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Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors

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Kathryn Cearns
Herbert Smith LLP

Eilís Ferran
University of Cambridge and ECGI

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Abstract

This paper examines the UK's system for public oversight of financial and corporate governance disclosures by issuers and of auditors, taking account of the framework of European law and institutional arrangements within which that system operates. The paper examines the role of the public bodies that are responsible for oversight and how they relate to the Financial Services Authority (FSA). By presenting a detailed picture of this part of the UK's supervisory infrastructure, the paper demonstrates that there is a more complex allocation of institutional power than the impression that may be created by the emphasis on the FSA as the UK's single financial regulator. The paper also considers strategies that the various bodies employ to promote compliance so as to explain why analysis based exclusively on formal enforcement data is liable to be misleadingly incomplete. By seeking to improve the quality of the basic data about the UK and drawing out features of the system that may not be easy to capture in objective measurements, the paper contributes to the task of addressing the crucial question: what substitutes for the very heavy reliance on public enforcement in the form of penalties and other punitive measures that is associated with the United States in other credible and effective systems of regulation and supervision?

Keywords: companies, capital markets, financial disclosures, audit, public oversight; enforcement

JEL Classifications: G18, G28, G38, K22

Kathryn Cearns*
Herbert Smith,
Exchange House,
Primrose Street
London EC2A 2HS
United Kingdom
e-mail: Kathryn.Cearns@herbertsmith.com

Eilís Ferran
University of Cambridge - Faculty of Law
10 West Road
Cambridge CB3 9DZ,
United Kingdom
phone: + 44 1223 338335
fax: + 44 1223 338340
e-mail: evf1000@cam.ac.uk

Part I: Introduction

Closer co-operation between regulators is widely seen to be crucial to the development of a system of international securities regulation that is better adapted to the nature of the modern global marketplace. As part of this agenda, national securities market supervisors are increasingly willing to consider relying on their foreign counterparts to perform some supervisory functions, an idea that is particularly developed in relation to oversight of the auditing profession[1] and is now under serious consideration in other areas too.[2] However,

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[1] PCAOB *Oversight of Non-U.S. Public Accounting Firms* (PCAOB Release No. 2003-020); Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits [2006] OJ L157/87, arts 46 – 47 ('Statutory Audit Directive').

[2] An approach, termed 'substituted compliance' has been suggested by SEC officials so as to permit foreign brokers direct access to US investors: Tafara, E and Peterson, RJ, 'A Blueprint for Cross-Border Access to US Investors: A New Institutional Framework' (2007) 48 *Harvard International Law Journal* 31. Comments on this proposal have included the suggestion that the SEC should also permit US exchanges to list foreign issuers that do not comply with the US disclosure or governance standards: Greene, EF, 'Beyond Borders: Time to Tear Down the Barriers to Global Investing' (2007) 48 *Harvard International Law Journal* 85. Jackson suggests that the logic of the approach suggested by Tafara and Peterson could be extended widely: Jackson, HE, 'A System of Selective Substitute Compliance' (2007) 48 *Harvard International Law Journal* 105.

these moves will attract considerable opposition unless they can be achieved without compromising the fundamental underlying regulatory goals embedded within a country's national system and without undermining the international competitiveness of its capital market.[3]

If the development of a more streamlined system of cross-border securities regulation, in which national regulators co-operate more closely with each other, is preconditioned on all of the co-operating regulators having virtually identical regulatory requirements and supervisory structures and behaving in more or less the same way in their approach to supervision and enforcement, the idea is stillborn. Even within the European Union, which can credibly claim to have the world's most sophisticated mutual recognition regime in securities regulation, that degree of uniformity is not present. On the other hand, too much diversity is a barrier to progress because it is only natural for the regulators of one country to be mistrustful of other systems that look very unlike their own.

Two strategies can help to move things forward. The first is to focus on reducing diversity and the second is to understand it better so that differences in approach that do

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[3] Coffee, JC, 'Law and the Market: The Impact of Enforcement' (March 7, 2007). Columbia Law and Economics Working Paper No. 304 Available at SSRN: http://ssrn.com/abstract=967482, Pt D notes the potential adverse implications for the competitiveness of the US capital markets that could result from a move towards substituted compliance.

not affect outcomes do not hold up meaningful progress. The two strategies need to run in tandem because the first, on its own, is likely to produce results at a much slower pace than the market needs and, in any case, universal uniformity is not desirable and diversity should be accommodated. The European experience can usefully inform the international debate on these strategies. The new institutional model in Europe is built on a network of national supervisors co-ordinated by the Committee of European Securuties Regulators (CESR). Various forces are promoting convergence in the legal nature and powers of the national supervisors and in how they conduct their operations. Yet, despite considerable streamlining and rationalisation influenced by both Brussels-led initiatives and by Member States learning from each other as they work more closely together, many differences still remain in the structure of supervisory authorities[4] and in the resources that their countries make available to them.[5] This lack of homogeneity in institutional arrangements reflects the fact that the oversight system is embedded within each country's economic, legal, and political infrastructure and is strongly influenced by local corporate ownership patterns and corporate governance norms. It is recognised that forcing all countries to adopt the same model is not appropriate because there is a balance

[4] For a wide ranging review of different models of supervision of financial markets generally both within the EU and internationally see Wymeersch, E, 'The Structure of Financial Supervision in Europe: About Single, Twin Peaks and Multiple Financial Supervisors' (2006). Available at SSRN: http://ssrn.com/abstract=946695.

[5] Jackson, HE and Roe, MJ, 'Public Enforcement of Securities Laws: Preliminary Evidence' (August 8, 2007). Available at SSRN: http://ssrn.com/abstract=1000086.

to be struck between common European benchmarks and diversity of national law, practice and custom.

How can individual countries go about the task of testing the robustness of each other's system of securities regulation and supervision with a view to establishing whether there is broad equivalence notwithstanding differences that will inevitably be present? Recent advances in scholarship suggest that there is much that can be achieved by using quantitative analysis in which features of different systems are objectively measured and compared.[6] However, it would be dangerous to draw firm conclusions from such work without asking some fundamental questions. First, has it focused on the most important elements of the systems under review? One of the leading papers in this line of scholarship is vulnerable to the criticism that it puts undue emphasis on laws on the books as opposed to how they actually operate in practice.[7] Secondly, is the data on which the measurements are based accurate and complete? Given the complexity of national supervisory systems this is a major concern. Jackson and Roe, who have sought to evaluate the value of public enforcement of securities law on the development of stock markets around the world by measuring the intensity of public enforcement of securities

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[6] In particular, Jackson and Roe, above, and earlier work by Jackson: Jackson, HE, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 *Yale Journal on Regulation* 253.

[7] La Porta, R, Lopez-de-Silanes, F and Shleifer, A, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1, criticised by Coffee, 'Law and the Market', note XXX above and Jackson and Roe, 'Public Enforcement', note XXX above on this ground.

regulation by reference to budgetary resources and staffing levels, acknowledge the need for more complete and better quality data.[8] Thirdly, are there differences in supervisory style and philosophy, in market structures or corporate ownership patterns that are not easily susceptible to objective measurements with the consequence that the quantitative analysis may generate an ambiguously incomplete set of results?

One area where the dangers of reading too much into the results of quantitative analysis are especially strong is with regard to cross country comparisons of formal enforcement outcomes – that is, regulatory actions brought, fines levied and conviction rates. Even allowing for some possible gaps in the data, it is incontestable that European countries come out badly in a comparison with the US from an enforcement outcomes perspective focused on formal sanctions.[9] Yet this gives a questionable impression of the effectiveness of public enforcement of securities regulation in Europe because it fails to capture a large number of relevant considerations, including differences in regulatory style. In the case of the UK, for example, the Financial Services Authority (FSA) is avowedly not an enforcement-led regulator and actions to impose penalties or other sanctions are only part of the FSA's overall risk-based supervisory and enforcement

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[8] Jackson and Roe, 'Public Enforcement', note XXX

[9] This is evident from an earlier paper by Jackson: Jackson, HE, Jackson, HE, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 *Yale Journal on Regulation* 253. Germany also fares badly on this measurement: ibid.

strategy [10] Its approach and temperament are quite different to those of the SEC. Moreover, as Coffee has noted, it is the United States that occupies the outlier position in that its public and private enforcement efforts dwarf those of other nations.[11]

This paper examines the UK's system for public oversight of financial and corporate governance disclosures by issuers and of auditors, taking account of the framework of European law and institutional arrangements within which that system operates. Although the FSA is known around the world as the UK's *single* regulator, it is not correct to regard it as having sole responsibility in this area because the Financial Reporting Council (FRC) also plays an important role. The FRC is the UK's regulator responsible for promoting confidence in corporate reporting and governance and the functions of its operating bodies cover everything from setting accounting and auditing standards through to disciplining issuers and auditors. The paper examines the role of the FRC and its operating bodies, and how they relate to the FSA, with a view to providing a more detailed and fuller picture of the UK's supervisory infrastructure than is sometimes presented. It considers strategies that key bodies within this system employ to promote

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[10] 'The FSA is not an enforcement led regulator, but aims to maintain clean markets and deter abuse through a combination of enforcement action and preventative measures' said Sally Dewer, Director of Markets Division, Speech 22 May 2007, text available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0522_sd.shtml (accessed January 2008). A formal statement of the FSA's approach to enforcement can be found in the FSA, *Enforcement Guide*, section 2.

[11] Coffee, 'Law and the Market', note XXX

compliance so as to demonstrate why analysis based exclusively on formal enforcement data is misleadingly incomplete. By seeking to improve the quality of the basic data about the UK and drawing out features of the system that may not be easy to capture in objective measurements, the paper contributes to the task of addressing the crucial question: what substitutes for very heavy reliance on public enforcement in the form of penalties and other punitive measures in other credible and effective systems of regulation and supervision?

Explaining the scope of the paper

The paper is selective with regard to the aspect of securities market activity on which it concentrates (financial and corporate governance disclosures by issuers and regulation of auditors), its country focus (UK) and its emphasis on public oversight (as opposed to other mechanisms that play a role in the delivery of accurate information to the market). This selectivity can be justified.

As was said by Henry Paulson, the US Treasury Secretary in a recent speech the trust that is essential for the operation of capital markets, 'is based on financial information presumed to be accurate and to reflect economic reality'.[12] Maintaining public confidence in the credibility of the financial statements of publicly traded companies is a crucial element of an effective system of securities regulation.

[12] http://www.treas.gov/press/releases/hp407.htm (accessed January 2008).

