

**CO-ORDINATING GROUP
ON AUDIT AND
ACCOUNTING ISSUES**

Interim Report

**To the Secretary of State for Trade and Industry
and the Chancellor of the Exchequer**

JULY 2002

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CO-ORDINATING GROUP ON AUDIT AND ACCOUNTING ISSUES

INTERIM REPORT TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY AND THE CHANCELLOR OF THE EXCHEQUER

1 EXECUTIVE SUMMARY

1.1 The Co-ordinating Group on Audit and Accounting issues (CGAA) was set up by the Chancellor of the Exchequer and the Secretary of State for Trade and Industry to:

- ensure that there is a co-ordinated and comprehensive work programme by individual regulators to review the UK's current regulatory arrangements for statutory audit and financial reporting in the light of the collapse of Enron, avoiding any unnecessary overlap;
- commission additional work or reviews, if that is judged appropriate; and
- reach a view on the adequacy of the proposals, and, if appropriate, make specific recommendations.

The Group was asked to provide an interim report by summer 2002, with a final report at a later stage. This report fulfils the Group's commitment to provide a progress report.

1.2 In taking forward the work, the Group has taken into account the wider context, both in the UK and internationally. In the UK, we have kept in mind the substantial improvements that have been made to the regulatory regime over the past decade, but have balanced that with the need to guard against complacency. We have also been mindful of the international context, given the proposals within Europe to develop a common regulatory approach in many of the areas, and the fact that these issues need increasingly to be considered on a wider international basis. Developments in the USA are of particular relevance, although we have borne in mind that there are significant differences between UK and US requirements and practice.

1.3 The work of the Group to date has focused on work being taken forward by regulators in a number of key areas:

1. Auditor independence, in particular the issues of the provision by the auditor of non-audit services to audit clients and auditor rotation;
2. Corporate governance, focusing on the role of Audit Committees;

3. Regulatory oversight of the accountancy profession, under the auspices of the Accountancy Foundation and its subsidiary bodies, including the arrangements for the monitoring of the quality of audit work;
4. Financial reporting, including accounting standards and their enforcement;
5. Reform of Company Law, including the issue of wider corporate reporting; and
6. Auditing standards.

1.4 High standards of financial reporting and corporate governance are promoted in the UK in a variety of ways - through regulation, professional standards, voluntary codes and market pressures. It is the combination of these elements which determines the effectiveness of our arrangements. Our recommendations need to be seen in the same light: as a package of measures, which taken together, we believe will ensure that the UK regulatory arrangements remain effective and appropriate to their purpose at the leading edge of disclosure and governance standards. Our comments and recommendations on each of the areas considered to date by the Group are as follows:

1.5 Company law reform (*Section 8*)

We **welcome the recently published proposals** from the Government in response to the Company Law Review, in particular to:

- a) require large companies to prepare a statutory Operating and Financial Review (paragraph 8.7);
- b) set out a statutory statement of directors' duties (paragraph 8.8);
- c) extend the existing obligations on directors and company employees to provide information to the auditors. These are backed by stiff criminal penalties (paragraph 8.9).

1.6 Audit Committees (*Section 4*)

The role and membership of Audit Committees need to be strengthened. It must be clear that they act on behalf of and report to the shareholders, particularly in relation to appointment and remuneration of the auditors, upholding auditor independence and monitoring audit quality (paragraphs 4.9-4.10). In particular, we propose that:

- a) The Audit Committee should approve the purchase of non-audit services (see paragraph 4.9).

- b) The **Audit Committee** should have the principal responsibility for making **recommendations on auditor appointment** to the shareholders (paragraph 4.9).

This will require members of Audit Committees to have the necessary skills, experience and independence. To help Audit Committees fulfil these enhanced responsibilities:

- c) We have invited the Financial Reporting Council (FRC) to set up a group to **develop existing Combined Code guidance for Audit Committees**. (paragraphs 4.10 and 4.11). We are pleased that the FRC has agreed to take this forward as a matter of urgency.
- d) We look forward to the outcome of the **Higgs Review of the role and effectiveness of Non-Executive Directors (NEDs)** and note the need for close co-operation with the Higgs team (paragraph 4.18).
- e) The Government should carefully consider underpinning the role and responsibilities of Audit Committees through company law (paragraph 4.14).

1.7 Auditor independence *(Section 3)*

Auditors must not only be independent, they must be perceived to be independent. Whilst much has been done in recent years to safeguard the independence of auditors, **tougher mechanisms** are needed to underpin this. As well as the proposals concerning Audit Committees outlined above:

- a) We have asked for further work to identify the types of **non-audit services which are incompatible with the principles underlying auditor independence**. This should include a close look at the nine non-audit services deemed by the SEC as inconsistent with an auditor's independence. This could lead to a further tightening of the work that auditors should not carry out for their audit clients. We note, with approval, that a number of companies are already strengthening their auditor independence policy voluntarily (paragraphs 3.19 to 3.21)
- b) We welcome DTI's intention to consult on **improved disclosure of the nature and value of non-audit work**. (paragraph 3.22).
- c) The case for **mandatory audit firm rotation of the audit appointment should be examined further** (paragraphs 3.30-3.33). The case for mandatory re-tendering should be further considered at the same time. (paragraphs 3.35-3.37)
- d) We welcome the decision by the leading professional bodies to **extend the requirement for partner rotation beyond the lead audit partner**

(paragraph 3.34). However, the requirement for rotation of the audit engagement partner should be for at least every 5 years rather than every 7 years as at present (paragraph 3.34).

1.8 Regulation of the accountancy profession *(Section 5)*

Arrangements for **regulating the accountancy and audit professions** must be clear and strong. This must be assured in relation to current needs, and in the light of international developments (paragraph 5.6). In particular

- a) it is important that the oversight arrangements continue to adapt to current needs and show that they are effective. We note that the Government is committed to a review of the regulatory arrangements put in place under the Accountancy Foundation after a period of operation. We **recommend** that the Government brings forward this timetable and **undertakes an early review of the regulatory arrangements, including the consequences for the basis of funding** (paragraph 5.9).
- b) Arrangements for **monitoring the work of auditors**, particularly of listed companies, must also be robust. (paragraph 5.14). We therefore welcome the **review of monitoring** which the Review Board has in hand. This should include consideration of whether the monitoring function (at least in relation to the auditors of listed companies) should remain the responsibility of the professional bodies.

1.9 Transparency of accountancy firms *(Section 9)*

- a) The major accountancy firms should improve their own openness and transparency, by providing better information on their processes and practices, publishing full financial statements and accounts, and making more information publicly available on the structure of their international networks. We would welcome further work on the proposition that such firms should be required to provide this information as a condition of appointment as statutory auditors of listed or public interest companies (paragraph 9.3).

1.10 Financial reporting *(Section 6)*

- a) We endorse a **continuing emphasis on accounting standards** which stress the need for “substance over form” (paragraph 6.5).
- b) We welcome the **work of the Accounting Standards Board (ASB) and the International Accounting Standards Board (IASB) to develop proposals for accounting standards on issues related to the recent**

corporate failures. We welcome the leading role that the ASB is continuing to take in developing high-quality accounting standards. We emphasise the importance of having in place for 2005 a robust set of international standards which promote transparency in company accounts and address issues such as accounting for share-based payments and revenue recognition (paragraph 6.6).

- c) There should be **more pro-active and wide-ranging enforcement of accounting standards** in financial statements made by companies. The Financial Reporting Review Panel (FRRP), which has been an effective feature of the UK system to date, should finalise its proposals for introducing a pro-active element to its work as soon as possible (paragraph 6.12). **The Government should consider the adequacy of the current enforcement arrangements in the UK**, taking closely into account international developments (paragraph 6.12).

1.11 Auditing standards *(Section 7)*

- a) We welcome the move to adopt **International Standards of Auditing in the EU from 2005, while acknowledging that this presents a major challenge.** We endorse and encourage the efforts of the Auditing Practices Board and the Government to ensure that the necessary further development of international standards takes place quickly enough; and that in the meantime important features of UK standards are retained. **We welcome the leading role that the APB is continuing to take in developing high-quality auditing standards.** (paragraph 7.6).
- b) We recognise the value of APB's work to raise the issue of aggressive earnings management and encourage other regulators to reinforce that from their own perspectives (paragraph 7.7).

1.12 Other aspects *(Section 10)*

- a) The DTI and HM Treasury should discuss with the Office of Fair Trading whether there are any **competition implications of the high concentration in the market for audit and accountancy services and whether any of the other proposals in this report have competition implications** (paragraph 10.3);
- b) In determining the scope of particular proposals, regulators should carefully consider the **impact on unlisted and smaller companies, taking into account the principle set out in the Companies Bill White Paper to "think small first"** (paragraph 10.4)

Annex to Executive Summary

ACTIONS IN HAND OR PROPOSED BY CGAA TO BE CARRIED OUT BY UK REGULATORS

Action	Lead Body	Timing/Comment
Large companies to prepare a statutory OFR (1.5a)	Government (DTI).	Part of reform proposals set out in the Modernising Company Law White Paper. Responses to White Paper due by end November 2002
Statutory statement of Directors' duties (1.5b)	Government (DTI)	Part of reform proposals set out in the Modernising Company Law White Paper. Responses to White Paper due by end November 2002
Extend obligations on directors and employees to provide information to auditors (1.5c)	Government (DTI)	Part of reform proposals set out in the Modernising Company Law White Paper. Responses to White Paper due by end November 2002
Audit committee should approve purchase of non-audit services (1.6a)	Link to FRC work below	As below
Audit committee to be responsible for recommending auditor appointments to shareholders (1.6b)	Link to FRC work below	As below
Improved Combined Code guidance for Audit Committees (1.6c)	Financial Reporting Council (FRC)	Work should be completed by around the turn of the year, in tandem with the Higgs Review
Review of the role and effectiveness of Non-Executive Directors (1.6d)	Derek Higgs	Final report scheduled around the end of 2002.
Consideration of underpinning the role and responsibilities of Audit Committees in company law (1.6e).	Government (DTI)	Link to Modernising Company Law White Paper. By end of 2002
Identify non-audit services incompatible with principles underlying auditor independence (1.7a)	Government (DTI), in consultation with Review Board (RB), Ethics Standards Board (ESB), Auditing Practices Board (APB) and Financial Services Authority (FSA)	Work should be completed in time for Group's final report around the turn of the year. Link to the ESB work <i>Setting the Agenda for Ethics</i> , where responses to the consultation document are scheduled by mid-September 2002. Also link to RB work on audit quality (exercise scheduled to be completed August 2002) and ICAEW work due August 2002
Consultation on changes to existing disclosure requirements on non-audit services (1.7b).	Government (DTI)	Consultation by end 2002

Action	Lead Body	Timing/Comment
Further examination of audit firm and auditor rotation, including the case for mandatory re-tendering (1.7c).	Government (DTI), in consultation with RB, ESB and FSA	Work should be completed in time for Group's final report around the turn of the year. Link to ESB work referred to above. Also to RB work on auditor switching and rotation. Emerging conclusions due September 2002
Implement recommendation of EU Recommendation that rotation of audit partners should go beyond the lead audit partner (1.7d).	CCAB professional accountancy bodies	ICAEW rules to change from 1 October 2002. Revised standards by mid 2003
Examine conclusion that rotation of audit engagement partner should be reduced from 7 to 5 years (1.7e).	Government (DTI) to discuss with CCAB bodies	For discussion
Early review of the regulatory arrangements for the accountancy profession (1.8a).	Government (DTI) in consultation with CCAB and Accountancy Foundation	Timing for Government to determine.
Examination of monitoring arrangements (1.8b).	Review Board	By early 2003
Major accountancy firms should improve their openness and transparency. Examination of proposal that audit firms be required to be more open and transparent as a condition of registration with a recognised supervisory body (1.9a)	Government (DTI) in consultation with accountancy firms and CCAB bodies	For discussion with the CCAB
Continue to develop robust accounting standards, in the UK and internationally (1.10b)	ASB	
Proposals to develop a pro-active element to the work of the Panel (1.10c)	Financial Reporting Review Panel (FRRP)	By end of 2002
Review of the adequacy of current enforcement arrangements in a wider context (1.10c).	Government (DTI)	Timing for Government to determine
Continue to develop robust auditing standards, in the UK and internationally (1.11a)	APB	
To discuss with the OFT whether there are competition implications (1.12a).	Government (DTI/Treasury)	Timing for Government to determine

2 INTRODUCTION

2.1 This report sets out the progress to date of the work of the Co-ordinating Group on Audit and Accounting (CGAA). The Group was set up to oversee and co-ordinate the response in the UK to the issues raised in the aftermath of the collapse of Enron and other corporate failures, and to ensure that UK systems of financial reporting and audit regulation are reviewed thoroughly by the appropriate regulators with the aim of making clear that they are effective and continue to provide appropriate underpinning for strong and efficient national and international capital markets. This report fulfils the Group's commitment to provide a progress report to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer by the summer of 2002.

2.2 Enron and other cases have raised a number of issues about corporate governance more generally, including for example executive remuneration, and the role of company advisers, analysts and investment banks. The focus of this report is on accounting, auditing and on the role of the Audit Committee.

2.3 We set out below:

1. the issues we have identified as important in relation to audit, accounting and corporate governance;
2. the work in hand by regulators in relation to each, with expected timings
3. the conclusions we have reached so far;
4. any additional work we consider is needed;
5. a summary of what is happening internationally on each issue; and
6. the focus for the future work of the group.

2.4 The report also takes into account, as far as possible, the implications of more recent developments, most notably the disclosure in June of accounting improprieties at WorldCom, and the responses being proposed by the US authorities.

2.5 A number of important factors need to be taken into account when reviewing how UK regulatory arrangements address the issues raised by the collapse of Enron and other recent corporate failures. The first is that they can no longer be seen simply in a UK context. As markets become increasingly global, careful account must be taken of what is happening elsewhere in Europe, in the US, and more widely. Second, while there are significant differences between the US and UK systems, it would be complacent to suggest that the UK is immune to the problems highlighted by the collapse of Enron. Third, much has changed for the better in the UK in recent years. For example the

Companies Act 1989 paved the way for a much strengthened regime for setting and enforcing accounting standards. And, there has been much development of auditing standards, the regulation financial services business, and the regulatory framework for auditors and accountants. Fourth, it is also the case that much of the work relevant to the concerns raised by Enron was in progress before the collapse of Enron.

2.6 The Government recognises that different regulators have their own responsibilities. It is also important, however, that the work of each regulator is well informed by that of others, and that there is close cooperation and coordination. The Secretary of State for Trade & Industry and the Chancellor of the Exchequer therefore invited Melanie Johnson, Minister for Competition, Consumers & Markets, DTI, and Ruth Kelly, the Economic Secretary (and now Financial Secretary), HM Treasury, to lead a coordinating group on accounting and audit issues. Details of the membership of the Group, which encompasses the principal regulators, are at **Annex 1**.

2.7 The main issues drawn at the outset to the attention of the Group were on accounting and audit areas, as follows:

1. the adequacy of the existing ethical standards of the professional audit bodies in ensuring the independence of auditors, and in particular whether they provide sufficient underpinning for auditor independence where auditors also provide non audit services to audit clients;
2. a possible requirement (for some or all companies) for the mandatory rotation of audit firms; or for the mandatory re-tendering for company audit; or for a strengthening of existing requirements for the rotation of the audit partner;
3. the need for more detailed disclosure in company accounts of the fees paid to the auditors for audit and non audit services;
4. the need to strengthen the role of the Audit Committee, for example in relation to the appointment of auditors and the upholding of auditor independence and audit quality, and the purchase by the company of non-audit services from the auditor;
5. the appropriateness of the regulatory framework for company reporting, audit and oversight of the self regulation of the accountancy profession more generally;
6. the implications of these issues for accounting standards and their enforcement in the UK;
7. the implications of these issues for auditing standards and their enforcement in the UK.

2.8 A number of parties have submitted written evidence and papers to the Group to assist in its consideration of the issues. A short summary of those responses is at **Annex 2**. The Group is grateful to all those who submitted material.

2.9 Secretariat support has been provided by officials from the DTI and HM Treasury. The Group met three times in the period April to July 2002.

