



Select Committee on Treasury [Minutes of Evidence](#)

Annex

1. THE BACKGROUND

Introduction

The Institute of Chartered Accountants in England and Wales ("the Institute") welcomes this opportunity to submit evidence to the Treasury Committee as part of its inquiry into the arrangements for financial regulation of public limited companies^[1] in the United Kingdom.

This submission sets out the Institute's response to the Committee's call for evidence, for which the formal terms of reference are:

"To examine, in the light of the Enron collapse, the arrangements for financial regulation of public limited companies in the United Kingdom."

In preparing our response, we have taken account of comments made by the Committee Chairman, John McFall MP, who noted that concerns in the United States have crossed the Atlantic and are now being raised in the United Kingdom.

The Institute's locus

With 122,000 members the Institute is the largest of the United Kingdom bodies offering professional qualifications to accountants and the second largest in the world. We have some 52,000 members in business including the Finance Directors of 56 of the FTSE 100 companies. As a Recognised Supervisory Body under the Companies Act 1989, we regulate virtually all the Registered Auditors of the some 2,800 companies listed on UK Stock Exchanges.

Following the major corporate failures of the late 1980s and early 1990s in the United Kingdom, we were instrumental in setting up the Cadbury Committee, which established a new code of corporate governance. We have since maintained our involvement in this field, notably through our submissions to the subsequent work of the Hampel Committee and our preparation of the Turnbull Report^[2].

The Institute is also active at the international level. We participate in the work of the International Federation of Accountants (IFAC, the world-wide organisation for the accountancy profession) and the Fédération des Experts Comptables Européens (FEE, the equivalent body for the accountancy profession in Europe) and have played a leading role in recent work to establish global standards for ethics, accounting and auditing. We also provide input to the DTI representative on the EU Committee on Auditing.

Our Royal Charter requires us to operate in the public interest. The collapse of Enron has raised wide concern about the effective working of the capital markets on which the well being of the market-based economies and the living standards of their people depend. We therefore wish to offer evidence on three aspects—accounting standards, corporate governance and audit—in which the Institute has particular expertise.

We are concerned that any proposals arising from the Committee's deliberations should be founded on sound analysis and an understanding of the different regulatory environments in the United States and the United Kingdom. We would therefore be happy to provide further detailed information at any stage if the

Committee wishes.

The background and issues

Enron grew dramatically in an energy market that was undergoing great change. It was becoming more global, so that transactions were no longer limited to local markets subject to the same laws and business practices. The development of computer technology has enabled and encouraged the use of sophisticated financial and non-financial instruments such as derivatives and swaps. The opening of the market through, for example, privatisation has provided new opportunities.

All this happened during a period of uninterrupted economic growth in the 1990s which was reflected in rising stock market indices that often anticipated growth in company profits. This environment led to increased expectations of dividend and capital growth and the development of management rewards through non-cash incentives (such as share options) that did not burden company resources, but whose value depended on the company's performance—sometimes short term performance rather than long term strength. It also encouraged short-termism in the capital markets, which often overreact to bad news, putting heavy pressure on management to take short-term measures including aggressive earnings management.

Confidence in the capital markets is essential. Without that confidence, capital to finance day-to-day business and longer term investment funds will be less forthcoming and more expensive as higher interest rates and greater security are sought to offset the perceived high risk involved. Confidence depends crucially on the quality of reporting by listed companies. Undoubtedly the collapse of Enron has dented that confidence and we need to understand why and what steps might be taken to reduce the likelihood of similar occurrences.

The circumstances that led to the collapse of Enron are currently under investigation in relation to the actions of the company's board, its managers and its auditors. We make no comment on the specific issues that are under examination or on the many business issues that have been raised.

Questions have been raised, however, in relation to three areas where the Institute has a particular expertise:

- financial reporting;
- corporate governance;
- audit.

We consider these areas below, with particular reference to factors that might affect the likelihood of similar events occurring within the United Kingdom. We do not consider in detail in this submission how the capital market operates. However, we do touch on some concerns about, for example, short-termism and the pressure that this creates on directors.

It should be borne in mind that the board of directors is responsible for:

- the management of a company, including the prevention and detection of fraud;
- reporting to shareholders and, where appropriate, to other bodies such as the FSA; and
- providing full and complete information to auditors.

2. FINANCIAL REPORTING

Background

In the case of listed companies, there is a clear distinction between ownership and management. The directors and the majority shareholders are largely different groups of people. The law requires that directors report annually to shareholders. The annual accounts prepared by directors must give a "true and fair" view of the financial performance and position of the company.

The development of United Kingdom accounting standards

The current United Kingdom model for accounting standards has developed to address widespread concern in the 1980s over the quality of financial reporting. A key issue was the proliferation of off-balance sheet financial arrangements used by companies to avoid consolidation of certain assets and liabilities. These arrangements often involved investments of less than 50 per cent, which were nevertheless significant, in other companies.

The changes since the 1980s reflect the basic UK concept (also accepted in the EU's 4th Company Law Directive) that accounts should give a true and fair view. In other words, the overall picture is just as important as compliance with specific requirements.

The provisions of the 1989 Companies Act brought many of the off-balance sheet arrangements within the legal definition of a subsidiary by focusing on effective economic control rather than legal ownership. However, scope for abuse remained. The solution was the development by the independent Accounting Standards Board (ASB) of principles-based standards, which required financial statements to reflect the substance of transactions.

FRS 5 "Reporting the substance of transactions", published in 1994, was perhaps the most significant of a series of high quality and robust standards. It adopted a new and effective approach based on a requirement for an entity's financial statements to report the substance of the transactions into which it had entered. The standard refers to the concept of a "quasi-subsidiary" and brings on to the balance sheet any vehicles that are directly or indirectly controlled by the reporting entity and provide benefits no different in substance from those that would arise from subsidiaries.

Other key standards included FRS 8 "Related Party Disclosures", published in 1995. The standard significantly improved the reporting of transactions and balances with parties with a relationship with the reporting entity. More recently, FRS 18 "Accounting Policies" introduced a requirement for companies to adopt accounting policies that are "the most appropriate to its particular circumstances".

Enron: lessons for the United Kingdom?

There are currently significant differences between United States standards on the one hand and United Kingdom and international accounting standards (IAS) on the other. In particular, the United States financial reporting model places far more emphasis on extensive rules and regulations. This focus on detailed rules can encourage compliance with the letter of the law rather than the spirit.

From early reports, the off-balance sheet accounting treatment of special purpose entities (SPEs) appears to be central to the Enron affair. For many companies, SPEs are a beneficial source of finance. The difficulties lie in deciding to whom the assets and liabilities of SPEs "belong" and therefore whether they should be included in the consolidated accounts. In the United Kingdom, the consolidation model is based on the principle of control of economic benefits, not just control of a company. The IAS approach is broadly comparable. However, under United States GAAP (generally accepted accounting principles), consolidation is more often based on legal ownership, with specific rules regarding non-consolidation of certain SPEs.

It would be simplistic and premature to state unequivocally that United Kingdom GAAP or international standards would have prevented the inappropriate treatment of SPEs by Enron. Under any method, borderline and difficult cases will arise. However, a clear and important conclusion of an Institute working group that reviewed United Kingdom practice in late 2001 was that far more SPEs were reported on consolidated balance sheets by companies using United Kingdom and international accounting standards than those using United States GAAP.