With several high-profile reports identifying links between the recent successes of London's capital markets and the UK's overall approach to securities regulation and supervision, characterised by an emphasis on principles and a measured approach to the imposition of penalties or other formal sanctions, the UK merits attention as providing a system that is credible whilst being very different to that in the USA, where the system is perceived to be more prescriptive and more punitive, and, in the view of some, achieves a less satisfactory balance between investor protection and amenability to market participants. [13] Even though the UK's reputation for sound regulation was dented to some extent by the near failure of the Northern Rock Bank in late 2007 and its eventual nationalisation in February 2008, it is not clear that the root of the failure lay in the principles-based, risk-based regulatory approach or was more narrowly confined to the workings of the tripartite arrangements between the government, Bank of England and the FSA for the oversight of banking crises; furthermore, even after Northern Rock, some reform-minded regulators in other countries continue to see merit in a more principles-based approach.[14] Why, though, a country focus rather than an examination at the

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[13] Including McKinsey & Co, *Sustaining New York's and the US' Global Financial Services Leadership* (report commissioned by Bloomberg, MR and Schumer, CE, January 2007); *Interim Report of the Committee on Capital Markets Regulation* (November 2006) (Paulson Committee).

[14] In particular the Japanese FSA that, in late 2007, came out in favour of a shift towards a more UK-style principles-based regulatory model, to strengthen the country's competitiveness as a financial centre: Nakamoto, M, 'Tokyo Eyes Move Towards UK-style Financial Regulation' Financial Times, Oct 25, 2007. See further Financial Services

European level? A country focus is appropriate because despite considerable EU intervention, responsibility for oversight and enforcement remains with national regulatory authorities. It is thus mainly at this level that formal EC law becomes 'law in action'. Why the UK rather than any other Member State? In part the choice is pragmatic, based on the authors' area of knowledge, but it can also be justified by reference to the continuing influence that the UK FSA has within the European network.[15] Since 'bottom-up' forces are expected to be strong drivers of EC securities regulation and supervisory structures in the coming years, an examination of the UK's approach to public enforcement may give some indications of supervisory practices and philosophies that carry particular weight in Europe.

As for the focus on public oversight, it is now generally recognised that numerous mechanisms are involved in the delivery of accurate information by issuers to the market and no single element stands on its own.[16] The wide range of supervisory, professional,

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Authority, *Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets* (December 2007), Pt III, provisional and unofficial translation at http://www.fsa.go.jp/en/news/2007/20071221/01.pdf

[15] Boury, P-M, 'Does the European Union Need a Securities and Exchange Commission?' (2006) 1 *Capital Markets Law Journal* 184, 194.

[16] Including internal corporate governance structures, systems and controls (such as the role of independent directors and audit committees), the duties imposed on directors by company law, shareholder rights and remedies within company law, auditing standards, auditor training and oversight, market sanctions resulting from the reputational damage

market, institutional and other complementary forces that promote compliance creates a dilemma for a researcher: should work that seeks to deepen understanding of compliance-promoting strategies trade detail for comprehensiveness and risk a charge of superficiality, or should it drill down more deeply into selected areas and be vulnerable to the criticism that it is incomplete? In this paper we have opted for the second approach. An obvious gap is that we say relatively little about role played by institutional investors, as manifested in areas such as the operation of pre-emption rights and in takeovers where the City Code still retains much of its 'market' orientation notwithstanding that it has now been put on a statutory footing (although we do comment on the inter-relationship between market and public oversight in the context of the Combined Code on Corporate Governance). This 'gap' should not be interpreted as suggesting that we do not recognise the considerable importance in the UK of private governance supported by transparency, and strong shareholder power. Yet it is worthwhile to single out public oversight because of its likely centrality in any determination by the regulatory authority of one country as to the equivalence of the supervisory regime in other countries.

Our survey includes the public oversight of audit since that is a vital component of the corporate reporting regime. Until recently, auditors in the UK were to a great extent self-regulated (although within a statutory framework), which could be seen as a barrier to efforts to deepen international co-operation between regulators. The UK has adjusted this model by moving public interest regulation and inspection of auditors, as well as setting of auditing standard and independence standards for auditors, into an independent

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done by being associated with the publication of inaccurate information, and private securities litigation.

regulatory regime and leaving only limited standard setting and ethical rule setting with the accountancy profession. The question arises as to whether the cost of removing such a barrier will actually be beneficial in practice in terms of maintaining the acknowledged strength of the UK auditing profession.

The paper proceeds as follows. Part II outlines changes in EC law relating to financial disclosures and accompanying developments at the EU level in the institutional arrangements for oversight and enforcement. Part III examines the UK's system for public oversight of financial disclosures, with a particular emphasis on the role of the Financial Reporting Review Panel, an operational body of the FRC, and how it interacts with the FSA. A clear preference for non-enforcement led, compliance-promoting strategies emerges. Part IV addresses the UK's institutional framework for the public oversight of audit and the role played by various bodies within the FRC. These bodies have been functioning with their current powers and responsibilities for too short a time for any firm trends to have become established. Part V considers and defends the limited role played by public oversight (compared to market mechanisms) in the area of corporate governance. Part VI concludes.

Part II:EU Developments Aimed at Promoting Convergence in Supervision and Enforcement of Financial Disclosure Obligations

Recent EC legislation has sought to upgrade the enforcement regime relating to financial disclosures through clearer statements of where internal corporate responsibilities and liabilities are located and what penalties apply, and through more systematic organisation of the oversight and enforcement activities of external national agencies so as to achieve greater consistency and to promote a common approach. The principles-based character of International Financial Reporting Standards (IFRS) leaves room for the exercise of professional judgment over a wide variety of accounting issues, a feature that makes it especially important for enforcers to operate on a consistent basis and avoid conflicting decisions. The EU Financial Services Action Plan (FSAP) was the primary impetus for this area of regulatory activity but the design of the legislative programme was also shaped by the aftershocks of the corporate scandals that became public in the early 2000s. Key elements of the framework that is now in place include the following.

The existing Directives providing for mandatory publication of audited annual accounts were amended in 2006 to introduce rules relating to the collective responsibility of the board for the annual reports and corporate governance statement, underpinned by personal liability at least towards the company.[17] This largely confirmed what already existed in Member States' national laws but it was thought to improve the position by

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[17] Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (Text with EEA relevance) [2006] OJ L 224/1, arts 1 - 2.

enhancing clarity.[18] The European approach is to regard collective responsibility as providing the best incentives for ensuring that directors exercise proper controls over financial statements. Also introduced into EC law by the same set of amendments was a requirement for Member States to lay down effective, proportionate and dissuasive rules on penalties for infringements.[19] For companies admitted to trading on a regulated market, a further change was the introduction of a mandatory corporate governance comply or explain statement in the annual report.[20]

The Transparency Obligations Directive (2004) imposes an obligation on Member States to ensure that responsibility and liability for the information in annual accounts, half year reports and interim financial statements published by companies admitted to trading on regulated markets lies with company boards.[21] This Directive also requires Member States to make provision in conformity with their national law for the taking of

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[18] As suggested by the UK Department of Trade (now Department for Business, Enterprise and Regulatory Reform), *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A Consultative Document* (March 2005) para 3.3.2.

[19] Directive 2006/46/EC, arts 1 – 2.

[20] Ibid.

[21] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, [2004] OJ L 390/38, art 7.

administrative measures and the imposition of civil and/or administrative penalties for non-compliance with obligations adopted in accordance with the Directive.[22]

The Transparency Obligations Directive further requires Member States to designate their securities regulator as the central competent administrative authority responsible for carrying out the obligations provided for in the Directive but makes provision for the delegation of tasks relating to the examination of financial statements and the taking of appropriate measures in case of discovered infringements.[23] This means that the national agencies with direct responsibility for oversight and enforcement in respect of financial statements may or may not be members of CESR, depending on the local distribution of responsibilities in each Member State. Where there is delegation, the securities regulator and the agency responsible for the supervision of financial statements will have overlapping powers in cases where the publication of inaccurate financial statements is both an infringement of the accounting rules and a contravention of other securities laws, such as where it amounts to market abuse.

[22] Article 28.

[23] Article 24. As of November 2007, a competent authority had been so designated in 24 out of 27 Member States: CESR, *CESR's Review of the Implementation and Enforcement of IFRS in the EU* (Ref 07-352, November 2007).

In most European countries, the supervisor in respect of financial statements is the securities regulator (and thus CESR member).[24] Exceptions are the Czech Republic Denmark, Ireland, Germany, Iceland and the UK, where there is another designated body. In these countries, the CESR members have different degrees of involvement in the enforcement of the accounts. Overall, this represents a considerable and rapid rationalisation of institutional arrangements: a 2001 a study of European oversight and enforcement mechanisms in respect of the accounts of listed companies found four different models in operation and also discovered that eight Member States had no specific institutional enforcement oversight system to enforce financial reporting standards.[25]

CESR has developed standards that are intended to promote a common pan-European approach to enforcement in respect of financial statements.[26] CESR-Fin, a permanent operational group within CESR comprising experts in the field of accounting and auditing, has the role of coordinating the work of CESR members in the area of financial

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[24] See list of monitoring bodies at http://www.iaasa.eu/useful_links/index.htm#Financial_Reporting_Enforcement_Bodies (accessed January 2008).

[25] Fédération des Experts Comptables Européens, *Enforcement Mechanisms In Europe: A Preliminary Investigation of Oversight Systems* (2001) 10 – 12.

[26] Standard No 1: Financial Information (CESR/03-073, March 2003); Standard No 2 on Financial Information: Coordination of Enforcement Activities (CESR/03-317c, April 2004).

reporting standards.[27] CESR has established a forum, European Enforcers Coordination Sessions (EECS), which meets monthly, for the national agencies responsible for supervision of financial statements (including those that are not CESR members) to discuss issues, share experience and provide advice.[28] CESR has also set up a database of enforcement decisions, which is intended to promote consistency by allowing enforcers to take account of decisions taken by other enforcers. The full EECS database is confidential but extracts from it have been published.[29]

CESR-Fin works with the staff of the SEC to endeavour to avoid conflicting regulatory decisions on the application of IFRS and US GAAP.[30] As of November 2007, three meetings between CESR and the SEC had taken place, mainly devoted to discussing how information could be exchanged between the SEC and individual CESR members on specific cases and between the SEC and CESR-Fin on broader accounting issues arising from enforcement and policy developments.[31]

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[27] CESR Annual Report 2005, p 50. See further *Terms of Reference on the Organisation and Functioning of CESR-Fin* (CESR/06-117 B, May 2006).