Context for the Group's work

2.10 Good systems of financial reporting and audit regulation are vital to ensure the efficient and effective operation of capital markets to underpin confidence in the markets. Such systems should achieve a number of key objectives:

- timely financial statements that give a 'true and fair view' of a company's financial performance and position, prepared on the basis of high quality accounting standards;
- effective arrangements for the enforcement of those standards, to ensure that they are implemented on a consistent and rigorous basis;
- effective corporate governance arrangements to ensure that companies are directed and controlled in a way that protects the interest of shareholders and other stakeholders, and minimises the risk of fraud and the manipulation of information.
- transparency of corporate reporting to supplement the financial statements with information that would provide an analysis of business performance and enable users to assess the strategies adopted by the business and the potential for successfully achieving them;
- effective and independent audit of those financial statements, conducted on the basis of high quality auditing standards;
- effective, independent and transparent regulation of the profession, including monitoring of the firms to ensure audit quality;
- transparent processes and practices of the audit firms; and

2.11 In assessing the current regulatory requirements, we are mindful that there have been substantial changes for the better over the past decade or so which have greatly changed the framework within which business operates in the UK. This strengthening of the regime has been in part a response to previous problems and failures in the UK. For example, the setting up of the Financial Reporting Council (FRC), the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP) in the early 1990s was a response to the accounting abuses of the 1980s. These arrangements are widely

seen as successful. Thus the FRRP has provided the backbone to auditors to stand up to clients who wish to press a particular accounting policy with which the auditors disagree. Similarly there has been a substantial strengthening of UK auditing standards through the 1990s under the Auditing Practices Board. And, more recently, the development of oversight arrangements for the self-regulatory activities of the professional accountancy bodies has introduced a strong independent and lay element into the regulatory framework.

2.12 In a free market economy, corporate failure is an inevitable fact of business life. For example, some businesses will fail because the business model was unsustainable, or tastes or technology change. But a number of corporate failures have raised issues or concerns about regulatory or public policy. A particular factor highlighted in recent months has been the need to maintain the confidence of investors and savers. The Government has taken, and continues to take, such issues and concerns seriously, but in responding, recognises that there is a trade-off to consider between the burden of regulation and the encouragement of wealth-creation and innovation. The current regulatory regime seeks to strike the right balance. A summary of work that UK regulators have in hand or planned to review areas of the regime in their control in the light of recent events is at **Annex 3**.

2.13 As noted above, the work of the Group has taken account of the international context. Parallel reviews and developments are being carried out in a number of other jurisdictions, including Australia and the Republic of Ireland, but most notably in the USA. **Annex 4** summarises the response in the US as of 10 July 2002.

2.14 A number of international bodies are also taking forward work to examine the issues that have come to light in the collapse of Enron and other corporate entities. These include the International Federation of Accountants (IFAC), the European Commission, the International Organisation of Securities Commissions (IOSCO), and the Financial Stability Forum (FSF). **Annex 5** sets out some examples of the work being carried out.

CGAA work to date

2.15. We have focused so far on the work being taken forward by regulators on the following issues

- A Auditor independence, in particular the issues of the provision by the auditor of non-audit services to audit clients and auditor rotation;
- B Corporate governance and the role of Audit Committees;

- C Regulation of the audit and accountancy professions;
- D Financial reporting, including accounting standards and their enforcement;
- E Auditing standards and their enforcement;
- F Reform of Company Law

2.16. As stated above, details of the reviews being undertaken by regulators in each of the above areas are set out in Annex 3. We have also considered a number of other issues that are relevant to the current regulatory arrangements, in particular the accountability of audit firms. These are outlined in sections 9 and 10 below.

3 AUDITOR INDEPENDENCE

General

3.1 Auditor independence is crucial to provide an assurance of the credibility of financial statements and to assist in the efficient functioning of capital markets.

3.2 Company Law in the UK requires that auditors act with integrity and independence. The detailed requirements for auditor independence are set out in the ethical standards of those professional accountancy bodies recognised by the DTI for the supervision of auditors. In summary, they apply a “framework” approach, under which fundamental principles are set out which must always be observed by a professional accountant. In the case of auditor independence:

- The auditor must consider, before taking on work, whether it involves threats – both real and perceived - to independence;
- Where such threats exist, the auditor must put in place safeguards that eliminate them or reduce them to 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.

3.3 The Ethics Standards Board (ESB), part of the recently established oversight arrangements under the Accountancy Foundation, is addressing the issue of auditor independence as part of its agenda-setting role for the ethical standards of the accountancy bodies. On 28 May it published a consultation paper “*Setting the Agenda for Ethics*”, seeking comments by 16 September. This paper deliberately takes a broad approach to the ethical issues involved in the work of accountants. Whilst not a specific response to Enron and other recent concerns it discusses many of the issues which have been put under the spotlight following the Enron collapse. The Review Board is conducting an attitudinal survey of auditors, audit clients and institutional investors, to complement the ESB’s work.

3.4 The FSA may also be addressing auditor independence issues from the perspective of the requirements it places on listed companies, as part of its review of the Listing Rules. The FSA is publishing a Discussion Paper shortly. Following this initial stage the Listing Rules review will operate through working groups (similar in nature to those which took forward the recent Company Law Review). This provides a possible route to explore aspects of

auditor independence. However, the Review is a long term exercise, expected to take some 18-24 months to complete. There may also be constraints on the FSA (as the Listing Authority) implementing new rules on auditor independence. This depends on the outcome of negotiations in the EU. And the Listing Authority can only enforce its rules against listed companies.

3.5 It is in any event important, in relation to auditor independence issues, that there is careful discussion between FSA and DTI on the respective roles for the Listing Rules and Company Law.

International context

3.6 In January 2002, the International Federation of Accountancy Bodies (IFAC) issued a revised version of its *Code of Ethics for Professional Accountants*. Member bodies, which include the leading UK accountancy bodies, are committed to meeting its requirements, unless they conflict with national law. The Code essentially reflects the existing UK approach to ethical standards setting and auditor independence. The Code sets out a framework that focuses on the factors that pose a threat to independence for all assurance engagements (including audits) and the safeguards that auditors should put in place to preserve their independence. The Code contains examples of how this approach is to be applied to specific circumstances and relationships.

3.7 The European Commission published a Recommendation on auditor independence in May 2002. Most of the work was completed by the summer of 2001, though the text was reviewed in the light of Enron. The text reflects extensive discussion in the advisory Committee on Auditing, on which Member States are represented. It addresses the provision of non-audit services to audit clients, improved disclosure of audit and non-audit fees, and the rotation of audit partners, as well as relations between the auditor and the Audit Committee. All these are discussed below. The Recommendation also recommends “cooling off” periods before a senior member of an audit team should be free to take up employment with an audit client. It leaves Member States free to set more stringent requirements. Giving effect to its provisions requires a strengthening of existing UK requirements.

3.8 The DTI is discussing what is needed to achieve this with the relevant professional accountancy bodies, the Auditing Practices Board and the Ethics Standards Board. The Institute of Chartered Accountants in England & Wales has agreed in principle to make the necessary changes, that is to:

- subject audit partners to a 2-year ‘cooling off’ period before they can join their audit client as an employee or director;
- extend the requirement to rotate audit partners at least every 7 years to cover all key audit partners, not just the engagement partner; and
- tighten the framework on the provision of non-audit services to the audit client by prohibiting valuation or litigation support work, where these services relate to material amounts in the accounts, and to require more detailed safeguards for the provision of internal audit work or financial information systems design.

3.9 In the USA, the jurisdiction most affected by the corporate failures, the Securities and Exchange Commission (SEC) introduced new auditor independence rules in November 2000. The SEC believes that these rules provide an appropriate framework but has said that it will revisit them to ensure the prevention of conflicts of interest that might compromise audit performance. The SEC says that it has been guided by four principles against which to judge an auditor’s independence. In general, an auditor is not independent when the auditor:

1. has a mutual or conflicting interest with the audit client;
2. audits the audit firm’s own work;
3. functions as management or an employee of the audit client; or
4. acts as an advocate for the audit client.

CGAA Views

3.10 We believe that there need to be tougher mechanisms to underpin auditor independence. Auditors must not only be independent, they must be perceived to be independent. Protecting the public interest and ensuring market confidence in the independence of the audit should be the prime consideration. These impact on four areas in particular:

- the provision by the auditor of non-audit services to the audit client;
- the rotation of auditors or a requirement to re-tender
- auditor and client relationships
- the appointment of auditors.

Each of these areas is considered in more detail below.

Provision by the auditor of non-audit services to audit clients

3.11 Professional ethical guidance in the UK already restricts the provision by the auditor of non-audit services to the audit client. It forbids the provision of such services when they would present a threat to auditor independence for which no adequate safeguards are available. However, it remains open for audit firms to supply a wide range of non-audit services to their audit clients, the value of which can exceed the cost of the audit.

3.12 The question, long discussed, but which Enron has brought into sharp focus is whether there should be an outright ban, or greater restrictions on, the provision of non-audit services. The nature of the non-audit services, their absolute level, and their level relative to the audit fee are all relevant factors. A survey of FTSE-100 companies in the January 2002 edition of *Finance Director* magazine highlighted audit fees of £216 million, and non-audit fees of £675 million, paid almost exclusively to the “Big 5” accountancy firms. But there is a need to look behind these stark figures, in particular to get a better understanding of the make-up and nature of what comes under the broad definition of “non-audit”. The ESB and, from a different angle, the FSA are both considering this as part of their work on auditor independence. The Review Board of the Accountancy Foundation is carrying out a study of the provision of non-audit services to audit clients. The results of the study are expected in the autumn and will inform future work.

3.13 A less interventionist approach would be to require greater disclosure of the value and nature of non-audit work carried out by auditors for audit clients. (This could also sit alongside more stringent requirements.) A further option is that a company’s Audit Committee should approve the purchase of any non-audit services from the auditor and justify to shareholders why this did not impair the independence of the auditor.

3.14 One long standing concern has been that the audit might be seen as a “loss-leader” in order for the firm to gain more lucrative non-audit work with the audit client. Whilst there was some evidence of low pricing in the early 1990s, there is little evidence of cross-subsidisation from empirical studies.

International context

3.15 Within the EU, the Recommendation on auditor independence adopts a principles-based framework of safeguards for auditor independence, as well as setting out specific instances where the provision of non-audit services are perceived to cause too high a level of risk to the auditor’s independence. It also recommends greater disclosure on audit and non-audit fees paid to the statutory auditor

3.16 In the USA, the SEC's current rules do not require that auditors forsake all non-audit services for their clients, but identify nine non-audit services that are deemed inconsistent with an auditor's independence (see **Attachment 1 to Annex 4**). The SEC's view is that a blanket ban is not necessary and it seems unlikely that the US will change direction on this. The approach of imposing a ban on certain specified services is also taken in the draft Bill *Public Company Accounting Reform and Investor Protection Act of 2002* proposed by US Senate Banking Committee Chairman, Paul Sarbanes. His list largely follows that of the SEC, together with a ban on an auditor providing to the audit client expert services unrelated to the performance of the audit. The US Government Accounting Office accepts the concept of restrictions, rather than a blanket ban, but believes that the principles relating to the provision of non-audit services in the US Government Auditing Standard on independence should be applied more widely. This standard states that:

- auditors should not perform management functions or make management decisions; and
- auditors should not audit their own work or provide non-audit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

3.17 In his 10-point plan to improve corporate responsibility and protect shareholders, President Bush has proposed that the SEC should establish guidelines for Audit Committees to prohibit the provision of any service that compromised the independence of the audit. In addition, there should be greater disclosure of all fees paid to the auditor.

3.18 In Australia, the 2001 report of an independent review of the independence of Australian company auditors conducted by Professor Ian Ramsay concluded that: "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".

CGAA Views

3.19 We acknowledge that the perception of auditor independence can be adversely affected by the scale and scope of non-audit services provided by the auditor to audit clients. Set against that, some services are required by legislation or contract to be provided by the auditor, such as regulatory returns, for example to the FSA. More importantly, there are also circumstances where it makes commercial and economic sense for the auditor to provide non-audit

services, either because of the auditor's existing knowledge of the business, or because the information required is a by-product of the audit process, and where the threats to independence are manageable through safeguards. **On these grounds, we do not favour a blanket ban on the provision of non-audit services.**

3.20 We take the view, however, that – in delivering tougher mechanisms to deliver auditor independence – each type of service which auditors currently provide should be assessed against the key principles which should underpin the provision of non-audit services:

- **auditors should not perform management functions or make management decisions; and**
- **auditors should not audit their own work.**

3.21 Whilst auditors are already required to follow these principles under professional ethical rules, **we recommend that further work is commissioned to look carefully and afresh at how these principles are best delivered in practice.** In particular that work should identify which types of services are incompatible with these principles, which might be supplied provided that there are suitable safeguards in place, and which do not present a credible threat to auditor independence. The work should look in detail at the SEC list of the nine non-audit services that are deemed inconsistent with an auditor's independence, though taking into account our preference for a principles-based approach rather than a “cook-book” of very specific rules. We recommend that the Government should decide who is best placed to take this work forward following discussion with the Review Board, Ethics Standards Board, Auditing Practices Board and the Financial Services Authority, with a view to clear proposals in the next six months. We note that the Review of the Listing Rules may provide a suitable mechanism. Alternatively it may be appropriate for the Government to invite the Coordinating Group to take forward further work in time for the Final Report.

3.22 As a minimum, and in line with the Commission Recommendation, **we believe that there needs to be greater disclosure of the provision by the auditor of the nature and value of all services to audit clients,** broken down by category (broadly audit, audit-related and non-audit, although what falls into each category would need to be defined). **The DTI will consult on detailed changes to the existing disclosure requirements by the end of 2002.**

3.23 This should be combined with **a requirement on Audit Committees (see below) to approve such services and to set out publicly the reasons why the**

auditor (rather than another firm) was engaged to undertake non-audit work and that this does not compromise auditor independence. The Chair of the Audit Committee should be available at the Annual General Meeting and be prepared to answer questions as to why the Committee believed that such services did not impair the objectivity of the auditor and the safeguards that were put in place.

Rotation of auditors and re-tendering

Mandatory rotation

3.24 UK professional guidance currently requires the audit engagement partner for a listed company to be rotated at least every 7 years. However, there is no requirement for mandatory periodic rotation of the audit firm.

3.25 Rotation has been discussed for many years as a way of preventing too cosy a relationship to develop between executive management and auditors. The DTI consulted on mandatory rotation of audit firms as far back as 1987 but concluded against at that time. It was again looked at by the Cadbury Committee in 1992 and rejected. The collapse of Enron and the close and long standing relationship this revealed between the company and Andersen's Houston office has generated renewed interest in rotation. Again, this issue is being considered by the ESB and FSA, where the options (not all are mutually exclusive) include:

- mandatory rotation of audit firms at a defined period;
- more frequent rotation of the audit engagement partner, a change from 7 to 5 years is a possibility;
- an extension of rotation beyond the audit engagement partner.
- regular re-tendering by listed companies for audit work;

3.26 The ICAEW has prepared a paper for the Group: *Mandatory rotation of audit firms : Review of current requirements, research and publications*. The paper sets out the findings from reviews of:

- current regulatory requirements setting out how the threat of over-familiarity from a lengthy auditor-client relationship is addressed;
- reports of recent reviews commissioned by Governments (most notably in the Republic of Ireland and Australia); and
- research and studies carried out by academics.

3.27 The paper concludes that there are arguments for and against mandatory rotation, but notes that the most recent Government reviews, in both Ireland and Australia, concluded that – on balance – the costs of mandatory rotation outweighed the benefits.

International context

3.28 The EU Recommendation on auditor independence recommends as a minimum rotation of the key audit partners within 7 years of appointment to the engagement team. This goes beyond existing UK requirements but stops short of rotation of audit firms. In the USA, the SEC has stated that mandatory rotation of firms “would be unwise” and could lead to “opinion shopping” by companies in deciding which new firm to select. SEC Chairman Harvey Pitt has gone on record as suggesting that the required rotation of the lead audit engagement partner (currently at least every 7 years, as in the UK) could be reviewed to determine whether a deeper rotational requirement, affecting more members of the audit team, would be “advantageous”.

3.29 There is little sign of significant moves towards mandatory audit firm rotation in other countries. At present, of the major economies that are members of the Organisation of Economic Co-operation and Development (OECD), only Italy has mandatory audit firm rotation. Evidence on its effects is at best mixed. Other countries have tried rotation, but dropped it after it was felt to create more problems than it solved. Spain introduced it but dropped it before it took practical effect. A study carried out in Spain in the mid-1990s offered two main reasons against firm rotation. First, mandatory rotation reduces the incentive on the firm to improve audit quality, given that – after a set period – it will lose the audit. Second, mandatory rotation will increase the number of first-time audits, with the resulting loss of much of the knowledge base accumulated by the previous auditor.

