

Part I
The Background

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Introduction and Background

1.1 WHAT THIS BOOK IS ABOUT

This book offers important and unique insights into how the largely unobservable financial reporting and auditing process in UK listed companies actually works in the current UK regulatory environment, which has undergone significant change in the last eight years. It explores how finance directors (i.e. Chief Financial Officers (CFOs)), Audit Committee Chairs (ACCs) and Audit Engagement Partners (AEPs) interact with each other to reach agreement on key financial reporting issues as the financial statements are finalized. It also examines how the new regulatory regime is being implemented, by exploring corporate governance practices relating to financial reporting and auditing issues — part of the context within which these interactions take place. The governance practices mainly relate to the role of the audit committee and the audit committee chair.

By means of a wide ranging questionnaire survey and nine company case studies, we identify and analyse the interaction process involving these three principal parties in (a) discussing and negotiating financial reporting issues and (b) reaching the agreed financial reporting outcome of each interaction that took place. We also explore the key influences on the interaction outcomes. Key findings and conclusions are briefly summarized at the end of this chapter. The survey and company case studies were carried out in the UK in 2007/8. The changes to the UK's financial reporting, auditing and corporate governance regulatory frameworks were introduced in the UK in 2003/4 by the UK government (CGAA, 2003) after the collapse in 2002 of the US company Enron and the audit firm Andersen and the passing of the US Sarbanes-Oxley Act (SOX) (2002).

1.2 RECENT REGULATORY CHANGES

The UK-initiated post-Enron reforms include:

- The setting up of a new body, the Audit Inspection Unit (AIU), under the aegis of an expanded and reformed Financial Reporting Council (FRC),¹ to inspect public interest audits and issue public reports on their findings.

¹ The Financial Reporting Council was previously responsible only for the setting and enforcement of UK Accounting Standards. Following the CGAA reforms responsibility for setting auditing standards and auditing ethical standards was passed to the FRC, as was oversight of the accountancy professional bodies.

- Changes to the UK Corporate Governance Code (previously known as the Combined Code for Corporate Governance)² now require audit committees to engage with the audit and financial reporting process in a more formalized way (FRC, 2005)
- Change to the operations of the Financial Reporting Review Panel (FRRP),³ the UK's financial reporting enforcement body, from reactively responding to complaints and concerns about companies' accounts to a pro-active role of systematically reviewing public interest company accounts and other outputs.
- Transferring the Auditing Practices Board (APB), the UK auditing standard setting body, to the FRC and giving it the additional responsibility for setting auditors' ethical standards. The APB then adopted International Standards on Auditing (ISAs) amended for use in the UK (APB, 2004a) for 2005 year ends. These are based on ISAs set by the International Auditing and Assurance Standards Board (IAASB) and include ISA 260 (APB, 2004b) which requires the auditor to engage with the client's audit committee on audit and accounting related matters. The APB also issued a suite of Ethical Standards (ES) (APB, 2004c) which restrict the supply of non-audit services (APB, 2004c, ES 5) and require audit engagement partners to rotate off listed company audit every five years (APB, 2004c, ES 3).

There was also a major change at European level. A European Union (EU) Regulation (2002) required EU listed companies to adopt International Financial Reporting Standards (IFRS), set by the International Accounting Standards Board (IASB), for their group accounts for December 2005 year-ends onwards. A major influence on the IASB standard-setting process has been the planned convergence of IASB standards with those of the US Financial Accounting Standards Board (FASB), (FASB and IASB, 2006). This convergence process commenced in 2002. The change to IFRS and the convergence plans have been subject to much criticism with concerns about convergence, the complexity of accounts prepared under IFRS (FRC, 2008a), the accounting model itself, particularly the fair value or mark-to-market principle, convergence with US GAAP and the rules-based nature of the standards (Fearnley and Sunder, 2007; Page and Whittington, 2007; Isaac, 2009; Beattie, Fearnley and Hines, 2009a).

1.3 CONTRIBUTION OF THIS BOOK IN THE 2010/2011 REGULATORY ENVIRONMENT

The insights from this book will be useful for policy makers in the development of the UK regulatory framework. The global financial crisis that hit in 2008⁴ is the latest

² As the UK Corporate Governance Code was known as the Combined Code for Corporate Governance at the time this study was carried out, we have used term Combined Code throughout.

³ The FRRP has powers to apply to the court to force a company to restate its accounts if the directors refuse to do so voluntarily.