[28] Half-yearly report on the activities of the Committee of European Securities Regulators to the European Commission the European Parliament the European Securities Committee (CESR/06-421, December 2006), 14.

[29] CESR 07-120, April 2007; and CESR 07-630, December 2007.

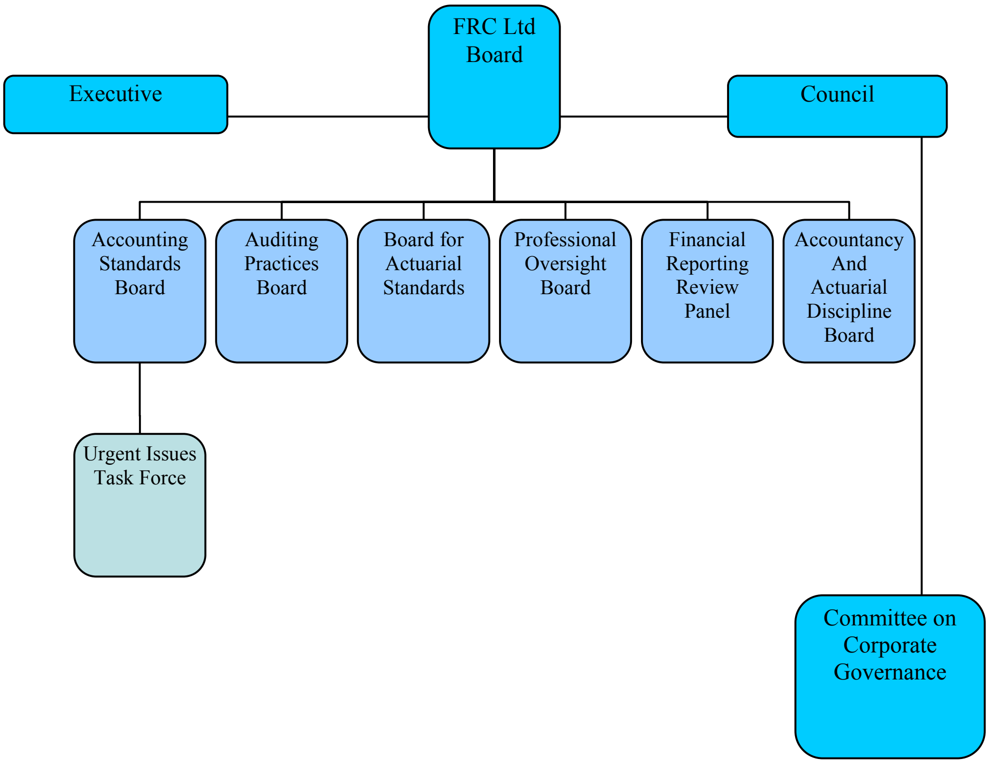
[30] Half-yearly report (CESR/06-421, December 2006), 15.

[31] CESR, *CESR's Review of the Implementation and Enforcement of IFRS in the EU* (Ref 07-352, November 2007)

Part III: Supervision and Enforcement of Financial Disclosure Obligations in the UK

The UK is one of the countries where the securities regulator, the FSA, does not have direct supervisory responsibility in respect of financial statements. Instead the Financial Reporting Council performs this role. The FRC was established in 1990 in the wake of various corporate failures and financial scandals involving poor financial reporting.[32] The role and responsibilities of the FRC have grown over the years in response to various developments including the UK's post-Enron review of the oversight regime. The current structure of the FRC is as follows.

[32] Dearing Committee, *The Making of Accounting Standards* (1998).


FRC Ltd Board
Executive
Council
Accounting Standards Board
Auditing Practices Board
Board for Actuarial Standards
Professional Oversight Board
Financial Reporting Review Panel
Accountancy And Actuarial Discipline Board
Urgent Issues Task Force
Committee on Corporate Governance

The FRC's core operating costs in relation to accounting, auditing and corporate governance are funded in equal proportions by the accountancy profession, the business community and the government under a 'tri-partite funding arrangement'.[33] Certain other costs (eg of audit inspection, and case costs relating to the investigation and discipline of accountants) are funded entirely by the accountancy profession.[34]

It is worth noting that the FRC is comparatively a very low cost regulator. The FRC's total budget for itself and its operating bodies dealing with accounting, auditing and corporate governance for 2007/8 was £16.5m.[35] The FSA's total budget for 2007/8 was £301.7m.[36] Although these figures are, of course, not directly comparable, the difference in order of magnitude is striking given the vital role that financial reporting and corporate governance play in maintaining confidence in the markets. Given that the bulk of regulators' costs tend to relate to staff and board members, the FRC's low cost base is partly a reflection of the its approach to board membership, where the majority of members are unpaid volunteers who remain in practice in their specialist field. Permanent staff also work alongside secondees from audit firms and companies. This involvement of

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[33] FRC, *Levy Proposals 2007/08*, (March 2007), 5. See also FRC, *2007/08 Levy* (May 2007).

[34] FRC, *Levy Proposals 2007/08,* 5.

[35] FRC, *Draft Plan and Budget 2008/9* (January 2008), 23 (noting also a proposed budget of £18.3m for 2008/9).

[36] FSA, *Business Plan for 2007/8*, 37.

current practitioners, with suitable safeguards imposed where necessary, is seen by many as a strength of the organisation.

Role of the Financial Reporting Review Panel

In relation to supervision and enforcement in respect of the content of financial statements, it is the role of the Financial Reporting Review Panel (FRRP) and its relationship with the FSA that call for particular comment.

The FRRP has statutory authority to review the accounts and reports of all UK companies that prepare accounts under the Companies Act 2006 (under UK GAAP or IFRS) or through the FSA's rules, although in practice it normally exercises this authority only in relation to public and large private companies.[37] This includes UK-incorporated companies listed on the Main Market of the London Stock Exchange and also those that are admitted to trading on AIM or on either of the Plus Markets.[38] The FRRP also has

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[37] FRRP, *Operating Procedures*, para 11. Larger private companies are private companies not qualifying as small or medium sized and private companies within a group which does not qualify as a small or medium-sized group: ibid. Statutory backing for this aspect of the FRRP role is provided by the Companies Act 2006, s 457 and the Companies (Defective Accounts) (Authorised Person) Order 2005 (SI 2005/699).

[38] The PLUS Group provides two markets, PLUS-Quoted, which, broadly speaking is similar to AIM in being aimed at less mature companies, and the recently established

authority to review the periodic accounts and reports of foreign companies that have a primary listing in the UK.[39] 'Listing' in this context means admitted by the FSA to the Official List (which is an EC-law concept) and a 'primary' listing denotes a listing to which regulatory requirements over and above those mandated by EC law apply. This category covers issuers with securities admitted with a primary listing to the Main Market of the LSE or the PLUS-Listed Market, but not AIM or PLUS-quoted issuers. The FSA may also send to the FRRP for review the periodic financial statements of foreign issuers with a secondary listing (i.e. an official listing to which only EC requirements apply and super-equivalent provisions do not) on the LSE Main Market or the PLUS-Listed Market that report in accordance with IFRS, and also financial information in prospectuses.[40]

The FRRP has twenty five members, who tend to be qualified accountants or lawyers with substantial senior experience in the professions or in industry. In 2006/7 the core

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PLUS-Listed Market, which is an EC regulated market for securities admitted to the Official List.

[39] Under the Companies (Audit, Investigations and Community Enterprise) Act 2004, the Supervision of Accounts and Reports (Prescribed Body) Order 2005 (SI 2005/715) and the Memorandum of Understanding between The Financial Reporting Review Panel and The Financial Services Authority (http://www.frc.org.uk/images/uploaded/documents/300305%20-%20FSA-FRRP%20Memorandum%20of%20Understanding%20_Final_.pdf (accessed January 2008).

[40] FRRP/FSA, MoU, para 6.

operating costs of the FRRP were £1.4 million.[41] The FRRP had an average staff of ten persons during the year.[42] Apart from the Chairman and Deputy Chairmen, members of the FRRP are unpaid.

The FRRP aims to reach agreement with the directors of a company under review by persuasion but if its concerns are not resolved via the voluntary process, at least in respect of the annual accounts or reports companies produce under the Companies Act 2006, it can apply to court for a declaration that a set of financial statements or report is defective and for an order requiring the directors of the company to prepare revised accounts or a revised report.[43] In other cases the FRRP may inform the FSA of its findings.[44]

FRRP reviews are conducted on a confidential basis. If the company under review produces satisfactory explanations in response to the issues raised or only minor issues are identified that can be rectified by a corrective adjustment in the next period's accounts, nothing is ever made public.[45] It is only where significant remedial action is required that a public announcement is made by means of a press notice.[46] The FRRP

[41] FRC, *Annual Report 2006/7*, 23.

[42] Ibid.

[43] Companies Act 2006, s 456, re-enacting Companies Act 1985, s 245B.

[44] Companies (Audit, Investigations and Community Enterprise) Act 2004, s 14.

[45] Ibid, para 19.

[46] Ibid. This contrasts with the approach of the SEC, which publishes all comment letters on issuers' accounts.

does not give guidance or pre-clearance to companies, which contrasts with the approach of the SEC's Office of the Chief Accountant.[47] The FRRP's refusal to give guidance or pre-clearance may be resource-driven, but the Panel may also be reluctant to expand its remit in this way because of the associated problems that might arise, including second-guessing directors' decisions in relation to applying principles-based standards to company-specific situations, usurping the role of auditors as the primary check on the financial statements, and encroaching on the accounting standard setter's territory by narrowing or redefining areas of generally accepted accounting practice.

In 2006/7 the FRRP carried out 311 reviews, and issued four company specific press notices.[48] Of the 311, 266 were selected by the Panel of its own initiative and the remaining 45 came to its attention through complaints, referrals from other regulators or in connection with matters raised in the financial press. It wrote to 135 issuers requesting further information about areas of possible non-compliance and, of these, 94 voluntarily undertook to provide corrected or improved treatments or disclosures in their next accounts. In 2006 it also published two general reports giving an overview of its findings from reviews of IFRS implementation in interim and annual accounts.[49] The statistics in

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[47] See http://www.sec.gov/info/accountants/ocasubguidance.htm for the approach to guidance given by the OCA to issuers.

[48]FRRP, *Activity Report 2006/7* (FRRP PN 104).