CGAA Views

(i) Audit Firm Rotation

3.30 A requirement to rotate the **audit firm** (the usual period suggested is 7 or 8 years) is an obvious way of preventing or curtailing over cosy relationships between auditor and audited. An argument commonly deployed against audit firm rotation is that most audit failure occurs in the first two years of an appointment, and by implication that audit quality can suffer badly as a result of a change of auditor. However, as Sir Howard Davies has pointed out recently, that experience relates not to a system of mandatory rotation but to the existing

circumstances in which auditors change for different reasons. Another counter argument is that problems come to light in the first years of a new auditor appointment precisely because the new auditor, lacking the familiarity with the client, takes a more careful and thorough look.

3.31 Whilst there are attractions therefore in mandatory audit firm rotation, we also note that there are significant disadvantages:

- It is inflexible and does not relate the decision to change auditors to the circumstances of the individual company, which in practice are very important. It does not allow for example that at a time when there are major changes in a company's senior financial management it may be important **not** to change the auditors.
- For major listed international companies the choice of auditors is in practice restricted to the four remaining major firms. One or more may be ruled out by conflicts of interest or be otherwise unacceptable to the company, who may not for example wish to have the same auditors as a major competitor. Requiring a change could then simply lead to a game of "musical chairs" in which the number of chairs and players remain the same;
- Mandatory firm rotation must also be set in the context of other changes we are proposing. The additional benefits might be small if, as we encourage, there is an effective Audit Committee able to review auditor appointment and required to report to shareholders;
- There is little evidence in support of audit firm rotation from other countries.

3.32 From the evidence available to date, we conclude that **the case for mandatory rotation as a solution to the problems of auditor independence has not yet been made.** That said, we believe that there is a need to **examine further the evidence and the arguments for and against mandatory audit firm rotation (by which is usually meant a change of audit firm every 7 or 8 years).** We look forward therefore to the ESB's findings on this issue and note that there is also relevant work in hand by the Review Board. We believe that this should be taken forward together with the work on non-audit services referred to at para 3.21 above.

3.33 This should also include consideration of the proposition posed by Sir Howard Davies, in evidence to the Treasury Committee in July 2002, that a 'backstop' requirement for rotation every 15-20 years might provide a useful part of a solution to the issue of over-familiar relationships between auditors

and the company management. Consideration of this issue needs to take account of both the national and international markets for audit and accountancy services.

(ii) Rotation of Audit Partners

3.34 We share the view expressed in the EU Recommendation that there is a need for rotation of audit partners to go beyond the lead audit partner. We therefore welcome the intention of the principal accountancy bodies to make this change as soon as possible, as part of the UK's response to the EU recommendation. **However, we consider that the maximum period before rotation of the audit engagement partner should be reduced from 7 to 5 years.** This would tighten up the existing requirement but leave sufficient flexibility to allow for orderly succession planning.

(iii) Compulsory re-tendering

3.35 We have also considered regular re-tendering for the audit appointment as a less radical variant of mandatory firm rotation. This has some attractions but also downsides.

3.36 On the one hand:

- It is less intrusive than mandatory rotation, and ensures that the appointment decision remains with the shareholders of the company;
- It breaks the assumption that the current auditors will be re-appointed and encourages the Audit Committee to assess auditor performance;
- It gives other audit firms an opportunity to bid for the work.
- It avoids the restriction of competition implicit in firm rotation.

3.37 On the other hand:

- Compulsory re-tendering could encourage an expectation that, in the absence of exceptional circumstances, auditor appointment need not be considered until the next mandatory tender.
- Tendering takes time and money. It is not clear that in many cases these burdens would offer additional material benefits; in which event the costs are a deadweight. It will usually be possible to re-appoint the incumbent where that is the wish.

- Compulsory re-tendering could focus on price, leading to downward pressure on audit fee, and an increased risk of a reduction in the audit work undertaken and audit quality.

3.38 Our initial view is that **this issue should be examined further as part of the further work on mandatory firm rotation we suggest should take place at paragraph 3.32 above.**

Auditor and Client Relationships

3.39 Professional ethical guidance already sets out principles, guidance and some rules to ensure that the appearance of auditor independence is not compromised by business and personal relationships. By way of contrast, US requirements consist of detailed rules. Despite some simplification last year to remove over burdensome requirements, US requirements attempt to cover every possible circumstance with a bright line between what is and is not permissible.

3.40 Most recently this subject has been addressed in detail in the EU Recommendation on auditor independence and in a revised Code of Ethics issued by the International Federation of Accountants. The professional bodies in the UK are committed to ensuring that their ethical requirements at least meet the provisions of the EU Recommendation and the IFAC Code.

3.41 **We do not see a need for further work beyond what is already in hand to ensure UK requirements at least meet the terms of the EU Recommendation.** It is important, however, that the audit firms have effective systems in place to ensure compliance, and that the monitoring arrangements provide an external check on this.

3.42 We also welcome the readiness of the recognised audit supervisory bodies to identify the most appropriate means of introducing **a 2-year ‘cooling off’ period before an audit partner can join an audit client as an employee or director;**

Appointment of auditors

3.43 For limited companies, as a matter of law, the auditor’s client is not the board of directors, but the shareholders, who formally are responsible for appointing the auditors. Shareholders need assurance that the annual accounts prepared by the directors 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. In practice, the decision to appoint/re-appoint the auditors is often taken by the board, on the advice of management. As the ESB has highlighted in its consultation document, the mechanics of auditor appointment

do not make it easy for shareholders to influence the process. The way in which auditors are appointed is therefore perceived as a threat to the auditor's objectivity and independence and inconsistent with the audit being an independent review for shareholders of the directors' stewardship.

3.44 Some commentators have suggested that the ability to appoint auditors should be taken away from the company altogether and given instead to an independent body. For example this might replicate the system in the UK public sector, where for example, the Audit Commission appoints the auditors of local authorities and health bodies in England and Wales. A benefit is that the auditor is not dependent on the audited body itself for continued appointment and its advocates maintain that the auditor is then able to report without fear or favour.

3.45 Adopting such a model would, however, break the assumption that it is the shareholders that appoint the auditors. Moreover, giving effect to this option, at least for the largest companies, would require a global, not national, approach.

CGAA Views

3.46 **We do not favour establishing an external body to appoint company auditors.** Nevertheless, there may be lessons to be learned for company audit from the existing public sector model in the UK. **We look forward therefore to the results of the work which the Chartered Institute of Public and Financial Accountants is doing for the Review Board on this topic.** We understand that this is likely to be available towards the end of the summer. More generally, the issue of how to improve the auditor appointment process remains. We believe that there is a need for greater transparency in assessing the rationale for the re-appointment (or otherwise) of the auditors and for the process to be more independent of management and the executive directors. **We consider therefore that there should be an enhanced role for the Audit Committee** (see below).

4 CORPORATE GOVERNANCE AND THE ROLE OF THE AUDIT COMMITTEE

4.1 Corporate governance has been high on the UK agenda for a decade or more, following a number of financial scandals in the late 1980s and early 1990s. There have been some important initiatives to strengthen corporate governance, in particular:

- The Cadbury Report (1992) – focused on internal controls, the need for effective Audit Committees, and a recommendation to separate the role of the Chairman and Chief Executive;
- The Rutteman Report (1994) – recommended that directors should disclose the key procedures established to provide effective internal control;
- The Greenbury Report (1995) – published a code setting out best practice in determining and accounting for directors’ remuneration;
- The Hampel Report (1998) – reviewed the implementation of the Cadbury and Greenbury Codes to ensure that their original purpose was being achieved and, in particular, addressed the role of shareholders and auditors in corporate governance issues;
- The Combined Code (1998) – this sets out the principles of good governance and a code of best practice, consolidating the work of Cadbury, Greenbury and Hampel. It is appended to, but does not form part of, the Listing Rules; and
- The Turnbull Report (1999) – focusing on internal control. The report recommended a risk-based approach to establishing a sound broadly-based system of internal control with Board review of its effectiveness.

Audit Committees

4.2 Although Audit Committees are not a universal feature of corporate life, the Combined Code already sets out best practice guidance on their composition and duties. The Code notes that their duties “should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors”. There is no formal obligation on a company but the Listing Rules require the company to “comply or explain” their adherence or otherwise to the provisions of the Code.

4.3 A thread running through many of the commentaries post-Enron is that a strengthening of the membership and role of Audit Committees has a key role. In particular, the Audit Committee can act as a proxy for shareholders (who in

theory appoint the auditors) and judge the threats to auditor independence and review audit quality.

4.4 The main suggestions have been that the Audit Committee should:

- Monitor the integrity of the company's financial controls and financial policies;
- Be responsible, and be seen publicly to be responsible, for recommending to shareholders the appointment and/or re-appointment of the external auditors;
- Be responsible, and be seen publicly to be responsible, for approving the provision of non-audit services by the auditor;
- Be an independent element in the relationship between the company management and the auditor;
- Review the quality of the audit process and audit judgment, including a review of auditor independence; and
- Report annually to shareholders on how it has discharged its responsibilities.

4.5 The Combined Code already contains a provision that where auditors also supply a substantial volume of non-audit services to the company, the Audit Committee should "keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money".

International Context

4.6 One of the European Commission's proposed policy actions post Enron is to examine the role of Audit Committees in European listed companies. It notes that of the 35 non-binding corporate governance codes, only "some" refer to Audit Committees, and even then in a limited way. There is no legal requirement at present anywhere in the EU for companies to have Audit Committees. However, reform in the Irish Republic will require Boards of Directors by law to establish Audit Committees, each with a charter setting out a clear set of responsibilities.

4.7 In the US, the New York Stock Exchange (NYSE) has required all listed companies to have audit committees composed solely of independent directors since 1978. The NYSE Corporate Accountability and Listing Standards Committee submitted proposals for reform in June 2002 which, if implemented, would increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors and to approve any significant non-audit relationship with the independent auditors.

4.8 In Australia a review of auditor independence last year, following failures in the insurance sector there, recommended a listing rule requirement to establish Audit Committees, specifying their composition and requiring the adoption of a written charter.

CGAA Views

4.9 **We strongly support the view that an effective Audit Committee, with clear responsibilities, and reporting to shareholders, can play a key role on behalf of the shareholders in driving up audit quality and preserving auditor independence.** More can be done to develop the role of Audit Committees. For example, **shareholders should be invited to appoint the auditors on the basis of a recommendation from the Audit Committee rather than from management, as is often the case at present.** The Audit Committee should also have responsibility for the approval of the purchase of non audit services from the auditor, and for considering whether, in a given year, to change auditors or go out to tender. The Audit Committee **should also be required to produce a report to shareholders (as part of the annual report) each year on how it has discharged its responsibilities.** We also note that Audit Committees are not universal amongst our larger and listed companies. Further work is needed to determine whether, and in what circumstances, it might be mandatory to establish an Audit Committee (see also paragraph 4.13 below).

4.10 **We also believe that there should be improved Combined Code guidance for Audit Committees setting out their responsibilities and how to meet them, taking into account the wider responsibilities recommended in this report.** Whilst Derek Higgs' Review (see paragraph 4.16 below) is likely to touch on the responsibilities of the Audit Committee, it is not part of his remit to develop such guidance.

4.11 **We have therefore invited the Financial Reporting Council, which is the custodian of the Combined Code, to set up a small group to develop the existing Code provisions. We are pleased to say that the FRC has agreed to take this forward as a matter of urgency.** The work would need to be taken forward in tandem with Derek Higgs, reporting to his timetable of around the end of this year. There should also be close cooperation with the Auditing Practices Board, which is working on improved guidance for auditors on working with Audit Committees.

4.12 There is little point in promoting these ideas, however, unless investors believe in the integrity and competence of the members of the Audit

Committee, in particular (i) that they can act independently of the executive directors, and (ii) have the specific skills and expertise for the role we now envisage for the Audit Committee. This requires guidance on the attributes needed for the Chairman and members of an Audit Committee and on the training they will require. If the ideas outlined in this report are taken forward, members of Audit Committees will be assuming very significant responsibilities on behalf of shareholders. The findings and conclusions of both the FRC work and Derek Higgs' review will be extremely important.

4.13 We have also considered the case for giving some form of statutory backing for Audit Committees, at least for some large companies. There are various ways of doing this, for example by taking a power to establish Audit Committees with statutory responsibilities, or by statutory underpinning for rules made by a Standards Board. We note that legislation is being enacted in Ireland to require certain companies to establish Audit Committees made up of non-executive directors and with statutory responsibilities.

4.14. Introducing the law into this aspect of corporate governance requires very careful thought in the UK. There are important wider considerations, in particular a concern that this might weaken the concept of the single unitary board. **However, we propose that the Government considers underpinning the role and responsibilities of Audit Committees in company law.**

Non-Executive Directors (NEDs)

General

4.15 NEDs play a central role in the corporate governance of UK companies. From the point of view of UK productivity and competitiveness, the progressive strengthening of the role of NEDs is strongly desirable. The Combined Code already makes clear the principle that Boards include a balance of executive directors and NEDs (including independent NEDs) such that no individual or small group of individuals can dominate the Board's decision taking.

4.16 Given the importance of NEDs, in April 2002, the Government asked Derek Higgs to lead a short independent review of the role and effectiveness of NEDs in the UK. Derek Higgs published an initial consultation document on 7 June, setting out the key issues on which comments are sought. (The document includes the questions: "Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?") The Higgs Review is scheduled to produce a final report around the end of 2002.

International context

4.17 More generally on corporate governance within the EU, the remit of the Commission's High Level Group of Company Law Experts has been expanded to cover additional corporate issues, including the role of NEDs and supervisory Boards.

CGAA Views

4.18 There is a clear read-across between the Higgs Review and the work of the Coordinating Group. That review is particularly relevant to the question of the quality and composition of Audit Committees. **The FRC and Derek Higgs will liaise closely, in particular in taking forward the question of detailed guidance on the role of audit committees.**

5 REGULATION OF THE ACCOUNTANCY PROFESSION

The Accountancy Foundation

5.1 A system of non-statutory oversight over the regulatory functions of the accountancy bodies under the Accountancy Foundation has been set up recently. This was in part in response to a commitment given in Labour's 1997 Business Manifesto to "ensure that there is a framework of independent regulation for the accountancy profession" which led to an agreement between the Government and the accountancy profession in April 1999. The Accountancy Foundation was established in 2000, since when the rest of the arrangements have been set in place (see **Annex 6**). All the bodies have non-accountants in the majority (in the case of the new Auditing Practices Board, there is a non auditor majority.)

5.2 There are separate statutory arrangements under the Companies Act 1989 for the regulation of auditors. The DTI recognises relevant accountancy bodies for the training and supervision of auditors. However, as envisaged, the arrangements under the Accountancy Foundation also provide oversight of the key elements of audit regulation.

5.3 The Accountancy Foundation bodies are relatively new and need time to establish themselves fully. There is a stated Government commitment to review the arrangements after a period of operation.

5.4 There have been calls for further changes to the structure of regulation in the UK. In particular, it has been suggested that:

1. the funding of the Accountancy Foundation by the six CCAB bodies is inconsistent with the concept of independent oversight;
2. the arrangements look too complicated, with overlapping regulatory responsibilities;
3. the authorisation and supervision of auditors might become the responsibility of an independent body rather than that of the professional bodies (with external oversight); and
4. given that this is a non-statutory arrangement, a legal underpinning could enable the powers and accountability of the regulator to be clarified.

International context

5.5 The current UK arrangements for independent oversight of the accountancy profession are generally in advance of practice in other countries.

Some countries have looked at the recent changes in this country and are introducing arrangements on similar lines and which, in some respects, develop this further. For example, in Ireland, a review of auditing, triggered by a scandal over the use of bogus non-resident accounts to evade tax on savings, recommended the creation of a statutory Oversight Board with 40 per cent Government funding. This is currently being put in place.

5.6 In the USA in the wake of Enron, the SEC has recently issued for consultation its proposed detailed rules for the regulation of the accountancy profession in the USA through a private sector Public Accountability Board (PAB). These proposals replicate a number of features of the current UK regime, but go further, in particular in relation to:

- the degree of SEC control and oversight. The proposals envisage that the SEC would need to be satisfied with, among other things, the PAB's charter, by-laws, proposed budget and proposed board members. The SEC would have the ability to review, alter, modify, or abrogate any PAB rule and to review any PAB disciplinary action; and
- the proposed funding arrangements, through the imposition of levies on both accounting firms and SEC registrant companies.