⁴ This crisis followed on from the subprime mortgage problems in the US that emerged from mid-2007.

economic event to raise intense interest globally in financial reporting and auditing quality and further changes to the framework are under consideration. In its report on the banking crisis which sparked this global financial crisis, the UK Treasury Committee (2009) expressed concerns about the role of audit (based on the bank audits with 2007 year-ends). They concluded that audit was in danger of being ‘lost in a sea of detail and regulatory disclosures’ and identified this as a possible unintended consequence of the changed regulatory regime. The Committee also questioned the value of audit. In June 2010 the UK Financial Services Authority (FSA) and Financial Reporting Council (FRC) issued a joint discussion paper suggesting that auditors should be more sceptical and challenge management more (FSA and FRC, 2010). This was followed by an APB (2010a) discussion paper on the same topic. The Future of Banking Commission (Which, 2010) has questioned the erosion of judgement in favour of a rules-based approach in the UK and calls for a restatement in law of the ‘true and fair view’ principle.

At the EU level, a green paper on the role of auditors has been published (EC, 2010). The objective of this green paper is to initiate a debate on the role and governance of auditors. The commissioner responsible, Michel Barnier, said ‘While the role of the main economic and financial actors (banks, hedge funds, credit rating agencies etc.) were immediately called into question following the financial crisis, the role of the auditors has not really been questioned until now’. Interest in financial reporting quality has, however, been ongoing for many years. This book will provide insights into a vital process which is normally inaccessible to all but its participants.

This book is a successor to *Behind Closed Doors: What Company Audit is Really About* by Beattie, Fearnley and Brandt, which was published in 2001 by Palgrave (Beattie, Fearnley and Brandt, 2001). *Behind Closed Doors* explored, for the first time, how finance directors and audit partners of UK listed companies interacted with each other in agreeing the contents of the company’s financial statements. The analysis was based on six matched interviews with company finance directors and their audit partners. The authors were called in 2002 to give evidence based on the book to the Treasury Select Committee on the Financial Regulation of Public Limited Companies. The researchers received the prestigious Deloitte/American Accounting Association Wildman Medal in 2007 for the book. The Wildman Medal is awarded for research which is judged to have made the most significant contribution to the advancement of the practice of accounting. The researchers were the first non-US research team to receive this award.

A key change for financial reporting and audit quality since *Behind Closed Doors* was published is the enhanced engagement of the company’s audit committee, particularly the audit committee chair, with the auditing and financial reporting process. Our main reason for writing a new book in this area is that our research results reveal that the process for reaching agreement on financial reporting outcomes has changed significantly under the revised UK framework. In a book we can offer readers both an analysis of behaviour in the recent pre-financial crisis environment and compare

it to the previous research, thus providing insights into the impact of the changed environment. Given the ongoing pressures for further changes emanating from the current economic climate, this will be highly topical and policy-relevant.

1.4 RESEARCH APPROACH

The book reports on two unique datasets, using a mixed methods research design (Creswell, 2009). First, we report on the results of the 2007 survey of finance directors, audit committee chairs and audit partners of UK listed companies. The survey asked which financial reporting issues the three parties had discussed and negotiated. It also asked about the functioning of the audit committee and sought views on the effectiveness of the UK regulatory framework relating to audit quality. An exceptionally high response rate for surveys to these groups of 36% was achieved, making the results authoritative. This large-scale survey allows the extent, nature and outcome of interactions to be assessed for the population as a whole. A summary of the findings from this stage is presented in Chapter 3.

The major part of the book consists of nine company case studies where the researchers conducted face to face interviews with CFOs, ACCs and AEPs of companies with different attributes including size, industry sector and ownership structure. The researchers' reputation enabled them to obtain unprecedented access, hold frank and open discussions with the interviewees and record all the interviews verbatim. The interviews explored the financial reporting and auditing interactions which had taken place and how each party perceived his or her role in the resolution of the issue. The analysis of individual case studies and the cross-case analysis will provide the only publicly available evidence of how financial reporting outcomes are achieved in the recent UK regulatory environment. The comparative analysis in *Behind Closed Doors* offers a unique opportunity to review the differences between two regulatory environments. This will enable the researchers to draw valuable conclusions about the overall impact of the recent changes (1996–2007) on the quality of financial reporting and auditing in the UK and the implications for public policy going forward.

Although the cases relate to a particular point in time, and hence a specific economic and regulatory environment, some of the issues that emerge, such as inventory valuation, are shown to be generic and insensitive to the passage of time, while others, such as financial instruments and intangibles, are a product of the prevailing regulatory setting.

1.5 OUTLINE OF BOOK

This book has been organized in three parts, as follows.

Part I comprises Chapters 1–3. Chapter 1 provides an introduction and background to the accounting regulatory framework in the UK. Chapter 2 reviews the relevant

academic literature relating to the auditor–client relationship. Specific areas covered are: regulation theory; IFRS; audit quality; enforcement; corporate governance and the role of the audit committee; interactions and negotiation in non-audit settings; and interactions and negotiation in audit settings, including the grounded theory model developed in *Behind Closed Doors*. Chapter 3 summarizes the results of the questionnaire which provided the introduction to the nine case companies. This first stage of the study shows the frequency of discussion of 35 accounting issues; the frequency of negotiation about these issues; and the frequency of resulting changes to the accounting numbers and disclosures.

