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# Briefing

## AUDITOR/COMPANY INTERACTIONS IN THE 2007 UK REGULATORY ENVIRONMENT

Discussion and negotiation on financial statement issues reported by finance directors, audit committee chairs and audit engagement partners

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# Briefing

## AUDITOR/COMPANY INTERACTIONS IN THE 2007 UK REGULATORY ENVIRONMENT

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## Purpose of the study

The issue of audit quality currently sits at the top of the financial reporting policy agenda (eg, FRC, 2006a; 2007, 2008). The audit process involves interactions (ie, discussions and negotiations) between the audit team and client company directors and staff. At senior level, these interactions determine the content of the published financial statements and hence impact on the overall integrity of the financial reporting process and capital market confidence.

This Briefing reports findings from a survey of the three principal parties (finance directors/chief financial officers (CFOs), audit partners (APs) and audit committee chairs (ACCs)), part of which explores their role in the audit interaction process. The data was collected between June and September 2007 and therefore relates to the current UK regulatory environment. In this Briefing we report on the extent, nature and outcomes of financial reporting interactions which took place involving the three parties.

## Background

In 1995, we undertook a similar investigation sending a questionnaire to CFOs and APs of UK listed companies (Beattie, Fearnley and Brandt, 2000). The auditing and financial reporting environment has changed radically since then. The failure of Enron in the US in 2001 was a major shock and led to the passage of the Sarbanes-Oxley Act in 2002. Since then, similar reforms have been adopted in Europe and elsewhere (Oxley, 2007; Quick et al, 2007). Although audit committees have been a longstanding feature of UK corporate governance, their role has been strengthened. The UK's *Combined Code on Corporate Governance* incorporated the recommendations of the Smith Report (2003) on the role of audit committees. The Financial Reporting Council (FRC, 2005) produced detailed guidance about the role and responsibilities of the audit committee regarding financial reporting (paragraphs 4.1-4.4) and the external audit process (paragraphs 4.16-4.38). International Auditing Standard (ISA (UK and Ireland) 260 (APB, 2004)) requires the auditor to communicate in a timely manner to those charged with governance in the company about audit matters. The ISA 260 requirements mirror some of the provisions in the Combined Code but they make compliance mandatory for auditors, whereas the Combined Code requires companies to comply or explain.

Other significant UK changes include: the mandatory adoption of International Financial Reporting Standards (IFRS) for the group accounts of listed companies throughout the EU for December 2005 year ends; more rigorous ethical standards for auditors; the adoption of International Standards of Auditing (ISAs) (UK and Ireland) for December 2005 year ends; and independent inspection of public interest audits by the Professional Oversight Board.

Consequently, new variables have emerged that are likely to influence audit interactions and moderate the influence of others. The audit committee is now expected to have a significant role in the relationship between the company and the auditor.

## Research approach

A questionnaire was sent to CFOs, ACCs and APs of domestic, officially listed UK companies, (excluding AIM companies and investment trusts) asking (among other matters) about their recent experience of discussions and negotiations on 35 financial statement issues. The sample covered the top 250 qualifying companies by market capitalisation (as at 5 February 2007) and a systematic sample of 250 from the remaining qualifying companies. To eliminate multiple selections of ACCs, the final sample sent out to this group was reduced to 446.

To identify suitable APs acting as engagement partner for qualifying companies and facilitate the distribution of the questionnaire, we were assisted by 11 large audit firms. The firms identified 439 listed company APs who were asked to respond with reference to their largest listed client within the scope of the study.

For each financial statement issue that had been the subject of discussion and/or negotiation in the most recent financial year respondents were asked:

- which parties were involved in the **discussion** (defined as: matters raised by one or more participants and considered in speech or writing);
- whether the discussion became a **negotiation** (defined as: the process of reconciling conflicting views advanced in discussion, by concessions by one, two or all participants);
- whether the discussions or negotiations resulted in a change to the proposed accounting numbers or disclosures;
- whether the issues discussed led to: the possibility of a qualified audit report; consideration of or actual auditor change; or a third-party opinion being sought.

The nature of interactions between the three groups is very often complex and does not necessarily follow the sequence above. A 'normal' progression from discussion to negotiation to changes to the accounts cannot be assumed. For example, respondents have cited many examples where discussion resulted in changes to the financial statements without going through a negotiation stage. Clearly it is difficult fully to capture this complexity of the interactions in a structured questionnaire. The second stage of our research project will therefore involve interviews to explore this aspect further.

The following overall useable response rates were obtained: CFOs 30%; ACCs 29%; APs 50%. The characteristics of the three respondent groups are broadly comparable, although the ACC group contains a slightly higher proportion of FTSE 250 companies than the other two groups.

