Auditing regulations in the uk

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Introduction

Following the financial disasters that led to the collapse of corporations such as Enron and WorldCom, international and national regulators sought to strengthen legislation relating to the internal and external auditing of corporations. This resulted in the introduction of a number of international and national Acts and enforceable codes, commencing with the Sarbanes-Oxley Act 2002 [1] in the US (www. sarbanes-Oxley . com). In the UK the government introduced the Combined Code (FSA 2006) in 2003, which has subsequently been revised and strengthened, and revised the Companies Act (2006). These became the foundation for corporate governance and appropriate auditing procedures. This paper seeks to evaluate the effectiveness of this regulatory framework in creating an auditing environment that will prevent a repeat of the disasters that led to their introduction. This will follow a brief overview of the auditing processes is provided initially.

The Audit Process

There have been several definitions of the term audit; perhaps the most succinct of which is that based upon the American Accounting Association's, which states that: –

" Auditing is a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organisation making the assertion has been engaged, to ascertain the degree of correspondence between those assertions and

established criteria, and communicating the results to users of the reports in which the assertions are made. ” Porter et al (2003, p. 3).

In other words, the task of an auditor is, through the use of a structured programme, to gather evidence relating to the financial statements made by a corporation, evaluate the accuracy of the statements made in the light of this evidence and also to ensure that any opinions and reports presented are in accordance with the prevailing rules, regulations and criteria. They then have to present a certified unbiased view of their findings from the audit to external stakeholders, such as the shareholders and government authorities (See figure 1).

There are several types of audits conducted throughout an organisation. However, this paper concentrates upon the external and internal audit. A licensed and qualified firm of auditors, whose independence from the organisation must comply with the definitions set out the combined code and accompanying guidance notes, carries out an external audit.

The essential purpose of the internal audit is, in the words of the Institute of Internal Auditors (Spencer-Pickett 2003, p. 2), intended to “ *improve the effectiveness of risk management, control and corporate governance processes.* ” Whilst the intention of this process, as with external auditing, is to provide and independent assurance on these processes and controls, the internal audit personnel are employed directly by the corporation.

Current regulations

The auditing process relates to most corporations (Gray and Stuart (2004), but this paper concentrates upon the Public Limited Company. In respect of

financial reporting within the UK, commercial organisations are governed by the rules of the Combined Code (2006) and the international reporting standards set by the IFA [2] , as explained within their handbook (2006).

Combined Code

The combined code concentrates upon five areas of the corporation's activity and internal structure. These include: –

- Directors – which include advice on suitability, proportion of executive to non-exec directors on the board and their roles and independence. It also defines a clear distinction of duties between CEO and Chairman.
- Remuneration – This relates formula for the make-up and levels of director's pay, together with the inclusion of an independent remuneration committee.
- Accountability and audit –Requires the board, through an independent audit committee, to maintain an adequate system of internal control that should be audited, the selection and independence of external auditors and outlines the process of accountability of the organisation to the various stakeholders.
- Relations with shareholders – Outlines the responsibility of the board to its shareholders and the reverse. This section of the code also sets out the requirements of the board to include the shareholders rights within their voting and operating procedures.
- Institutional shareholders – Section E of the code concentrates specifically upon the relationship that exists between the board and its

institutional shareholders and outlines the dialogue that should occur between the two stakeholders of the business.

IFRS

Perhaps most important aspect of the financial reporting and auditing process is contained within the FRS [3] and SSAP [4] (ASB 2007) regulations, the former of which are based upon the international standards, which have been subjected to a series of amendments in recent years.

Main Objective

The Main IFRS objective is to promote a universal financial reporting standard, with the intention of providing an equality of financial information that can improve comparison and reliability of content on a global basis. In addition, the standards set out to increase the trust and reliance on financial reporting system, thus reducing the likelihood and potential risk of financial disasters such as Enron.

Other objectives

The objective of IAS 1: 7 is directly related to the provision of financial information to be used for investment or other economic reasons, such as acquisitions. As such it concentrates upon the reliability of the accounting and reporting standards for the Balance Sheet and Cash Flow statements. Therefore, it focuses on a fair representation, attracting significant importance to the “ fair value” of assets, liabilities and equity, allowing interested parties to ascertain the current real market value, thus making “ historical cost accounting” redundant. Company officers have to prepare and sign compliance statements in terms of the veracity of the information and

internal controls operated by the corporation and there must be a separate external audit certificate.

The IFRS measurements are applied to each of the standards, although there is intent to introduce measurement as a separate application [5] . However, at present IFRS 2, relating to share based performance has specific measurement guidelines, as does the IFRS relating to the treatment of fixed assets, Here the initial measurement is the acquisition paid, but in later reports these values must reflect a fair current market value, unless there is a reason for this not being possible. In general, the measurements require a " current fair value" model to be used

The presentation of financial statements and disclosures is also addressed For example, the Balance Sheet must contain at least sixteen lines (IAS1. 68), which include tangible and intangible assets, current and future liabilities and a breakdown of the equity structure. IAS 1. 81 provides the requirements for the income statement including revenue, costs, profit or loss and its distribution.

As shown within the list of standards prepared by Deloitte (2005), in addition to the above there is a range of other requirements, including risk assessment corporate governance regulation compliance. If any disclosure cannot be made a certified statement has to be prepared by management and included within the financial reports giving the reasons for this omission.

The major task for external auditors is to certify the accuracy and compliance of the statements, and the effectiveness of internal controls ensure efficient business management and a secure level of protection for

investors and shareholders exists. Where risks exist, this must be identified with recommendation for actions.

Concerns

In spite of the regulations and codes, there are still concerns being expressed by investors and shareholders. These generally fall within three categories.

Auditor competence and independence

A recent survey shows shareholders are concerned about the external auditors. This focuses on their independence, experience and suitability and compliance with procedures.

Independence of internal controls

Similar concerns are being expressed regarding the internal controls and auditing process. Shareholders are not convinced that the level of effectiveness in identifying fraud and risk is effective or transparent enough and are thus seeking an expansion of financial reporting statements (John Lorinc 2002).

Shareholder concerns are supported by research at the university of Auckland (Cheung and Hay 2004), which particularly showed auditor independence to be a major concern to investors.

Fair value

The concept of “ fair value” is another issue causing disquiet. To date, the IFRS do not have a single definition for the term. Therefore it becomes

subject to independent expertise and opinion. However, the fact that such opinions can vary significantly means that the level of reliance on “ fair value” is considerably reduced.

Conclusion

As can be seen from this evaluate, whilst the IFRS’s go a long way towards addressing the issues surrounding the accuracy, reliability and honesty of financial reporting, the issues of “ fair value” and auditors independence are still a major concern in the minds of investors. This is supported by events such as the near collapse of Northern Rock PLC in the last quarter of 2007, which shows that that there are still inadequacies within the reporting standards that need to be addressed. In this case there are questions to be asked about the interpretation of “ fair value” and the internal controls. By inference, this must also raise the issue of auditor suitability.

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Footnotes

[1] Also known as the “ Public Accounting Reform and Investor Protection Act of 2002”

[2] International Federation of Accounts

[3] Financial Reporting Standards

[4] Statement of Standard Accounting Practice

[5] seehttp://www. iasb. org/Current+Projects/IASB+Projects/Fair+Value+Measurements/Fair+Value+Measurements. htm