

<p>Institution:</p> <p>University of Portsmouth</p>
<p>Unit of Assessment:</p> <p>19 Business and Management Studies</p>
<p>Title of case study:</p> <p>The Impact of Changing Regulation on the Behaviour and Perceptions of UK Directors and Auditors</p>
<p>1. Summary of the impact</p> <p>The financial crisis has prompted a public policy debate about the appropriate regulatory framework for financial reporting and audit. Evidence produced by this research on the current regulatory system has informed and influenced this debate in the House of Lords, particularly regarding the respective roles of auditors and audit committees. Furthermore, findings have had a significant impact on the audit procedures of Deloitte, one of the Big Four global audit firms. Their National Audit Technical Partner stated that it had prompted a reconsideration of the timing of their audit processes and the nature of interaction with their audit clients.</p>
<p>2. Underpinning research</p> <p>Concerns relating to how the finance director (FD) of a company and the audit partner (AP) interact with one another to finalise the corporate financial statements prompted an investigation into the process by a project team (two of the three whom were based at Portsmouth at the time) in 1996/7. The findings, reported in (1), found that the quality of outcome was heavily dependent on a range of context specific factors, such as the quality of the primary relationship between the AP and the FD. The findings aroused much interest in the profession and their policy relevance saw the authors give evidence to the Treasury Select Committee on the Financial Regulation of Public Limited Companies in 2001.</p> <p>Following Enron (2001) and the growing challenges posed by globalisation processes, the UK regulatory framework for financial reporting was reformed. Directors and auditors now increasingly interact in an environment characterised by international standards, a stronger enforcement regime and audit committees (ACs) with enhanced responsibilities. The 2007 research project therefore revisited the previous research in the new regulatory setting and provided evidence of how these reforms have impacted on the behaviour and perceptions of key participants. To reflect the changed environment, audit committee chairs (ACCs) were included in the project design. The methodology involved sending an experiential questionnaire to 500 FDs, ACCs and APs of UK listed companies, and subsequently the same three parties (FD, ACC, AP) in nine companies were interviewed.</p> <p>The interview based case studies, published as a book in 2011 (2), provided the only publicly available evidence of how financial reporting outcomes are achieved in the recent UK regulatory framework - and the first evidence in any jurisdiction on the extent to which ACs and ACCs were involved in financial reporting and audit interactions. The research was significant as it found that ACCs had swiftly become an integral part of the financial reporting process, were as aware as other respondent groups of the issues discussed and also made a significant contribution to audit outcomes. Case studies moreover provided evidence that ACCs were managing the business of the AC and often took on the monitoring role that is formally assigned to the AC. The research provided concrete evidence that all parties shared the objective of compliance and no non-compliant outcomes were encountered among the sample frame. The research disclosed that the</p>

FD and AP often chose to take an agreed position to the AC so that there was no likelihood of loss of personal reputation. Confrontation, which had characterised past relationships, was found to have been replaced by a problem-solving focus and the crucial factor behind this change was proven to be the regulatory regime.

The results of the questionnaire survey have mostly been published in academic journals and have reinforced the case study findings. However it did provide evidence that ACs have less than full engagement with audit related issues (3). It also found that most ACs were fully involved with monitoring NAS supplied by audit firms but that regulatory change has discouraged the practice of joint provision. The questionnaire also examined how the key parties perceived the impact of the regulatory changes on audit quality. Results (4) suggest that the changed framework is process and compliance driven, involving high costs for a limited improvement in audit quality (a finding consistent with regulatory over-reaction).

University of Portsmouth staff involved:

Stella Fearnley 1996-2007 (Professor of Accounting),

Richard Brandt 1996-2001 (Research Fellow in Accounting),

Tony Hines 2006-13 (Principal Lecturer in Accounting).