## Key findings

Key findings are grouped under four headings: discussion issues; negotiation issues; change to the financial statements (separated into change to accounting numbers and change to disclosures); and events triggered by key issues. Tables 1 to 4 show the 10 most frequently cited issues for each group. The tables are ordered on the CFO group; issues ranked outside the top 10 are shown in square brackets. Table 5 presents the incidence of significant events triggered by these interactions.

### 1. Discussion issues

**Table 1: Top 10 discussion issues**

Issue	% indicating discussion took place (n=)			Rank		
	CFO (149)	ACC (130)	AP (219)	CFO	ACC	AP
Intangible assets/goodwill	62.4	58.5	59.4	1	1	3
Issues in subsidiary undertakings	61.1	53.1	71.2	2	8	1
Segmental reporting	57.7	49.2	54.8	3	9	5=
Deferred tax assets/liabilities	56.4	43.8	51.1	4	[12]	9
Presentation of the primary financial statements	55.7	57.7	63.9	5=	2=	2
Business review	55.7	53.8	55.3	5=	6=	4
Revenue recognition	53.0	53.8	54.3	7=	6=	7
Exceptional items	53.0	57.7	49.3	7=	2=	10=
Fair value on acquisition	49.0	57.7	49.3	9=	2=	10=
Liabilities/provisions	49.0	55.4	53.0	9=	5	8
Share-based payments	44.3	42.3	54.8	[12]	[13=]	5=
Financial instruments	38.9	45.4	43.4	[13]	10=	[12]
Directors' remuneration report	37.6	45.4	40.6	[14]	10=	[14]

The top 10 discussion issues are shown in Table 1. What is immediately apparent is that there is a very high level of agreement among the three groups on the most discussed issues – approximately half of each group discussed the same issues. Issues arising from business combinations dominate the list. Thus, intangible assets/goodwill, issues in subsidiary undertakings and fair value on acquisition feature highly. This may be because IFRS 3 requires the fair value of the cost of the combination to be allocated to the various identifiable components, such as brands and customer lists, and the accounting treatment is different from that of goodwill. A recent study for the European Commission found that one third of companies do not provide a description of the components (ICAEW, 2007). It also revealed that

many preparers had doubts that the costs involved in valuing individual intangibles were justified. This may explain the high level of discussion on this issue.

Presentation of primary statements and exceptional items are both ranked highly (even more so as a negotiation issue). The FRRP has already made clear its view that additional line items in the income statement may be included when this is necessary to explain elements of financial performance, but such changes should be justifiable (FRRP, 2006). It is possible that this high level of discussion is related to the format of the income statement.

Overall levels of discussion reported by each of the participating groups are broadly similar, with ACCs being as aware of the issues as the other groups. This contrasts with the findings of Beattie et al (2000) where APs reported higher levels of discussion than CFOs. Additional comments in response to open questions on the survey were generally positive regarding the impact of audit committees on the process:

'By the audit committee, in substance, setting the terms for the auditors on behalf of the shareholders, the audit committee are better informed by the auditor and in a better position to question the quality of the audit. The auditors are relieved of the problem of inappropriate time pressures or compromises with management.'  
ACC 428

'I see the AP/CFO/ACC as a threesome working to a common objective – we watch each other but primarily to protect each other's backs.'  
ACC 440



## 2. Negotiation issues

**Table 2: Top 10 negotiation issues**

Issue	% indicating negotiation took place (n=)			Rank		
	CFO (149)	ACC (130)	AP (219)	CFO	ACC	AP
Presentation of the primary financial statements	12.1	6.9	14.6	1	4=	6
Exceptional items	9.4	9.2	16.9	2	2	2
Issues in subsidiary undertakings	8.1	6.9	19.2	3=	4=	1
Revenue recognition	8.1	5.4	13.7	3=	6=	8
Segmental reporting	7.4	4.6	12.8	5=	8=	9
Liabilities/provisions	7.4	5.4	15.5	5=	6=	4=
Intangible assets/goodwill	6.7	7.7	16.4	7	3	3
Financial instruments	6.0	3.1	7.8	8=	[13=]	[12=]
Deferred tax assets/liabilities	6.0	1.5	14.2	8=	[21=]	7
Fair value on acquisition	5.4	10.0	15.5	10=	1	4=
Business review	5.4	2.3	10.0	10=	[19=]	10
Inventories	3.4	4.6	4.6	[14=]	8=	[17=]
Identification of pre/post acquisition expenses	0.7	4.6	2.7	[25=]	8=	[22=]

The top 10 negotiation issues are shown in Table 2. Only one financial statement issue is cited by at least 10% of CFOs (presentation of the primary financial statements) and only one issue (fair value on acquisition) is cited by at least 10% of ACCs. By contrast, 10 issues are cited by at least 10% of APs. Thus, APs report substantially higher incidence of negotiation than either ACCs or CFOs. This phenomenon was also noted in the previous study (Beattie et al, 2000). The most likely explanations are either that the APs' concerns regarding audit quality result in them having different perceptions regarding their involvement in negotiations and the impact on financial statements. Alternatively, it may be because the role of an AP is focused on the production of audited financial statements, whereas ACCs and CFOs have a broader range of responsibilities.