We note that the Financial Accounting Standards Board (FASB—the US standards setter) is now exploring the possibility of adopting standards that "emphasise basic principles and objectives rather than . . . detailed rules, exceptions and alternatives to underlying principles". Such standards would "place the focus on accounting for the substance of a transaction rather than its form".^[3]

It appears from more recent reports that, in addition to SPEs, there may be other significant corporate reporting issues. When determining the valuation of companies, analysts and investors sometimes appear to make inappropriate economic assumptions about particular markets. More transparent discussion and disclosure by management regarding, for example, their vision of the future prospects of the business and

risk might assist analysts and investors to value companies appropriately. The importance of this aspect of corporate reporting is highlighted below.

Other financial reporting issues that may prove to be relevant to the Enron affair are aspects of revenue recognition and the use of a "mark to model" approach^[4] to the fair values for complex financial instruments not traded on an active market. The Institute has strongly supported the current ASB project exploring different approaches to revenue recognition, and has expressed reservations in its response to international proposals for the adoption of a "mark to model" approach to valuing financial instruments. Further work is required in these areas.

Improving United Kingdom financial statements

Although the Enron affair does not so far appear to have raised any new issues for United Kingdom reporting, we are very conscious that no system is perfect and are committed to further continuous improvement of the effective systems and standards developed in recent years. For example, we have highlighted above the current work of the ASB in the area of revenue recognition. The focus of efforts to improve the accounting of United Kingdom listed companies has, however, now largely moved to the international level. Financial reporting across Europe is undergoing an unprecedented period of change as a key component of the drive to create an integrated financial services market in the European Union.

In February 2001, a draft Regulation was published on the application of IAS in the European Union (EU), following the announcement by the European Commission in June 2000 that EU listed companies would be required to use IAS in their consolidated accounts from 2005. In March 2002 the European Parliament approved the Regulation requiring the adoption of standards issued by the new International Accounting Standards Board (IASB) by listed companies when preparing financial statements, which consolidate the results and balance sheets of the group as a whole. The Council of Ministers is likely to give final approval to the proposal in May.

The IASB has this year commenced a major process of reform and improvement to ensure that IAS provide a single set of understandable and enforceable global accounting standards require high quality, transparent and comparable information in financial statements. Several new standards are planned by the IASB, which is well resourced and committed to working with national standard setters to make progress on key projects.

The Institute has consistently supported convergence with IAS that provide accounting solutions of the highest quality. Earlier this year, we wrote to IASB emphasising the fundamental importance of standards that focus on principles, drawn clearly from IASB's conceptual framework. We will continue to respond to all IASB and ASB proposals for change and contribute actively to the development of new thinking.

Enforcement of standards

A financial reporting regime will enjoy credibility only if high quality standards are implemented on a consistent and rigorous basis. Effective arrangements for enforcement are therefore essential.

In the United Kingdom, the Financial Reporting Review Panel (FRRP) investigates apparent departures from accounting requirements following a complaint or press comment. Some commentators have suggested that the effectiveness of the FRRP might be improved further by, for example, introducing an element of pro-active monitoring. Any proposals for change should, however, be co-ordinated closely with developments in Europe.

Convergence with IAS demands consistent and rigorous enforcement across Europe, and ultimately around the world. The various mechanisms for enforcement are currently being assessed by FEE with a view to the establishment of effective co-ordination at European level. The FRRP is regarded by FEE as a potential model for other national jurisdictions.

Other aspects of corporate reporting

The Institute recognised some years ago the limitations of traditional financial statements as a source of information for investors seeking to make rational economic decisions. Annual reports and financial statements tend to have a historical perspective and provide limited information about strategic strength or other future-oriented matters.

We believe that corporate reporting should provide users with more forward-looking information and more information about intangible assets and other drivers of shareholder value. At present, such matters are covered by limited statutory requirements relating to the directors' report and by non-mandatory ASB guidance, published in 1993, on the operating and financial reviews (OFRs) of listed companies.

Although the ASB guidance is not a standard and has persuasive rather than mandatory force, it has been implemented successfully by many United Kingdom listed companies. In our submissions to the Company Law Steering Group in 2000-01 we recommended the introduction of mandatory OFR for all listed companies (and some large private companies) as a key part of their annual report. We also recommended that broad requirements for the OFR should be enshrined in company law and supplemented by more detailed ASB guidance on specific areas such as risks and intangible assets.

The importance of supplementing financial statements with understandable, qualitative and forward-looking information is highlighted by the early focus of the United States Securities and Exchange Commission (SEC), in its news release of 13 February, on the quality of the United States MD&A (Management's Discussion and Analysis of Financial Condition and Results of Operations) following the collapse of Enron.

Transparent reporting was the common thread linking a number of influential Institute publications, including:

- No Surprises—The Case for Better Risk Reporting, which encouraged directors to present disclosures of key risks.
- Inside Out: Reporting on Shareholder Value which recommended more transparent reporting by management on their strategy and the key indicators of successful implementation.
- Market Metrics: What Should We Tell the Shareholders? Which looks at how successful marketing builds brand equity and how this reputational asset should be reported to shareholders.

To understand the potential for future cash flows of any company, investors require a proper understanding of risk. The quality of risk reporting may have been significant in the Enron affair, and could be improved in the United Kingdom. The Institute recommended in No Surprises that directors provide clear and transparent information regarding key risks, the actions they plan to address them and any relevant measures.

The Institute is at present developing guidance on the preparation of forward-looking financial information and related disclosures. The guidance will take account of comments received on the Institute discussion paper *Prospective Financial Information: Challenging the Assumptions*, developed by a steering group that included members of the United Kingdom Listing Authority, the Takeover Panel and the Auditing Practices Board. Progress depends on the level of support provided by regulators and other parties. In addition, it may be necessary to consider whether directors and auditors should be provided with some legal protection where forward looking statements are made with due care.

Summary and conclusions on financial reporting

Since the late 1980s there have been continuing efforts in the United Kingdom to limit the scope for excluding from the balance sheet assets and liabilities which could substantially affect the overall financial position of companies. A key development was the move by the ASB in the mid-1990s to standards that focused on the underlying reality of the transactions.

United States standards have not yet moved so far in this direction, although we note that FASB is considering such a move.

Although the Enron affair has not so far brought to light any substantive issues that raise new threats to United Kingdom financial reporting standards, there is always a need to develop standards to take account of new business practices, reasonable shareholder expectations, and other developments. The leading role in this will now be played by the IASB, and the Institute will contribute actively to its work.

The FRRP is now being considered as a potential model for enforcement of accounting requirements at European level.

We believe that traditional financial statements, however well constructed, will rarely provide sufficient information for analysts and investors. We therefore recommend that a wide-ranging OFR with due emphasis on risk-related information should be a key component of companies' annual reports. In addition, we will continue to stimulate discussion and produce guidance on improving information for shareholders and investors.

3. CORPORATE GOVERNANCE

What is corporate governance?

Many definitions of corporate governance have been produced by bodies, including the Organisation for Economic Co-operation and Development, that have examined the subject. The Cadbury Committee defined it as "the system by which companies are directed and controlled". Shareholders are likely to attach the greatest importance to arrangements for maximising the value of their shares on a sustained basis. Regulators tend to focus on policy, compliance, supervision and operational issues. Employees look to the company for continued employment opportunities. Other groups have interests in various social and environmental issues.

