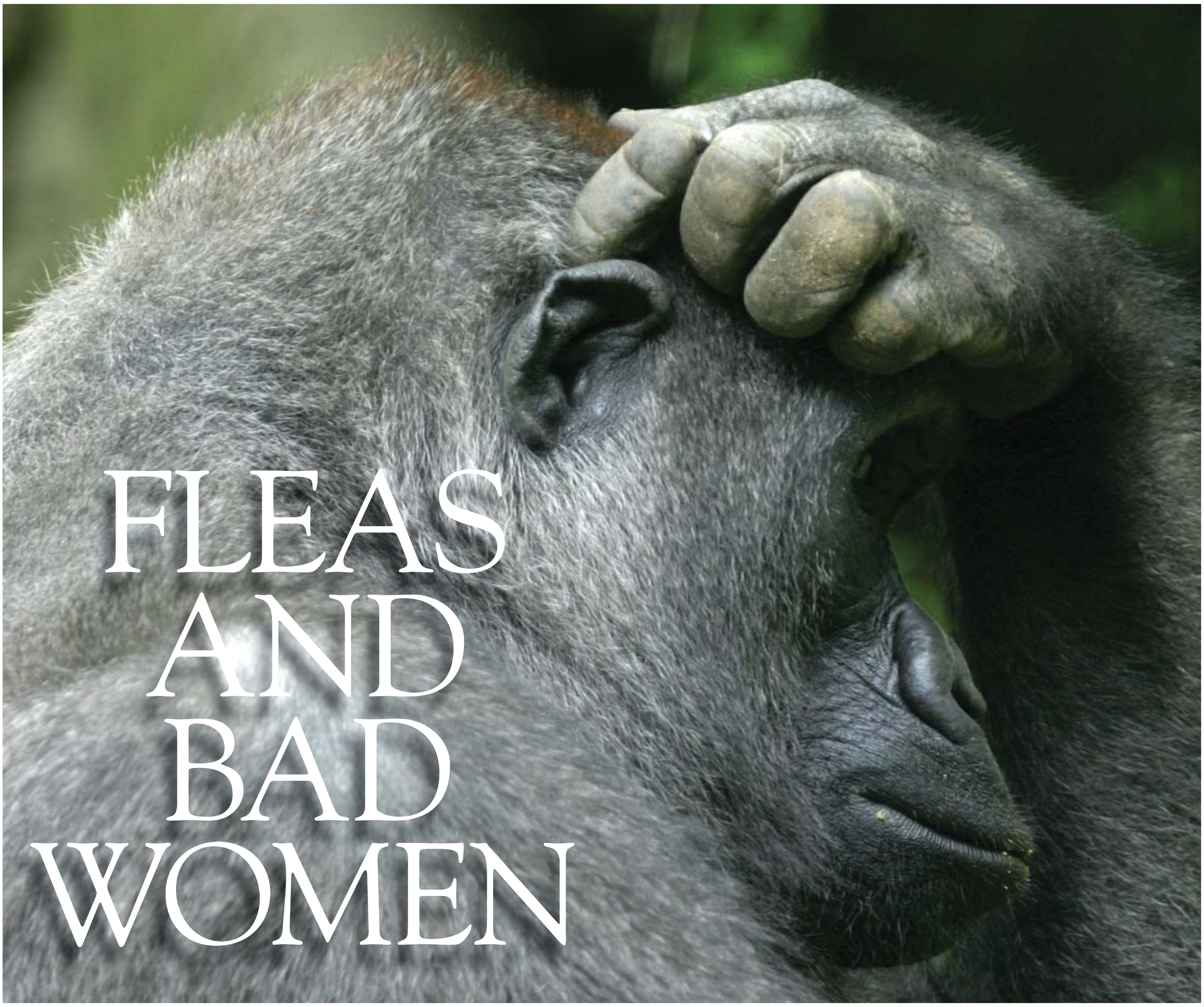

FLEAS AND BAD WOMEN

DON'T BREAK THE BACKS OF AUDIT COMMITTEES AND THEIR AUDITORS WITH UNREALISTIC EXPECTATIONS, SAY ACCOUNTING ACADEMICS

The 2011 PD Leake lecture this year drew on our research into how finance directors, audit partners, audit committee chairs and audit committees of UK listed companies interact on audit-related issues. We did the research in 2007/08 by a survey and interviews with all three parties.

After the banking crisis, regulators wish to impose more responsibilities on audit committees and their chairs. The Financial Reporting Council's (FRC) *Effective Company Stewardship* paper, published in January this year, suggests that the committee increase its oversight of the audit process and include details in its report, which the auditors will review. The question now is not how they do this, but whether or not they *should*.

Two poems relevant to answering this question come to mind. First, Jonathan Swift's *The Siphonaptera:* 'Big fleas have little fleas on their backs to bite 'em, and little fleas have lesser fleas and so ad infinitum.' Second, a line from Juvenal's *Sixth Satire*, 'Quis custodiet ipsos custodes?' (Who guards the guards?) is often quoted in the context of regulation. This poem is known to classicists as *The Legend of Bad Women*. Juvenal's context is the untrustworthy wife who, if locked up by her husband, will seduce the guards.