[49] Financial Reporting Review Panel, *Preliminary Report: IFRS Implementation* (December 2006); Financial Reporting Review Panel, Review *of 2005 Interim Accounts Prepared Under IFRS* (February 2006).

the equivalent reports for the previous two years were not dissimilar.[50] Before 2004 the FRRP did not operate on a proactive basis and relied on complaints being filed with it.[51] The shift away from a purely reactive stance came after a government review of accounting that was part of the UK's response to the problems revealed by the Enron collapse.[52]

Whilst the FRRP has certainly conducted more reviews since it became pro-active,[53] the number of reviews undertaken by the FRRP remains small compared to the number of companies that fall within its remit: UK-incorporated companies listed on the Main

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[50] *Activity Report 2005/6* FRRP PN 97 (October 2006)' *Activity Report 2004/5* FRRP PN 88 (August 2005).

[51] From the inception of the FRRP in 1991 to June 2000, only 54 press notices were issued: Fearnely, S, Hunes, T, McBride, K and Brandt, R, 'The Impact of the Financial Reporting Review Panel on Aspects of the Independence of Auditors and Their Attitudes to Compliance in the UK' (2002) 34 British Accounting Review 109, 111. By 2002 the number of press releases issued had risen to over 70: Co-ordinating Group on Audit and Accounting Issues, *Interim Report* (July 2002), para 6.7.

[52] Davies, P, 'Post-Enron Developments in the United Kingdom' in Ferrarini, G, Hopt, KJ, Winter, J and Wymeersch, E, *Reforming Company and Takeover Law in Europe* (OUP, 2004) 185.

[53] The Co-ordinating Group on Audit and Accounting Issues, *Interim Report* (July 2002), para 6.7 reported that up to that date, the total number of reviews (since 1991) was over 350.

Market of the London Stock Exchange alone number more than 1,000 and the FRRP's jurisdiction extends considerably beyond this category.[54] Comparatively, too, its efforts can appear modest: for example, in 2006 the SEC staff reviewed the annual reports of more than 100 foreign private issuers containing financial statements prepared for the first time on the basis of IFRS, even though the number of foreign private issuers that filed annual reports on Form 20-F that contained IFRS financial statements during 2006 was less than 200.[55] However, the comparison with the German Financial Review Enforcement Panel is less harsh: in 2006 that agency commenced 158 and completed 109 examinations out of a pool of approximately 1,200 listed companies that fell within its remit.[56] Selective, risk-based review and random sampling is also the approach in

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[54] According to London Stock Exchange monthly statistics (see www.londonstockexchange.com) there were 1,147 fully listed UK issuers as of July 2007. There were 11,500 UK-incorporated public companies on the register at 31 March 2006: DTI, *Companies in 2005 -2006: Report for the Year Ended 31 March 2006.*

[55] SEC, *Soliciting Public Comment on Eliminating Reconciliation Requirement for IFRS Financial Statements*, http://www.sec.gov/rules/proposed/2007/33-8818.pdf (accessed Janaury 2008) and *Staff Comments on Annual Reports Containing Financial Statements Prepared for the First Time on the Basis of International Financial Reporting Standards* http://www.sec.gov/divisions/corpfin/ifrs_reviews.htm (accessed January 2008).

[56] DPR/FREP*Annual Activity Report For the Period from January 1 through December 31, 2006* http://www.frep.info/docs/jahresberichte/2006_tb_pruefstelle_eng.pdf (accessed January 2008).

Denmark, where the activities of the review body, the Danish Securities Council, annually cover up to 20 per cent of listed or traded undertakings.[57]

The FRRP states that its selection of companies for review is based on its assessment of the risk of non-compliance and the risk of significant consequences if there is non-compliance.[58] A noteworthy feature of the FRRP's activities is that thus far it has never made use of its power to apply for a court order. The FRRP presents this in a positive light – 'To date the Panel has succeeded in resolving all cases brought to its attention without having to apply for a court order'[59] – and it is in accordance with the first principle of its self-defined operating procedures, which is that as far as possible the Panel seeks to operate by agreement with the entities whose reports it reviews. As Kershaw has said, the FRRP's self-understanding of its role is that it works with business to improve the standards of corporate reporting rather than raising standards through the deterrent effect of catching wrongdoers.[60] However, this feature is obviously capable of being interpreted less benignly as an indication of a lax and ineffective system of

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[57] For competencies of the Danish Securities Council, see http://www.fondsraadet.dk/sw19086.asp (accessed January 2008). In 2006 the Danish Securities Council in 2006 checked a total of 39 annual and interim reports: *Account of the Danish Securities Council's enforcement activities 2006*, http://www.fondsraadet.dk/sw27906.asp (accessed January 2008).

[58] 'How the FRRP Works', http://www.frc.org.uk/frrp/how/ (accessed January 2008).

[59] 'About the Panel', http://www.frc.org.uk/frrp/about/

[60] Kershaw, D, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33 Journal of Law and Society 388, 412.

enforcement, especially when taken together with the relatively small number of reviews undertaken overall.

Notwithstanding the fairly modest number of reviews undertaken, the low number of cases resulting in the publication of press notices[61] and the lack of any court enforcement activity, there is a general perception within the UK that the FRRP works well. For example in one of the plethora of official reports commissioned by the UK government in the wake of Enron, it was described as a 'well-respected' enforcement regime and the report noted that the European Commission had cited the FRRP as a good model of an independent enforcement agency'.[62] The recommendation in that report for a shift towards pro-activity indicated that its authors, a group that included government Ministers, civil servants and senior members of the accountancy profession, recognised that there was some room for improvement but had confidence in the ability of the FRRP to deliver it. However, the group's vote of confidence in the FRRP was qualified

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[61] Between 1993-1997 the average was seven per year:Brown, PR and Tarca, A, 'Achieving High Quality, Comparable Financial Reporting: A Comparison of Independent Enforcement Bodies in Australia and the United Kingdom' (March 2005). Available at SSRN: http://ssrn.com/abstract=691702. However, the number has declined since then: 3 in each of 2005/6 and 2006/7.

[62] Co-ordinating Group on Audit and Accounting Issues, *Interim Report* (July 2002), para 6.7.

somewhat by its later report that included a call for an enforcement regime that built on the past success of the Panel but incorporated a role for the FSA.[63]

There is some empirical evidence to support the view that the FRRP activities have had a positive impact on compliance. One study, which drew primarily on qualitative interview research with company directors and auditors who had had direct dealings with the FRRP and also used publicly available evidence of the FRRP's impact on audit firms, found that the FRRP had motivated auditors to improve accounting compliance by increasing the possibility of errors being exposed, to have enhanced the independence of auditors by changing the balance of costs and benefits for auditors of permitting non-compliance, and to have provided auditors with an additional negotiating tool in dealing with directors.[64]

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[63] Co-ordinating Group on Audit and Accounting Issues, *Final Report* (January 2003), paras 4.22 – 4.24.

[64] Fearnley, S, Hines, T, McBride, K and Brandt, R, 'The Impact of the Financial Reporting Review Panel on Aspects of the Independence of Auditors and Their Attitudes to Compliance in the UK' (2002) 34 British Accounting Review 109. In some cases disciplinary action against auditors has followed from the FRRP alerting the auditors' regulatory body to defective accounts: Fearnley, S and Hines, T, 'The Regulatory Framework for Financial Reporting and Auditing in the United Kingdom: The Present Position and Impending Changes' (2003) 38 International Journal of Accounting 215, 220; Fearnley, S, Hines, A, McBride, K and Brandt, R. 'Problems and Politics of Regulatory Fragmentation: the Case of the Financial Reporting Review Panel and the Institute of Chartered Accountants in England and Wales' (2000) 8(1) Journal of Financial Regulation and Compliance 16.

In another paper drawing on this research, the authors concluded that the evidence suggested that the FRRP was an effective regulator, albeit one that engaged in some 'myth building' about its achievements designed to bolster its credibility.[65]

In a study by the European Federation of Accountants, the strength of the FRRP was thought to lie in the mechanism for public 'naming and shaming' by means of press notices.[66] That the threat of adverse publicity should have a powerful effect is consistent with empirical work identifying a significant reputational penalty, in the form of loss in the present value of future cash flows due to lower sales and higher contracting and financing costs, that the market imposes on firms involved in issuing financial

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[65] Hines, T, McBride, K, Fearnley, S and Brandt, R, 'We're Off to See the Wizard: An Evaluation of Directors' and Auditors' Experiences with the Financial Reporting Review Panel' (2001) 14 Accounting, Auditing and Accountability Journal 53. See also Fearnley, S, Hines, T, McBride, K and Brandt, R, *'A Peculiarly British Institution: An Analysis of the Contribution made by the Financial Reporting Review Panel to Accounting Compliance in the UK,* (Centre for Business Performance, Institute of Chartered Accountants in England and Wales, 2000) reporting concern that the FRRP was too focused on relatively minor issues of non-compliance and was missing issues of substance.

[66] Fédération des Experts Comptables Européens, *Enforcement Mechanisms In Europe: A Preliminary Investigation of Oversight Systems* (2001) 11.

misstatements.[67] Another international study identified the threat of potential court action by FRRP as a 'big stick' that it could wave against recalcitrant reporters.[68] A particular feature of the court procedure that is likely to focus the minds of directors is that if the court finds that the accounts or report were defective, it can order that all or part of the costs of the application and any reasonable expenses incurred by the company in connection with the preparation of revised accounts are to be borne personally by the directors who approved them.[69] Every person who is a director at the time approval was given is deemed to be a party to it unless he or she can show that they took all reasonable steps to prevent that approval.[70]

Another indicator of the success of the FRRP's largely consensual model is that it appears to have been copied to some extent in other European countries. In 2004 Germany established its own Financial Reporting Enforcement Panel (FREP) comprised

[67] Karpoff, JM, Lee, D and Martin, GS, 'The Cost to Firms of Cooking the Books' Journal of Financial and Quantitative Analysis, Forthcoming Available at SSRN: http://ssrn.com/abstract=652121.

[68] Brown, PR and Tarca, A, 'Achieving High Quality, Comparable Financial Reporting: A Comparison of Independent Enforcement Bodies in Australia and the United Kingdom' (March 2005). Available at SSRN: http://ssrn.com/abstract=691702.

[69] Companies Act 2006, s 456(5).

