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STANDARDS OF FINANCIAL REPORTING AND OF AUDITING

GROUNDS FOR CONCERN

The evidence which has come before the Committee suggests that there is general concern about present standards of auditing and of financial reporting. There have been some notable failures of companies whose audited accounts apparently gave no warning of the real state of their affairs and there has been an increase in litigation against accountants and auditors. Confidence in the audit process has also been affected by what is referred to as the "expectations gap". This arises from the difference between what auditors regard as their duties and what those outside the accounting profession consider that auditors do, or should do. There is undoubtedly confusion in the public mind over the role and responsibilities of auditors.

Both the accounting profession and the Government have shown that they believed that action was called for to raise accounting and auditing standards. As a result the FRC and the ASB have been set up and the APB has been reconstituted. In addition, our Committee has been formed to recommend what further steps might be needed and the Government has introduced a new regime for the regulation of auditors. All of which is clear evidence of the degree of consensus that means had to be found to strengthen confidence in the practical value of accounts and of audits.

CAUSES

Most of the evidence put before the Committee points to competitive pressures as the reason for concern over accounting and auditing standards. This starts with the pressure which quoted companies feel that they are under to meet shareholders' expectations of a continuous improvement in results. Their activities, and hence their accounts, are often complex, so that to provide a balanced picture of the outcome of their trading in a single year - an artificial break-point in an ongoing enterprise - a measure of judgement is required. Most companies will have pockets which they can fill or draw on, with varying degrees of justification, in order to present as orderly a progression of earnings as possible. In addition, the breadth of accounting standards, the lack of a coherent body of thought on which to base them and the ingenuity of those determined to circumvent the spirit of the rules, provide considerable scope for judgement and argument.

In theory, no company could gain by abusing the room for accounting manoeuvre, because the market would correct for any deviation from the accepted rules. But this utopian state is unobtainable, in part because what the rules will stretch to is a matter of debate, but more fundamentally because it would depend on the market having access to all the information which it would need to make such a judgement. The main imperfection of the real market place is that the cost of obtaining information, and most importantly of analysing its implications, is high.

Companies will avoid as far as they can showing discontinuities in their results. The argument for smoothing the results in this way is that it may reflect the underlying position of the company more faithfully than, for example, a drop in one year followed by a recovery in the next would have done. It is in the interests of shareholders for companies to avoid an apparently erratic earnings record, which the market will find hard to assess due to the difficulties, already referred to, of interpreting the published figures and the narrative which accompanies them.

The justification for a board taking a view of this kind over its annual results is that it is looking beyond the artificial boundary of a single year in order to present as accurate a picture as it can of the ongoing state of the enterprise. There is no obvious way, however, in which financial analysts can distinguish between smoothing to maintain a trend and the deliberate concealment of unwelcome news. The reasons which boards may have, for presenting a more favourable picture of the progress of their company in any given year than its longer-term prospects may justify, range from fraud to the hope that some change in their external environment will resolve their immediate problems.

The situation facing auditors is, therefore, one where quoted companies are likely to have a clear and forceful view as to the figures which they wish to see published and one where the scope for the interpretation of the rules is broad. At the same time, the auditing firms themselves are under commercial pressures of their own, in their case not to lose customers. In addition, as with any business, they will wish to do their best for their clients.

THE POSITION OF AUDITORS

Against that background, auditors do not, in Sir Ron Dearing's words, have enough rocks to stand on. What are the main weaknesses of their position?

One is that they have no direct link with the shareholders who officially appoint them and in whose interests they carry out their audit, while they are in close touch with the managers whose stewardship they are auditing. Auditors have to work with a company's managers to carry out their task and their working relationship is built up over the financial year, it is not confined to the period of the audit. What shareholders require is that the auditors should work with and not against management, while always retaining a critical detachment and a consciousness of their accountability to those who appoint them. Objectivity was the word used by one of the auditors whom we interviewed and it may be more accurate to refer to the need for auditors to remain professionally objective, in carrying out their task, rather than independent.