We believe that, although in the modern corporate economy relations with other stakeholders, such as employees, suppliers and customers, are important, the key element is the shareholder interest (it is after all their money that is at risk). The interests of all stakeholders are ultimately best served by ensuring that companies are directed and controlled to protect their long-term value. The guiding principles to achieve this may be summarised as follows:

- Governance structures need to be designed with clear delineation of power, responsibilities, and checks and balances, including the establishment of board committees for complex areas such as financial reporting.
- Accountability and control are fundamental and can only be safeguarded through appropriate disclosure and transparency when reporting to the market.
- Board members must be selected on the basis of their professionalism and ethical behaviour; non-executive directors should also be independent.
- There should be formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors, who help to safeguard shareholders' interests.

Developments in the United Kingdom

The development of United Kingdom corporate governance in the last decade started in the wake of the financial scandals of the late 1980s and early 1990s (notably Maxwell, BCCI and Polly Peck). The publication in 1992 of the groundbreaking Cadbury Code of Best Practice (the "Cadbury Report"), which the Institute helped to establish, raised standards of corporate governance and the level of confidence in financial reporting and auditing, and has provided the basis for similar initiatives in many other countries. One of the Cadbury Committee's key recommendations was the separation of the role of chairman and managing director/chief executive.

The Cadbury Report was the first of a series of initiatives to strengthen corporate governance in which the Institute has been closely involved.

- The Rutteman report (1994) recommended that directors should disclose the key procedures that they had established to provide effective internal financial control.
- The Greenbury Report (1995) recommended the establishment of a remuneration committee of the board comprising non-executive directors and the publication of information on directors' remuneration and compensation in the annual report.
- The Hampel Committee's Report (1998) reviewed the implementation of the Cadbury Code to ensure that its original purpose was being achieved and, in particular, addressed the role of shareholders and auditors in corporate governance issues.

In June 1998 the United Kingdom Listing Authority published the Combined Code, based on the Hampel report, which requires listed companies to explain in their annual report how they have applied the principles and complied with the provisions of the Code or give reasons for their non compliance. The company's external auditors are required to review the directors' compliance statements on some key elements of the Code including those relating to internal control and audit committees. At the request of The United Kingdom Listing Authority the Institute provided guidance on internal control in the Turnbull Report (1999), which is discussed later in this submission.

Audit committees

Audit committees have a key part to play in effective corporate governance. The first paragraph of the introduction to the Institute's 2001 booklet on the audit committee^[5], which had a foreword from Sir Adrian Cadbury, stated:

"Public criticism. Damaged reputations for the company and individual directors. Accusations of fraudulent financial reporting. Directors forced to resign. These could happen, which is why more than ever before, the boards of listed companies need an effective audit committee, an important element of the corporate governance framework, to help reduce the possibility of such problems occurring."

Compliance with the Combined Code requires listed companies to have an audit committee entirely composed of non-executive directors (NEDs), a majority of whom should be independent. Audit committees give additional assurance to shareholders about the quality and reliability of the financial statements issued by a company. They also deal with matters relating to both internal and external audit.

In the case of the external auditors, the Combined Code requires the audit committee to keep under review:

- the scope and results of the audit
- the cost effectiveness and the independence and objectivity of the auditors
- the provision by the auditors of non-audit services.

Auditing Standards specifically require the external auditor of a listed company to provide the audit committee (or those charged with governance) with a written statement, at least annually, about the audit firm's independence and in particular the objectivity of the audit engagement partner and audit staff.

Within the company the audit committee can play a leading role in challenging the processes for risk analysis/monitoring and the related internal controls, provide a focal point for whistleblowing, focus attention on policies and procedures to prevent fraud and unethical activities and act as the lead committee on compliance with corporate governance codes.

Where an audit committee operates effectively, it has the potential to improve the quality of financial and other reporting, enable non-executive directors to make an active independent contribution to the governance of the business, support the finance director and strengthen the position of the external and internal auditors who can raise issues of concern directly with the audit committee.

In order to operate effectively, however, the committee needs to be able to ask challenging questions about the company's management. In the United States it has recently been suggested (through the bringing into effect of the recommendations of the Blue Ribbon report) ^[6]that all newly appointed audit committee members should be financially literate or become financially literate within a reasonable period of time. The Institute believes that an over-emphasis on financial literacy (which, in any case, is hard to define) might distract from the essential characteristics of an audit committee member. We believe the key qualities are common sense, wide experience, independence, good judgement and an understanding of the committee's role. If necessary, the audit committee should seek independent expert advice on financial reporting issues.

Audit committees are a key element in public confidence in corporate governance and financial reporting. To meet these expectations, members of an audit committee will need:

- regular updates on matters related to their role;
- adequate resources, provided by the company, to support them in their duties; and
- sufficient time to devote to the job, with consequential implications for their remuneration.

By itself, however, even the most effective audit committee cannot guarantee to prevent financial irregularities or fraudulent financial reporting. The whole Board, and not audit committees, are responsible for company management. The concept of the unitary board in the United Kingdom should not be undermined by changing this principle.

Non-executive directors

Non-executive directors sit on two other important sub-committees of the board: the remuneration committee and the nomination committee. Their independent input is fundamental to these committees, as well as to the board itself.

A key matter for future consideration is likely to be whether non-executive directors are truly independent. The current requirement in the Combined Code is for them to be "independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement". We believe that there is a case for additional guidance including examples of factors that might affect independence. Other issues for future consideration might include improved communications between the non-executive directors and shareholders—in particular the large institutional shareholders.

We would, however, caution against the introduction of too onerous requirements or the extension of liability. It would not benefit United Kingdom companies if good candidates were deterred from serving as non-executive directors.

Internal control and the management of risk

A common factor in past corporate failures has been the lack of effective systems of internal control and risk management. The Turnbull Committee recommended in its report a risk-based approach to establishing a sound broadly based system of internal control with board review of its effectiveness. The report, which is based on a framework approach, proposed that, to reflect sound business practice, internal control should:

- be embedded in a company's processes;
- remain relevant over time in the continually evolving business environment; and
- form part of the corporate culture.

The report makes explicit reference to the duties of boards of directors in relation to internal control and the management of risk. Although boards will normally delegate to management the task of establishing, operating and monitoring the system of internal control, they cannot delegate their ultimate responsibility. The report also makes it clear that all employees have some responsibility for internal control and should collectively have the necessary knowledge, skills, information, and authority to establish, operate and monitor the necessary systems.

The report recommends that, to ensure that they remain effective, systems of internal control and risk management must be subjected to ongoing monitoring through regular reviews by management and internal audit. The board should regularly receive and review reports on internal control, undertake its own annual assessment and state in the annual report that:

- there is an on-going process for identifying, evaluating and managing significant risks faced by the company;
- it has been in place for the year up to the date of the approval of the annual report and accounts;

- it is regularly reviewed by the board; and
- it accords with the guidance in the Turnbull Report.

To put themselves in a position to make these statements, boards and their senior management team will have to consider carefully each year how they control their company, which is the foundation of good corporate governance.

Although the recommendations of the Turnbull Report were seen as stringent, it has been generally well received in the United Kingdom and is respected overseas. The Sharman Report (2001) on "Holding to Account—The Review of Audit and Accountability for Central Government" recommended that central government should also adopt the principles of the Turnbull Report.

We consider that the next steps should be to review the practical implementation of Turnbull and whether there should be external reporting of risk.

Summary and conclusions on corporate governance

The key element in corporate governance is the way companies are directed and controlled to protect the interests of shareholders. Effective corporate governance requires clear delineation of responsibilities, transparent reporting and principled directors.

United Kingdom corporate governance has been comprehensively reviewed since the early 1990s through a series of influential reports.

Audit committees and non-executive directors on other committees play a key role in corporate governance through their active independent contribution to the businesses.