NO SURPRISES WANTED

We find that the audit committee averages 3.4 members, with 1.3 members having an accounting qualification. It meets four times a year. Frequent attendees other than committee members are the FD (94% cases), CEO (75% cases) and the internal auditor (65% cases). Other attendees include the company secretary, the financial controller and the chairman. Thus the meeting is important and influential, at which no one would wish to look incompetent.

The vast majority of audit committee chairs, FDs and audit partners believe audit to be valuable to companies and that the committee has significantly enhanced audit quality. A particular feature of committee and chair behaviour is that they don't want surprises from the FD and audit partner and they don't expect to resolve disagreements between them. Audit committees want the proposed solution from the FD and audit partner and, given the committee's power in the current framework, inability to reach agreement would look bad.

We identified 16 issues where an audit committee would oversee auditor performance (eight audit planning issues and eight performance and

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finalisation issues). We asked FDs, audit partners and committee chairs to indicate which issues were discussed and which negotiated between them and which parties, including the committee, were involved in the interactions.

While we generally found that audit committees were engaged with the issues, attitudes to risk by directors and auditors were only discussed in half the committees, and internal control quality and audit materiality were not discussed in a quarter. It is possible that some respondents had risk committees or risk was addressed at the main board meetings. There is already further guidance on both these issues post crisis. The issues most commonly negotiated were fees, timetabling, group audit scope (also the most discussed) and technical department referrals.

FINANCIALLY LITERATE CHAIR CRUCIAL

Unsurprisingly, there was more discussion and negotiation in large company audit committees, those audited by Big Four firms and where two or more committee members had recent and relevant financial experience. Also, where the chair was a former auditor, they were more likely to be involved in interactions on audit-related matters without the committee being involved.

We found the role and financial experience of the chair to be critical to the effectiveness of the committee in audit-related matters. Our interviews contained many criticisms of the complexity of the regulatory framework for accounting and auditing for committee (and main board) members who are not accountants and unhappiness about increasing dependence by all parties on dictats from audit firm technical departments.

Survey respondents wanted clearer guidelines about how to evaluate auditor effectiveness and were unenthusiastic about disclosing more company-specific information in the committee's report.

FLEAS AND BAD WOMEN

Post Enron, the audit committee was required (under comply or explain) to take a more proactive role in overseeing and engaging with auditors, and this has been successful. But how much can we reasonably expect a committee of three or so part-timers to do?

This is where the fleas and bad women come in. Auditors already have enough fleas on their backs from the Audit Inspection Unit and the Financial Reporting Review Panel, and the increasing burdens and box-ticking coming from International Financial Reporting Standards, International Standards on Auditing and Ethical Standards. The FRC is now suggesting that not only should audit committees jump more on auditors but also that the auditors jump on the audit committee's report.

As for bad women, audit committees are composed of members of a unitary board and are therefore not independent of the company. They can only do so much. So let us avoid an audit committee expectations gap by not asking them to take on more than they can reasonably achieve.

The scientific definition of fleas is 'wingless insects that suck blood'. Regulators generally should avoid creating a more flea-ridden regulatory environment than we already have.

Vivien Beattie and Stella Fearnley are accounting professors at the University of Glasgow and Bournemouth University respectively. Tony Hines is head of the department of accounting and finance at the University of Portsmouth. Their book, *Reaching Key Financial Reporting Decisions: How Directors And Auditors Interact*, is published by Wiley (www.wiley.com). The 2011 PD Leake lecture 'Do audit committees really engage with auditors on audit planning and performance?' can be viewed at www.auditqualityforum.com

VIEW FROM BUSINESS

Graham Roberts is former finance director at British Land and chairman of an audit committee. He agrees that, as the research shows, the whole arena of audit committee, auditors and audit quality has improved immeasurably since audit committees became part of mainstream business life in the UK.

'It is no longer a hostile environment', he says. 'It's now all about knowledge. There is more sharing, and the views of the auditors are well aired.' And with the improvements that audit committees have brought about, the effect on financial reporting in the business world has been positive. 'There have been very few UK financial reporting failures over the last 15 years relative to other jurisdictions and that is a great credit to the changed system.' Any failures have been more to do with failed business models, he believes.

The way that boards, audit committees, the auditor and the regulator interact for financial organisations is very different to other companies,' he points out. More should be done to study how these interacted and operated ahead of the financial crisis and what lessons can be learnt.

On the research findings that risk issues had only been discussed in half the audit committees surveyed, Roberts believes the statistics will have changed since the research was carried out: 'Risk discussions will have increased dramatically since the financial crisis.'

He backs the research finding that finance directors have now lost some of their influence over the auditors. 'There has been a shift in power,' he says, 'with wider circulation of information and issues compared to how it used to work before audit committees existed. There is now a pragmatic relationship between the audit partner and the audit committee. Everything is out in the open.' Tensions too, are diffused earlier, with committees ensuring that negotiation happens early, 'well in advance of the audit issues being discussed finally, and that means issues are resolved more reliably'.

Roberts notes however the increasingly technical element to an audit committee's work which requires significant input from members with relevant financial experience.