[70] Companies Act 2006, s 456(6).

of persons drawn from the professions and from industry.[71] The German Panel has even less firepower than its British counterpart as it can only examine financial statements of companies that are willing to cooperate and does not have any power to impose sanctions, although it can notify the authority that is responsible for the oversight of auditors of possible infringements of professional duties.[72] If, through an FREP examination, it is determined that the financial statements are erroneous and the company agrees with that assessment, BaFin, the German financial regulator, is informed and orders the publication of the error unless no public interest for such a publication exists or, in rare cases, overwhelming company interests conflict with publication.[73] If consensus cannot be reached, responsibility for taking further action passes to BaFin. The FREP has reported that its existence and the examinations it has conducted have had a preventative impact as they have led management, audit committees of supervisory

[71] The enforcement regime of which the Panel is a part was established in December 2004: DPR/FREP*Annual Activity Report For the Period from January 1 through December 31, 2006*, p 16. See http://www.frep.info/docs/jahresberichte/2006_tb_pruefstelle_eng.pdf
The Panel is formally recognised under the German Commercial Code, s 342b, http://www.frep.info/docs/section342b.pdf

[72] DPR/FREP*Annual Activity Report For the Period from January 1 through December 31, 2006* http://www.frep.info/docs/jahresberichte/2006_tb_pruefstelle_eng.pdf

[73] Ibid.

boards and auditors to discuss accounting questions and accounting solutions more critically and intensely.[74]

In Ireland, legislation has been passed to allow the Irish Auditing and Accounting Supervisory Authority to review accounts and to apply to court for declarations of non-compliance and for costs orders against directors personally, which is very similar to the statutory framework within which the FRRP operates in the UK.[75] Ireland does not have a distinct panel as such but, in functional terms, the way in which the IAASA intends to discharge its functions relating to the monitoring of financial statements through its Financial Reporting Supervision Unit appears to be broadly comparable to the British position.[76] The Chief Executive of the IAASA has been quoted as saying that: 'The FRRP's approach of seeking to resolve issues by consensus rather than seeking recourse to enforcement in every instance is one that appeals to us'[77] and it has been reported that

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[74] Ibid.

[75] Companies (Auditing and Accounting) Act 2003, s 26.

[76] IAASA, *Annual Report 2006*, ch 2 provides an account of the arrangements for monitoring of financial statements.

[77] Downes, D, 'IAASA's Watchwords Include Consultation And Co-operation - A Conversation With Ian Drennan' *Accountancy Ireland* Volume 38 (2), at http://www.accountancyireland.ie/dsp_articles.cfm/goto/1222/page/IAASAs_watchwords_incluse_consultation_and_co-oporation_-_a_conversation_with_Ian_Drennan.htm (accessed January 2008).

Irish representatives have met with FRRP staff on several occasions with a view to better understanding their philosophy and methodologies.[78]

In assessing the FRRP's overall effectiveness, it is important to bear in mind that it can always refer its findings to other bodies, including auditors' professional bodies and, in particular the FSA. Being able (or required) to divert the more adverserial stage of enforcement to another body fits comfortably with the self-understanding of a regulator whose preferred modus operandi is consensus based. It also makes sense given the FRRP's limited financial and staff resources. This then prompts questions about the role of the FSA, how the FRRP and the FSA operate in situations where they have overlapping powers and, in particular, whether the FSA supplies the enforcement firepower though its ability to impose financial penalties and other sanctions.

Role of the FSA in relation to issuer disclosures

The FSA has various powers of oversight and enforcement in relation to financial reporting.

The FSA's *Disclosure Rules and Transparency Rules* (DTRs) implement the provisions of the Transparency Obligations Directive relating to publication of annual and half-yearly financial statements and interim management statements.[79] They also implement a

[78] Ibid.

[79] Transparency Obligations Directive, arts 4 – 6.

provision in the Market Abuse Directive that requires ad hoc disclosure of inside information as soon as possible.[80] The DTRs apply to issuers admitted to trading on a regulated market in the UK (this does not include companies admitted to trading on AIM or PLUS-Quoted[81]). The FSA has power to censure publicly an issuer for failure to comply with transparency obligations.[82] It may also suspend or prohibit trading in the issuer's securities.[83] Sanctions of public censure or penalties may also be imposed on directors.[84] These powers are exercisable directly in relation to issuers for which the UK is the EU 'home State'.[85] Where the EU home State is not the UK, primary enforcement responsibility lies with the Member State that is the home State but the FSA can act where the home State fails to act or its response is inadequate.[86] This allocation of enforcement power is part of the European framework, which seeks to give the home Member State regulator primary supervisory responsibility.

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[80] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [2003] OJ L96/16, art 6.

[81] For AIM and PLUS-Quoted issuers the burden of policing the accuracy of disclosures mainly lies with the: market operators themselves: Davies, P, *Davies Review of Issuer Liability: Final Report* (June 2007) para 56.

[82] Financial Services and Markets Act 2000, s 89K and s 91.

[83] Financial Services and Markets Act 2000, s 89L.

[84] Financial Services and Markets Act, s 91.

[85] i.e, issuers with a registered office in the UK or third country issuers that have elected for the UK as their EU home State: Transparency Obligations Directive, art 2.1(i).

[86] Financial Services and Markets Act 2000, s 100A.

The publication of defective accounts is likely to involve a breach of the general listing principles that, under the FSA's *Listing Rules*, apply to officially-listed UK companies and foreign companies that have a primary official listing in the UK. In particular, Listing Principle 2 requires companies to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable them to comply with their obligations. The sanctions for breach of the *Listing Rules* are public censure or the imposition of penalties on the issuer and/or its directors.[87] The FSA may also suspend or discontinue listing.

The FSA is empowered to take enforcement action against any person who engages in market abuse, which is broadly defined and could certainly include publishing defective financial statements.[88] This regime has a wide scope and catches behaviour relating to investments on all UK recognised investment exchanges including AIM and PLUS-Quoted. The sanctions available to the FSA in respect of market abuse include public censure and penalties.[89]

A 2005 Memorandum of Understanding between the FSA and FRRP sets out how the authorities will cooperate to promote effective monitoring and enforcement of standards on financial information in the UK. Thus far, this MoU has not been put to the test in an

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[87] Financial Services and Markets Act 2000, s 91.

[88] Financial Services and Markets Act 2000, Pt VIII.

[89] Financial Services and Markets Act 2000, s 123.

actual case in the public domain because the FSA has not yet stepped in to sanction an issuer (or its directors) for failures in financial disclosures in circumstances where its powers overlap with those of the FRRP. There is therefore no publicly-available information on the practical operation of this MoU.

If we look beyond situations where FSA and FRRP powers overlap to the FSA's role in policing corporate disclosures more generally,[90] the picture with regard to enforcement activity by the FSA does not change significantly. Between 2002 and 2005 the FSA imposed sanctions in respect of disclosure failures against only eight issuers, although it also brought a successful criminal prosecution in another case.[91] Of the FSA's cases, the £17 million fine imposed on Shell/Royal Dutch for market abuse stands out but there is a dramatic drop from it to the next largest fine, which was £450,000 imposed on Pace Micro. As Paul Davies noted in a study on issuer liability in the UK that was commissioned by the government: 'this is a relatively modest level of public enforcement activity'.[92] Davies continued: 'Even so, eight sets of penalties or censures imposed over a

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[90] This is a reasonable thing to do because the scope of both bodies' powers has been rather fluid in recent years with both of them acquiring a wider remit as a consequence of EC and domestic legislative developments.

[91] *R c Rigby, R v Bailey* (August 2005). The defendants Rigby and Bailey were, respectively, Chairman & CEO, and CFO of AIT plc. Both were sentenced to prison but had the length of their sentences cut on appeal ([2005] EWCA Crim 3487) and they also appealed successfully against confiscation orders ([2006] EWCA Crim 1653).

[92] : Davies, P, *Davies Review of Issuer Liability: Discussion Paper* (March 2007) para 65.

period of four years might not seem a high level of enforcement, even though the penalty imposed in the case of Shell was very large in absolute terms – though perhaps less so in comparison with the turnover of that issuer'.[93] Yet, notwithstanding these comments, the deterrent effect of FSA sanctions figured significantly among the factors that led Davies to conclude that it was unnecessary for him to recommend to the government that new civil liabilities for misleading disclosures should be imposed on directors or that the civil liability of issuers for such disclosures should be judged by the less demanding standard of negligence rather than fraud.[94] He noted that among those with whom he discussed the issue the view was that 'FSA enforcement was currently effective'.[95]

It is possible that confidence in the robustness of enforcement in the UK is misplaced and could come to be seen as dangerously complacent should a major fraud come to light. On the other hand, the fact that the UK largely emerged unscathed from the Enron/Worldcom period (described by one commentator as leading to an 'unprecedented numbers of major fraud cases in a record period of time')[96] is significant.[97] We draw from it the conclusion that it is not unreasonable to work on the basis that there is roughly 'enough' formal

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[93] Ibid.

[94] *Davies Review of Issuer Liability: Final Report* (June 2007) para 19.

[95] Davies, P, *Davies Review of Issuer Liability: Final Report* (June 2007) para 19.

[96] Brickey KF, 'Enron's Legacy' (2004) 8 Buffalo Criminal Law Review 221, 245.

[97] Though that an element of luck may have played a part must be acknowledged: Kershaw, D, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 MLR 594.

enforcement for deterrence purposes, when seen in combination with other elements of the system. Clear evidence to the contrary is lacking.

Maintenance of audit quality

The European Commission has described the enforcement infrastructure for financial reporting as comprising a 'cascade of different elements including clear standards, timely interpretation and implementation, statutory audit, monitoring by supervisors and effective sanctions'.[98] Taking this idea of a cascade, this paper now turns to the role played by the statutory audit.

Audit quality is crucial to public confidence in the integrity of financial statements, or at least those of companies with shares traded on a public market.[99] As stated in the EC Statutory Audit Directive, 'good quality audit contributes to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements'.[100] Financial statements are also a primary mechanism for shareholders to hold directors to account and audit serves to reinforce this accountability. The strength of the auditing profession

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[98] European Commission, *EU Financial Reporting Strategy : the way forward.*

[99] In some jurisdictions there is no audit requirement for companies whose securities do not trade on a public market. In EC law, the audit requirement applies to unlisted companies but there are exemptions from audit for small companies.

[100] Rec 9.

and the way it is regulated and supervised are thus crucial to the integrity of corporate reporting: the stronger the auditing profession in any jurisdiction, the less aggressive other mechanisms for the delivery of reliable corporate disclosures can afford to be because auditors act as a powerful first line of defence when companies are tempted to produce misleading financial statements.