Further details are at **Annex 4**, together with a summary of the proposals put forward in the Bill proposed by Senator Paul Sarbanes¹. These proposals reflect the call in the Bush 10-point plan that an independent regulatory board should be established.

5.7 In the EU, the Commission is calling for minimum requirements for proper public oversight of the profession, at national level, with strong participation from outside the profession. The UK already more than meets the Commission's current ideas, which will be discussed further by Member States.

CGAA Views

5.8 The reform of regulation of the accountancy profession in the UK through the establishment of the Accountancy Foundation has introduced strong lay involvement and injected a considerable degree of independence into the regulatory arrangements. Before the latest SEC proposals were developed, this was ahead of practice elsewhere. While we should be cautious about simply following proposed US practice, it would equally be unwise to ignore developments there. It would also be wrong to ignore the points of concern

¹ At the time of writing Senator Sarbanes Bill is being considered in a Conference Committee of the US Senate and the House of Representatives.

raised about the complexity of the wider UK regulatory structure, and of the basis of funding.

5.9 We note that the Government is committed to a review of the regulatory arrangements put in place under the Accountancy Foundation after a period of operation. **There are pros and cons in conducting an immediate review of the regulatory arrangements. On balance, we recommend that the Government brings forward this timetable and undertakes an early review of the regulatory arrangements, including the consequences for the basis of funding.**

Monitoring of the work of audit firms

5.10 In the UK, monitoring the work of audit firms to ensure audit quality is the responsibility of the recognised audit supervisory bodies (RSBs), as part of a system of delegated statutory regulation under the provisions of the Companies Act 1989. It is open to the DTI to challenge the approach to monitoring if it concludes that the arrangements are inadequate. Individual auditors and audit firms are subject to inspection by the RSB's monitoring team. The costs of inspection are met by charges on the firms to be inspected and the inspectors are employed by the professional bodies.

5.11 Inspections for the Institutes of Chartered Accountants in England and Wales, Scotland and Ireland are undertaken by their Joint Monitoring Unit (JMU). The Association of Chartered Certified Accountants (ACCA) has separate but similar arrangements. Monitoring visits are carried out by professionally qualified inspectors. All auditors are visited, usually within a five years cycle other than for low risk cases. Auditors with listed company or public interest audit clients are monitored more closely. The 20 firms registered with the Institute of Chartered Accountants in England & Wales which audit most listed companies are visited every year, with a full inspection every three years. The JMU visits other firms with listed company clients every four, or five years. ACCA also visits firms with public interest or higher risk clients (e.g. charities funded by public money, companies authorised under the Financial Services and Markets Act 2000) on a more frequent basis. Both entities undertake special purpose visits if there is specific cause for concern, whether because of the outcome of a previous routine visit, changed circumstances in the firm or a relevant complaint. Any breaches of regulations, or of ethical codes, can result in a range of actions, including fines, removal from eligibility to conduct statutory audits, or exclusion from membership of the licensing body. Cases which appear likely to give rise to issues with wider implications for the public interest have to date been referred to the Joint

Disciplinary Scheme (JDS), but will be passed to the Investigation and Disciplinary Board (IDB) of the Accountancy Foundation as soon as a new Disciplinary Scheme is adopted.

International context

5.12 Practice in the UK is generally more developed than elsewhere in the EU. A recent European Commission recommendation on audit quality aims to bring the arrangements in all member states up to a minimum standard, either by UK-style dedicated monitoring units, or by a system of peer review.

5.13 In the USA at present, the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (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. The SECPS requires member firms to adhere to quality control standards established by the AICPA. The recent SEC proposals and the Sarbanes Bill would both give a Public Accountability Board strong oversight powers in carrying out independent quality control reviews of member firms, with the ability to impose a broad range of disciplinary sanctions.

CGAA Views

5.14 Whilst the UK has one of the best developed and well respected monitoring systems in the world, this does not mean that it cannot be strengthened. In particular, we have initial reservations that the system can monitor effectively the work of the auditors of listed companies. **We therefore welcome the high priority that the Review Board is giving to an examination of monitoring.** This should include consideration of whether in the short or medium term the monitoring function (at least in relation to listed companies) should remain the responsibility of the professional bodies. It is important that the monitoring function targets accurately those audits where there is a reason to think that the risks of poor quality work may be higher, for example where a firm may have put in a low bid to win the business, or where it appears that the audit fee is lower than might be expected. The Review Board's examination should therefore include a check that the current arrangements focus sufficiently on those audits where the fee appears disproportionately low. That work should also consider whether the current arrangements provide an adequate basis for testing compliance with ethical standards and requirements.

6 FINANCIAL REPORTING

6.1 Effective financial reporting is essential for the efficient operation of capital markets. Responsibility for financial reporting standards and their enforcement in the UK rests with the Financial Reporting Council (FRC) and its subsidiary bodies, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP). The FRC and ASB have provided the Group with information on the operation of the ASB and FRRP, together with issues being taken forward by the ASB as part of its current agenda that may be relevant to problems encountered at Enron and other high profile cases (**Annex 7**).

Accounting standards

6.2 The agenda for financial reporting standards is now very clearly an international one, in particular following the adoption in June 2002 of an EU Regulation requiring companies admitted to trading on an EU regulated market to apply international accounting standards (IAS) in their consolidated financial statements from 2005. On 3 July, the Australian Financial Reporting Council announced its intention to apply international accounting standards from 2005. The International Accounting Standards Board (IASB) is taking forward a major programme to improve its existing standards, as well as developing new ones, to ensure that by 2005 there is a high quality set of international accounting standards. This is a challenging agenda, but the IASB is well seized of the importance of the task. In the UK, the ASB is working closely with the IASB with a view to ensuring that the standards to be adopted by listed companies in 2005 will enhance the high quality of current UK financial reporting. The ASB is also actively pursuing a convergence agenda to align UK standards with newly agreed international ones. In May, the ASB issued seven Financial Reporting Exposure Drafts (FREDs) as the first step in that process.

6.3 Much has been made of the differences between UK and international standards, and those in force in the USA, with the emphasis here on the need for the accounts to present a ‘true and fair’ view and standards that emphasise broad principles and the economic substance over legal form, rather than adherence to detailed rules. But while there are differences between the UK and US regimes, there is a need to avoid the assumption that failures such as Enron “could not happen here”. There are areas of business where new standards need to be developed and/or old standards brought up-to-date to improve financial reporting globally. The ASB and IASB are taking forward proposals in a number of important areas, including:

- **Accounting for share-based payment** – the IASB is preparing an Exposure Draft of a standard, scheduled for publication in the 4th quarter of 2002. The basis for this work was a consultation paper published by the ASB in October 2000. Despite the increasing use internationally of share-based payment most jurisdictions, including the UK, do not yet have an accounting standard in this area. The need for accounting guidance on this topic is particularly important in the post-Enron environment. The climate for making progress internationally may be much more favourable than hitherto.
- **Accounting for financial instruments** – on 20 June, the IASB issued proposals to revise its existing standards on disclosure of financial instruments (IAS32) and their recognition and measurement in the primary statements (IAS39). On the same day, the ASB launched a consultation on their application in the UK. The UK currently does not have an equivalent of IAS39, in part because the law currently prohibits fair value accounting;
- **Revenue recognition** – there is currently no specific UK standard in this area. The ASB is currently developing a draft standard, which it will discuss with the IASB (whose revenue standard is out-of-date). This follows the international board’s agreement – announced on 27 June - to put the issue onto its work programme. This should address the revenue recognition issues that have come to light in a number of recent high-profile cases, notably in the telecommunications industry;
- A number of measures to curb the scope for ‘**off balance sheet**’ structures and finance – including consolidation policy (particularly relevant to Special Purpose Entities, SPEs), the recognition and derecognition of assets and liabilities (where the existing UK standard, FRS5, appears to have operated successfully, but an internationally-agreed approach needs to be found), and a new leasing standard to eliminate an artificial distinction between operating and finance leases (and so eliminate off balance sheet leasing structures);

International context

6.4 The ‘principles’ versus ‘detailed rules’ debate is a subject of close interest in the US following Enron. The Financial Accounting Standards Board (FASB) sets US accounting standards. US standards rely much more on detailed rules, rather than broad principles, and their interpretation involves lawyers as much as accountants. SEC Chairman Harvey Pitt is on the record as stating that US accounting standards “at least going forward, should evolve to become general and principle-based, instead of encyclopaedic and rule-based, standards”. This reaffirms the proposal in President Bush’s 10-point plan that accounting

standards should “reflect economic reality rather than compliance with technical requirements”. The new chairman of the FASB, Bob Herz, is a former part-time member of the IASB and is believed to also favour standards that emphasise principles, rather than detailed rules.

CGAA Views

6.5 We endorse the need for accounting standards to maintain an emphasis on ‘substance over form’ as currently in the UK (e.g. with FRS5, including provisions for accounting for Special Purpose Entities) and in IASB standards. This is a particular strength of the UK and international approaches to standard-setting.

6.6 We welcome the commitment of the ASB to develop proposals in partnership with the IASB on issues related to Enron and other corporate failures and note the high level of current activity, with a large number of exposure drafts of new or revised standards being published for comment. **We emphasise the importance of having in place a robust and high-quality set of international standards for 2005 and the need to make progress on all issues as soon as possible,** in particular on the proposals to improve transparency referred to at paragraph 6.3 above. That said, the Group is conscious that new accounting standards take time to develop and finalise, both because of the increasing complexity of the subject matter and of the requirements of both Boards to ensure proper due process in the development of new standards.

Enforcement of Accounting Standards

6.7 The enforcement of accounting standards is the subject of considerable international debate. However good the accounting standards might be, a financial reporting regime is only credible if those standards are applied in a consistent and rigorous way. Effective arrangements for enforcement are therefore essential. As set out in **Annex 7**, the UK already has a well-respected enforcement regime for listed and large private companies through the Financial Reporting Review Panel (FRRP). The FRRP is at present reactive in that it looks only at the accounts of public and large private companies that are brought to its attention by third parties or in response to Press comment. The Panel can refer matters to another regulator in circumstances where there is prima facie evidence of something relevant to the scope of that regulator. In terms of its history, The Panel has dealt with over 350 cases since it was set up and issued over 70 press releases. The Panel’s decisions to date have never been disputed. The Panel has proved an effective deterrent. The European

Commission has cited the FRRP as a good model of an independent enforcement agency, and several EU member states (notably Germany and Sweden) are considering introducing a similar system.

6.8 The reactive nature of the Panel has led to the suggestion that it should for example look at samples of accounts of listed companies to assess whether they would raise issues for the Panel. In 2001, the FRRP commissioned a study of a sample of accounts of listed companies. This concluded that there was no evidence to suggest that there were widespread issues of concern that escaped the Panel, but it did reveal examples of non-compliance that might have been expected to come to the FRRP's attention, (and had not). The Panel has acknowledged that this situation needs to be further considered, and while both the Panel and the FRC do not favour an SEC-style approach (as outlined below), the Panel is presently reconsidering the issue of pro-activity.

6.9 Pro-activity could take various forms. The most active would be a model along the lines of that of the SEC. That would require an enormous expansion of staff resources. There is a range of more modest variants. The Panel currently has only one administrative staff member, sharing duties with the FRC, and one technical staff member. The Chairman and Deputy Chairman decide cases with appropriate involvement from Panel members whose experience and standing provide the key strength of the system. However, with a number of additional staff, the Panel could take a more pro-active approach by reviewing a sample of financial reports from companies within its remit, to see if there are issues that could, or should, be brought to the Panel's attention. Courses of action are open to the Panel other than opening a formal FRRP case. For example, the Panel in 2001 issued a 'generic' press notice with a view to ensuring that companies that had not made the disclosures required by Financial Reporting Standard (FRS13) *Derivatives and other Financial Instruments: Disclosures* understood the nature and scope of the standard. Effectively, companies were put on notice of the need to comply with the standard.

International context

6.10 The FRRP's current approach is in contrast to the USA, where the SEC's Division of Corporation Finance monitors a sample of annual reports. The SEC has announced that the Division will monitor all annual reports submitted by Fortune 500 companies that file periodic reports with the SEC in 2002. The SEC is also encouraging all companies to consult with Commission staff with queries before they file reports. The SEC also has an Enforcement Division that can, and does, bring financial reporting and issuer disclosure actions against companies. The SEC also actively encourages companies to consult its Chief

Accountants' Office if they have accounting issues where there are some doubts about the correct treatment. This is referred to as the "pre-clearance system". The USA, through the SEC, has the most pro-active regime, but a number of other jurisdictions (including Australia, Canada, France and Italy) share some of the key features in having a statutory securities regulator, pro-active reviews of accounts and an element of pre-clearance of difficult issues.

6.11 The European Commission is looking to develop EU and national enforcement mechanisms to ensure the "proper and harmonised application" of international accounting standards within the EU, in co-ordination with the Committee of European Securities Regulators (CESR). CESR's Finance Committee has a sub-committee on International Standards Enforcement that is working in this area. A report on enforcement principles is expected in September.

CGAA Views

6.12 The enforcement of accounting standards is extremely important and increasingly high on the international agenda. Within the EU, agreement on the minimum acceptable mechanisms for enforcement is seen as an essential element of the move to follow international accounting standards. There are undoubted strengths in the existing UK model and the Panel arrangements are generally perceived as having worked well to date. And we also share the concerns some have as to the attractions of a "pre clearance" system. In particular it tends to take away the responsibility of the company and its auditors for making judgements on the financial statements and encourages persistent detailed debate on what falls within the rules. Nevertheless the international debate and the current environment means that it is only sensible to ask whether the current UK arrangements are adequate to the challenges ahead. We look forward to seeing the CESR report on enforcement in due course, but in the meantime, **we recommend** that

- (i) **the FRRP should press ahead urgently with developing a pro-active element to its work and come forward with specific proposals by the end of 2002.** We recognise that this has implications for the way in which the Panel works and its funding;
- (ii) **the Government should look at the adequacy of the current enforcement arrangements in the UK in a wider context, and taking closely into account the international developments outlined above.**

7 AUDITING STANDARDS

7.1. The Auditing Practices Board (APB), now within the ambit of the Accountancy Foundation, is responsible for developing auditing standards in the UK. A note on the current framework for auditing standards in the UK, and current issues on the agenda, is set out at **Annex 8**. There has been a substantial strengthening of UK standards through the 1990s and the APB is seen as one of the leading standard setters in the world.

7.2 In June 2001 the APB issued a Consultation Paper on 'Aggressive Earnings Management'. It was concerned that, despite the progress made during the last decade in corporate governance, accounting standards and auditing standards, the quality and reliability of financial reporting may be undermined by increasing commercial pressures on those responsible for preparing financial statements. This was widely recognised as a topic of considerable importance. The subsequent collapse of Enron and the questions that this provoked concerning financial reporting and auditing underlines this. Responses to the Consultation Paper suggested that the issues raised could not simply be addressed by the APB in guidance to auditors but needed a wider response.

7.3 The APB plans to respond to the threat of aggressive earnings management (and thereby the possibility of a 'UK Enron') by:

- updating, in conjunction with the International Assurance and Auditing Standards Board (IAASB), auditing standards on fraud, materiality and the audit of accounting estimates.
- emphasising the importance of the fundamental principles of auditing (The Auditor's Code) by updating it and embedding it in a revised statement of the scope and authority of APB pronouncements;
- reviewing the impact of its new standard on communications with those charged with corporate governance Committee investigating the financial regulation of public limited companies and exploring with Derek Higgs and others whether guidance should be developed for members of Audit Committees on how they should work with auditors
- reviewing other standards, including those on related parties and quality control, and assessing whether they are sufficiently robust.

International context

7.4 The agenda for auditing standards, as for accounting standards, is increasingly international. As suggested above, the APB is committed to co-operating with IAASB to develop International Standards of Auditing (ISAs).

7.5 The European Commission has noted that there are no agreed auditing standards across the EU but is working with Member States to facilitate the adoption of ISAs for 2005.

CGAA views

7.6 We welcome the move to adopt ISAs for 2005. However, it is important that this does not lead to a dilution of standards in the UK. International standards must by their nature set a hurdle which is reasonable for all countries. It is important therefore that the UK retains the option of setting higher standards where this is justified. We therefore **endorse and encourage the efforts of the Auditing Practices Board and the Government to ensure that the further development of international standards, which is urgently needed, takes place quickly enough;** and that the **existing strengths of UK standards** are retained.