Part II comprises Chapters 4–13. Chapter 4 begins by explaining how the case companies were selected and approached, and the interview techniques employed. The broad approach taken to the analysis is then set out, including a brief explanation of grounded theory and how we use it on the cases, together with details of how each case was written up. This is followed by a description of the preliminary within-case analysis, and a tabular summary of the general context and the interaction issues in each of the nine cases.

Chapters 5–13 present the findings from the interviews. These nine chapters tell the story of each case as described by the interviewees, including numerous direct quotations for seven of the cases. Each case is presented using the same structure, beginning with an overview of the background setting in which the interactions take place. This is followed by the interviewees' perceptions of the corporate governance structures and processes relating to financial reporting and auditing which are in place within the case company. The third main section introduces the key interaction issues to emerge before each is considered in depth. The process of interaction and resolution for each issue, seen from the perspective of each party, is documented. The fourth section presents the within-case analysis, beginning with the key contextual factors and moving on to identify and discuss the key influences, parties and strategies adopted, in each of the interaction issues. The concluding section offers a brief summary of what the case tells us about the audit, financial reporting and governance process in the case company.

Part III comprises four chapters. Chapter 14 offers a description and analysis of the comments made by the interviewees about the regulatory framework generally. Chapter 15 reviews the attributes and activities of the audit committee and ACC which emerge from the survey and the nine case studies. Chapter 16 begins by summarizing the financial reporting interaction attributes and the cross-case analysis, using a tabulated analysis of the 45 interactions as a key analytical tool. The revised grounded theory is then presented which shows that new concepts have emerged, the significance of established concepts has changed and relationships have altered. Finally, a comparison of the findings of this study with those of the extant literature is made, particularly the previous UK study of Beattie *et al.* (2001). Finally, Chapter 17 summarizes the findings and conclusions, and offers implications for policy and suggestions for future research.

1.6 KEY FINDINGS AND CONCLUSIONS

The key findings from this study are outlined here. Further discussion and additional findings are presented in Chapter 17.

- ***Nature of financial reporting interactions between CFOs, ACCs and AEPs.*** A total of 45 financial reporting interactions were identified across the nine case companies and it is likely that the high level can be partly attributed to the (then) recent implementation of IFRS. Some specific issues occurred in several cases, notably identification/valuation of intangible assets on acquisition (five cases), inventories (four cases) and Business Review (five cases). While 69% of the decision types were categorized as judgements and only 11% were pure compliance, the latter were more likely to result in an interaction between key parties escalating into a negotiation. In some cases this negotiation arose because of disagreement with the principles involved. The overall frequency of negotiation is lower than in the Beattie *et al.* (2001) study.
- ***Engagement of ACC and audit committee.*** The study provides evidence that ACCs are fully engaged with the financial reporting process. They act as filters to, and managers of, the audit committee. Members of audit committees who do not have an accounting qualification and IFRS experience find the complexity of IFRS challenging — this has become the *de facto* benchmark for ‘recent and relevant financial experience’. Consequently, the ACC (generally the most financially literate audit committee member) personally takes on much of the monitoring role formally assigned to the audit committee, while the audit committee most often fulfils a ceremonial role (i.e. reviewing decisions and judgements already sanctioned by the ACC).
- ***Goals and objectives of key parties.*** There is now a shared general objective to comply with the rules and the processes underpinning judgements in standards in order to keep out of trouble with the regulatory enforcement bodies. The CFO and AEP are keen to take an agreed position to the ACC so that there is no loss of face and damage to personal reputation. The ACC wants no surprises at the audit committee. All three parties seek to take an agreed position to the audit committee, again so there is no loss of face in a forum where senior executive directors and senior managers are also present. Neither the ACC nor the audit committee is keen to act as arbiter.
- ***Interaction process.*** The corporate governance changes relating to the role of the audit committee and the ACC served to shift the predominant dynamic in financial reporting interactions of a dyad relationship between the CFO and the AEP to a triad relationship where both the CFO and AEP are accountable to the ACC, who manages the AC. Consequently, interactions now tend to be characterized by problem-solving behaviour and rarely by disagreement and confrontation. The complexity of judgements introduced by IFRS into a number of accounting areas (e.g. intangible valuations), combined with the more detailed auditing standards and the strong enforcement regime, meant that more attention was given to the process

underpinning a judgement. Thus, auditors sought to ensure that judgements made would comply with the process and evidence for a decision was documented. At times this could take precedence over the quality of the decision itself.