The auditing firm is financially independent of the company which it is auditing. In practice, however, it is the company which appoints and pays the auditors and the auditors depend on the company to provide them with the material which they audit. Thus to demand greater independence for auditors may add to the confusion about their role, since it is not a logically attainable goal, unless it were possible to link their appointment and remuneration more directly to the shareholders. Professional objectivity, on the other hand, is the quality which shareholders, regulators and the public expect of auditors in carrying out the audit function. It is on their ability to apply their professional skills impartially that the reputation of their firms depends.

A second weakness stems from the scope which accounting standards and practice give for presenting facts and the figures derived from them in a variety of ways. This is common ground. A particular aspect of this freedom under the rules relates to materiality. This may allow one company's exception, on the grounds that it was not significant, to be built on by others and to provide a basis for opinion shopping.

Then there are the effects of competition between audit firms for business. Companies wish to minimise their audit costs and audit firms to maximise their business with companies, of which auditing may only be a part. To the extent that audit firms compete on the basis of their professional reputation, this will act as an incentive to maintain high standards. To the extent that they compete on price and on meeting the needs of their clients (the companies they audit) this may be at the expense of the shareholders, who formally appoint the auditors but have no effective say in the audit negotiation.

The greater role which legislation plays in the presentation of accounts, as a result of the Fourth and Seventh Directives, is also said to have weakened the auditors' position. Legal rather than accounting opinions may come to carry more weight in arriving at judgements and the test which companies may now apply is whether a particular interpretation is or is not within the law.

A final weakness is the lack of understanding of the nature and extent of the auditors' role. This leads from unrealistic expectations of what audits can and should achieve at one end of the range, to an immoderate disenchantment with the value of audits, in the wake of the Caparo judgment, at the other. In particular, the responsibilities of auditors in relation to fraud and illegal acts - an issue which we had to scamper over at our last meeting and to which we must return - are clear to few outside the legal and accounting professions.

WHAT ARE THE REMEDIES?

Taking together the consequences of competitive pressures and the lack of rocks for auditors to stand on, where do the remedies lie?

ACTION BY THE PROFESSION

The first line of attack has to be to reduce the room for accounting manoeuvre. This can be achieved by drawing the standards themselves more tightly and by the way in which they are framed. The proposed cash flow statement, for example, requires companies to provide better information than the sources and applications of funds statement it will replace.

Secondly, it is crucial to be clear as to the responsibilities both of auditors and of directors for the financial statements of companies. These are well set out in the Consultative Paper on the expanded auditors' report, recently published by the APB. If the proposals in that paper are adopted, both as to their form and as to the language in which they are expressed, the gap between what auditors do and what they might be thought to do will be narrowed. Further progress can be made in narrowing the gap, if the scope of the audit is widened. To this end, we shall be examining at the next two meetings the case for requiring auditors to report on the adequacy of resources for the year ahead and on the adequacy of internal controls.

On the matter of retaining the objectivity or independence of auditors, a number of propositions have been put forward including, rotation, "quarantining", and involving shareholders in the selection of auditors. The view of the meeting was that any improvement in professional impartiality which compulsory rotation might bring would be more than outweighed by the loss of the trust and experience, which are built up where the relationships are sound, and by the risk to audit effectiveness at the changeover.

There was, however, agreement that a change of senior audit staff was beneficial in bringing in fresh thinking, when the timing was convenient and it was pointed out that staff moves meant that in practice a measure of rotation already took place on both sides. On "quarantining", the Committee felt that the impact of the new regulations on disclosure should be observed before any further steps were considered. A number of ways in which shareholders might become more closely involved were debated, but none were felt to be practical. In sum, none of the proposals before us seemed likely to achieve an improvement in the combination of efficiency and objectivity for which we are seeking, although both rotation and a closer link with the shareholders are in themselves desirable.

ACTION BY COMPANIES

Progress along these lines on the side of the auditors needs to be matched by progress on the part of companies. The preparation and presentation of financial statements is the responsibility of the board of directors. The board as a whole has to accept this responsibility and at the same time the shareholders need to be assured that the auditors are acting solely on behalf of those who appoint them. This is where audit committees have a key role to play.