The issues most frequently negotiated are similar to the issues most frequently discussed for all three groups, although ACCs place inventories and identification of pre/post acquisition expenses in the top 10 negotiation issues, well above the other respondents. Other issues for all three groups – US GAAP reconciliation issues; for ACCs – inventories, property, plant and equipment, leases and identification of pre/post acquisition expenses; and for APs – prior year adjustments. Relative rankings vary.

It is surprising that financial instruments, the IFRS standards which have been heavily criticised, do not appear higher in the rankings, although several respondents made adverse narrative comments about IAS 32 and 39.

While direct comparisons with the previous study (Beattie et al, 2000) are not possible due to differences in the scope of the work, there are indications that the proportion of discussions which evolve into negotiations has declined. Some possible explanations for this were provided by narrative comments.

'We work through the year to identify and resolve issues and new policies as we go; the result is that if there are no surprises, the need for 'negotiation' is avoided. This is what has happened.' AP 44

'I don't recognise negotiation as part of the audit committee process.' ACC 440

Beattie et al (2000) did note that levels of negotiation were lower for companies with audit committees. In 2007 virtually all listed companies have audit committees and their role is more clearly defined, so it would be expected that negotiation is rarer. Their presence appears to impose a structure on the audit process that largely precludes last minute negotiation to clear an issue.

### 3. Change to the financial statements

**Table 3: Top 10 issues resulting in change to the accounting numbers**

Issue	% indicating change took place (n=)			Rank		
	CFO (149)	ACC (130)	AP (219)	CFO	ACC	AP
Deferred tax assets/liabilities	7.4	4.6	13.7	1=	[13=]	4=
Share based payments	7.4	6.9	7.3	1=	5	9
Exceptional items	6.7	6.2	12.8	3	6=	7
Revenue recognition	6.0	8.5	15.1	4=	2=	3
Intangible assets/goodwill	6.0	7.7	13.7	4=	4	4=
Issues in subsidiary undertakings	5.4	6.2	26.9	6=	6=	1
Retirement or other employee benefits (eg, pension schemes)	5.4	5.4	5.9	6=	9=	10=
Financial instruments	5.4	5.4	9.6	6=	9=	8
Liabilities/provisions	4.7	5.4	13.7	9=	9=	4=
Prior year adjustments	4.7	6.2	4.6	9=	6=	[14=]
Fair value on acquisition	4.0	10.0	18.7	[11=]	1	2
Issues in associates or joint ventures	4.0	8.5	2.7	[11=]	2=	[19=]
Presentation of the primary financial statements	2.7	5.4	5.5	[14=]	9=	[12=]
Segmental reporting	2.7	2.3	5.9	[14=]	[18]	10=

**Table 4: Top 10 issues resulting in change to the disclosures**

Issue	% indicating change took place (n=)			Rank		
	CFO (149)	ACC (130)	AP (219)	CFO	ACC	AP
Presentation of the primary financial statements	17.4	9.2	31.5	1	2=	1
Segmental reporting	16.8	9.2	21.0	2	2=	4
Business review	15.4	9.2	24.2	3	2=	2
Issues in subsidiary undertakings	12.1	6.9	23.7	4	9=	3
Exceptional items	11.4	10.0	16.9	5	1	6
Intangible assets/goodwill	9.4	8.5	16.4	6	5=	7=
Financial instruments	8.1	7.7	15.5	7	7=	10
Deferred tax assets/liabilities	7.4	3.8	16.4	8=	[16=]	7=
Directors' remuneration report	7.4	5.4	16.0	8=	[11]	9
Liabilities/provisions	6.7	4.6	11.0	10=	[12=]	[14]
Retirement or other employee benefits (eg, pension schemes)	6.7	4.6	13.2	10=	[12=]	[12]
Issues in associates or joint ventures	6.0	7.7	5.0	[12=]	7=	[19=]
Fair value on acquisition	4.7	8.5	18.7	[14=]	5=	5

The top 10 issues resulting in change to the accounting numbers are shown in Table 3, while the top 10 issues resulting in change to the disclosures are shown in Table 4. In both tables, the same set of issues that featured at the top of the discussion and negotiation tables are at the top of the change to financial statements tables (albeit with slightly different emphasis). A notable exception to this is share-based payments (introduced for the first time by IFRS 2), which sit high in the change to accounting numbers table and did not feature in the negotiation table. Other exceptions are retirement or other employee benefits and prior year adjustments. The directors' remuneration report, always a sensitive issue, appears in the change to disclosures table. Deferred taxation heads the list of issues resulting in changes to the accounting numbers. This is always a subjective area and was ranked in the top six in the previous study (Beattie et al, 2000). ICAEW (2007) confirms that, in the transition to IFRS, deferred tax had caused more restatements than any other issue.

