give the market the free hand, let the market self-regulate, because more regulations deter innovation of new products that are good for the market. So they did not interfere very much. But after what happened to the Lehman Minibond affair, the belief, especially from the perspective of the retail investor, is that they could have come in earlier. Retail investors expected MAS—knowing that these are very sophisticated products that not many of us understand—to regulate a little bit more. For example, if these financial products are very sophisticated, they should not be offered to retail investors without first educating them, as many retail investors have very little financial education and don’t quite understand these products. Instead, companies selling these products should be required to educate retail investors before they launch a product, by providing clearer information on the product and risks. In this respect, many retail investors feel the Monetary Authority should have done more. So there is always a regulation versus innovation balance to be sought; the crisis highlighted this imbalance, and the need for it to be regained.”

**Look into claw-back clauses for executive remuneration**

*Should there also be increased regulation of executive remuneration, as incentive schemes might have contributed to the financial crisis?*

“It is fair to say that the practice of awarding share options and other performance-related incentive schemes has been abused in some cases. Nevertheless, the market principles of demand and supply still hold true for securing the services of talented professionals. Therefore, the mechanisms of financial reward need to be fine-tuned.

“One suggestion may be to look into claw-back clauses should the company collapse or get itself into severe difficulties within a specified number of years, and perhaps to phase out the payments accordingly. Perhaps human resource experts will agree on this.”
Companies should try to recruit people with high levels of integrity

What else can be done in the area of corporate governance to avert future crises?

“I hope I don’t sound too skeptical, because in the current climate, corporate governance is a very important subject. But since I started my career some 25 years ago, further improvement of corporate governance is an issue that has always been talked about, and yet you still see things happening. Now, my view is quite simple. I feel that no amount of regulations or governance can guarantee good corporate behavior, because there will always be people who will try to beat the system. Of course, we can take measures to minimize that risk, but I think, ultimately, it is the people who we are talking about, because cheating is a personal behavior.

“Companies need to get the right people, with high levels of integrity. The corporate governance of a company may not be completely sufficient, but the management’s attitude has to be right, and this tone at the top will translate throughout the organization.”

Financial reporting has become too complicated

How would you like to see business reporting evolve over the next 5–10 years, so investors can make more informed decisions about a company?

“Annual reports are getting so complicated that preparers of financial reports now have to explain to investors and other readers [through management commentary, for example] what the financial numbers tell about the organization. Many people tell me today that they can no longer understand annual reports. For example, when bankers extend a loan to a company, many of them don’t just look at the financial statements; they go and look beyond them to management analysis of the business operations, credit history, loan use, and the business plan.”

Fair value has greatly increased complexity of financial reporting

What are the main causes of this complexity and, more importantly, how can we reduce it?

“I think it all started with the concept of fair value. After Sir David Tweedie became the first chair of the International Accounting Standards Board (IASB) in 2001, we invited him to Singapore, and then on stage he made a statement about fair value. He believed that the fair value concept would become a big part of the way forward for accounting standard setting. And we would have to turn away from the historical cost model. Not to say you would no longer apply it, but it was really the fair value concept that he was championing.

“The use of fair value accounting of course has its merits, such as bringing to light earlier the often understated business risks from derivatives. However, the push back on International Financial Reporting Standards (IFRSs), especially from developing economies, is mainly due to the complexity of fair value. For example, in property valuation, there are various factors, such as the occupancy rates, ...

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2 The IASB is responsible for developing the International Financial Reporting Standards. See also the interview with David Tweedie in this business reporting series at www.ifac.org/frsc.
rent rates, interest rates for related loans, and developments in the area, that impact the fair value of the property. This certainly requires a certain level of expertise and professional judgment.

“In addition, the disclosure requirements in IFRSs are far too demanding in my view, especially the recent ones—IFRSs 7 and 8—which request disclosures of the ratios and sensitivity analyses. I mean, those are probably good for very huge publicly listed entities, but too demanding for other companies.”