We will be dealing with audit committees in detail at a later meeting, but they can provide the bridge between the board and the auditors which is needed and a means of involving the outside directors constructively in the board's responsibility for financial statements. Equally, an audit committee, mainly or wholly made up of outside directors, is best placed to take an impartial view of all the interests served by the company and to hold the balance between them.

Then there is the quality and content of the reports and accounts which are being audited. This is a matter to which we will return in discussing company reports. The higher the standards of reporting by companies, the less the need for the auditors to intervene in the interests of the shareholders. In the same way, the auditor's hand would be strengthened if companies would accept that they should be concerned with the principles on which accounting standards are based, rather than with the small print, and that substance should take precedence over form.

In all this, the chairman of the board and the finance director have crucial roles to play. They can be expected to have the most direct interest in the way in which the audit is carried out and with its outcome. Chairmen, because they report the audited results to the shareholders and will normally answer in public for the reliability of the figures and for the inferences to be drawn from them. This in turn suggests that they will look to the audit to alert them to potential financial or ethical problems.

Finance directors will be the members of the top management team working most closely with the auditors. They will probably negotiate the scope of the audit and the fee, although the final decision on these matters may be taken by the audit committee where one exists. The majority of the issues which arise during the audit will be settled with the finance director, but it is over the unresolved issues that problems can arise. In settling such matters, finance directors have two constituencies to satisfy. As key members of the management team they have to meet the commercial expectations of their colleagues, as heads of the finance function they have to meet the professional expectations of the auditors. It is precisely in resolving potentially conflicting views and loyalties that the audit committee comes into its own.

The audit committee can give the time to the matters which either the finance director or the auditors bring to it, to an extent that would not be possible for the board. In addition, through the medium of an audit committee, the outside directors can safeguard the interests of the shareholders in a way which the shareholders, although formally responsible for the appointment of the auditors, cannot.

Audit committees are also in a position to ~~ensure~~ review that the company's internal audit arrangements are effective in themselves and that they complement the work of the outside auditors.

ROLE FOR THE COMMITTEE

Although this paper is directed at criticisms of the state of auditing, it is the Committee's view that the annual audit is one of the cornerstones of corporate governance. The audit system provides an external and objective check on the duty of boards to act as stewards of the funds entrusted to them by their shareholders. Given the separation of ownership from management, the audit safeguard is an essential part of the checks and balances which separation demands.

Audits are a reassurance to all who have a financial interest in quoted companies, quite apart from being in themselves of value to management. The best way of ensuring that companies are accountable for their actions is through open disclosure by boards and through annual audits carried out against strict rules.

Ways in which the Committee could increase the level of confidence in the financial and audit systems include:-

- Stating our conviction that the annual audit is of fundamental value in providing an external and objective check on the way in which boards discharge their stewardship function.

- Welcoming the clarification of the responsibilities of directors and auditors for preparing and reporting on financial statements and the proposal to expand the audit statement.

- Requiring quoted companies to appoint effective audit committees.

- Emphasising that it is the joint responsibility of boards and of auditors to maintain the objective and professional relationship between them which is required to meet the needs of the shareholders.

- Supporting the FRC in its determination to take action against boards whose financial reporting falls short of the required standards and the accounting profession in disciplining those firms who do not meet the necessary auditing standards.

- Putting our weight firmly behind the work of the ASB and endorsing their statement of the objective of financial reporting. The requirement on boards is that their reports should be drawn up in good faith and with consistency.

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- Alerting shareholders to the importance to them of the audit process and to their opportunity in general meeting to assess the effectiveness with which it has been carried out on their behalf.

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Given the extent of the awareness that auditing and accounting standards have to be raised, the Committee has the opportunity to help bring about the necessary reforms. This will require the commitment of boards, the self-discipline of the accounting profession and the active involvement of shareholders in general meeting. Principles and systems can only achieve so much. It is the quality of the effort which is put behind them which will determine whether the expectations of those who look to the audited accounts for guidance are met.

The common interest which boards and accountants have in the matter is that the failure to raise standards sufficiently through self-regulation may well result in externally imposed regulations with all the costs and limitations of that form of control.