BEHIND CLOSED DOORS

Behind Closed Doors

What Company Audit is Really About

Vivien Beattie

Stella Fearnley

and

Richard Brandt

Foreword by Sir David Tweedie

Based on research sponsored by the Institute of Chartered Accountants
in England and Wales

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I dedicate this book to my mother and father, Joyce and Bill Urquhart. In their different ways, they have both given me enormous support and encouragement throughout my life.

Vivien Beattie

We thank our families for their tolerance and support throughout the writing of this book.

Stella Fearnley and Richard Brandt

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Preface

The audit of public companies is a very private activity. All that the outsider is aware of is the existence of a (usually clean) external audit report that says that the financial statements represent a true and fair view. Periodically there is a highly publicised company collapse and there are allegations of audit failure. This book uncovers, for the first time, what really goes on behind the closed corporate doors. It reveals the true extent of the effort that goes into finalising the financial statements of a public listed company and the generally high level of expertise and integrity within the UK auditing profession.

It does this by identifying a varied group of six UK public companies that had recently experienced audit interactions involving significant accounting issues. Matched interviews with both the finance director and the audit engagement partner were conducted and analysed using grounded theory methods. This method of analysis is designed to establish the factors that influence the nature and outcome of these audit interactions. It supports a rich understanding of the principal parties and their motivations, their relationship, the contextual factors that influence the interaction process and the strategies adopted, and the critical factors that determine the quality of the financial reporting outcome and the ease with which it is achieved.

‘Earnings quality’ may be a relatively recent term, but concern with this issue has been a central theme for the accountancy profession for decades. The impact that the auditor has on earnings quality is also central and associated with this are well-publicised concerns regarding auditor independence. The findings of this book inform both debates.

V.B.
S.F.
R.B.

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V.B.
S.F.
R.B.

List of Abbreviations

AEP	Audit Engagement Partner
AICPA	American Institute of Certified Public Accountants
APB	Auditing Practices Board
ASB	Accounting Standards Board
CAJEC	Chartered Accountants Joint Ethics Committee
CCAB	Combined Committee of Accounting Bodies
CEO	Chief Executive Officer
DTI	Department of Trade and Industry
EC	European Community or European Commission
EU	European Union
FD	Finance Director
FEE	Fédération des Experts Comptables Européens
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
FRS	Financial Reporting Standard
ICAEW	Institute of Chartered Accountants in England and Wales
ISB	Independence Standards Board
MAS	Management Advisory Services
NAS	Non-Audit Services
NASD	National Association of Securities Dealers
NED	Non-Executive Director
NYSE	New York Stock Exchange
POB	Public Oversight Board
PwC	PricewaterhouseCoopers
SEC	Securities and Exchange Commission
SECPS	Securities and Exchange Commission Practice Section
SPR	Second Partner Review
UITF	Urgent Issues Task Force

Foreword

In a speech (September 2000) to the National Association of State Boards of Accountancy, Chairman Arthur Levitt, of the Securities and Exchange Commission quoted from an author of the 1960s:

‘accountants began to take on the corporate mentality, to think of themselves no longer as independent, critical, perhaps even judicial examiners, but as part of management, members of the corporate “team” ... “It was a question of role definition.” Accountancy was losing its soul, then, the way so many souls are lost – by definition and by degree.’

Chairman Levitt concluded:

‘I believe the time has come for the profession’s own broader membership ... to stand up and take back what some are trying to take from them: the pride and privilege of serving the American public and its investors as the most rigorous, objective, and independent accountants in the world; it’s time that the profession’s own take back the cause and determine the course; it’s time that the profession’s own take back the spirit of the franchise that America’s investors bestowed upon them long ago.’

The decline in the standard of British auditing was probably most marked in the mid to late-1980s. Schemes were developed, many in the City of London, which, while not contrary to the (then) accounting standards or the law, were at the edge, and some of us would say beyond, the limits of acceptability. In the absence of a strong accounting standards regime the true and fair view proved to be a double edged sword. It consists not only of accounting standards but also accepted practice. Some of the accounting schemes were accepted by one or two major firms of auditors and consequently moved within the corpus of practice covered by true and fair. From that moment auditors were powerless to reject the schemes by qualifying the accounts. This situation, in part, led ultimately to the formation of the Financial Reporting Council and its two attendant bodies, the Accounting Standards Board (which in turn created the Urgent Issues Task Force) and the Financial Reporting Review Panel. What was needed, however, was a sea-change in the attitude of the profession. As Mr Levitt has put it, it was time that the profession’s own took back the cause.

The will for change in the 1990s was manifest. The Board would not have succeeded in its programme of reform had it not been backed enthusiastically by auditors, finance directors and users of accounts. While the Auditing Practices Board set out to define best practice, the new generation of auditors developed more backbone and began to question practices that previously would have been accepted.

This fascinating book pulls aside the veil over the audit process and shows to those who have not been involved the difference between good and bad auditors. It shows in its case studies the highly competent auditor imbued with integrity (deemed to be the 'crusader' or the 'safe pair of hands'). In contrast, it reveals 'the accommodator' and the 'truster' – the former bending to the client's wishes, forgetting that the auditor's role is to serve the public not management's interest, the latter tending to leave his client alone assuming all will be well. Fortunately, evidence was not presented of the incompetent or rogue auditor, although the accommodator came very close.

The cases highlight, too, the need for accounting firms to match engagement partners with management. It is senseless sending along a newly qualified partner to deal with a highly experienced senior finance director who could set out to intimidate the younger accountant.

Questions are also raised about the appointment of auditors and the use by finance directors of the threat of putting the audit out to tender. This, of course, raises issues of corporate governance and whether executive directors should have the power to appoint or fire auditors.

The case studies are anonymous – which is as well for the auditor who allowed overvalued stock to be written down over three years – for goodness sake! In better cases, however, it reveals the standards to which all auditors should aspire. The encouraging conclusion is that, despite the exceptions, both the profession and the quality of its audits are fundamentally sound.

This book will be fascinating for those involved in audit and who know the dynamics of the meetings between company management and auditor. It should be a stern lesson for those auditors who still do not reach the required level of independence from management. For those to whom the audit is something of a mystery, it shows how a good audit and a good auditor is a vital safeguard in ensuring transparency and investor protection.

I was encouraged by this readable study. It shows the audit profession in a much stronger position than it was ten years ago and clearly on the way up. For those auditors who do not match the best, the appropriate standard is clearly visible. Independence from management can

be achieved, it should be achieved, and, for the sake of the auditing profession, it must be achieved or the societal purpose of the audit is lost and with it the accounting profession.

September 2000

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London