- **Power.** Corporate governance changes, combined with the strength of the enforcement bodies, have changed the power relations between the key parties. The ACC (and audit committee) have gained power on accounting and auditing matters at the expense of the CFO and AEP. IFRS complexity has delivered more power into the hands of the technical departments of the audit firms.
- **Influences on financial reporting outcomes.** The strongest influence on the interactions is the national enforcement regime (i.e. FRRP and AIU) which has been strengthened post-Enron and greatly increases the risk of cases of non-compliance being discovered with adverse consequences for those involved. It has changed behaviour and reduced the extent to which key parties are prepared to negotiate.
- **Change in influences since Beattie et al. (2001).** Characteristics that had been an important influence on the interactions in the previous study were now of peripheral or no importance. Features such as the quality of primary relationships, company circumstances, reporting style, audit partner type and company buyer type all fell into this category. The increased relationship complexity has tended to reduce the impact of such factors as personality differences. The compliance culture has removed other influences such as audit partner type. Also, certain negotiation strategies (e.g. ingratiation and reciprocity-based strategies) were no longer observed as they could have been exposed by the enforcement regime.
- **Quality of financial reporting outcomes.** This is one dimension of the interaction outcomes. The outcome of all the compliance issues was classified as compliant. While it was not possible to evaluate the quality of a judgement issue, it was classified as either acceptable or unacceptable in terms of compliance with the process of reaching the judgement. All the judgement outcomes were classified as acceptable. While the good news is that there are no unacceptable outcomes as a consequence of the strong compliance culture, the undermining of the true and fair view and the loss of the principles of substance over form and prudence mean that some of the highest quality outcomes are no longer achievable. The only significant influence on the quality of financial reporting was the regulatory framework.
- **Ease of outcomes.** The ease of agreement, the other dimension of the interaction outcomes, was also strongly affected by the regulatory framework. The existence of accounting standards which are more rules-based often made agreement easier. The enhanced role of the audit committee made it more difficult for other executive directors to get heavily involved in decisions. However, other factors could also be significant. Agreement was more difficult where the regulatory framework was unclear, where primary relationships were less good, where individuals had a face-saving agenda, or where the CFO was prepared to challenge the rationale of the relevant accounting standard.
- **Quality of IFRS.** Interviewees did not believe that the introduction of IFRS had improved the quality of UK financial reporting, due to excessive complexity, high

disclosure volume and increased emphasis on rules rather than principles. Some standards were considered to produce dysfunctional results and to require costly information collection that was subsequently ignored by users (e.g. intangibles in business combinations).

- **Quality of ISAs.** Although ISAs were a less prominent feature of the cases, views were expressed that they, like IFRS, were overly detailed and prescriptive.
- **Quality of auditors' ethical standards.** Some aspects of audit ethical standards were considered to be problematic. The five year rotation period for AEPs was a concern, particularly for more complex clients and where CFOs and ACCs had also changed. The restrictions on non-audit service provision presented some challenges, particularly for small cap companies with fewer accounting resources who were no longer able to obtain accounting and business advice from their auditor.
- **Effectiveness of enforcement.** The FRRP was considered to be an effective financial reporting enforcement body and all key parties have strong incentives to comply with standards. The procedures of the AIU (the enforcement body for auditing standards) were considered to be process-driven and based on box-ticking; however, it was still considered a formidable regulator in enforcing ISAs and AEPs were most anxious to avoid adverse reports. Although the AIU has reduced drastically the scope for poor quality audit, the nature of the procedures may, in conjunction with other aspects of the regulatory framework, have helped to reduce the scope for very high quality audit as well. Thus, the boundaries within which audit quality and compliance can be measured are narrower.
- **Relationship between standards and enforcement and between audit quality and financial reporting quality.** Under an effective enforcement regime, it is the quality of the standards and regulations being enforced that will determine the quality of the final outcomes. The quality of the mainly international accounting and auditing standards being enforced by the national regulators has been subject to criticism. High quality financial reporting requires *both* high quality accounting standards and high quality audit. High quality audit is, therefore, a necessary but not sufficient condition for high quality financial reporting as audit is only one piece of the financial reporting jigsaw. The auditing and financial reporting outcomes that arise from the unique UK regulatory nexus formed by IFRS and ISAs (sets of standards with perceived deficiencies), a robust financial reporting enforcement regime, and a robust auditing standards enforcement regime will themselves be deficient in some respects. It may be appropriate to move towards a more *de facto*, principles-based set of standards — one that would perhaps reinstate the substance over form principle and the true and fair view override. This would avoid some of the undesirable (and unintended) consequences of the detailed, complex, rules-based, process-driven nature of IFRS and ISAs (and consequently enforcement procedures).