**More countries—especially developing—should consider IFRS for SMEs**

*How can we address this complexity in financial reporting standards?*

“I don’t think IFRSs are going to change much, because these are the standards for the major stock markets. Especially for developing countries, I think the answer partly lies in the implementation of [IFRS for use by small- and medium-sized enterprises](https://www.ifrs.org) (IFRS for SMEs), issued by the IASB in July 2009. This is believed to be a move in the right direction. It is now being considered for adoption in Singapore. Communication with stakeholders will be essential to obtain buy-in and gain acceptance. It is too early to comment on its effectiveness in overcoming complexity and other problems related to the use of full IFRSs.

“Europe only applies full IFRSs for listed companies. That is where the rest of the world gets confused, because if you ask them to apply global standards, they seem to think that—lock, stock, and barrel—the whole set of global standards has to be imported into their jurisdiction, even though most companies in their marketplace are not listed. And full IFRSs might easily get too complicated for them. So I think that those jurisdictions need to look at their own marketplace and ask themselves whether they really should adopt the full IFRSs.

“So yes, full IFRSs are complex, and whether they need to be looked at again is a call for the IASB. But I think the various jurisdictions around the globe have to look at their own circumstances and see whether they should adopt the full IFRSs or limit themselves to the adoption of IFRS for SMEs, at least for non-listed companies. So, hopefully, part of the answer lies in the adoption of IFRS for SMEs.”

**Develop a very simple, historical cost-based standard for micro entities**

*If the answer to complexity only partly lies in the implementation of IFRS for SMEs, what else needs to be done?*

“I said partly because I still don’t feel too comfortable with the fair value concept especially for the smallest entities. If you look at the economy from an international perspective, there are many micro entities. The current accounting standards only seem to focus on large, medium, and small entities, but they may not quite appreciate micro entities. Therefore, I think we need a micro-entity standard, as well.

“An accounting standard for micro entities has to be something very straightforward. I know that it may be very old fashioned, but I am literally saying, ‘Just go for a set of very simple, historical cost-based standards, like those that we used to have many years back.’ Don’t talk about this fair value and all that. Make it very simple. As micro entities grow bigger, then migrate them to the IFRS for SMEs, and then to the full IFRSs.”

**IASB should not compromise its principles-based approach**

*Are you a supporter of further global convergence of accounting standards?*
“Having to comply with more than one accounting standard increases costs on the part of the preparer. An obvious solution is further harmonization of accounting standards so that a single global yardstick is used. If we commit resources to a single set of standards now, there will be long-term savings.

“However, with respect to the convergence project between IFRSs and the US accounting standards (US GAAP), I am not very convinced that that is the best way to go simply because the US regulatory and legal environment—given its history—is quite different from the (British) Commonwealth environment. This has led to the development of quite different accounting standards; more rules based in the US, versus more principles based in the Commonwealth. Because of the differing concepts, convergence of those two sets of standards is almost impossible. So I think the two concerned standard-setting bodies, the US Financial Accounting Standards Board (FASB) and the IASB, are trying to compromise. As a result of that compromise, we have seen more and more IFRSs becoming very big. That is what could have been expected, because if you look at the US accounting standards, as issued by the FASB, many of them go into many, many pages. If standards have to be rules based, they have to articulate everything. Part of that now has already slipped into IFRSs. So if you look at this whole convergence project, the future IFRSs will become much, much heavier. So, yes, I believe in one global set of international standards, but the FASB/IASB convergence project does not make it very easy.”

Companies should better explain their performance

If you were an investor, what would you like to see in the management commentary report?

“As an investor, I would be looking for information that is unique to that company, basically some useful financial ratios. I would expect to see some form of management commentary that either comes from the company’s website or maybe the other non-financial sections of the annual report. However, in a typical financial statement, we have little commentary. Companies only disclose historical information, such as revenue. The accounting standards require companies to break down their revenue numbers into sales of goods, services, and interest income, etc., but they don’t need to explain or have a discussion on their performance. I think a comparison between a company’s current position and its future prospects is useful information. In a typical initial public offering (IPO) prospectus, however—when a company is trying to get itself into the marketplace to sell its shares—it does give some of this commentary. In my view, this should be a continuous obligation. Companies don’t need to cover all the areas that have been mentioned in their prospectus document, but the major items should be repeated in the subsequent financial statements. Then it is up to the reader to go and make a better-informed judgment.”