7.7 We therefore also welcome the **APB's continuing work to improve standards, wherever possible on an international basis.** And we also recognise the value of APB's work to raise and respond to the concerns over **aggressive earnings management.** We **encourage other regulators to reinforce that from their own perspectives.**

8 COMPANY LAW REFORM

8.1 The Company Law Review (CLR), which reported to the Government last July, makes a number of important recommendations relevant to our work. We summarise these below and note that the Government has just published its first formal response to the CLR proposals². In particular we welcome the fact that the Government intends to proceed with the specific proposals outlined below.

Wider company reporting

8.2 Financial statements have limitations as a source of information for investors seeking to make rational economic decisions. The ASB recognises this in its *Statement of Principles for Financial Reporting*. Annual reports and financial statements largely provide information that is historical and therefore do not reflect future events or transactions that might impact on a company's operations. Also the value of a company is increasingly to be found in intangible assets – in particular human capital – for which there is no reliable valuation and which are generally not found on a company's balance sheet. At present, these wider factors, often crucial to the future success of the business are covered by limited statutory requirements relating to the directors' report and in a non-mandatory Operating and Financial Review (OFR), for which the ASB issued best practice guidance in 1993.

8.3 One of the major CLR proposals is for a mandatory Operating and Financial Review (OFR), with the objective of giving better non-financial information. The Government agrees and this is reflected in the White Paper outlining the first tranche of proposals for a Companies Bill.

8.4 In advance of a mandatory OFR, the ASB has recently issued an Exposure Draft (ED) of a revision to its 1993 OFR statement, with a deadline for responses of 31 October. The purpose of the OFR is to provide a framework of best practice within which directors can discuss the main factors underlying the company's performance and financial position, in order to provide to investors a historical and prospective analysis of the reporting entity "through the eyes of management". The ED provides a broader framework for the discussion of business performance than the 1993 statement and includes:

- A recommendation that boards of directors identify and comment on "key performance indicators" used in managing the business; and

² Modernising Company Law Command Paper CM 5553 16 July 2002

- Recognition that business objectives, and thus discussion of performance, may encompass both financial and non-financial measures.

8.5 In recognition of the recent calls for more transparent reporting, the ASB is recommending that the OFR should “highlight accounting policies which are key to an understanding of the performance and financial position, focusing on those to which the results are particularly sensitive”.

International context

8.6 In the United States, the SEC has issued proposals for improvements to the US equivalent of the OFR, the Management Discussion and Analysis (MD&A). The SEC is also expanding the list of significant events listed companies are required to disclose to the markets and shortening to two days the period allowed for such disclosures.

CGAA Views

8.7 We welcome the Government’s commitment to a mandatory OFR along the lines proposed by the CLR. This has an important contribution to improving corporate reporting. Pending its introduction, we welcome the ASB’s project to revise the existing OFR is an important step forward.

Directors’ Duties

8.8 We note that the Government agrees that directors’ general duties to the company need to be codified, broadly as proposed by the CLR; and that the basic objective of directors should be to promote the success of the company for the benefit of its members as a whole. We believe that this has a useful part to play in improving corporate governance.

Rights of Auditors to Information

8.9 The CLR proposed an extension of the existing rights of auditors to information, in particular that the directors of the company must volunteer information to the auditors of the company that the auditors need. These are backed by stiff criminal penalties: 2 years imprisonment plus an unlimited fine for dishonestly giving the auditors false information (or not volunteering it). This is a significant change, which will put pressure on directors tempted to conceal the true position from the auditors. We welcome the Government’s intention to include this reform in the Companies Bill.

9 IMPROVING ACCOUNTABILITY OF AUDIT FIRMS

9.1 Some large audit and accountancy firms (KPMG and Ernst and Young) publish annual reports and financial statements that are audited by independent external auditors. In part this reflects the traditional partnership form. The move towards the adoption of the Limited Liability Partnership form also facilitates greater transparency, however, since an LLP is required to report much as a limited company.

9.2 There is, however, a legitimate public interest in the affairs of the auditors of our major companies. The firms are amongst the largest business organisations in the economy, but their affairs can remain shrouded in secrecy, in terms of their processes and practices, their structure and international links, their various business activities and their financial performance. **We would therefore urge in particular those accountancy firms which are the auditors of listed companies, or of companies in which there is a legitimate public interest to take the initiative to improve openness and transparency.**

9.3 Audit firms enjoy a privileged status, in that they alone are able to act as company auditors. We believe that the **Government should consider further the case for making greater disclosure a pre-condition of the right to take on such an appointment** (at least in relation to listed and public interest companies).

10 OTHER ISSUES

Competition implications

10.1 On 1 July, the European Commission gave regulatory clearance to the proposed acquisition of most of Andersen's UK business by Deloitte and Touche. The Commission examined the acquisition's impact in the UK, in particular the market for audit and accounting of large quoted companies, which has been dominated by the "Big 5" accountancy firms.

10.2. We have discussed the implications for competition of the reduction in the number of major accountancy and audit firms from 5 to 4 for the audit of major multinational companies, in particular the potential reduction of customer choice and increased risk of conflicts of interest. The FSA has also made public its concern about the implications of this in the light of its need for independent audit/investigatory services. For complex financial services groups, only the major audit firms can normally provide suitable professional services. The FSA often finds it difficult to appoint a suitable non-conflicted firm, which the demise of a major firm can only make worse.

CGAA Views

10.3 The implications for competition of the reduction of the number of major firms in the audit and accountancy market from 5 to 4 is properly a matter for the competition authorities. However, we note that a competitive market for audit and accounting services is an important adjunct to formal regulatory measures to secure auditor independence. It is also vital in considering a regulatory response to the current concerns, to take account of possible adverse effects on competition. **We recommend therefore that the DTI and HM Treasury should discuss with the Office of Fair Trading whether there are any competition implications of the high concentration in the market for audit and accountancy services and whether any of the other proposals in this report have competition implications.**

Impact on Smaller Companies

10.4 Our work has focused very largely on the issues as they apply to listed companies and large private companies. However, in taking forward the ideas for change analysed in this report, it will be important for regulators, in determining the scope of particular proposals, to consider carefully the impact on smaller companies. One potential significant impact will be the fact that smaller companies will face higher costs of audit, even if excluded from any changes to the regulatory regime.

CO-ORDINATING GROUP ON AUDIT AND ACCOUNTING ISSUES

On 27 February 2002, the Secretary of State for Trade and Industry announced the setting up of a group to ensure that there was a co-ordinated and comprehensive programme of work by individual regulators to review the UK's current regulatory practices for statutory audit and financial reporting. The collapse of Enron and other corporate bodies has raised concerns over financial reporting and the role of the auditors. The Government saw a need to be clear that the regulatory regime in the UK, for financial reporting and audit, continues to be effective and provides appropriate underpinning for strong and efficient national and international capital markets.

The Secretary of State for Trade & Industry and the Chancellor of the Exchequer therefore invited Melanie Johnson, Minister for Competition, Consumers & Markets, DTI, and Ruth Kelly, the Economic Secretary (and now Financial Secretary), HM Treasury, to lead a co-ordinating group on accounting and audit issues, to:

1. ensure that there is a comprehensive work programme, to be undertaken by individual regulators, and avoiding unnecessary overlap;
2. provide an interim report by the summer, with a final report at a later stage;
3. commission additional work or reviews, if that is judged appropriate; and
4. reach a view on the adequacy of the proposals, and, if appropriate, make specific recommendations.

The members of the Group are as follows:

Melanie Johnson MP, Minister for Competition, Consumers & Markets, DTI.

Ruth Kelly MP, Financial Secretary to the Treasury.

Sir John Bourn, Chairman, Accountancy Foundation's Review Board, and Comptroller and Auditor General.

Colin Reeves, Director, Review Board.

Michael Foot, Managing Director, Deposit Takers and Markets Directorate, Financial Services Authority.

Ken Rushton, Director of Listings, Financial Services Authority.

Mary Keegan, Chairman, Accounting Standards Board.

Ann Wilks, Secretary, Financial Reporting Council.

Professor Ian Percy, formerly Chairman, Accounts Commission for Scotland. Former Deputy Chairman, Auditing Practices Board.

Rosemary Radcliffe, Economist and Complaints Commissioner for the Financial Services Authority. Formerly a member of the Company Law Review Steering Group.

Peter Wyman, President, Institute of Chartered Accountants in England and Wales (ICAEW), has also attended two meetings by invitation, as a representative of the Consultative Committee of Accountancy Bodies (CCAB – which comprises the six chartered accountancy bodies: ICAEW, ICAS, ICAI, ACCA, CIMA and CIPFA).

Richard Fleck, Deputy Chairman, Auditing Practices Board, has also attended two meetings by invitation.

Annex 2

SUMMARY OF COMMENTS ON REMIT OF THE CO-ORDINATING GROUP ON AUDITING AND ACCOUNTING ISSUES (CGAA)

We invited 80 firms, individuals and organisations with a particular interest in audit and accounting issues to comment on the issues raised for the regulation of audit and accounting in the UK following the collapse of Enron in the US. An invitation to comment was also placed on the DTI website. 25 replies were received which are summarised below. There is a longer summary of the individual responses on the DTI web-site, or it can be obtained by contacting 020 7215 0228. The full responses³ have been placed in the DTI Library.

2. The breakdown of those responding is as follows:

Institutional Investors	1
Professional accountancy bodies	3
Accountancy Firms	4
Organisations (e.g. CBI, OPRA)	10
Other (including individuals)	7

3. Most respondents agreed that the Group had highlighted the major issues and regarded these as requiring careful consideration. Most regarded current UK accounting and auditing standards as broadly effective and saw no reason to make major changes. Corporate governance and financial reporting requirements were seen as areas where there was greater scope for improvement of regulation and standards, including those advocated in the final report of the Company Law Review. Comments on the main areas identified in the letter were as follows:

Role of the Audit Committee (AC):

4. About half the respondents emphasised the need for a greater role for ACs in ensuring that the audit is independent, and that non-audit work is appropriately awarded. Suggestions include:

- AC must either comprise non-executive directors only or be subject to review by the non-executive directors, and these must invest the time needed to enable them to understand the company.
- AC's responsibilities must be more clearly defined, whether in statute or in standards (e.g. Listing rules).
- AC should be the main point of contact for auditors, and have regular dialogues with them without executive management being present. Auditors must discuss all independence issues with the AC, and must feel able to raise with it any aggressive accounting policies or pressure to enhance profits or window-dress accounts, etc.
- AC should be responsible for ensuring that only appropriate non-audit work contracts are awarded to the auditor, and that fees for non-audit work are in balance with those paid for the audit.
- AC should be responsible for regular review of the audit contract, for making recommendations to shareholders on the election of new auditors or re-election of the existing firm, and for agreeing auditors' fees, which must cover fair costs.

³ Except one response, which the sender asked to be kept confidential.

One respondent expressed concern that ACs should not be expected to shoulder unreasonable responsibilities, such as second-guessing professional advice on interpretation of accounting standards.

Provision of non-audit services to audit clients

5. Many respondents saw this as an area in need of more detailed consideration. Several argued that it was more efficient for a company to obtain some services from auditors who were already familiar with them, and one noted that it would be difficult to define whether or not particular work was so audit related as to be permissible. Several mentioned the provision of internal audit services as being incompatible with the statutory audit. As stated above, many thought that the Audit Committee could be well placed to decide whether particular work could be done by the auditor without compromising his independence. Some big firms argued that any change which led to audit-only practices would be counter-productive because career variety was important in attracting higher quality entrants to the profession. Greater disclosure of audit and non-audit fees was seen as a way of improving transparency in this area.

Mandatory rotation or re-tendering for audit:

6. Few respondents saw a strong case for compulsory regular rotation of audit firms, or for re-tendering audit engagements after a number of years. The higher risks in the first years of a new engagement was the main argument against regular rotation. The current system of seven yearly rotation of the audit partner was generally thought to be an adequate safeguard. The proposal that auditors should be appointed by an independent agency was raised by the Public Audit Forum and Austin Mitchell MP. One respondent suggested that a fresh auditor appointment should be compulsory if an audit partner joins the audit client.

The implications for Accounting Standards in the UK

7. UK accounting standards, were generally seen as more effective than US standards. There was no call for major changes to UK standards but a wish that some should be reviewed. There was concern that the UK should maintain its principles-based approach and do all it could to ensure that global convergence from 2005 does not threaten this or lead to lower standards here.

The implications for Auditing Standards in the UK

8. Here too there was little call for change as respondents did not see the failure of Enron as pointing to any deficiencies in UK standards. Respondents agreed that principles-based approach should be maintained, but that nevertheless, the rules should be reviewed.

Professional bodies' existing ethical standards

9. Few respondents referred to this. One noted that penalties handed down by the Joint Disciplinary Scheme in public interest cases were inadequate – “a gentle slap on the wrist and a modest fine”. Others commended the bodies' prompt response to the EU recommendation on auditor independence. Another, from an accountant, suggested that the profession needed to look at whether its training programmes and culture adequately nurtured the spirit of independence which auditors need.

Other Points

10. Respondents raised few topics not already on the Group's agenda. Some referred to the need for clarification of directors' duties, advocating the changes put forward in the Company Law Review final report. A couple suggested that the Group should look to corporate governance practice elsewhere in Europe, with one favouring two-level boards. One of the major accountancy firms highlighted auditor liability as a major factor discouraging auditors from looking as widely as they might at a company's affairs.

11. One respondent suggested that the Group should look at the big firms' domination of the audit market, while several noted that the collapse of Andersen could adversely affect the cost and quality of audit.

CGAA Secretariat
July 2002

SUMMARY OF REVIEWS AND ACTIONS IN HAND OR PLANNED BY UK REGULATORS, JULY 2002

<u>LEAD BODY</u>	REVIEW/TASK	TIMING/COMMENT
A. AUDITOR INDEPENDENCE		
ESB (Accountancy bodies, DTI, FSA)	<ul style="list-style-type: none"> The Ethics Standards Board (ESB issued a consultation paper "Setting the Agenda for Ethics" on 28 May. This is not focused exclusively on audit-related issues, but auditor independence is a major focus. 	<ul style="list-style-type: none"> Comments sought by 16 September 2002. <p>Should the ethical standards of the professional bodies (and their application in practice) on auditor independence be strengthened to provide an increased assurance to protect the public interest and market integrity? The ESB document discusses the approach to the setting of ethical standards for accountants and raises most of the audit independence issues mentioned in the paper (e.g. non audit services, auditor rotation, employment with audit clients).</p>
FSA (ESB/RB/DTI)	<ul style="list-style-type: none"> The FSA is likely to address, as part of the Review of Listing Rules, the principal auditor independence issues in relation to listed companies 	<ul style="list-style-type: none"> Initial Discussion Paper to be published in July. Review expected to take 18 months to 2 years (using CLR-style approach). The specific issues to be considered might be auditor rotation or mandatory retendering, and the split of audit and non audit work. (For role of audit committees, see under separate heading below). The FSA recognises, however, that the Listing Rules by definition apply to only the top slice of UK companies and are not the only way of changing requirements in this area (professional rules, Companies Act requirements are alternatives). Were the conclusion of such a Review that mandatory change was necessary, we would need to consider the most appropriate means of implementation. <p>Note: Review of listing Rules is a suitable opportunity to address these issues carefully, but will not produce answers in a short timescale. There also needs to be careful liaison and coordination with other work on auditor independence.</p>
Review Board (ESB/FSA/DTI)	Review Board Studies of provision of non-audit services, in particular: (i) conceptual (spectrum of services from audit through to consultancy to identify which are legitimately audit related services); (ii) statistical (audit fees and non-audit fees (both auditors and third parties); (iii) behavioural	<ul style="list-style-type: none"> Emerging conclusions Q4 2002. Could provide valuable input into ESB's work and into FSA Review of Listing Rules.