In the last few years, mainly as a result of government reaction to corporate reporting failures such as Enron and regional and international trends, there has been a pronounced move towards independent regulation and the professional accountancy bodies have lost many of their standard-setting and self-regulatory powers. This move to independent regulation of auditors within the overall framework is likely to bode well for efforts to develop greater international co-operation in securities regulation; it seems likely that extensive self-regulation by local professional bodies would not be acceptable to national regulators of other jurisdictions. Yet, notwithstanding these changes, the regulation and oversight of auditors in the UK (as well as much of Europe) still remains a quite complicated patchwork of statute, independent regulatory mechanisms and self-regulation. It is therefore worthwhile to begin this section by examining the nature of the professional accountancy bodies, which have been at the centre of audit regulation and which still carry much responsibility even after the legislative and regulatory changes of the last few years. The accountancy profession in the UK is quite fragmented in terms of its representative bodies, in direct contrast to some other countries, such as the USA, which has one main national body.[101]

Professional accountancy bodies

The institutes and associations in the British Isles are of differing ages and aims. The oldest and largest were set up to represent accountants generally and to give a 'marque' to the title 'accountant'. These bodies were often geographical in nature and eventually, through various mergers, two main chartered institutes emerged in Great Britain, the ICAEW and the equivalent Scottish body (ICAS). The Irish Institute (ICAI) developed on a similar geographical basis. The primary focus of the institutes, historically, was on public practice but they now have many members in industry, not-for-profit and other areas. The Association of Chartered Certified Accountants (ACCA) was launched to provide a broader basis than the established institutes and, although UK-based, it is international in focus, with branches and members widely spread over areas such as the Far East, Africa and the Asian Sub-continent. The other professional bodies developed for accountants working in specific areas where accountants were perceived to have different and particular needs, such as management accountancy (the Chartered Institute of Management Accountants (CIMA)) and the public sector (the Chartered Institute of Public Finance and Accountancy (CIPFA)).

[101] In contrast, of course, accountants and auditors are regulated centrally by law in the UK, whereas in the USA certified public accountants (CPAs) are regulated at state level and auditors of registrant companies are regulated by the SEC.

There is a substantial degree of cooperation between the major accountancy professional bodies in the UK and Ireland. In 1974 they formed the Consultative Committee of Accountancy Bodies (CCAB). CCAB is a limited company with six members: ICAEW, ICAS, ICAI, ACCA, CIMA and CIPFA. The CCAB is used as a forum in which matters affecting the profession as a whole are discussed and coordinated and it enables the profession to speak with a unified voice to governments.[102]

Until the UK government's post-Enron review, most powers of supervision, including setting auditing standards and ethical standards for auditors, lay with the professional bodies. There had been moves to put these on a more independent footing,[103] but the UK government decided that, although certain functions would stay with those bodies, it was no longer acceptable to maintain a system that was almost entirely self-regulating in respect of audit. The FRC therefore took over the overall oversight role for auditors. The key bodies within the FRC in relation to auditor oversight are now the Accountancy and Actuarial Discipline Board (AADB), the Professional Oversight Board (POB), of which

[102] There are also several non-chartered accountancy bodies outside the CCAB umbrella, such as the Association of Authorised Public Accountants (AAPA), The Association of International Accountants, the Institute of Internal Auditors (IIA) and the Association of Accounting Technicians (AAT).

[103] By putting auditing and ethical standard setting under the remit of an independent body, the Accountancy Foundation, which would nevertheless still be funded by the accountancy profession.

the Audit Inspection Unit (AIU) is an important part, and the Auditing Practices Board (APB).

Disciplining auditors: the role of the AADB

Before Enron and the demise of Arthur Andersen, the professional bodies disciplined their own members. The ICAEW and ICAS had also set up a Joint Disciplinary Scheme (JDS) to conduct independent investigations into the work and conduct of chartered accountants in cases of public concern, which tended to focus on the role of auditors and company management in cases of fraud or other major failures of financial reporting. Other cases were dealt with by the individual professional body. Post-Enron reports recommended that the disciplinary process for public interest cases should be removed completely from the profession and to this end the FRC established the Accountancy Investigation and Disciplinary Board, now the AADB, which commenced formal operations in 2004.[104] Other non-CCAB accountancy bodies are not covered by the scheme.

The focus of the AADB is on cases of public interest, with other cases continuing to be dealt with by the professional accountancy body of the member concerned. The normal channel of reference to the AADB for 'public interest 'cases is the accountancy body

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[104] The AADB's Scheme and Regulations were made on 13 May 2004 and amended on 13 September 2007. See http://www.frc.org.uk/aadb/publications/. (Accessed November 2007)

primarily concerned; however, the AADB also has the power to call in cases. The members of the AADB are people with backgrounds in the accounting and auditing profession, the law and the civil service. Cases are head by a Disciplinary Tribunal established on a case-by-case basis and composed of either three or five suitably qualified people drawn from a Panel of Tribunal members maintained by the AADB. A majority of the Tribunal will always be non-accountants (or non-actuaries) and its Chairman will always be a lawyer. Tribunal proceedings are formal, in that parties can and do have legal representation. In contrast to the JDS, the AADB hears cases in public.

The AADB has commenced and publicly announced a number of investigations but it is notable that, as yet, it has not yet successfully prosecuted a case. The only major case it has pursued to a tribunal since its inception was in relation to the collapse of the Mayflower Corporation, when the AADB brought a case against the auditors (PricewaterhouseCoopers) and the company's finance director. The case failed and, perhaps somewhat ironically, it was the majority lay members of the Tribunal that sided with the auditors, whereas the accountant on the tribunal dissented.[105] Costs of £1 million were awarded against the Tribunal, which meant that the AADB core operating costs for the year exceeded their budget by some margin.[106] The JDS, in contrast, successfully prosecuted several cases in its time, including in relation to some of the UK accounting

[105] The full reports arising from the tribunal are at http://www.frc.org.uk/aidb/tribunal/pub1248.html (accessed January 2008).

[106] The AADB launched a consultation on amendments to its scheme on 17 January 2008 (AADB PN3).

scandals of the late 1980s and early 1990s such as Polly Peck, Barings and Maxwell.[107] It is early days to judge the AASB's effectiveness, given the length of time investigations into these matters can take. Nevertheless, the AADB has yet to demonstrate that it can operate as an effective prosecutor of cases, leaving the question of whether the apparently successful JDS regime – which although described as independent was a body set up by the profession as part of its self-regulatory mechanisms – has been replaced with one that is not as effective, although it is entirely independent of the profession.

It is likely that the AADB will amend its procedures and the regime in which it operates, in order to operate more effectively.[108] This may therefore offer an example of how regulatory and supervisory mechanisms have to evolve in the light of experience, so that regulators can succeed in achieving their regulatory goals.

Oversight of eligibility to conduct statutory audits and of audit quality

With regard to ensuring that only those who are properly supervised and appropriately qualified are appointed as company auditors, statutory requirements are laid out in the Companies Act 2006 [109] and the Statutory Auditors and Third Country Auditors Regulations 2007, implementing the Statutory Audit Directive.[110] The UK already had a statutory audit regime before the original EC measure in this field (the Eighth Company

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[107] The JDS website carries details of all decided cases: www.castigotor.org.uk .

[108] For reference to this possibility see FRC, *Annual Report 2006/7*, 6.

[109] Companies Act 2006, Pt 42.

[110] SI 2007/3494.

Law Directive (1978)) and in fact many of the requirements of UK law found their way into the Directive as the UK was seen as being ahead of many other European countries in the sophistication of its audit regime.[111] The changes needed to implement the new Statutory Audit Directive are mainly refinements of the detail rather than fundamental change.[112]

Supervision of the eligibility requirements for company auditors is devolved by the Act on to Recognised Supervisory Bodies (RSBs),[113] namely various accountancy institutes, including the ICAEW. A company auditor must be a member of an RSB and be eligible to act as an auditor under the relevant RSB's rules. RSBs are thus responsible for specifying who may act as a company auditor within the context of the law. Their duties

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[111] In fact many accounting and auditing concepts found in UK law and regulation have been adopted into EU-wide law. The concept of "true and fair" was a UK construct introduced in mid-twentieth century company law. It was adopted in EC legislation and is now the bedrock of accounting and auditing in the EU and elsewhere (for example New Zealand). See Chastney, J, *True and Fair View* (Research Committee of the ICAEW(1975), for a full history of the term.

[112] DTI, *Implementation of Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts (8th Company Law Directive)* (Consultative Document, March 2007) p 4 (foreword) and BERR, *Implementation of the Directive on Statutory Audit of Annual and Consolidated Accounts: Summary of the comments on the draft regulations and the government's conclusions* (December 2007), para 8.

[113] Companies Act 2006, s 1217.

include maintenance of a register of auditors, giving various details about individuals and firms that act as auditors.

The statutory framework also makes provision for the designation of professional bodies as Recognised Qualifying Bodies (RQBs) – again the accountancy institutes – through which the Act seeks to maintain the quality of company auditors. Anyone acting as a company auditor must have an 'appropriate qualification' which, subject to transitional arrangements for existing long-standing auditors and recognition of certain foreign qualifications, means a qualification from a UK RQB.[114]

Auditors that contravene RSB rules are subject to sanction by their own RSB or, in serious cases, by the FRC's AADB.[115] Penalties can include withdrawal of registered auditor status.

Role of the POB and its AIU

The government delegates its statutory responsibilities for authorising professional accountancy bodies to act as supervisory bodies and/or to offer a recognised professional qualification to the FRC. The Professional Oversight Board (POB) then discharges that responsibility on behalf of the FRC.

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[114] Companies Act 2006, s 1219.

[115] The AADB replaced the profession's own disciplinary bodies, such as the Joint Disciplinary Scheme, which is nevertheless still in existence as it finishes dealing with cases that started under its remit. See www.frc.org.uk/aadb and www.castigator.org.uk.

The POB's role includes overseeing the regulation of the accounting and auditing profession by the recognised bodies and confirming that they continue to serve the public interest in all respects. Extending beyond audit, it also provides independent oversight of the regulation of the accountancy profession by the professional accountancy bodies. In relation to this part of its role, the POB reviews the regulatory activities of the professional accountancy bodies in relation to their members, including education, training, continuing professional development, standards, ethical matters, professional conduct and discipline, registration and monitoring. This includes making recommendations on how these activities might be improved. On non-audit areas of accountancy, the POB does not have statutory powers but the CCAB bodies have accepted a commitment to consider carefully POB recommendations and to implement them within a reasonable period or to give reasons in writing for not doing so.