Auditors should request disclosure of information that is significant to users, but they are limited in what they can request

Do you see a larger role for the auditor to assure the relevance and completeness of the management commentary?

“I think that as a general rule, the answer is yes, auditors have to request the management to disclose if a piece of information is significant for the readers. Having said that, disclosures are governed by accounting standards, regulations, and legislation. We cannot go beyond. So if the legislation, the listing
regulation, or the financial reporting standards don’t require those disclosures, there is little we can do to force them (see also ‘Judgment calls need to be based on legislation, regulation, or standards’).”

**Judgment calls need to be based on legislation, regulation, or standards**

“During the course of conducting our audit, if we do come across a piece of information that requires disclosure, first of all, we have to ask ourselves as auditors, ‘Why do we need them to disclose?’ Then, our basis must be either that it is required by the accounting standards or the listing regulations. If not, then it must be by legislation and so forth.

“There are certain areas in which auditors may have to make an assessment, for example, subsequent event disclosure. Quite often that area is quite subjective as to what is impactful in the eyes of the readers, or in the eyes of the investors, or in the eyes of shareholders. We (the auditors) have to make those judgment calls. So yes, indeed, there are certain areas that we need to express judgment, but by and large, it has to be governed by either a piece of legislation, listing regulations, or the accounting standards.”

**Auditors should be prepared to take shareholder questions about the audit**

*Is there an expanded role for the auditor in communicating undisclosed significant MD&A items to the users of the financial report, for example by expanding the ‘Other Matter’ paragraph in the auditor’s report?*

“This is a tough call. One side of this equation is this communication responsibility and so forth. But don’t forget, on the other hand, there is also a liability issue. Especially in the US, auditors get sued from time to time. So there is always that balancing act. Not to say auditors are not willing to communicate more, but we have to look at our legal obligation as auditors, and what our obligation as an auditor is in terms of expressing a view.

“While there is a call from the stakeholders for the auditors to communicate more, auditors also have to assess to what extent they should increase their communication and to which groups, because our obligation as an auditor is to the shareholders, although we have a public interest duty that we do have to make sure that the interests of the wider stakeholders out there are not marginalized. But primarily under Singapore’s Companies Act, our responsibility is to the shareholders of the company. And that line is always open at the annual general meeting (AGM), that if shareholders have questions to us about the audit, they can always raise them at the AGM.

“Now, I have sat in annual general meetings all these years, and I do get questions from the shareholders as to my audit work. Obviously, if they ask me something about the management, about the financials, I say, ‘Look, you have to refer those questions to the CFO or CEO.’ But anything about the quality of the audit, or about the work of an auditor, I am obliged to answer and I always answer those questions.”

*Previous IFAC studies identified limited auditor communication as an area of concern. If you were parachuted into the board of the IAASB, how would you further improve auditor communication?*

“Frankly, I am not so sure whether indeed there is a lack of communication. Communication is always there at the AGM, and auditors are bound to answer questions. Also, IFAC recently updated the *Code of Ethics for Professional Accountants* that governs auditors, and the IAASB has been already progressing in
terms of audit reports. In addition, compared to 15–20 years ago, this current audit report is quite onerous. This long-form report tells a lot in terms of what auditors are doing and what their findings are. So personally, I do not think we need to say more.”

**Investors should realize there is a price attached to increased reporting and assurance**

*Should companies increase the frequency of their financial reporting, and should the audit profession move along providing additional assurance?*

“It is always nice to have more information, and it may be even better to have everything audited, but don’t forget, there is a price attached to it. Somebody has to pay for those additional requirements. So I am not so sure whether we should move in that direction, but I think it will happen over time.

“Listed companies already announce their results quarterly. In certain jurisdictions, some of these results need to be audited or reviewed, but in other jurisdictions they just need to be disclosed to the shareholders without any audit or review. I am not sure whether such quarterly information released by the companies requires auditing or review, because of the cost. I do think, however, that if anything happens that will affect a company’s profit (forecast) significantly—and this can happen any time—the company should release a timely profit warning. So I think there is always a balance to be made. When it comes to auditors doing more, we need to weigh the costs vs. benefits. You may want a Rolls Royce, but someone else may say, ‘A Mercedes Benz is good enough.’”