The link between companies' objectives, internal control and risk management in the Turnbull Report, which requires directors to re-examine their control of the company on a regular basis, is a further important strengthening of corporate governance.

More generally, the combination of United Kingdom Company Law (specifically the 10 per cent rule for the calling of an extraordinary general meeting that can dismiss directors) and the concentration of share ownership in the hands of the leading City institutions has meant that United Kingdom shareholders have greater leverage in discussions and disagreements with management than shareholders in the United States. A leading United States shareholder activist and fund manager was recently quoted^[7] as saying:

"in truth, US corporate governance should be called 'apparent' while in the UK it can be considered 'real'".

No one can guarantee that "another Enron" could not happen here, but we believe that UK corporate governance practices are strong and improving, and will help to mitigate the risk. Nonetheless, there are several areas where we believe that consideration could be given to further improvements in United Kingdom corporate governance. Above all, there is the continuing need to remind board members of their role and responsibilities and to ensure that they fully understand their fiduciary duty.

Other areas for consideration include:

- additional guidance on criteria for independence of non-executive directors;
- improved communications between non-executive directors and shareholders; and
- sufficient time and resources for audit committee members.

However the concept of the unitary board should not be weakened. The board as a whole is responsible for the control and direction of the company.

The Institute is willing to work with others, such as the FSA, to consider these matters.

4. AUDIT

The value of audit

In view of the separation of management from shareholders, the latter need assurance on the annual accounts prepared by the directors. The law requires the auditors to report to shareholders stating whether, in their opinion, those accounts give a true and fair view of the financial performance and position of their company and have been prepared in accordance with the Companies Act. The auditors' responsibility is to the shareholders, not the directors.

The purpose of audit is often misunderstood. It is not intended to detect fraud (except fraud which is material to the financial statements) or to analyse every financial transaction a company may make to ensure that it is correctly recorded. The audit report is neither a guarantee as to the future viability of the entity, nor an assurance as to the efficiency or effectiveness with which management has conducted the affairs of the entity. The aim is to give shareholders confidence in the annual accounts prepared by the directors. However, the degree of confidence can never be total, principally because a balance needs to be sought between the cost and benefit of the audit, but also because of the degree of judgement necessary in the preparation and audit of accounts.

The auditor's independent assurance of the reliability of the accounts also provides investors with high-quality information on which to base their decisions. This is crucial for the efficient working of the capital markets, which in turn is a key factor in economic growth. A decline in the quality of audit or in the perception of that quality would therefore have grave consequences.

Modern businesses are extremely complex, and the process of auditing large enterprises almost always involves judgements on matters that cannot be decided on a purely factual basis (for example, how to assess the appropriateness of the directors calculation of goodwill following an acquisition), the quality of such judgements depends critically on the auditor's intellectual and professional skills and his knowledge of the company's business. Some of the proposals reported in the press as having been put forward since the Enron collapse, in particular the creation of audit-only firms and the forced replacement of auditors after a fixed period, could fatally undermine these requirements. (The arguments on these issues are further developed in the Appendices to this submission.)

Auditor independence

For the public to have confidence in the quality of audit it is essential that auditors should be, and should be seen to be, independent of the companies which they are auditing. In the United Kingdom, the requirements for auditor independence are embodied in the ethical codes of the professional bodies.

The United Kingdom's approach, pioneered by the Institute, to setting independence requirements for auditors using a conceptual framework has proved a model for many others. It has been adopted by both FEE and FIAC, and the European Commission has taken a similar line in its proposed Recommendation on auditor independence.

In broad outline, the framework approach works as follows:

- Fundamental principles are set out which must always be observed by a professional accountant. In the case of audit, the key fundamental principles are integrity and objectivity, which necessarily require the auditor to be independent.
- The auditor must conscientiously consider, before taking on a piece of work, whether it involves threats to his independence. Both actual threats and situations that might be perceived as threats by a reasonable and informed observer must be considered.
- Where such threats exist, the auditor must put in place safeguards that eliminate them or reduce them to clearly insignificant levels. All such measures need to be recorded in a form that can serve as evidence of compliance with due process; and
- If unable to implement fully adequate safeguards, the auditor must not carry out the work.

The ethical guidance based on this framework includes illustrative examples of threats that might arise

and the appropriate safeguards to deal with them. However, the auditor must be able to demonstrate that, in the particular circumstances under consideration, the fundamental principles have in fact been observed: it is not sufficient to demonstrate that particular examples of threats and safeguards have been addressed by merely going through the motions.

By contrast, independence requirements in the United States are in the form of specific rules set by the SEC. Although the rules are derived from underlying principles, it is compliance with the rules themselves, rather than the underlying principles, that is taken as the test of independence. Although every endeavour is made to ensure that the rules are up to date and comprehensive, a rule-based approach is always open to circumvention by finding new ways of complying with the form rather than the substance.

In some instances, the framework approach can effectively prohibit an activity. For example, holding or dealing in securities of any audit client would constitute such a severe actual or apparent threat to independence that there are no adequate safeguards. However, the prohibition is the outcome of the fundamental principles, not a free-standing rule.

The proposals for complete separation of audit and non-audit work and forced rotation of audit firms discussed in the Appendices are crude attempts to secure auditor independence through the imposition of rules designed to prevent auditors and their clients from developing close relationships. The threat of undue familiarity is, however, well recognised within the United Kingdom system. It can be addressed satisfactorily by a wide range of safeguards without the risk of damage to the quality of audit that these proposals would entail.

Examples of the sorts of safeguards that are adopted within the United Kingdom system to protect the independence of auditors include:

- provision for staff on the audit assignment to communicate concerns to a separate partner^[8];
- arrangements for an independent partner to act as reviewer or reviser of the work;
- regular rotation of audit partners;
- effective interaction between the audit committee and the auditor; and
- compartmentalisation of responsibilities and knowledge within the audit firm.

This is not, however, and cannot be a comprehensive list. It is always necessary to consider carefully and document fully the precise arrangements that have been made in each case to ensure that independence is preserved.

Our position on the provision of other services is consistent with the views expressed by Harvey Pitt, the SEC Chairman, who stated^[9]:

"Auditor independence is a complex subject. It can't be resolved by simplistic solutions. We are opposed to those who say that accounting firms as a whole should be restricted to providing only audit services".

It is also consistent with the views expressed in an Australian report^[10] (before Enron):

"there is no solid evidence of any specific link between audit failures and the provision of non-audit services... A ban should not be imposed in the absence of compelling evidence of a problem."

The latter report also counselled against mandatory rotation.

Inspection and sanctions

The effectiveness of auditor independence codes depends in the first instance on the willingness of the auditors to comply. There is a strong ethos among the United Kingdom accountancy profession of compliance with our demanding principles-based ethical code. Moreover the risk of damage to reputation, the most precious asset of an auditor, is—as recent events at Andersen have graphically illustrated—a

powerful consideration.

Auditor independence is reinforced by systems of inspection, to detect breaches of auditing standards and ethical requirements, and the imposition of restrictions, conditions and/or penalties where failures have occurred or offences have been committed.

Until 1989, monitoring of the quality of audit work in the United Kingdom was undertaken by the firms themselves through a process of internal review. Compulsory inspection was introduced as part of a system of delegated statutory regulation, sometimes referred to as "self-regulation", under the provisions of the Companies Act 1989.