3. References to the research

Research books:

1. Beattie, V. Fearnley, S. and Brandt, R. (2001), *'Behind Closed Doors: What Company Audit is Really About'*, Basingstoke: Palgrave. ISBN: 0-333-74784-4.
[Winner of the American Accounting Association / Deloitte Wildman Medal in 2007]
2. Beattie V, Fearnley S and Hines T (2011), *'Reaching Key Financial Reporting Decisions: How UK Directors and Auditors Interact'*, Chichester: Wiley. ISBN: 978-0-470-74874-9. Ref output: 19-TH-004
[Cited in Accountancy, July 2010, p106; Telegraph 13 March 2011; Accountancy, April 2011, p87]
Review by Professor Jean Bedard, Universite Laval, Canada in 'The Accounting Review' Vol.87, No.5, 2012, pp. 1819-20, ISSN: 0001-4826, doi: 10.2308/accr-10297
'I believe that this book should be on the 'must read' list of researchers interested in audit committees and financial reporting, regardless of their research approach...The book should also be of interest to regulators, auditors, accountants and students who are interested in the financial reporting process and the impact of recent regulation on this process.'

Peer reviewed academic journal articles:

3. Beattie, V., Fearnley, S. and Hines, T. (2012) 'Do UK Audit Committees Really Engage with Auditors on Audit Planning and Performance?', *Accounting and Business Research*, 42 (3), pp. 349-375, ISSN: 0001-4788, doi: 10.1080/00014788.2012.698090 Ref2 output: 19-TH-003
4. Beattie, V., Fearnley, S. and Hines, T. (2013) 'Perceptions of Factors Affecting Audit Quality in the Post-SOX UK Regulatory Environment', *Accounting and Business Research*, 43 (1), pp. 56-81, ISSN: 0001-4788, doi 10.1080/00014788.2012.703079. Ref2 output: 19-TH-002

Details of peer reviewed grant that supported this work:

Awarded to: Beattie, V., Fearnley, S. and Hines, T.

Grant title: An Empirical Investigation into the Effect of Recent UK Regulatory Changes On Audit Interactions and the Integrity of the Financial Reporting Process.

Sponsor: Institute of Chartered Accountants in England and Wales' (ICAEW) Charitable Trustees.

Period of the grant: 2.5 years from January 2007.

Value of the grant: £154,839.

4. Details of the impact

The 2007 research project had an almost immediate impact insofar as Hines and his colleagues were invited to present their preliminary findings from the questionnaire survey on 21 April 2008 to the Audit Quality Forum (39 senior staff drawn from audit firms, investors, business and regulatory bodies attended), a body convened by the ICAEW's Audit and Assurance Faculty, which aims to encourage open and constructive dialogue and to contribute to the work of government and regulators. The Forum Meeting notes state "*academic evidence on the recent impact of audit committees on UK audit practice is limited but an important contribution will be provided by the research begun in 2007 by Vivien Beattie, Stella Fearnley and Tony Hines*" (Corroborating Source – CS1, p.6). The questionnaire findings had already been considered of sufficient import to the profession to warrant their release in advance of the meeting as an ICAEW (Centre for Business Performance) Briefing Report (CS2) reflecting "*leading-edge research on performance-related issues of immediate and long-term importance to the business community.*"

The ICAEW Centre for Business Performance subsequently published another briefing on the provision of non-audit services by auditors. This argued that regulatory changes had already affected behaviour and further restrictions were unnecessary (CS3). The publication prompted the Audit Quality Forum to invite Hines to present a paper on the subject at the 24 November 2009 Forum meeting (CS4) to promote wider dissemination among the business community. The meeting notes report that "*there is general agreement that current regulation to limit the provision of NAS is based on a thorough analysis of the related risks to audit quality*" at the conclusion of the debate that followed Hines presentation. Among the 100+ invitees who attended the Forum was The National Audit Technical Partner Deloitte (Corroborating Person – CP1) who subsequently commented in an unsolicited letter to the Vice Chancellor of Portsmouth that the research project "*has had more impact upon our auditing processes than any other research in almost twenty years. It created a rare "light bulb moment" on audit behaviour that enabled us to re-orientate how we should go about the timing of our audit process and the nature of interaction with our audit clients*". The research (particularly the 2008 ICAEW Briefing Report – CS2) had helped him realise the extent to which the latter stages of a statutory audit focused on disclosures in the annual report rather than key numbers in the primary financial statements. Changes were therefore initiated in Deloitte's audit procedures so that disclosures were considered at an earlier stage in the process - thereby ensuring an enhanced focus on key accounting numbers in the closing stages of the audit. The letter made it clear that the effects of the change were far-reaching: "*...to put this in context we perform annually about twenty thousand audits here in the UK...the benefits are not only economic but also in terms of improved quality of financial reporting by our clients... The benefits are not only being received in the UK, but are also being obtained as far apart as the Netherlands, Switzerland, Russia, New Zealand, Canada and Southern Africa. It has enabled us to provide a better foundation for discussion with our regulators and our people.*"¹