	(views on non-audit services provision from auditors, clients, users of accounts and audit committees).	
Review Board (ESB/FSA/DTI)	<ul style="list-style-type: none"> Review Board studies on audit switching by listed companies and costs associated with rotation: Analysis of the costing and pricing policies adopted by the large accountancy firms. 	<ul style="list-style-type: none"> Emerging conclusions Sept 2002. Could provide valuable input into ESB's work and into FSA Review of Listing Rules.
CCAB	<ul style="list-style-type: none"> Review of EU Recommendation on Statutory Auditor Independence, consideration of implementation of requirements and update of Ethical standards and guidance, and liaison with the Ethics Standards Board of the Accountancy Foundation. 	<ul style="list-style-type: none"> In progress by CCAB Ethics Group; revised standards and guidance due mid 2003
ICAEW	<ul style="list-style-type: none"> Mandatory rotation of auditors – review of public reports and academic research papers (this and the next item are relevant to the consideration the EU Recommendation on Statutory Auditor Independence) Provision of non-audit services – similar review to be led by Professor V Beattie Consideration by Council of proposal to encourage early implementation of the EU Recommendation in areas such as cooling off periods (firms to clients) 	<ul style="list-style-type: none"> Source material identified and reviewed; position paper prepared July 2002 Due 31 August 2002 Council met and approved measures June 2002
Professional bodies in conjunction with DTI and ESB. FSA also interested	<ul style="list-style-type: none"> Implementation of EU recommendation on audit independence. This was formally promulgated by the Commission in May. 	<ul style="list-style-type: none"> To lead to revised ethical standards by mid 2003. An opportunity to revisit existing professional ethical guidance on auditor independence, in particular to revisit rules governing provision of non audit services. (Open to member States to go beyond recommendation.) Recommendation also paves the way for fuller disclosure of fees for non audit services and for tighter restrictions on employment of auditors by former client companies.
Auditing	<ul style="list-style-type: none"> An Audit Review Working Party is reviewing CIMA's position on auditor independence. Provisional thoughts in TSC submission 	<ul style="list-style-type: none"> Report to CIMA Council July 2002
B. REGULATION OF THE PROFESSION		
Review Board (DTI)	<ul style="list-style-type: none"> Review Board work programme on professional regulation 	<ul style="list-style-type: none"> Work on complaints and discipline essentially complete. See also CGAA 05. Complaints and discipline, registration and monitoring of auditors, training studies to follow. Lessons of high profile "audit failure" cases Monitoring a high priority?

ICAEW	<ul style="list-style-type: none"> As part of continuous development of new ACA and CPE requirements, consideration of training on ethics and professional scepticism is being reviewed. 	<ul style="list-style-type: none"> On-going
ICAEW	<ul style="list-style-type: none"> Independent review by a QC of DTI inspections and JDS Inquiries to ascertain recurring factors has been commissioned 	<ul style="list-style-type: none"> 31 August 2002
ICAEW	<ul style="list-style-type: none"> Comments on Review Board document “Protecting the Public Interest” 	<ul style="list-style-type: none"> Submitted 24 May 2002
C. CORPORATE GOVERNANCE		
DTI/HMT (FSA/FRC)	<ul style="list-style-type: none"> Derek Higgs leading review of Non Executive Directors with DTI/Treasury support. Initial consultation document published on 7 June 	<ul style="list-style-type: none"> Late 2002/early 2003 Will address the quality of Non Executive Directors, which is highly relevant to effectiveness of Audit Committees. Will also address Audit Committees in a broad way but less likely to get into new detailed guidance for Audit Committees
<u>FRC/FSA/APB/</u>	<ul style="list-style-type: none"> Review Existing Provisions of Combined Code on Audit Committees? Series of high-level Roundtables proposed with senior persons from the business and regulatory communities (under Chatham House Rules) to discuss governance issues. 	<ul style="list-style-type: none"> For discussion – see main text of the paper. First event - 21 May 2002 discussed the unitary board, non-executive directors and audit committees; other Roundtables to be arranged
ICAEW	<ul style="list-style-type: none"> Thought pieces (ie articles) on role and responsibilities of non-executive directors for Press and magazines Paper setting out advantages and disadvantages of unitary board followed by possible research later Research by an academic into application of Turnbull Consideration of application of Turnbull into risk reporting (see above) 	<ul style="list-style-type: none"> Ongoing
CIMA	<ul style="list-style-type: none"> Research into more detailed requirements of an OFR, particularly in respect of non-financial business drivers where CIMA can add value to the debate. Research into extending corporate governance role of fund managers 	<ul style="list-style-type: none"> In progress Research report <i>Financial Institutions and Corporate Governance: A Dynamic Model of Corporate Governance</i>
D. FINANCIAL REPORTING		
ASB (FSA/DTI)	<ul style="list-style-type: none"> ASB work programme addresses a number of issues which may be relevant to what is known of the accounting problems encountered at Enron 	<ul style="list-style-type: none"> “Creative accounting” – Problems of revenue recognition; consolidation policy including treatment of special purpose vehicles. For more detail see Annex 7. ASB needs to work closely with international standards setter, given adoption of IASB standards in UK from 2005

FRRP/FSA/DTI	<ul style="list-style-type: none"> Review of existing UK enforcement arrangements, or of manner of operation of the UK Financial Reporting Review Panel 	<ul style="list-style-type: none"> Changes to FRRP procedures by end 2002? Whilst the UK arrangements are generally admired and seen as effective, we should not be complacent. FRC and FRRP looking in particular at a more proactive approach. This must also be seen in the context of discussion under way in Europe, in particular amongst securities' regulators
DTI (ASB/FSA)	<ul style="list-style-type: none"> Implementation of proposals on reporting in Company Law Review, in particular proposal for a statutory Operating and Financial Review 	<ul style="list-style-type: none"> Likely to be part of Companies Bill. Improved communication with stakeholders
ICAEW	<ul style="list-style-type: none"> Risk reporting - a "blueprint for further change" has been developed as a part of improving the relevance and quality of corporate reporting Managing risk – a publication providing practical guidance for business (although not about corporate reporting this is, in effect, a sister publication) Prospective financial information – developing principles for preparers of PFI with representatives from FSA, LSE, Take-over Panel and APB Operating & Financial Review – working party established to develop practical guidance for preparers of OFRs which will be based on ASB's update (due June 2002) of its 1993 Statement Round Table to discuss sustainability reporting (to be led by Graham Ward, a previous President) 	<ul style="list-style-type: none"> Published 13 June 2002 Publication in draft for final reviews; publication date anticipated August 2002 Paper anticipated Autumn 2002 Aiming to publish by December 31 2002 (will depend on ASB timetable) July 2002
E. AUDITING STANDARDS		
APB (ACCA/ICAEW/ ICAI/ICAS)	<ul style="list-style-type: none"> The Auditing Practices Board has reviewed UK auditing standards in the light of what is known about Enron. However there have been extensive relevant changes to standards over the last decade, some in response to other "audit failures", and it is doubtful that a major new work programme is needed post Enron 	<ul style="list-style-type: none"> APB has taken a lead in addressing concerns over aggressive earnings management and in working with other regulators to address this. APB also needs to work internationally to ensure that international standards on auditing match up to existing UK requirements, as the pace quickens in Europe towards the adoption of international standards
ICAEW	<ul style="list-style-type: none"> Review of application of SAS 240 (revised) <i>Quality Control for Audit Work</i> (will cover leadership within firms, appointment and continuance of engagements, resources (numbers and competencies of individuals), consultation, management of individual engagements, independent reviews and monitoring of quality of audits) Research arguments for and against individuals signing audit reports 	<ul style="list-style-type: none"> 31 October 2002 31 August 2002

SUMMARY OF US RESPONSES TO ENRON AND OTHER CORPORATE PROBLEMS

This note summarises the main responses to Enron from the US Administration, the Securities and Exchange Commission (SEC) and Congress.

US Administration

In **March 2002**, President Bush announced a 10-point plan to improve corporate responsibility and protect American shareholders. The plan covered:

- 1. Investors should have quarterly access to the information necessary to judge a company's performance, condition and risk.**

Companies are required to submit quarterly reports to the SEC already, on a standard form 10-Q. Under the changes being proposed, companies will be required to submit these forms more quickly following the end of the quarter, and the list of events requiring reporting would be expanded. It is also proposed that companies provide an outline of the company's activities in 'plain English'.

- 2. Investors should have prompt access to 'critical information'.**

The proposals will significantly increase the list of significant events requiring release between reporting periods.

- 3. Chief Executive Officers (CEOs) should personally vouch for the accuracy of their companies' public disclosures, including financial statements.**

At present, the CEO signs only a brief certification regarding annual financial statements. See below.

- 4. Executives will be banned from profiting from false financial statements**

- 5. Executives who abuse their positions may be disqualified from holding future corporate roles**

At present the SEC requires approval from the Courts in some cases.

- 6. Executives should disclose personal share transactions in their company's stock.**

At present, US executive officers, directors and large shareholders must report trades in the company's stock within a period of up to 10 days. Directors and officers who sell stock back to the company may not have to report this for over a year.

- 7. Company auditors should not carry out other services 'if the service compromises the independence of the audit'.**

Current SEC rules already restrict the scope of non-audit services that are deemed to be inconsistent with an auditor's independence, in particular where there is :

- A mutual or conflicting interest with the audit client;
- A situation where the auditor audits his or her own work;
- A situation where the auditor fulfils a management function;
- A situation where the auditor acts as an advocate for the audit client.

A regulatory board will ensure the accountancy profession is 'held to the highest possible standards'

See below for details of the SEC proposals and those in the Bill put forward by Senator Sarbanes to tighten up the regulation of the profession.

8. **The SEC will reinforce its supervision of the Financial Accounting Standards Board (FASB) and require standards that reflect economic reality rather than technical requirements**

See below for proposals on FASB.

9. **Company accounting systems must be compared with best practice**

The proposal suggests that auditors would be required to compare the quality of a company's financial controls with the best practice of an industry and communicate the findings to the audit committee.

On 9 July, President Bush called for a new ethic of corporate responsibility, unveiling new criminal penalties and enforcement provisions, as part of a corporate reform agenda building on the 10-point plan. Some of the main features of the proposals include:

- Enhanced enforcement and tougher criminal provisions, including the creation of a Corporate Fraud Task Force, stronger laws against document shredding and measures to freeze any extraordinary payments being made to corporate executives whose company is subject to an SEC investigation.
- More funding for the SEC.
- Measures to strengthen corporate governance, including making directors truly independent, a requirement on CEOs and Chief Financial Officers (CFOs) to personally vouch for the veracity, timeliness and fairness of company financial statements, improved disclosure and justification for a CEO's compensation package, prompt disclosure of insider transactions, the elimination of company loans to corporate officers and a requirement that all executive stock options be approved in advance by shareholders.
- Strengthening auditor independence by banning non-audit service provided by an auditor, unless improved in advance by the independent audit committee of the board of directors. The President has asked the SEC to adopt such rules as soon as practicable.
- Improving oversight of the accounting profession, as highlighted in the 10-point plan. The President has called on the SEC to ensure that its proposed Public Accountability Board (PAB) is operational by the end of the year.
- Making analysts independent.
- Making disclosure of information more robust. The President has called for public companies to provide a true and fair picture of themselves, and warned that compliance with Generally Accepted Accounting Principles (GAAP) did not prove sufficient disclosure.
- More prompt disclosure of critical information.

Securities and Exchange Commission (SEC)

The SEC has taken action and made proposals in a number of key areas in response to the collapse of Enron, including:

1. **Auditor independence** – the SEC’s revised rules governing the independence of the profession were agreed in November 2000 and became effective from 5 February 2001. These are summarised in **Attachment 1**. The SEC is revisiting its independence rules in the light of Enron, including to propose a requirement that any non-audit service provided by the auditor must first be approved by the audit committee (see above). Even post-Enron, the SEC does not see a case for a blanket ban on the provision of non-audit services by the auditor, nor for the mandatory rotation of audit firm.
2. **Regulation of the accountancy profession**– see **Attachment 2** for details of the SEC’s proposals for a Public Accountability Board (PAB).
3. **Financial Reporting**– the SEC has called for improvements in the process of setting accounting standards in the USA. The SEC wants the Financial Accounting Standards Board (FASB) to address criticisms that:
 - a. The current standard-setting process is too slow and cumbersome;
 - b. Much FASB guidance is rule-based and focuses on a “check-the-box” mentality that inhibits transparency; and
 - c. Much FASB guidance is too complex.

The SEC also wants to have a direct role in the selection and approval of FASB members, and to make FASB’s funding sources more secure and non-discretionary.

4. **Enforcement of accounting standards**– the SEC is stepping up its role of pro-actively reviewing the statements of registrant companies, including all of the “Fortune 500”, plus encouraging greater use of the “pre-clearance” system (whereby companies consult with Commission staff on accounting treatment issues before filing reports).
5. **Other reporting aspects**– the SEC is proposing to improve disclosures required in the Management Discussion and Analysis (MD&A), the US equivalent of the Operating and Financial Review (OFR), in particular to give investors:
 - a. Greater awareness of the impact of critical accounting policies;
 - b. Much fuller disclosure of the risks and effects of ‘off balance sheet’ transaction structures; and
 - c. More trend information, including certain forward-looking information.

The SEC has also brought forward proposals to accelerate the timetable for the preparation of required financial reporting information. It is also requiring the CEOs and CFOs of 945 SEC-registered companies to personally certify – in writing, under oath, and for publication – that their most recent reports filed with the Commission are both complete and accurate. This is one aspect of President Bush’s 10-point plan.

Congress

Investigations into various aspects of the Enron, and the subsequent revelations relating to a number of other companies, notably Global Crossing and WorldCom, have been carried out by a number of Committees and Sub-Committees in both the Senate and the House of Representatives.

(a) **Senate Bill**

One of the most noteworthy items to emerge has been a draft Bill proposed by **Senator Paul Sarbanes**, Chairman of the Senate Banking Committee. His Bill, titled the *Public Company Accounting Reform and Investor Protection Act 2002*. The Bill, which has now been passed by the Senate, covered the following areas:

Regulation of the Profession

The Bill proposes the establishment of a Public Company Accounting Oversight Board to regulate the profession, under the oversight of the SEC, with authority to oversee the audit of public companies subject to the securities laws. In particular:

- Members of the new Board would be appointed by the SEC after consultation with the Department of the Treasury and the Federal Reserve Board and must be persons of integrity and reputation who have a demonstrated commitment to the interests of investors and the public. No more than two of its five members may have an accountancy background.
- The new oversight Board would establish its own budget and be independently funded by registered accounting firms and public companies as established by the Board and the Commission.
- The Board would have authority to establish or adopt auditing, quality control standards, and ethics rules to govern the conduct of audits for public companies. Auditors would be required to (1) retain all audit work papers for seven years (2) obtain 2nd partner review of audit reports, and (3) express an opinion on certain internal controls of public companies.
- The Bill provides for regular inspections by the Board of the work of registered public accounting firms, including annual inspections for the largest accounting firms (initially, those that audit more than 100 public companies). It further grants the Board full authority to investigate any act that may violate the Board or SEC's rules, the securities laws (including the new statute), or professional accounting standards.
- The Board, subject to SEC review, would be authorized to impose a full range of disciplinary or remedial sanctions.
- **Foreign accounting firms that issue audit reports for companies subject to US securities laws would be covered by the Bill.**

Independent Accounting Principles

- To better promote the effectiveness and independence of the accounting principles set by FASB the Bill (1) authorizes the SEC to recognize such a standard setting body; (2) provides for the secure funding of such body; (3) requires that it be selected by a board of trustees a majority of whom are not from the accounting profession; and (4) requires that the standard setting body set standards by majority rule.

Auditor Independence

- To further promote the independence of public company auditors, the Bill **restricts** the non-auditing or consulting work that can be provided by auditors. The draft prohibits providing public company audit clients with (1) financial information systems design, (2) internal audit work, (3) expert opinions, as well as (4) other categories of non-audit work previously restricted through SEC rules.
- The new Board is authorized to issue rules to implement these auditor independence provisions.
- All other non-audit work, including tax services, would be allowed if pre-approved by a public company's audit committee.
- The Bill would require the GAO to study the merits of requiring **audit firm rotation** and report to Congress. The Bill calls for the rotation of **accounting firm partners** providing auditing services for the same issuer for more than 5 consecutive years.
- A **one-year** "cooling off" period would be required prior to a public company hiring as its CEO or CFO, or someone who had just conducted its audit.