The term "self-regulation" is a misnomer. Although the costs of inspection are met by charges on the firms to be inspected and the inspectors are employed by the professional bodies, every aspect of the process is ultimately controlled by government. Both the regulations, which set out the standards to be achieved, and the pattern of monitoring visits, must be agreed in advance with the Department of Trade and Industry, and an annual report on audit regulation, including the results of the inspection programme, is made to the Secretary of State for Trade and Industry and laid before Parliament.

Under the provisions of the Companies Act 1989, the Institute is designated as a Recognised Supervisory Body (RSB). RSBs are permitted to register firms to carry out company audit work in the United Kingdom, and no firm may carry out statutory audit without being registered. A registered firm must comply with the RSB's audit regulations and open itself to inspection by the RSB's monitoring team.

The Institute's audit regulations, agreed with the Department of Trade and Industry, encompass the full range of auditing and ethical standards required of firms and include detailed guidance on procedures necessary to achieve the relevant standards. The main areas covered are:

- independence;
- integrity;
- technical standards;
- consultation on ethical and technical issues;
- arrangements for maintaining competence; and
- monitoring of compliance.

The Institute's inspections of audit firms are undertaken by the Joint Monitoring Unit, a team of some 50 staff including over 30 professionally qualified inspectors, which also carries out audit monitoring for the Irish and Scottish Institutes of Chartered Accountants.

The larger Institute registered firms, which audit the great majority of listed companies, are subject to a monitoring visit every year. Special purpose visits may also be undertaken if there is cause for concern. For example, in 2000 all the Institute registered firms which audited listed companies were visited, as a specific exercise, to establish whether failures to observe independence requirements, which had been reported in the United States, extended to the United Kingdom. No evidence was found of significant or systemic failure to comply with the requirements.

Any breaches of Audit Regulations which are detected are referred to the Institute's Audit Registration Committee, which consists of at least eight members of which at least two are not accountants. Such references may result in a requirement to take specified action, a penalty or, in appropriate cases, removal from the register, which would render the firm ineligible to conduct statutory audits.

Failure to comply with the Institute's ethical code, including auditor independence, would, in addition, render the individuals concerned liable to disciplinary action. This could result in a range of sanctions including heavy fines and, ultimately, removal of the right to practise as a Chartered Accountant.

Any cases which appear likely to give rise to issues with wider implications for the public interest are not heard by the Institute's own regulatory and disciplinary committees but are referred to the Joint Disciplinary

Scheme—an independent body financed jointly by the Institute and the Institute of Chartered Accountants of Scotland. (The Scheme deals with members in business as well as in practice.)

A recent addition to these arrangements is the establishment of the Accountancy Foundation. This provides an independent framework for the supervision of the profession, which has been put in place in co-operation with the United Kingdom government.

Within the framework, the most senior body is the Accountancy Foundation Board. None of its members, who are appointed by public interest bodies such as the Bank of England and the Trades Union Congress, are practising accountants. Beneath them, there are four special-purpose boards dealing with ethical codes, auditing practices, the hearing of public interest disciplinary cases and the continuous review of the professional bodies' regulatory and disciplinary functions to ensure that they are operating in the public interest. All of the boards have a majority of non-accountants.

Summary and conclusions on audit

The regulation of audit in the United Kingdom differs in many respects from the system currently in place in the United States:

- The independence code is a principles-based approach, which insists that the reality of independence, not merely the requirements of a set of rules, must be observed.
- The inspection regime is in the hands of full-time professionally qualified Inspectors, employed by the professional bodies, whose work programme is approved by the government.
- Supervision of the profession's regulatory and disciplinary arrangements to ensure that they are in the public interest is undertaken by the Accountancy Foundation, an independent body established in co-operation with the government.

Many of these differences between United Kingdom and United States practices resulted directly from the changes prompted by the major corporate collapses of the late 1980s and early 1990s in the United Kingdom.

5. CONCLUSIONS

The major corporate failures of the late 1980s and early 1990s—in particular Maxwell, BCCI, and Polly Peck—were a wake-up call for the business and regulatory community and the accountancy profession in the UK. Fundamental changes were introduced in financial reporting, corporate governance and audit, and work continues in a constant search for improvements.

Among the many lessons learned, three key themes emerged: substance over form, transparency, and the management of risk.

The principle of substance over form is deeply embedded:

- in our accounting standards, which bring "quasi-subidiaries" into the consolidated financial statements whatever their formal status;
- in our ethical codes, which require auditors to be independent in fact, not merely to appear to adhere to rules; and
- in the fundamental requirement for the annual accounts prepared by the directors to present a "true and fair" view, even if that means over-riding a rule which would tend to distort the picture.

The principle of transparency is now pervasive. Examples include:

- wide-ranging requirements to disclose information in companies' annual reports;
- the monitoring of audit firms by teams of independent professional inspectors; and

- the establishment of the Accountancy Foundation to provide external oversight of every aspect of the profession's regulatory and disciplinary arrangements.

The emphasis on internal control and risk management has emerged from a recognition that, however effective safeguards against misrepresentation and abuse may be, they will never be sufficient to eliminate all possibility of failure. In the modern rapidly evolving global economy the pattern of threats (and opportunities) can change over a very short period. The challenge is now to respond to this by embedding effective internal controls and risk management as an integral part of companies' way of doing business, with a particular focus on the effectiveness of these procedures by those charged with governance.

In the United States, many of the questions that were asked here in the UK a decade ago are being raised again in the wake of the Enron collapse. Similar conclusions to those reached and acted upon here are being reached now in the USA—in particular in relation to the primacy of substance over form on which there is now a developing international consensus.

We would not claim that the United Kingdom system now needs no further action. Change in the business world is constant. New entities, new products and new processes emerge all the time and we must be constantly alert to the new threats they may pose. We are constantly seeking, in co-operation with government, to improve our existing structures. Appendix 3 briefly lists a range of current important initiatives in which the Institute is involved.

The lessons of the 1980s and 1990s have been hard-won and must not be forgotten in the understandable desire to find "a solution" to Enron. In particular, any proposal to substitute form for substance through the imposition of rule-based compliance requirements must be viewed with great scepticism.

We believe that the accountancy profession and others involved in corporate governance in the United Kingdom have learned the hard lessons of the past. The search for improvements continues and many constructive initiatives are in progress to modernise company law and improve standards world wide (see Appendix 3 to our submission). It would be unfortunate if these carefully considered initiatives, which will be of long-term benefit, were blown off course. In particular, we strongly urge the Government not to be diverted from implementing the proposals for company law reform which, if the final report of the Company Law Review Steering Group is followed, include important recommendations on matters such as corporate governance.

28 March 2002

THE PROVISION BY AUDIT FIRMS OF NON-AUDIT SERVICES

The emergence of professional service firms in recent years has resulted from a growing demand from businesses for specialist advice to help them achieve business advantage in an increasingly competitive global market place.

To cater for this demand, many audit firms now offer wider counsel. There are good reasons for this development. Auditors are trained to understand the dynamics of a business from an external perspective and this independent viewpoint can often shed light on problems that may appear intractable from within an organisation.

From a regulatory perspective, however, this raises the question of whether the provision of non-audit services to audit clients will compromise the auditor's independence.

TYPES OF NON-AUDIT SERVICES

The non-audit services provided by auditors to their clients fall into three categories:

(1) Services required by legislation or contract to be undertaken by the auditors of the business. These include:

- regulatory returns eg to the Financial Services Authority;
- legal requirements in many countries, including the UK, for auditors to report on matters such as

share issues for non-cash consideration, expenditure for grant application purposes, etc; and

— contractual requirements, for example to report to lenders or vendors on net assets, covenant requirements, etc.