**Auditors should rely more on their professional judgment**

*How can we curb the “checklist mentality” among auditors?*

“Auditors are familiar with using checklists. Nevertheless, auditors have to exercise a great deal of judgment as they progress upwards within an audit firm when dealing with more complicated audit issues. It is a matter of striking a balance.

“Audit professionals who rely on the checklist approach excessively or inappropriately are bound to run into problems, as there will always be new developments that the checklist will not be able to deal with, just like computer viruses, which are always surfacing.”

**A specific set of SME auditing standards should be considered**

*Do you have any recommendations with regard to the further development of the International Standards on Auditing (ISAs)?*

“Some of the current ISAs are unlikely to add value to the audit of SMEs, yet the auditor has to consider them or perform them, thereby incurring more costs. In addition, for many small- and medium-sized accountancy practices (SMPs), it is a challenge to keep up-to-date with regard to changes in the ISAs and other standards and regulation.
“Some are of the view that there should be consideration of a set of auditing standards for the audit of SMEs. ISAs could be simplified or a set of ISAs specifically for SMEs could be introduced and adopted worldwide. That would significantly reduce the cost of implementation; ISAs would be more readily understood, and could be communicated more easily to audit clients. The Institute of Certified Public Accountants of Singapore (ICPAS) has issued an Audit Manual for Small Companies to assist SMPs in conducting audits, which we believe provides guidance that is appreciated by SMPs and is a step in the right direction.”

**Auditor oversight should be more stratified**

*What is your opinion of the increased oversight of auditors and audit firms?*

“As auditors work in the public interest, a certain degree of oversight is desired. However, the regulators could perhaps look into the frequency in which audit firms are selected for quality review. Firms that do not audit entities with public accountability could perhaps be exempted or considered with a lighter touch when being inspected.”

**Auditors should continue to do what they are already doing today**

*Do you have any final recommendations to further improve the work of financial auditors?*

“As an investor, I would not expect auditors to do more than what they are already doing today. I think we are to leave it to them to continue to do that, rather than pushing upon them far too many requirements.”

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3 IFAC’s Small and Medium Practices (SMP) Committee commissioned the *Guide to Using International Standards on Auditing in the Audit of Small- and Medium-sized Entities* to assist SMPs and other auditors of small and medium entities (SMEs) in applying ISAs to the audit of SMEs. The guide provides a detailed analysis of the standards and their requirements in the context of an SME audit and can be downloaded, free-of-charge, from [www.IFAC.org](http://www.IFAC.org).
Key recommendations from Ernest Kan

1. Before the financial crisis, companies overly focused on a financial controls-based monitoring framework. However, the financial crisis highlighted that many of the risks that have the greatest impact on a business may be derived from the external operating environment.

2. In order to react quickly to changes in a dynamic market, companies need business intelligence systems that help to identify unexpected movements from an internal control perspective, which subsequently can be analyzed and addressed.

3. To instill a more collective business conduct mentality, boards should consider more self-regulation for their business units, balanced by strengthened monitoring via the internal audit and risk management departments/functions.

4. To strengthen corporate governance, regulators should increase the number of independent directors on boards and better empower them to take an independent view.

5. Companies selling sophisticated financial products should be required to educate retail investors before they launch a product, by providing clearer information on the product and risks.

6. With respect to executive remuneration, boards should consider claw-back clauses should the company collapse or get itself into severe difficulties within a specified number of years, and phase out the payments accordingly.

7. Effective corporate governance depends upon employees’ levels of integrity which flows from management’s tone at the top. A top-down ethical culture will translate across the organization.

8. Small and non-listed entities in particular should consider whether or not they should adopt the full IFRSs or limit themselves to the adoption of IFRS for SMEs. In addition, there is a need for a very straightforward accounting standard for micro entities, based on the historical cost model.

9. Companies should better explain and discuss their performance and future prospects by providing more useful ratios and management commentary.

10. A set of auditing standards specifically for the audit of SMEs should be considered; these would significantly reduce the cost of implementation, reduce complexity, and increase ease of communication with audit clients.

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