Importantly, the POB also has responsibility for monitoring more directly the audit quality of economically significant entities through an independent Audit Inspection Unit (AIU). This is a significant change to the old arrangements as, historically, audit monitoring was carried out by the professional bodies themselves. The ICAEW, ICAS and ICAI did so through a limited liability company called the Joint Monitoring Unit (JMU), which they owned. The ACCA had independent arrangements. Again, this responsibility was transferred from the profession to the independent regulator in the post-Enron restructuring of audit oversight.[116] The AIU took over from the JMU responsibility for monitoring the audit of listed companies and major charities and

[116] See, in particular the discussion in the CGAA, *Final Report*, paras 5.7 – 5.12.

pension funds, i.e. those entities whose activities have the greatest potential to impact on financial and economic stability.[117]

In addition to monitoring audit processes and systems, the AIU also looks at audit firms' internal culture and, importantly, it undertakes a 'critical assessment of the key audit judgments made in reaching the audit opinion'.[118] The AIU is supported by a panel whose members, with substantial experience of audit, will provide advice on inspections, and particularly on issues involving professional judgment.

Recommendations for action from the AIU reports are sent to the accountancy bodies, which then take appropriate regulatory action, which may include referring the matter to the bodies' disciplinary procedures for action. The AIU also has reporting powers to other FRC bodies. It is therefore able to: inform the AADB if it identifies concerns about accountants which might lead to disciplinary action; inform the FRRP if it identifies concerns about the financial statements of companies, the audits of which it has examined; and advise the APB where it believes auditing standards need supplementing. The POB monitors the response of the professional bodies to AIU reports to check that appropriate action is being taken.

The AIU publishes an annual public report on the principal themes and issues arising from its inspections. In general they express satisfaction that the quality of auditing in the

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[117] The scope of AIU activity can be found at http://www.frc.org.uk/images/uploaded/documents/AIU%20Scope%202007-81.pdf. (Accessed January 2008)

[118] http://www.frc.org.uk/pob/audit/. (Accessed December 2008)

UK is fundamentally sound but are critical of certain aspects. Thus far the AIU has refrained from identifying in its annual reports specific examples of unsatisfactory practices by named firms. Furthermore its detailed reports on each audit engagement reviewed are not made public. This is an area where the right balance may not yet have been struck: debate continues on the way in which AIU findings are reported, with a view to seeing if more information on individual firms could be made available publicly and whether information on individual audits reviewed might be made available to the company's audit committee.[119]

In 2006/07 the AIU conducted inspections with the US PCAOB at two of the 'Big 4' UK audit firms.[120] This is an illustration of the sort of practical groundwork to foster mutual understanding of counterparts' practices that is a necessary precondition for any system of substituted compliance to operate effectively.

The costs of the AIU represent the costs of the programme of independent audit inspections. The costs in 2006/07 were £2.1m compared to a budget of £2.5m and £1.7m in 2005/06. In 2006/07 the average number of AIU staff increased to 16 from 13 in the previous year.[121]

Role of the APB

The current Auditing Practices Board was established in April 2002, replacing a previous APB which had been in place since 1991 and which had originally been a board of the

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[119] FRC, *Annual Report 2006/7*, 15.

[120] Ibid, 15.

[121] The figures in this paragraph are taken from the FRC, *Annual Report 2006/7*, 23.

professional accountancy bodies. That the body setting auditing standards should be independent of the professional accountancy bodies was a post-Enron recommendation. The APB is now one of the FRC operational bodies. Only 40 per cent of the APB's members can be persons eligible for appointment as company auditors under the Companies Act; the balance may be accountants, but cannot be office holders or similar of any accountancy body, nor partners in audit firms.

In relation to auditing standards, the APB has anticipated the eventual adoption of International Standards on Auditing (ISAs) in the EU, which will happen through the new Statutory Audit Directive.[122] ISAs are produced by the International Auditing and Assurance Standards Board (IAASB), which is a body of the International Federation of Accountants (IFAC).[123] Rather than setting UK standards, the APB adopts ISAs with additional material added where necessary in order to strengthen the standards where it is felt appropriate or where UK company law or regulation requires. The APB, like the UK's Accounting Standards Board, thus concentrates much of its effort on contributing to

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[122] See Statutory Audit Directive, art 26. It is not clear when adoption of ISAs by the Commission will happen. Experience of problems with the adoption of International Financial Reporting Standards in the EU has engendered some caution about how to approach the equivalent process for auditing standards.

[123] In light of the move away from self-regulation in the UK and USA, it is noteworthy that these standards are thus still under the control of the accountancy profession as IFAC is a body whose membership comprises the professional institutes worldwide. However, an external oversight body, the Public Interest Oversight Board, has been put in place to monitor its work.

the development of international standards rather than writing its own. The decision to take this approach reflects the APB's view of the international nature of auditing public interest entities, where global networks of audit firms are auditing global companies. The UK has thus pushed ahead with international standards in advance of most of the rest of Europe, which was also a feature of the ASB's approach to accounting standards before an IFRS regime was adopted on a mandatory basis into EC law.

The APB also has means to promote guidance on other issues, which allows it to continue to focus on national issues.[124] It produces Statements of Investment Circular Reporting Standards, which deal with how reporting accountants conduct engagements involving a securities transaction governed wholly or in part by the laws and regulations of the UK or Republic of Ireland. These are still very much focused on the UK and Irish environment and, perhaps surprisingly, there are no equivalents in most EU countries, nor at an international level.[125] However, given the importance attached to financial information when companies first come to the public markets, there is growing interest in developing a model for these types of standard across the EU, which would complement the pan-EU approach on prospectus and transparency rules, promulgated under the FSAP. The IAASB is also considering developing standards in this area.[126]

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[124] Other guidance includes Practice Notes and Bulletins, respectively to deal with issues arising in specific types of audit and to tackle emerging issues, which are persuasive rather than mandatory.

[125] Although IAASB standards also cover other assurance engagement outside statutory audits.

[126] IAASB Consultation Paper 'Proposed Strategy for 2009-2011 (October 2007).

All ethical rules for auditors (and accountants) were in the past set by the accountancy bodies. This, too, changed in the post-Enron review of responsibilities.[127] Now, the role has been split so that the APB has responsibility for ethical standards for external auditors on independence, objectivity and integrity. Ethics for accountants generally and other ethical standards for external auditors remain with the professional accountancy bodies and they will be subject to review as part of the work of the POB.

The APB has issued five main Ethical Standards (ESs) for auditors.[128] ES 1 is designed to be the lynchpin standard, containing the main principles in relation to auditor objectivity and independence. The other standards, of which there may be more in future, apply these principles to specific situations and areas of concern. The most controversial area is probably in relation to the provision of non-audit services to audit clients. There is also an ethical standard governing audits of smaller entities, which allows some relaxation from the ethical rules for major audits, and an ethical standard for reporting accountants.

Although developed by a national standard setter, these new standards have been developed in the context of international developments, particularly the EC Recommendation on *Statutory Auditors' Independence in the EU: a Set of Fundamental Principles*[129] and Section 8 of the International Federation of Accountants (IFAC) *Code of Ethics for Professional Accountants*.[130] They are very similar to the IFAC Code of

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[127] CGAA, *Final Report*, paras 1.5.16 and 1.71.

[128] Details of all the standards are at http://www.frc.org.uk/apb/publications/ethical.cfm.

[129] [2002] OJ L191/22.

[130] Available at http://www.icaew.com/index.cfm?route=135844 (accessed January 2008).

Ethics, but not identical. This international context is important: because the global firms are auditing global companies, their internal procedures need to meet the requirements in each jurisdiction in which they operate. However, the complexity of meeting multi-jurisdictional rules means that it is often the case that the firms will go to the most rigorous standards and apply them worldwide, in order to provide a modicum of simplicity and consistency, as well as certainty of compliance. It is in the interests of the large firms to have one set of ethical rules for auditors worldwide.

Auditor civil liability and the impact on the major firms

Although the focus of this paper is mainly on public oversight, in reality that represents only a part of the infrastructure for ensuring the integrity of financial reporting. Space constraints rule out a comprehensive review but in view of its general importance and, in particular, certain important recent developments, it is appropriate here to comment briefly on the position with regard to auditors' civil liabilities in tort in respect of the statutory audit.

In the UK, it is well established that the role of audited accounts is to enable shareholders to exercise their membership rights in general meetings and not to assist shareholders (or indeed other potential investors) in making investment decisions in their personal capacity, as laid out in the precedent case *Caparo Industries v Dickman* (although it has been refined and modified by subsequent cases).[131] Auditors are not taken, by virtue of the requirements to produce statutory accounts, to have any responsibility to third parties even though it is foreseeable that they may act on them. This is very different to the

[131] [1990] 2 AC 605.

situation in, for example, the USA. In spite of the fact that it is now rather difficult for shareholders to make a claim on the auditors, attempts to claim have continued and even claims by the company against the auditors are potentially ruinous. The claim by Equitable Life against its auditors, Ernst & Young, for instance, amounted initially to £2.6bn.[132]

Among the many repercussions of the fall of Arthur Andersen was that it put the issue of auditor liability to the forefront as far as the profession was concerned. Auditors in many countries – including the UK and the USA – have not been permitted historically to limit their liability in relation to their audit work. In cases of corporate failure, the auditors might be the only party left with funds (and insurance) that it is worth investors pursuing. This 'deep pocket' syndrome has meant that the level of claims has been so great that auditors can no longer obtain sufficient insurance cover on the open market and many have resorted to the use of captive insurers.

The failure of Andersen, notwithstanding that its immediate cause was a criminal conviction (which was of course subsequently overturned), led the profession to redouble its efforts to obtain the ability to limit their liability exposure in relation to audit work. They already limited their liability by contract for most other types of work. In the UK the campaign was successful, although the provisions in the Companies Act 2006 that will allow limitation of liability agreements between companies and their auditors from

[132] A similar amount was claimed by the mutual from its former directors: Tait N and Felsted, A, 'Bad Policies: Counting the Costs of the Equitable Case in Life Savings and Reputations', ‚ft.com article published 5 December 2005. (Accessed January 2008)

April 2008 are arguably not likely to give a great deal of protection as any agreement is limited to what is 'fair and reasonable', which will be determined by a judge after the event.[133] The European Commission also commissioned a study on auditor liability[134], and is likely to put forward a Recommendation to Member States asking them to limit auditor liability.[135] Even in the USA, the SEC has suggested it may be prepared to accept that auditors can limit their liability. This latter point would be crucial for the global audit firms as their level of exposure in the USA is so great.