Corporate Responsibility

- Public company directors would be held directly responsible for the accountants preparing their reported financials. The Bill would require audit committees to be responsible for the appointment, compensation, and work of auditors and hear directly from the auditors on key matters. Audit committees would have to be independent from management; have procedures to address complaints regarding auditing issues; and have authority to retain counsel and advisors.
- Holding corporate leaders responsible for their acts, the Bill includes the President's proposal requiring CEOs and CFOs to sign their company's audit report. Certifying that the financials fairly and accurately reflect the operations and financial condition of their companies, they would subsequently forfeit profits and bonuses realized in the 12 months before a material accounting restatement if it was as a result of material noncompliance with securities laws.
- The Bill also strengthens the sanction of barring securities law violators from serving as officers or directors. District courts would be permitted to impose bars if directors or officers demonstrate "unfitness," (rather than "substantial unfitness") to serve.
- The Bill makes it unlawful for any officer, director, or affiliated person to fraudulently influence, coerce, manipulate or mislead any accountant preparing an audit report.

Enhanced Financial Disclosures

- The Bill would further protect investors and promote transparent capital markets by enhancing a number of financial disclosures. It would require public companies to report loans to insiders on current reports filed with the SEC within seven calendar days or such other period determined by the SEC. Public companies would be required to present pro forma data in a manner not likely to mislead investors and clearly distinguished from GAAP financials. Public companies would be required to disclose off-balance sheet transactions and conflicts. Management and the company's auditor would be required to attest to the company's internal control procedures in the annual report. Insider trading would be required to be reported by the day following any transactions.

Analyst Conflicts of Interest

- To promote the transparency of markets and protect against investors being misled, the Bill requires the SEC to enact rules, or to direct the self-regulatory organizations to enact rules, to prohibit certain conflicts that could compromise a security analyst's independence and to disclose other potential conflicts in their research reports.

Commission Resources and Authorities

- The Bill proposes significant increases in the resources of the SEC.

(b) House Bill

The House of Representatives passed a weaker measure in April (HR3763). It would also create an oversight board for the accountancy profession but would place fewer restrictions than the Senate Bill and leave much more of the detail to the Securities & Exchange Commission. On 16 July, House Republican leaders rushed through another Bill (HR5118) that would create stiff criminal penalties for corporate malfeasance.

(c) Conference

As of 22 July, both Bills had moved to conference, where conferees will try to reconcile the two versions. The House of Representatives rises on 26 July, so the Bill must be approved by then if it is to be signed by President Bush before the August recess.

THE PROVISION BY THE AUDITOR OF NONAUDIT SERVICES TO AUDIT CLIENTS

SEC Rules

1. The SEC rules note the concerns that have grown over the years about the effects on independence when the auditor provides both audit and non-audit services to the audit client. As far back as the 1970s, the US Congress seriously considered limiting the types of non-audit services that auditors could provide to audit clients⁴, but in the end did not take legislative action. In a footnote to the rules, the SEC makes clear its view that "the perception of auditor independence is important to financial statement users and can be affected negatively by the extent and type of non-audit services provided by the auditor to audit clients".

2. The SEC rules do not impose a total ban on the provision of non-audit services, but rather restrict non-audit services only to the extent necessary to protect the integrity and independence of the audit function. The rules identify nine non-audit services that are deemed inconsistent with an auditor's independence:

1. Bookkeeping or other services related to the audit client's accounting records or financial statements - this would place the auditor in the position of auditing the audit firm's own work;
2. Financial information systems design and implementation – that said, an auditor may provide IT consulting services providing certain criteria are met. These criteria essentially specify that management has to ensure that it makes all significant decisions with respect to the IT project, evaluates itself the adequacy and results of the project, and does not rely on the auditor's work as the primary basis for determining adequacy;
3. Appraisal or valuation services or fairness opinions – where these would be material to the financial statements, and/or the auditor would audit the results;
4. Actuarial services – when they involve the determination of insurance company policy reserves and related accounts;
5. Internal audit services – although an audit firm can provide up to 40 per cent (measured in terms of hours) of an audit client's internal audit work, with no restriction for smaller businesses by excluding companies with assets of less than \$200 million. In all circumstances, management must make all management decisions concerning the internal audit function;
6. Management functions – an auditor must not act, temporarily or permanently, as a director, officer, or employee of an audit client, or performs ant management function;
7. Human resources – an auditor cannot be involved in recruiting, or recommending, a specific candidate for a specific job. However, an accounting firm could, at the request of the audit client, advise on the competence of candidates;
8. Broker-dealer services; and
9. Legal Services.

3. In addition, companies must disclose in their annual proxy statements⁵:

1. Separately, the fees for audit (under a caption entitled "Audit Fees"), IT consulting ("Financial Information Systems Design and Implementation Fees") and all other services ("All Other Fees") provided by auditors;
2. A statement as to whether the audit committee has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence;
3. The percentage hours worked on the audit engagement by persons other than full-time employees of the audit firm.

⁴ Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (1977) *Report on Improving the Accountability of Publicly Owned Corporations and their Auditors* (95th Congress, 1st Session)

⁵ US federal securities laws generally require public companies to deliver a "proxy statement" when they solicit proxy voting authority from their security holders

4. Even post-Enron, the Commission does not see a need for a ban on the provision of non-audit services: "those of us currently on the Commission do not believe it is necessary to propose such a ban at this time. Information gained through consulting engagements may be useful in performing an audit...We believe this framework (i.e. the SEC's existing rules on auditor independence)...will, over time, serve investors better than would a blanket ban on the receipt of non-audit services from the auditor"⁶.

⁶ Evidence given by Harvey Pitt *Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies* before the Senate Committee on Banking, Housing and Urban Affairs, 21 March 2002

REGULATION OF THE PROFESSION :SEC PROPOSALS FOR PUBLIC ACCOUNTABILITY BOARDS

1. In response to the collapse of Enron, SEC Chairman Harvey Pitt issued a public statement in January 2002⁷ stressing the need for reform of the accounting profession. In that statement, Harvey Pitt envisioned a new regulatory body for the profession (a Public Accountability Board, PAB), subject to independent leadership and governance, and "dominated by public members, with two primary components - discipline and quality control". On discipline, the body should be subject to SEC oversight, but have the power to perform investigations, bring disciplinary proceedings, publicise results, and restrict individuals and firms from auditing public companies. On quality control, the system of firm-to-firm peer review should be replaced by monitoring and control undertaken by permanent staff unaffiliated to any accounting firm.

2. This statement prompted an angry response from the Public Oversight Board (POB), since 1977 the body charged with regulating the accounting profession, that it had not been consulted on the proposals. The POB informed the SEC of its decision to end its existence, with the comment: "It was obvious from your remarks...that the proposals for changing the system of self-regulation of the accounting profession do not include a place for the POB". The POB declined a call from Harvey Pitt to reconsider its decision, but is continuing to carry out its work on a transition basis - under agreement with the SEC - until new arrangements are put in place.

3. The SEC has been working on the detail of the proposed PAB, and on 20 June the Commission agreed to propose rules to reform the regulation of the profession. The proposed rules establish the framework for the PAB, in what the SEC describes as a system of "private sector" (but not "self") regulation that would not be under the control of the accounting profession⁸. Key features of the proposed PAB arrangements are:

Membership – the financial statements of SEC-registered companies would not be deemed to comply with SEC requirements unless (a) the company's external auditors were members of the PAB; and (b) the company was an adjunct member of the PAB, and therefore bound to co-operate in any review or proceeding commenced by the PAB;

SEC Oversight - of the PAB's membership, rules and activities;

Independent PAB Board - a majority of members (no less than 6 out of 9 has been suggested) are to be independent representatives of the public interest, with a minority (no more than 3, with a Board of 6, or one-third of the Board if a different number) associated with the accounting profession;

Independent PAB Funding - the funding sources should be secure and independent. The SEC proposes that auditors must register with the PAB and be subject to pay membership fees, and will implement this requirement as part of its rules. In addition, all issuers whose financial statements are filed with the SEC and audited by PAB members should pay involuntary fees to the PAB. The detailed proposed rules also envisage that the US accounting standard-setter, the Financial Accounting Standards Board (FASB) should also have a mandatory and continuous source of funds, through fees paid to the PAB;

Strong Oversight by PAB – accounting firms, individual accountants, public companies and their management would be required to co-operate with PAB quality control reviews and disciplinary proceedings. Failure to co-operate could result in suspension of the right to conduct public audits;

PAB Quality Control Reviews - these should be carried out by PAB staff, who should determine the frequency of routine reviews of audit firms (at least annually for large firms and at least triannually for all other firms ie more frequently than the current three years) and the criteria that would trigger non-routine reviews;

⁷ SEC (2002) *Public Statement by SEC Chairman: Regulation of the Accounting Profession* (17 January)

⁸ SEC (2002) *Commission Formally Proposes Framework of a Public Accountability Board* (Press Release 2002-91, 20 June)

Disciplinary Powers- the PAB should have powers to impose a broad range of disciplinary sanctions against accounting firm and individual members, including fines, censures, removal from client engagements, limitation on activities and suspension from auditing some or all SEC clients for either a limited or unlimited time. It should also have the power to discipline firms for not having quality control systems that meet the highest professional standards or for not complying with those systems; and

Audit standard setting- the PAB will have the responsibility for assuring high ethics, auditing and quality control standards, either by setting them directly or by relying on and overseeing designated private sector bodies as authoritative sources of such standards.

SUMMARY OF REVIEWS AND ACTIONS IN HAND OR PLANNED BY NON-UK AND INTERNATIONAL ORGANISATIONS

The table below sets out a selective list of the work being taken forward by a number of international organisations on issues relevant to the areas being considered by the CGAA.

Organisation	Issue	Comment
European Commission (EC)	Comparative study of corporate governance codes relevant to the EU and its Member States (March 2002)	The Financial Services Action Plan (FSAP), published in May 1999, identified issues and actions to achieve deep and liquid European capital markets. One of the issues identified was the need to improve the framework for corporate governance in the EU. This study, carried out by Weil, Gotshal and Manges on behalf of the Commission, identifies and compares some 35 existing codes across the EU. The study has been passed to the High Level Group of Company Law Experts, which has been set up by the Commission to provide recommendations on how to set up a modern framework for EU company law (including corporate governance). The High Level Group is expected to deliver a final report in summer 2002.
	A first EU response to Enron related policy issues (April 2002, informal ECOFIN Council)	This papers sets out the Commission's view of the policy actions that need to be pursued at the European level in the following areas: <ul style="list-style-type: none"> <li data-bbox="1444 1038 2058 1315">i. Financial reporting – including the adoption of the regulation requiring the use of international accounting standards (IAS) from 2005, support for global convergence of accounting standards, endorsement of IAS, the development of enforcement mechanisms, modernisation of the Accounting Directives, and pushing forward proposals on regular reporting (transparency obligations); <li data-bbox="1444 1315 2058 1340">ii. Statutory audit – including adoption of a

		<p>Recommendation on Auditor Independence, preparing on a new Communication on policy priorities, notably the use of International Standards of Auditing by 2005, minimum requirements for oversight of the profession, the role of audit committees and the possible adoption of a code of ethics;</p> <p>iii. Corporate governance – notably expanding the mandate of the High Level Group of Company Law Experts to cover this (see above);</p> <p>iv. Transparency in the international financial system – inviting the Committee of European Securities Regulators (CESR) to report on supervisory issues related to the increased complexity of derivatives and derivative trading; and</p> <p>v. Financial analysts’ research and the role of credit rating agencies – including speedy adoption of the Market Abuse Directive, assessing the requirements for financial analysts as part of the consultation on the Investment Services Directive, and undertaking a cross-sectoral policy assessment of rating agencies.</p>
	Recommendation on independence of statutory auditors (May 2002)	This Recommendation sets out a series of principles to be adopted by statutory auditors and recommends that auditors should be prohibited from carrying out a statutory audit (one required by law) if the auditors have any relationship with their client that might compromise the auditor’s independence. This may include any financial, business, employment or other link, or any situations where the auditors provide non-audit services to their audit clients.
Financial Stability Forum (FSF)	FSF report to be prepared for the G7 Ministers and Central Bank Governors meeting in Autumn 2002	The report will cover the issues that have come to light in the Enron collapse and other corporate failures. The FSF is also considering how best it can facilitate the co-ordination of policy responses.

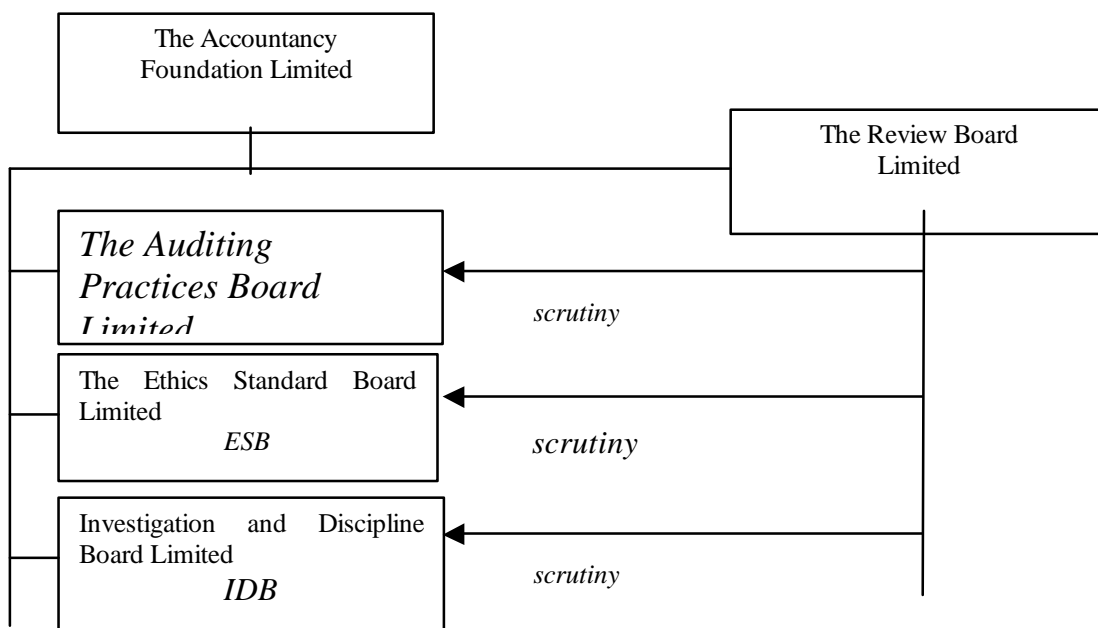
International Federation of Accountants (IFAC)	Code of Ethics for Professional Accountants (revised January 2002)	This code is intended to serve as a model on which to base national ethical guidance. It sets minimum standards of conduct for professional accountants and states the fundamental principles that should be observed by them. It includes rules on independence for audit and other assurance engagements.
	Measures to restore public confidence in the accountancy profession (March 2002)	<p>At its Board meeting in March 2002, IFAC announced:</p> <ul style="list-style-type: none"> i. a project focused on restoring the credibility of financial statements in the global marketplace, to be taken forward by an IFAC task force. The project is addressing worldwide problems issues, and best practices in the areas of financial reporting, corporate governance and auditor performance; ii. the membership of the newly-formed International Auditing and Assurance Standards Board (IAASB), with responsibility for establishing international standards on auditing.
International Organisation of Securities Commissions (IOSCO)	Creation of high-level sub-committee to co-ordinate and focus IOSCO's response to the securities regulatory issues highlighted by the bankruptcy of Enron and other high-profile business failures around the world.	<p>The sub-committee will consider:</p> <ul style="list-style-type: none"> i. accounting standards in liaison with the International Accounting Standards Board (IASB); ii. auditing standards; iii. disclosure and transparency issues; iv. unregulated entities/scope of supervision; v. the effects of consolidation in the auditing industry; and vi. the role of rating agencies.

Annex 6

REGULATION OF THE UK ACCOUNTANCY PROFESSION

There is no statutory regulation of accountants in the UK, though the Companies Act 1989 prescribes a statutory regime for the regulation of auditors, which is a reserved profession under the 8th EU Company Law Directive.

There are, however, new non-statutory oversight arrangements for the regulation of the accountancy profession. The structure of new system is as follows :



The **Accountancy Foundation** has an overarching responsibility for the system and to ensure it works. It appoints the members of the subsidiary bodies and ensures that adequate funding is available.

The **Review Board** has the role of monitoring the operation of the system to ensure that it serves the public interest. The **APB** has responsibility for establishing and developing auditing standards. The **ESB** has the role of securing the development of ethical standards for all accountants. The **IDB** will investigate disciplinary cases of public interest.