Following the Forum presentation, Hines was also invited to be the academic representative on the Institute of Chartered Accountants of Scotland's (ICAS) working party on NAS and in this role contributed the insights provided by the research project. The ICAS report that emerged in January 2010 (CS5) echoed the view of Hines and his colleagues - that there was no benefit to be gained from a complete prohibition on auditors providing NAS to listed audit clients, although debate on the issue has continued following the publication of proposals in this field by the European Commission in 2011.

Later that same year (October 2010), members of the research team were called to give oral

¹ The potential reach and significance of this change can be gauged by recourse to data on the size of the Deloitte group. UK Deloitte Group had revenues of £2,515 million and employed 13,789 people (2013). Globally Deloitte's employs 193,359 people and had a turnover of US\$31.3 billion (2012).

evidence to a House of Lords Select Committee on Economic Affairs entrusted with examining whether auditors could have mitigated the 2008 financial crisis. The Committee's report: 'Auditors: Market Concentration and their Role' was published on Wednesday 30th March 2011 (CS6). Citations to oral and written evidence, which drew on the research project, appear in the report (paras 20, 113, 127 and 139). Issues covered related to concentration at the industry sector level, the role of audit in capital markets, and the adverse impact of IFRS on audit. The evidence provided contributed to the Select Committee concluding that attempts to introduce greater competition into the audit market had failed, and this prompted the Office of Fair Trading to make a market investigation reference to the Competition Commission later that year.

A central component of the ICAEW's strategy to bring academic research to the attention of practitioners and regulators is the annual PD Leake lecture and Hines and colleagues were invited to deliver the lecture in London on 21st June 2011 following publication of their research findings (Reference 2). The content of the presentation formed the basis of publication (3). The PD Leake discussant was the FD of British Land plc who subsequently acknowledged in an article in Accountancy that his experiences were broadly in line with the research findings (CS7).

On 17 October 2012 the Director of Financial and Business Analysis at the Competition Commission contacted the research team (CP2), stating that they were "very interested" in our recent paper" (Reference 3 – published in the Accounting and Business Review) and requested clarification of AC engagement, specifically within FTSE350 companies, to which the project team responded. Although the Commission are not due to report until October 2013, their provisional findings released in February 2013 expressly state in Section 11.55 (CS8) that: "it is our view (supported by the views of external commentators such as Beattie (2012)) that there are limitations in the ability of the AC under the steward-ship of the ACC, at least in its current incarnation, to ensure audit quality and independence of the auditor."

5. Sources to corroborate the impact

Corroborating Source

CS1: Meeting Notes of the ICAEW Audit Quality Forum Meeting of 21 April 2008.

CS2: ICAEW Centre for Business Performance Briefing Report: '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'. 2008. London: Institute of Chartered Accountants in England and Wales, London, April, ISBN 978-1-84152-553-2

CS3: ICAEW Centre for Business Performance Briefing Report: 'The Impact of Changes to the Non-audit Services Regime on Finance Directors, Audit Committee Chairs and Audit Partners of UK Listed Companies', 2009. London: Institute of Chartered Accountants in England and Wales, November (23pp). ISBN 978-1-84152-852-6.

CS4: Meeting Notes of the ICAEW Audit Quality Forum Meeting of 24 November 2009.

CS5: ICAS Working Party Report 'The Provision of Non-Audit Services by Audit Firms to their Listed Audit Clients', January 2010.

CS6: House of Lords Select Committee on Economic Affairs Report: 'Auditors: Market Concentration and their Role', Wednesday 30th March 2011.

CS7: Article by FD of British Land plc in 'Accountancy' September 2011 p. 109

CS8: Provisional Findings Report of Competition Commission on Statutory Audit Services for Large Companies Market Inquiry, 22 February 2013.

Corroborating Person

CP1: Letter from National Audit Technical Partner, Deloitte to Vice Chancellor of the University of Portsmouth dated 12 January 2010. REPORTER.

CP2: Email from Director of Financial & Business Analysis Competition Commission dated 17 October 2012. REPORTER.