(2) Services that it is most efficient for the auditors to provide because of their existing knowledge of the business, or because the information required is a by-product of the audit process. These include:

— services such as those listed in category (1) above that the auditors are not required by law to undertake, but where the information largely derives from the audited financial records;

— tax compliance, where much of the information derives from the audited financial records; and

— "short form" or other reports in acquisition or reorganisation situations where completion is necessary in a very short time.

(3) Services that could be provided by a number of firms. In this case, the fact that the firm is the auditor is incidental and it would generally only be chosen because, for example, it had won a tender process. Examples of such services include:

— management consultancy

— tax advice

— human resources consultancy.

The case for change?

The first question to consider is whether there is a case for change. The underlying rationale for the proposal is that the provision of non-audit services by audit firms will inevitably compromise their independence, either because they will become too close to the company they are auditing (the "familiarity" threat) or, more directly, because their objectivity will be challenged by over-reliance on income from a single source.

These risks are, however, well recognised in the existing arrangements to protect auditor independence.

— First, the Institute's ethical code forbids auditors to provide non-audit services to audit clients if that would present a threat to independence for which no adequate safeguards are available. In such circumstances, the firm must either resign as auditor or refuse to supply the non-audit services. The code includes examples of activities where no acceptable safeguards are available—for example the promotion of the shares of audit clients—which are therefore effectively prohibited.

— Second, under the provisions of the Combined Code of corporate governance, the audit committee, as representative of the shareholders, is required to oversee the relationship with the auditors and keep the nature and extent of non-audit services under review. The audit committee must satisfy itself that the independence and objectivity of the auditor are not compromised. This important task is underpinned by United Kingdom Auditing Standards, which specifically require that, for listed companies, audit engagement partners^[11] in the firm who are responsible for a company's audit must:

— disclose in writing to the audit committee all relationships between the audit firm and the client that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and staff (including arrangements for ensuring that independence remains when non-audit services are commissioned) and the related safeguards that are in place.

— confirm that, in their professional judgement, the firm is independent and the objectivity of the audit engagement partner and audit staff is not impaired.

— Third, the ethical code specifies that an audit appointment to a listed company should not be accepted if the client provides an unduly large proportion (10 per cent) of a firm's gross practice income. That approach limits undue financial dependency on any client without artificial restrictions on the balance between different types of income. In practice, auditors of listed companies are well within this limit.

— Fourth, shareholders themselves are able to assess the extent of non-audit services provided by auditors. The Companies Acts have for some years required the total amount of non-audit fees paid to auditors to be disclosed. The Institute has gone further and called for an analysis of these fees by type of work in the categories set out above. This would create a greater climate of transparency and be helpful to shareholders. Many companies already provide this analysis.

At a more fundamental level, an examination of past cases of audit failure which have led to the imposition of regulatory or disciplinary penalties by the Institute or the Joint Disciplinary Scheme has shown that the provision of non-audit services was not the cause of the audit failure, nor did it arise from undue dependency on non-audit fees. The "problem" as stated is not supported by evidence and appears to be founded on subjective impressions of difficulties that might arise rather than fact.

IFAC's recent review of auditor independence¹² included an in-depth examination of the potential threat to objectivity arising from the provision of non-audit services to clients. Following extensive consultation, IFAC concluded that a balanced approach similar to that in use in the United Kingdom was the most appropriate way forward.^[12]

The case against change

An effective audit of a modern listed company requires experience far beyond the traditional auditing skill set. Auditors need to be able to draw on the knowledge and experience of colleagues who are expert in key risk areas: taxation, treasury operations, information systems, regulatory compliance, financial management, due diligence, actuarial assessments, fraud and business process. By inhibiting such exchanges within a firm, a rigorous separation of audit and non-audit services would lead to a deterioration in audit quality, an increase in cost (since the companies would need to buy in expertise from others), or some combination of the two.

Ultimately, the specialist divisions within an audit firm may be likely to find the constraint of being unable to accept work from clients of their auditor colleagues unnecessarily restrictive and establish themselves as entirely separate entities. The remaining audit-only firms would be expensive, because of the need to buy in specialist skills. They would also be risk-averse, because of the narrowness of their experience, and some of the more commercially innovative companies might have difficulty in finding an auditor. Perhaps the most serious consequence is that such firms would not attract the brightest graduates who enter a profession they perceive as opening the door to a broad range of subsequent careers.

We conclude that since such evidence as there is indicates that there is no correlation between levels of non-audit fees and audit failure, comprehensive safeguards are already applied, and rigorous separation of non-audit services seems likely to increase the cost and reduce the quality of the audit, the suggestion should not be pursued.

A final consideration is that on grounds of economic efficiency we should not limit the freedom of companies to select the providers of services they judge best able to meet their requirements unless there are compelling reasons to do so. Barring the provision of non-audit services could increase the time taken to complete the audit (at a time when companies are under pressure for prompter filing and publication of results), increase costs and, so far from reducing dependency on income from a particular source, actually increase the firm's reliance on fees from its audit clients.

Views of others

Harvey Pitt, Chairman of the SEC, stated earlier this year¹^[13]:

"... to create an 'audit only' firm as some have suggested—does not guarantee an 'audit failure free' future. For one thing, an 'audit only' firm also would be more dependent, not less, on their audit clients, and a single, large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenues. Moreover, information that can be gained through consulting engagements often is useful in performing audits."

Last year, the Australian Minister for Financial Services and Regulation commissioned an independent study on the Independence of Australian Auditors. The report^[14] identified the arguments for and against the provision of non-audit services by auditors to their clients. A key conclusion was:

"There is no solid evidence of any specific link between audit failures and the provision of non-audit services, and non-audit services have been provided by audit firms to their clients for many years. A ban should not be imposed in the absence of compelling evidence of a problem."

The report recommended that the provision of non-audit services be dealt with by:

- "revised and updated professional ethical rules;
- mandatory disclosure of non-audit services and the fees paid for these services;
- strengthening the role of audit committees; and
- establishing an Auditor Independence Supervisory Board which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services."

(This last recommendation has been met in the United Kingdom by the formation of the Accountancy Foundation and its subsidiary bodies.)

OBLIGATORY ROTATION OF AUDIT FIRMS

Effective audit of a complex business depends on a careful balance. On one hand, the auditor needs the deep knowledge of the company and the environment in which it works that can only be developed through long association. On the other hand, the risk that the auditor might develop such a strong sense of identity with the company that his independence would be impaired (the "familiarity" threat) must be avoided.

The main submission discusses the existing range of safeguards—including the role of audit committees, the Institute's ethical code and the liability of firms to external inspection—designed to deter lack of independence. In addition, auditors of listed companies are themselves very conscious of the threat to their reputation of audit failure and have their own stringent quality control procedures.

The proponents of obligatory rotation of audit firms nevertheless believe that independence would be further strengthened if companies were forced to replace their auditor after a fixed period of years. They argue that this would bring fresh minds to bear on the business and that this, together with the knowledge that the work of the auditor would in due course be subject to examination by a successor firm, would improve audit quality.

The two key questions in considering this proposal are whether in fact there is a link between length of association and deteriorating audit quality and whether in principle obligatory rotation of firms would lead to an increase in quality.

There is little experience on which to base empirical judgements. At present, only Italy and Brazil (for some types of business) have obligatory auditor rotation. Singapore has recently introduced auditor rotation for banks. On the other hand, Turkey, Slovakia and Spain, which previously operated such a system, have now ceased to do so.