The regulatory responsibilities of the 6 **CCAB** bodies (the Institutes of Chartered Accountants for England and Wales, Scotland and Ireland, the Association of Chartered Certified Accountants and the Chartered Institutes of Management Accountants and of Public and Financial Accountants) are subject to the scrutiny of the Foundation arrangements. The first 4 of these also have responsibilities in relation to audit which are subject to supervision by DTI. These cover qualification and training, registration, monitoring, investigation and discipline of members. All 6 bodies also, to a formula agreed among themselves, provide funding to the Accountancy Foundation to finance its operations and those of the four subsidiary boards.

THE REGULATION OF FINANCIAL REPORTING: NOTE BY THE ACCOUNTING STANDARDS BOARD (ASB) AND FINANCIAL REPORTING COUNCIL (FRC)

The Accounting Standards Board

1. The Accounting Standards Board (ASB) was set up in 1990; accounting standards had previously been set by the accountancy profession. In the wake of several spectacular corporate failures, there was widespread acceptance in business, government and the profession of the need for a new independent regime of accounting standard-setting. The current arrangements are in line with the recommendations of the 1988 Dearing Committee report on The Making of Accounting Standards.

2. The ASB is independent of sectional interests. Its over-arching body – the Financial Reporting Council (FRC) – assures this independence, makes appointments to the ASB and manages the funding (one-third each from government, the accountancy profession and from business, the latter largely through levy now administered by the FSA). The Chairman and Directors of the FRC are appointed by the Secretary of State for Trade and Industry and the Governor of the Bank of England. The authority of the ASB's standards ultimately derives from the recognition of the ASB by the Secretary of State under s 256 of the Companies Act 1985.

Current Financial Reporting Standards

3. The ASB's standards have been developed against the background of the corporate scandals of the 1980s; many are targeted at practices previously considered to represent abuses. Principal amongst these are:

- FRS 4 'Capital Instruments', designed to prevent corporate debt being characterised as equity;
- FRS 5 'Reporting the Substance of Transactions', focused on ensuring that operational assets and related finance are shown on the balance sheet and on curbing early revenue recognition;
- FRS 7 'Fair Values in Acquisition Accounting' and FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' which have curtailed the shifting of profits from one accounting period to another; and
- FRS 8 'Related Party Disclosures'.

Of more recent standards, FRS 17 'Retirement Benefits' highlights the pension funding obligations that companies have entered into, and the resources available to meet those obligations.

4. Each of the above-named standards has requirements which are, in their different ways, more stringent than equivalent International or US standards. UK standards are also written in a style which, unlike US equivalents, calls for the exercise of judgement. The absence of 'bright line' rules in the UK regime does not easily allow loopholes to be exploited; it also permits auditors to challenge company directors as to whether their proposed accounting treatments reflect a 'true and fair view' within the context of the standards.

5. If dangerous precedents begin to emerge within this judgmental regime, the ASB's Urgent Issues Task Force (UITF) has proved itself robust in issuing Abstracts to combat discreditable interpretations of the UK standards.

Current ASB work programme

6. The ASB's current work programme is fully set out in the 2001 Annual Report of the Financial Reporting Council, published in January 2002. It has been determined against the background of government policy to promote the use of the output of the International Accounting Standards Board (IASB), rather than UK standards, for the group financial

statements of listed companies. It is expected that the IAS-based regime will begin in 2005; it should be noted, however, that the present International standards are acknowledged as less robust in many respects than their UK equivalents.

7. Given this governmental (and EU) policy, the ASB's strategy is focused on:

- a. working with the IASB and with 'partner' standard-setters around the world to improve and extend the existing International standards and
- b. seeking to adopt the newly agreed International standards into the UK regime, in order to effect a smooth transition towards 2005 and a congruence of the standards applied by listed and unlisted companies.

8. On 15 May, the ASB issued 7 Financial Reporting Exposure Drafts (FREDs) and a Consultation Paper (CP), to start a programme to converge UK standards with those of the IASB. In summary, the FREDs cover the following areas:

- FRED23: Hedge Accounting
- FRED24: The effects of changes in foreign exchange rates and financial reporting in hyperinflationary economies
- FRED25: Related party disclosures
- FRED26: Earnings per share
- FRED27: Events after the Balance sheet date
- FRED28: Inventories and Construction and service contracts
- FRED29: Property, Plant and Equipment, and Borrowing Costs; and
- CP : IASB Proposals to Amend Certain International Accounting Standards

9. The ASB's current workload includes the following projects which may be relevant to problems encountered at Enron and in other recent 'profile' cases:

- i. Accounting for financial instruments. On 20 June, the IASB published a revision of its existing (and complex) standard on the presentation and valuation of financial instruments (including derivatives). On the same day, the ASB exposed this for comment, with a view to its being adopted in the UK. However, this will not be possible without changes in EU and UK law which, it is understood, may take until 2004 to complete.
- ii. Revenue recognition. Given increasing complexity in the terms of business, there is a need for a revenue recognition standard in the UK. Of note, the international standard on revenue recognition is simplistic and out-moded; there is no general US standard (although the US SEC and various US committees have issued a substantial volume of rules). An ASB Discussion Paper was issued in July 2001; work is in hand to develop a draft standard, which will be discussed with the IASB this year as part of its work programme announced on 27 June.
- iii. Consolidation policy and practice. The ASB is running a project for IASB, working with other national standard-setters. The aim is to promote the UK's 'control' model of consolidation, particularly relevant to special purpose entities (SPEs). A first paper was presented to IASB in May and this is another agenda item on the IASB's newly announced work programme. Note that the USA has consolidation policy based on strict 'bright lines' of ownership criteria.
- iv. De-recognition. The IASB has no standard dealing comprehensively with recognition and de-recognition issues (ie when an asset has been 'sold' or merely offered as security for loan finance). The UK standard, FRS 5, seems to have been successful in curbing 'off balance sheet finance'. The ASB has been asked to develop an overall framework approach to recognition and de-recognition issues, to be implemented internationally.

- v. Leasing. The UK ASB (currently alone, in terms of the international partnership of standard-setters) is developing the leasing model so as to eliminate the artificial distinction between operating and finance leases (and hence to eliminate off-balance sheet leasing structures). The aim is to share a draft standard with the IASB by the end of 2002.
- vi. Operating and Financial Review. Encouraging directors to set out their explanation of factors significant to prospects for the business is paramount in assisting investors to understand the financial statements. On 10 June, the ASB issued an exposure draft of a revision to its 1993 OFR statement. This was discussed with the FSA prior to issue.

10. One area of financial reporting remains a particular challenge. Insurance accounting has developed under the twin pressures of financial reporting and regulatory control; this latter aspect means that procedures are quite different from one country to another, and generally regarded as unsatisfactory. The ASB has been contributing to an international project on insurance accounting since 1996 and continues to participate in what has now become an urgent priority for the IASB. In the meantime, the ASB is involved in considerable discussion with the Association of British Insurers regarding the current update to its Statement of Recommended Practice for accounting.

The Financial Reporting Review Panel– Enforcement of accounting standards

11. The Dearing Committee, in setting up the present regulatory regime for financial reporting, recognised the importance not only of having quality standards but also of applying them properly. It thus recommended the creation of a separate body – the Financial Reporting Review Panel – (the Panel) to oversee this latter area. It was set up as a second operational body under the FRC.

12. At the same time, the arrangement recognised that primary responsibility for high quality financial reporting must continue to rest with the company's board of directors. It recognised too that the auditor remains the first line of defence against the pressures of defective financial reporting.

13. The Panel was given authority by the Secretary of State to enquire into the annual accounts of public companies and large private companies where they do not appear to comply with the requirements of the Companies Act 1985, including applicable accounting standards. The Panel's power is confined to the statutory accounts. It cannot consider other financial material such as the auditor's report or chairman's statement; nor can it consider preliminary announcements, interim reports or financial material included in prospectuses.

14. It relies on matters being brought to its attention either directly by complainants or by press comment. However, the Panel is reconsidering the introduction an element of pro-activity in its procedures.

15. When there is clearly a case to answer, it is heard by a Group normally of five Panel members including the Chairman, who selects the Group, and the Deputy Chairman. If having questioned the accounts and heard the companies' explanations, the Panel Group is still not satisfied, it seeks to persuade the companies voluntarily to adopt a more appropriate accounting treatment. The directors may then voluntarily correct the accounts taking the remedial action agreed with the Panel. Should the Panel fail to effect a voluntary correction, it can exercise its powers to secure revision of the original accounts through a court order. The Panel maintains a legal cost fund of £2 million for this purpose.

16. So far, the Panel has succeeded in resolving all cases brought to its attention without having to apply for a court order. Since 1 January 1997 the Panel has required corrective action to be taken in twenty-eight cases. Its pronouncements on such cases provide a useful additional analysis of contentious issues. More important than the statistics however is the support the Panel provides to preparers of accounts and to auditors in reinforcing commitment to good financial reporting. The deterrent effect of the Panel should not be underestimated although there are no statistics to show the instances where its findings have discouraged an unhelpful accounting treatment.

17. A further strength of the Panel is the fact that its members are held in high regard and command a wide range of professional financial and business expertise.

18. The focus of the Panel is the quality of company accounts on the public record. However, it does liaise with other regulators – specifically with the professional bodies of auditors and directors involved in Panel cases- and also where other regulators may have an interest in the material drawn to its attention.

Mary Keegan
Chairman,
Accounting Standards Board

Ann Wilks
Secretary,
Financial Reporting Council and
Financial Reporting Review Panel

AUDITING STANDARDS IN THE UK: THE AUDITING PRACTICES BOARD (APB)

The role and composition of the APB

1. Following a number of well publicised UK corporate failures in the late 1980s, the Auditing Practices Board (APB) was established in 1991 by the Consultative Committee of Accountancy Bodies (CCAB). The APB's objectives are to establish high standards of auditing for the United Kingdom and the Republic of Ireland; to meet the developing needs of users of financial information; and to ensure public confidence in the auditing process. From the outset, the APB has been unique in terms of world auditing standard setters in that 50 per cent of its voting membership was made up of non-audit practitioners who represented the community of users and preparers of financial reports, academia and the public sector.

2. A new system of non-statutory regulation of the accountancy profession, approved by Government, was put in place in 2001. A key feature of the new arrangements is yet greater independence from the control or undue influence of the accountancy profession. The aim was to secure improved public confidence in the impartiality and effectiveness of the profession's systems of regulation and discipline. With its members appointed by the Accountancy Foundation and its operations monitored by the Review Board, the new APB started work in 2002. It is now established as a company owned by the Accountancy Foundation representing major users of audited financial statements (and not auditors). Under its constitution, the proportion of non-audit practitioners on the new APB has been increased from 50 to 60 per cent.

3. In addition to issuing Statements of Auditing Standards (SASs) and guidance for auditors, and consistent with its objectives, since 1991 the APB has been active in promoting public debate on the role of auditing, and in supporting corporate governance developments (including those relating to the work of the Cadbury, Hampel and Turnbull committees). Some of the key initiatives taken by the APB to stimulate public debate on the role of auditing are described in the following paragraphs.

"The Future Development of Auditing"

4. One of the APB's first major initiatives was to undertake a comprehensive review of the role of auditing. That led in November 1992 to the publication of a discussion paper entitled "The future development of auditing". The paper was based on research into the changing role of audit, the needs of preparers and users of accounts, the issues that needed to be addressed and the difficulties in doing so. The paper discussed the security of tenure and rotation of auditors, the provision of other services by auditors and the role of audit committees. It engendered a considerable amount of discussion both within and without the accountancy profession.

"The Audit Agenda" and "The Audit Agenda—Next Steps"

5. Building on responses to "The Future Development of auditing" and other research and thinking, in December 1994 the APB issued "The Audit Agenda". This outlined concrete proposals designed to establish a framework for the development of audit services. The results of this exercise—and the implications for the APB's future work—were reported in "The Audit Agenda-Next Steps" which set out those matters which the APB believed should be pursued, including auditor objectivity, expectations regarding the likelihood that fraud can be detected in the course of an audit and the contribution that the audit can make in a corporate governance context. By way of illustration, two new Statements of Auditing Standards resulted from this work. These

related to "Quality control for audit work" (SAS 240) and "Communication of audit matters to those charged with governance"(SAS 610).

"The Auditors Code"

6. The APB was conscious that in some countries, including the United States of America, attempts were being made to safeguard auditor independence and objectivity by establishing detailed prescriptive rules. However, detailed rules of this nature can give rise to serious problems of definition, are often incomplete and can prove to be inflexible and ineffective in difficult cases. On balance, the APB considered that a more fruitful approach would be to concentrate on the fundamental principles that should govern an auditor's behaviour. The APB set out these fundamental principles in "The auditors code", issued in 1996.

"Fraud and Audit: Choices for Society"

7. In January 1995, the APB issued the UK's first Statement of Auditing Standards to address the approach to be taken by auditors when encountering actual or possible fraud by management; "Fraud and error" (SAS 110). In the period from 1995 to 1998, and with the benefit of four years experience, the APB sought to assess the effectiveness of that Statement and also undertook some research work in conjunction with the Serious Fraud Office and the Criminal Prosecution Service. The APB's preliminary conclusions were published in November 1998 in its consultation paper "Fraud and audit: choices for Society".

8. This paper explained the difficulties the APB faces as it endeavours to respond to the expectations of investors and the public (who continue to expect auditors to detect fraud) and the demands of governments and regulators (who expect the accounting profession to increase its contribution to the prevention and detection of fraud). The consultation paper also set out various changes to the audit process and to the structure of corporate governance which might be considered.

9. The overwhelming response from users, preparers, regulators and auditors to the consultation paper was that the APB should not seek to extend the scope of the audit. To increase audit costs across the board in an attempt to detect a limited number of cases of management fraud was seen as creating an unacceptable regulatory burden.

"Aggressive Earnings Management"

10. The APB issued a consultation paper on "Aggressive earnings management" in June 2001 because it was concerned that, despite the progress made during the last decade in corporate governance, accounting standards and auditing standards, the quality and reliability of financial reporting may be being undermined by increasing commercial pressures on those preparing financial statements. It is, in part, a follow on from the paper "Fraud and audit: choices for society".

11. Earnings management is not a new phenomenon. Accounting is not a precise science and there is always a range of acceptability within which companies can present their results and financial positions. The aim of the consultation paper was to alert executive directors, non-executive directors, auditors, regulators and users of financial statements to the potential threat that increased commercial and economic pressure may cause aggressive earnings management. The APB also sought views on the steps that auditors and others should take to respond to the risks of aggressive earnings management.

12. Commentators observed that aggressive earnings management is not something that can be countered by auditors alone: good corporate governance and appropriate accounting standards are prerequisites. Thus, in addition to identifying the scope for additional guidance for auditors (which the APB will be addressing), commentators suggested actions that might be taken by others including the Department of Trade and Industry, the Financial Services Authority, the Accounting Standards Board and institutional investors.

Current Action by the APB

13 APB intends to continue the work already commenced on aggressive earnings management and, in 2002, undertake work in the following areas:

International activity

Aggressive earnings management is an international problem and solutions to it will also need to be international. APB has been actively encouraging international auditing standards setters and the International Auditing and Assurance Standards Board (IAASB) to address the issue. APB also believes measures to prevent aggressive earnings management should be high on the International Accounting Standards Board's agenda.

Auditing standards

APB will, in conjunction with IAASB, consider the adequacy of existing auditing standards and guidelines on:

- 'Fraud and error', on matters that should alert auditors to the risk of aggressive earnings management;
- 'Materiality and the audit', on the auditors' consideration of unadjusted misstatements and the qualitative aspects of materiality; and
- 'Audit of accounting estimates', to reflect FRS 18 and to address the relationship between statements made in the auditors' report and the disclosures made in the financial statements on the use of significant estimation techniques.

Professional scepticism

An attitude of professional scepticism is vital to enable auditors to identify and deal with circumstances that may be indicative of aggressive earnings management. Although professional scepticism can be reinforced by auditing standards, APB believes that attitudes are principally influenced by the cultures that exist within audit firms and by the training the firms provide their partners and staff. APB believes that the accountancy bodies should review how their education and training programmes provide the foundation for scepticism and that audit firms should consider how to strengthen working environments to ensure that audit teams apply an appropriate level of professional scepticism. APB will consider how best it can contribute to this process.

Guidance for directors

As noted in paragraph 3.12 above, the APB believes that it will be helpful for members of audit committees to be aware of the new requirements of SAS 610 (Revised) and will consider how best it can contribute in this regard. APB has been in discussion with a number of organisations with a view to developing guidance for directors on a joint basis.

APB
July 2002