As with the negotiation issues, APs frequently report higher levels of change to the financial statements than either of the other two groups. The exception to this is issues in associates or joint ventures, which rank very highly for ACCs in the change to accounting numbers table relative to the other groups.

Segmental reporting features strongly as an issue causing a change to accounting disclosures. IAS 14 requires greater disclosure (particularly of segment assets and liabilities) than the old UK equivalent (SSAP 25) and this may have been resisted by companies on grounds of commercial sensitivity. The enhanced business review has been introduced for year ends beginning after 1 October 2007, but many companies may have been preparing for this event in advance and were discussing content with their auditors, hence the relatively high ranking.

While changes to the financial statements may occur after the relevant issue has been negotiated, this is not invariably the case. Respondents have cited many examples of discussion being linked to a change. A 'normal' progression from discussion to negotiation to changes to the accounts cannot be assumed and frequently the interactions are more complex.

#### 4. Events triggered by the most important issues

**Table 5: Events triggered by the most important issues**

Event	Number of reported cases			
	Combined groups	CFOs	ACCs	APs
Possibility of a qualified audit opinion	44	7	1	36
Second opinion sought from third party (eg, lawyer, regulator other audit firm)	56	11	13	32
Change of auditor considered by the company	23	7	3	13
Actual change of auditor	4	1	3	0

Respondents were also asked whether any of the issues they considered the most important had led to consideration of a qualified audit report, seeking an external second opinion, or the possibility or actuality of an auditor change. Responses are summarised in Table 5. CFOs and ACCs were aware of the possibility of a qualified audit report in only eight instances, compared to 36 for the APs. Going concern was the most common issue cited with five instances (although strictly under ISAs this would result in an 'emphasis of matter' audit report rather than a qualification). This suggests that CFOs and ACCs were less aware than the auditors of how close they may have been to a qualification or an emphasis of matter paragraph.

External second opinions were sought from a third party on 56 occasions, with intangible assets/goodwill (6 instances) being the most common issue. Auditors sought external opinions more frequently than company directors. This may be attributable to the changes in the ethical codes whereby auditors cannot provide certain types of service to their clients.

Auditor change was considered on 23 occasions. Surprisingly, APs were more frequently concerned about the possibility of their client seeking auditor change than client companies actually considered changing. Actual auditor change occurred only four times. Narrative comments gave an indication of why auditors might believe they were likely to be removed:

'Technical advice/input more limited or 'qualified or 'disclaimed' for fear of regulatory non-compliance, a frustration to the client.' FD 340

'Challenges of interpreting IFRS have put a strain on relationship due to need to involve technical department.' AP 50

'Less involved in providing commercial advice to clients on impact of changes in accounting standards for fear of breaching ethical standards.' AP 516

These comments suggest that the revised ethical standards and the other recent changes in the regulatory framework may have placed a much greater emphasis on compliance and changed the relationship between the CFO and AP.

## Conclusion

This research suggests that changes to the regulatory environment over the last 10 years have impacted on the way that key participants in the audit process interact with one another. ACCs emerge as an integral part of the process, although it is not possible from a survey to identify exactly how their role differs from that of the CFO.

The existence of audit committees with a clearly defined role may have created a more formal structure which has made negotiation less common, and encouraged earlier recognition and agreement of issues.

There is a high level of interaction between all three parties on specific financial statement issues and this appears to be linked to issues relating to IFRS standards. There is also a high level of agreement among respondents as to which issues have been discussed/negotiated/caused changes to financial statements. These have tended to be where IFRS has introduced significant change, particularly goodwill and intangibles, deferred taxation and presentation of primary statements.

The most surprising finding is the auditors' concerns about being removed from office and the extent to which auditors seek external opinions.

We conclude that auditors and audit committee chairs are making a significant contribution to financial reporting outcomes in the present UK environment.

## Directions for future research

Additional analysis will be undertaken into which of the three parties was involved in each interaction and whether this varies across interaction issues. The impact (if any) of audit firm and company characteristics upon the nature and outcomes of the interactions will also be examined (eg, audit firm type, audit firm tenure, audit partner tenure, industry sector, Stock Exchange group, US listing, and audit committee financial experience). In addition, further follow-up qualitative research is underway. Interviews are being carried out with all three parties in 10 companies. This evidence will explore the nature and process of the interactions and also provide more understanding of the key issues identified in the survey. The interviews will also test existing models of the interaction process (eg, the grounded theory model of Beattie et al, 2001) and develop this model to reflect changes in the financial reporting and auditing environment.



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