We are undertaking a thorough academic and regulatory literature search to see what information may be available. An in-depth academic study was carried out in Spain in the mid-1990s. ^[15]The study looked at the impact of rotation on audit prices and quality. It concluded that:

"Legislative intervention should strive to...pave the way for good, cheap audits. From this standpoint, rotation is almost always ineffectual, when not clearly counterproductive".

Two main reasons were given to support this conclusion. First, mandatory rotation reduces the incentive

for firms to invest in resources to improve audit quality. Whatever level of excellence in auditing the company may be achieved, they will still be unable to keep the client. Second, mandatory rotation will increase the number of first-time-through audits, with the resulting removal of the knowledge base accumulated by the previous auditor.

". . . the problem in these cases arose from too little involvement by the auditors in the activities of their clients, rather than too much. A significant proportion of the cases arose in initial audits where the main pattern was normally one of the client misleading the auditor rather than conspiring with him."

An AICPA paper of 1992 concluded that:

"Mandatory audit firm rotation would not enhance audit quality or strengthen investor confidence in the objectivity of audits."

Whether or not mandatory rotation would lead to a deterioration in the quality of audit, there can be little doubt that it will cause an increase in cost. Each time a new audit firm is retained, the first-time-through audits take longer, since the new firm must learn the particular features of the client company's accounting systems and the markets it operates in. They must, in effect, rebuild knowledge that was acquired over a long period of time by the outgoing auditor. For some complex and specialised modern businesses the pool of available auditor expertise may be too restricted to sustain a regular rotation process.

The case for regular rotation of audit firms is not conclusive, and serious independent analysts have decided that it is not a productive course to follow. The Cadbury Committee, when it undertook its fundamental review of corporate governance, concluded that there was no case for the introduction of compulsory auditor rotation in the United Kingdom. Most recently, the Republic of Ireland Review Group on Auditing, notwithstanding its willingness to introduce tough and if necessary controversial controls, decided that compulsory auditor rotation would not be beneficial.

The Australian Ramsay report (referred to in Appendix 1) also addressed mandatory rotation on audit firms and concluded that:

"We do not believe it appropriate to mandate rotation of audit firms. The Audit Review Working Party, in also reaching this conclusion, stated that the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors. We agree with these comments."

The report does, however, endorse the mandatory rotation of audit partners (as in the UK).

Against that background, unless further compelling evidence becomes available, the Institute would counsel supporting the ability of companies to base the choice of auditors on their own business needs, within the framework of the existing safeguards against threats to independence.

The Institute recognises that over-familiarity can be a threat to auditor objectivity. Our ethical code requires such threats to be balanced by safeguards including, for listed companies, that the audit engagement partner should not act for longer than seven years. Such safeguards achieve the underlying objectives of the proponents of auditor rotation without the damage to the quality of audits that such a requirement would entail.

Finally, United Kingdom law requires shareholders to appoint auditors annually and the Combined Code requires the audit committee to keep under constant review the independence of the auditor. Together, these provide a better safeguard than fixed-period mandatory rotation.

CURRENT INSTITUTE ACTIVITY

THE UK REGULATORY FRAMEWORK

Financial Reporting Council

The Financial Reporting Council (FRC) meets the needs of the wide range of interests in financial reporting at the policy level. The FRC model includes its two operational bodies—the Accounting Standards Board and the Financial Reporting Review Panel.

The Institute is closely involved with the ASB in its continuing development of Financial Reporting Standards and other guidance. As mentioned in the main submission, the FRRP is now under consideration as a possible model for enforcement of accounting requirements at European level.

Accountancy Foundation

The key feature of the Accountancy Foundation system is its independence from control or undue influence by the accountancy profession. Its primary aim is to ensure that the public interest in the way that the profession operates is fully met and thus to secure public confidence in the impartiality and effectiveness of the profession's systems of regulation and discipline, professional conduct and regulation.

The participation agreement for the Foundation was signed earlier this month and it is now moving into full operation.

INTERNATIONAL

On the international front, the Institute is closely involved with the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) and its subsidiary bodies including the International Auditing and Assurance Board (IAASB).

The international profession has recognised the need to strengthen all aspects of the profession's standards—accounting, auditing, ethical and quality assurance standards—in order to achieve consistent quality financial reporting and audits globally. This has resulted in a number of reviews to which members of the Institute have contributed and which have resulted in extensive action plans for the coming years.

IFAC is to form an international task force of investors, directors and auditors to make recommendations on the role and composition of audit committees and how they should report to shareholders. The task force is part of the drive by IFAC to encourage improved corporate governance.

The international accountancy profession's commitment to high professional standards is exemplified in a number of ways. For example, the international profession has recently established the Forum of Firms whose members are committed to significant obligations in terms of compliance with the IFAC international standards and the IFAC code of ethics. They will also be required to meet additional continuing education and training requirements.

EUROPE

The Institute is a member of the Fédération des Experts Comptables Européens (FEE), the body that represents the accountancy profession in Europe. FEE plays a significant role in influencing thinking in the European Commission (EC) that will lead to common accounting, auditing and ethical standards throughout the EU.

The EU has issued, or will issue, pronouncements on quality assurance, auditor independence, accounting standards and auditing standards. The Institute is working to ensure that these standards are the same as the international standards.

COMPANY LAW REVIEW

In June 2001, the Company Law Review Steering Group, appointed by the DTI, issued its final recommendations on the Company Law Review. The Institute made significant contributions to the

consultation papers through representations to the Steering Group and the individual involvement of members on the Steering Group and its working parties.

The Institute looks forward to commenting upon the proposed legislation which, we anticipate, will deal many of the areas covered in the main submission including corporate governance, responsibilities of directors and auditors, and corporate reporting (the Operating and Financial Review). It will be a substantial commitment that will last for several years as the legislation and secondary legislation, regulations and codes of practice are implemented.

INSTITUTE ACTIVITY

In addition to the above activities:

- The Institute has taken the lead in the e-Xtensible Business Reporting (XBRL) project in the UK. For three years we have assisted the global development of software that would facilitate the transfer of financial information. This project had its first pilot test in February 2002 with Reuters final reports.
- The Institute's Audit and Assurance Faculty has commenced a post-implementation review of SAS 240 (revised), the auditing standard on quality control on audit work. The requirements of SAS 240 (revised) applied, for the first time, to audits of financial statements undertaken in 2001.
- In June 2001, the Auditing Practices Board issued a consultation paper on "Aggressive Earnings Management" to alert executive directors, non-executive directors, auditors, regulators, and users of financial statements of the potential threat that increasing commercial economic pressures may cause "aggressive earning management". The Institute agrees that the issues surrounding aggressive earnings management should be addressed, but, as raised in discussions with the DTI, believes that a fundamental and comprehensive review is needed. This review should involve government, regulators, the financial reporting community and those involved in corporate governance.
- The Institute, together with other members of the Consultative Committee of Accountancy Bodies, is in discussion with the Ethics Standards Board (part of the new Accountancy Foundation framework) on revisions to code of auditor independence in the light of recent international work.

OVERVIEW OF THE AUDIT FRAMEWORK FOR LISTED COMPANIES IN THE USA AND THE UK

US Practice

Where does the authority come from?

The requirement for an audit for listed companies derives from the rules of the SEC, with which all companies listed on US stock exchanges must be listed.

The SEC has various rules governing the auditors (eg the independence rules) and the companies. These effectively sit on top of (and do not replace) those of the AICPA^[16]. While not all auditors are required to be members of the AICPA they are required to be licensed by a State Board of Accountancy.

US ethics standards are more rules based than in the UK.

Requirements to practice as an auditor

Individuals who wish to practice as public accountants, which includes auditing, must be

UK Practice

The Companies Acts require all non-small companies, private and public, to be subject to audit. The DTI has the power to regulate auditors, but delegates it to particular accountancy bodies (the Recognised Supervisory Bodies). These report to the DTI annually on their activities.

The FSA's Listing rules, which apply to listed companies, do not have provision for any direct oversight of interaction with auditors.

UK ethics standards are more principles/framework based than in the US.

To be able to sign an audit report, an individual must be a qualified member of one of the RSBs (the ICAEW and four others) and have a practising

qualified CPAs and be licensed with the relevant State Board. These have varying education, CPE and experience requirements.

If an AICPA member or firm audits an SEC client, the individual or firm must join the AICPA's SEC Practice Section. In addition, auditors of companies listed on the main stock exchanges have to be enrolled in a peer review program compliant with AICPA standards and subject to oversight by an independent body.

Accounting standards

The SEC has authority to establish standards for listed companies, but in fact relies on the FASB (which took over the role from the AICPA in 1973). This is a private body, run by trustees appointed from a variety of stakeholders, and paid for by companies, banks, etc and the AICPA's Research Association.

Through various Bulletins, the SEC has informed the accounting profession of its opinions on accounting and reporting issues. In addition, SEC staff attend meetings of the FASB (including the EITF[17]) and technical committees of the AICPA.

Accounting standards are more rules based than in the UK.

US reporting timetables are generally faster than in the UK.

Auditing Standards

Standards are issued by the Auditing Standards Board of the AICPA. The ASB is a senior technical committee of the AICPA.

Audit reports state, *inter alia*, "We conducted our audits in accordance with auditing standards generally accepted in the United States of America" and that the financial statements "fairly present".

The AICPA's Code of Professional Conduct requires an auditor to follow these statements in conducting an audit.

Auditors, whether members or not members of the AICPA, are also required to follow these auditing standards by their State Board of Accountancy.

Quality review of accounts

The financial statements of all first-time share issuers receive a thorough review by the staff of the SEC. Repeat share issuers are reviewed on a selective basis. If selected, reviews of registration statements usually trigger a simultaneous review of

certificate with one of those bodies. These have various experience and CPE requirements.

Firms must be registered with one of the RSBs.

Registered audit firms must, by UK and EU law, be majority owned by individuals qualified to be auditors.

The Companies Acts include certain accounting requirements derived from EU law. They also recognise accounting standards issued by the ASB (which took over the role from the ASC[18], set up by the profession, in 1990). The ASB is a private body, run by a board appointed by the FRC, and funded by the FRC. The FRC itself has a board consisting of various stakeholders and is funded by the profession, companies, banks, etc and the government.

ASB's Urgent Issues Task Force issues non-mandatory Abstracts on urgent issues.

Accounting standards are more principles and "substance over form" based than in the US.

UK reporting timetables are generally slower than in the US.

Standards are issued by the Auditing Practices Board. This was originally set up by the accountancy profession but its successor body is now part of the new independent regulatory framework under the Accountancy Foundation.

Audit reports state, *inter alia*, "We conducted our audits in accordance with auditing standards issued by the Auditing Practices Board" and that the financial statements give a "true and fair view".

Audit Regulations issued by the RSBs require that auditors adhere to auditing standards.

The FRRP[19] is a private body, run by a board appointed by the FRC, and funded by the FRC (see above). The FRRP does not proactively review accounts but will investigate complaints about accounts of public and large private companies.

annual and quarterly reports.

It has, by law, the power to require revisions to accounts.

SEC staff also perform periodic reviews of accounts filings.

Quality review of auditors

The SEC Practice Section of the AICPA has a peer review programme, mandatory for AICPA members that audit SEC registrants. However, the SEC does not mandate that a firm join the SECPS.

All registered auditors are monitored by the JMU [20], an independent body of full time inspectors employed by the ICAEW, ICAS and ICAI.

The SECPS requires member firms to adhere to quality control standards established by the AICPA.

The Audit Regulations, to which all registered auditors must adhere, require arrangements to be set up to ensure that quality is maintained.

Disciplinary arrangements

The SEC can instigate legal action or administrative action (eg prohibition for a period).

The initial complaints, either direct or from the committees overseeing the JMU's monitoring work, are investigated by the Institute, though in the case of public interest cases, they can be referred to the Joint Disciplinary Scheme (separately constituted but funded by the ICAEW and ICAS).

Member firms of the SECPS are required to report litigation alleging deficiencies in the conduct of an audit of an SEC client to the Section's Quality Control Inquiry Committee (QCIC). The activities of the QCIC are overseen by the Public Oversight Board and the SEC.

The government, through the DTI, will investigate separately where they are suggestions of breach of law (these investigations are usually of the company, but the auditors or individual accountants may be covered by the enquiry).

During the period 1991 to 2001, 261 SEC related cases involving AICPA members were opened. Of those 112 are in process, 105 were closed with violation findings, and 44 were closed with no violation. These cases involve auditors and company personnel.

Typically, around 2,000 complaints per annum (about all aspects of a member's behaviour) are dealt with by the ICAEW. Approximately 65 per cent are dismissed or there is no *prima facie* case, 10 per cent are settled through, typically, cautions, fines, or exclusions and the rest are settled through conciliation.

1 We assume that, for the purpose of the Committee's inquiry, public limited companies are those in the public domain ie listed other public interest companies, rather than "public companies" as defined in the Companies Act 1985 s 1(3). [Back](#)

2 "Internal control-guidance for directors on the Combined Code". [Back](#)

3 The FASB Report, 28 February 2002. [Back](#)

4 A method of assessing value by reference to a financial model. Where there is an active market, the "mark to market" approach is used which is based on actual market values. [Back](#)

5 The Effective Audit Committee: a Challenging Role, March 2001. [Back](#)

6 The Blue Ribbon Committee was set up by the U.S. Securities and Exchange Commission to consider

corporate governance issues. Its "Report on Improving the Effectiveness of Corporate Audit Committees" was published in 1999. [Back](#)

7 Financial Times, 18 March 2002. [Back](#)

8 Partner is the commonly used term, but under Audit Regulations the correct term is "principal" which covers sole practitioners and directors where the audit firm is established as a company. [Back](#)

9 To the US Senate Committee on banking, Housing and Urban Affairs on 21 March 2002. [Back](#)

10 "Independence of Australian Company Auditors" October 2001 (the "Ramsay report"). [Back](#)

11 Described as Responsible Individuals under Audit Regulations. [Back](#)

12 Section 8 of the "Code of Ethics for Professional Accountants": IFAC November 2001. [Back](#)

13 To the US Senate Committee on Banking, Housing and Urban Affairs on 21 March 2002. [Back](#)

14 "Independence of Australian Company Auditors" October 2001 (the "Ramsay report"). [Back](#)

15 Economic Consequences of Mandatory Auditor Rotation. Prof, Dr. Benito Arrunada and Prof. Dr Candido Paz-Ares (1995). A study undertaken in the United States by John Burton, a former Chief Accountant of the SEC indicated that audit failure is indeed far more frequent within the first two years of an engagement with new client. However commented that: [Back](#)

16 American Institute of Certified Public Accountants. [Back](#)

17 Accounting Standards Committee. [Back](#)

18 Emerging Issues Task Force. [Back](#)

19 Financial Reporting Review Panel. [Back](#)

20 Joint Monitoring Fund. [Back](#)

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