Part V: Oversight of Corporate Governance Disclosures

Companies also have their own responsibilities for the financial statements: indeed, the primary responsibility for the financial statements rests with the directors themselves. The final part of the regulatory jigsaw over financial reporting that falls to be considered, therefore, is how companies govern themselves and report good governance to the outside world. As well as dealing with financial reporting, the governance framework encompasses how companies interact with their auditors.

The principle underlying the UK Combined Code on Corporate Governance is that it articulates investor expectations with regard to good governance practices but allows

[133] Companies Act 2006, Pt 16, ch 6.

[134] http://ec.europa.eu/internal_market/auditing/docs/liability/consultation-paper_en.pdf

[135] Announced by Commissioner McCreevy in a speech on 17 December 2007 (Speech/07/835).

companies the flexibility to depart from them if that is more appropriate to their circumstances. This flexibility is underpinned by a 'comply or explain' obligation in the FSA *Listing Rules* that is intended to enable investors to make properly-informed decisions in respect of companies that depart from the recommended good practices.[136] The *Listing Rules* require non-compliant companies to give reasons for non-compliance but they do not mandate issuers to justify those reasons. The required disclosures must be made on an annual basis in the audited annual report and accounts. The *Listing Rules* require auditors to review the parts of corporate governance disclosure statements that relate to financial reporting, internal control and audit committee and audit sections of the Combined Code.[137]

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[136] A UK incorporated listed company must in its annual accounts state how it has applied the principles in the Combined Code and must state whether or not it has complied fully with it, providing reasons for any areas of non-compliance: FSA, Listing Rules, LR 9.8.6. An overseas company with a primary listing must disclose in its annual accounts whether or not it complies with the corporate governance regime of its country of incorporation and the significant ways in which its actual corporate governance practices differ from those set out in the Combined Code: FSA, Listing Rules, LR 9.8.7.

The amended Fourth Directive (amended by Directive 2006/46/EC) imposes a mandatory pan-European corporate governance 'comply or explain' disclosure requirement. Implementation of the revised Directive may require some changes to the detail of the UK position but the broad substance is not affected.

[137] FSA, *Listing Rules*, LR 9.8.10.

The Financial Reporting Council, through its Committee on Corporate Governance, is responsible for publishing and maintaining the Combined Code.[138] As part of this role, the FRC monitors the impact of the Code in practice. However, the FRC does not play a formal enforcement role in relation to the application of the Combined Code by individual companies.

When speaking of 'compliance' and 'enforcement' in relation to the Combined Code, it is necessary to distinguish between non-compliance with the Code itself and non-compliance with the *Listing Rules* comply or explain obligation in respect of the Code. Only internal corporate governance accountability to shareholders mechanisms and market sanctions apply in respect of non-compliance in the first sense and whether they are applied in any particular case will depend on investors' reaction to the explanations given for areas of deviation from the Code. Market disciplines seem to be working to the extent of increasing promoting compliance with the Code, [139] although there is some concern whether what is being encouraged is a propensity for 'tick box' compliance

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[138] FRC *The UK Approach To Corporate Governance* (November 2006).

[139]Padgett, C and Shabbir, A, 'The UK Code of Corporate Governance: Link Between Compliance and Firm Performance' (November 21, 2005). ICMA Centre Finance Discussion Paper No. DP2005-17 Available at SSRN: http://ssrn.com/abstract=934313 Arcot, SR and Bruno, VG, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (May 2006). Available at SSRN: http://ssrn.com/abstract=819784 finds that mere adherence to general accepted principles of good corporate governance is not necessarily associated with superior performance.

rather than meaningful engagement with the greater flexibility implied by the facility to explain deviations.[140] A review of the operation of Code, conducted in 2007 by the FRC, found that there had been a gradual but discernible improvement in the overall quality of disclosure by companies, although the general perception among investors and other observers was that there remained scope for considerable improvement.[141]

As part of the FSA *Listing Rules*, the comply or explain obligation is underpinned by the legal sanctions generally available for breach of those rules (including penalties and public censure). Although some non-compliance with the 'explain' part of this obligation has been identified –in one study an average of 17 per cent of non-compliances were found to be not explained at all[142] -⁻ the FSA has not intervened. The absence of lively public enforcement in this area is not surprising and is understandable. There is a breach of the *Listing Rules* disclosure obligation only where no reasons are given and the FSA's measured approach to the use of its enforcement powers implies that it is unlikely to act in relation to a 'mere' technical failure to explain a departure from the Combined Code. The wording of this disclosure obligation means that it is not part of the FSA's remit to monitor the quality of honest explanations[143] but, in any event, such monitoring should be

[140] Arcot, SR and Bruno, VG, 'In Letter', ibid.

[141] http://www.frc.org.uk/corporate/2007review.cfm

[142] Arcot and Bruno, 'In Letter', note XXX.

[143] Deliberately inadequate and misleading explanations for departures from the Combined Code could be part of a bigger series of events that constitute a breach of the

left to shareholders and the market generally, since they can provide a more flexible, graduated response to a range of disclosure shortcomings than an official body.[144] It has been found that one end of the range – non-existent explanations - is associated with underperformance whereas, at the other end, companies that provide genuine explanations perform exceptionally well.[145] However, there is evidence of less fine tuned

Listing Principles (LP 2 requires issuers to act with integrity towards holders of its equity securities) or a form of market abuse.

[144] This is consistent with the view of the European Corporate Governance Forum that: 'regulatory authorities should limit their role to checking the existence of the statement, and to reacting to blatant misrepresentation of facts. They should not try and second-guess the judgement of the board(s) or the value of its/their explanations. This is a matter for the company's shareholders.' *Statement of the European Corporate Governance Forum on the comply-or-explain principle* (2006) at http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf.

See also Wymeersch, E, 'Enforcement of Corporate Governance Codes' (June 2005). ECGI - Law Working Paper No. 46/2005 Available at SSRN: http://ssrn.com/abstract=759364

[145] Arcot, SR and Bruno, VG, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance' (January 15, 2007). 1st Annual Conference on Empirical Legal Studies, Forthcoming Available at SSRN: http://ssrn.com/abstract=887947.

responses to bland, uninformative explanations, which may indicate that there is room for improvement in shareholder- and market-based scrutiny.[146]

Part VI: Conclusion

At the international level, the idea of a country hosting foreign players (issuers, intermediaries or market infrastructure providers) in its securities markets on the basis of 'home State' supervision is gaining traction but it remains highly controversial. It won't ever happen except where the host country's authorities can satisfy themselves that the quality of regulation and supervision in the foreign system is sufficiently similar to that in the host country that reliance on it will not endanger fundamental goals of securities regulation. Yet, as experience in the accounting field demonstrates, determining that different sets of rules are equivalent to each other is hard enough; making a judgment on the equivalence of another country's public oversight and enforcement arrangements is even more difficult.

Having a detailed understanding of how public supervision is organised and actually works in individual countries is thus a crucial first step towards being in a position to make reliable and defensible equivalence decisions. Merely looking at one aspect of a national system – such as formal enforcement outcomes – is liable to be misleading. With

[146] Arcot and Bruno, 'In Letter', note XXX raises the question whether there is a monitoring failure in relation to inadequate, as opposed to non-existent, explanations.

this thought in mind, this paper takes a close look at the position in the UK with regard to public oversight of financial and corporate governance disclosures and at the closely related area of public oversight of auditors.

Several points emerge. First, despite being well known as a country that has adopted the single regulator model, the true position in the UK is that there is some degree of fragmentation of oversight and enforcement responsibilities in relation to financial and corporate governance disclosures and to auditor oversight. In these areas, the Financial Reporting Council plays a significant role. Each of operational bodies within the Council has one or more important functions in relation to reporting, accounting and auditing, as reviewed in the paper. The Council itself is responsible for the Combined Code on Corporate Governance and monitors its practical impact. The Financial Services Authority does have a role in the areas where the Council and its constituent bodies operate, but what its powers are and how they actually work depends on the particular context.

Secondly, there is indeed little use made of formal enforcement powers, either by the bodies that sit within the Financial Reporting Council structure or by the FSA. On the whole, the low level of formal enforcement reflects deliberate policy choices to use a range of compliance-promoting strategies and to have a measured approach to enforcement.[147] Whilst these policies could be misguided, they are not ones that have come about or persisted through inattention. During this decade the UK has had cause to conduct serious policy reviews on several occasions, as part of the post-Enron examinations that took place around the world, in the context of its major overhaul of company law and, at various times, in relation to the domestic implementation of new EC laws. Whilst various changes and refinements resulted from these reviews (as outlined in the paper), none of them led to a radical policy shift in relation to the role of enforcement.

That the UK's measured approach to public oversight and enforcement is a credible one is reinforced by looking at developments and discussion in other European countries and at the Community level. The UK model has been influential in the establishment in other European countries of accounting oversight bodies that seek to promote compliance by building consensus. So far as corporate governance is concerned, the European Corporate Governance Forum[148] has cautioned against public regulatory authorities playing a large role as it is primarily for shareholders to make their own evaluations. There is

[147] A caveat has to be entered against the AADB where it is too early to say and where the early experience (in the Mayflower case) suggest that its procedures and practices need further refinement.

[148] A group established by the European Commission and comprising fifteen senior experts from various professional backgrounds whose experience and knowledge of corporate governance are widely recognised at European level http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/1241&format=HTML&aged=0&language=en&guiLanguage=en

considerable wariness in Europe about giving regulators strong powers in the area of corporate governance as they could lead to rigidity, destroying the flexibility that is meant to be inherent in the 'comply or explain' approach that was pioneered by the UK.[149]

Formal legal sanctions imposed by public bodies do not exist in a vacuum as they are but part of a bigger machine. In relation to financial disclosures and corporate governance, the machinery includes internal control and accountability mechanisms available to shareholders, independent audit requirements, informal market sanctions and private enforcement in civil cases. Their interdependence means that all of these components and how they are used by the people who have control of them (in particular institutional investors and auditors) are relevant to assessments of the equivalence of supervision. It follows that we must conclude finally with an acknowledgement that this paper has looked at only part of the system. Our decision to be selective does not imply that in overall terms we think that public oversight is more important than other mechanisms of accountability and control. However, we do consider that a detailed understanding of complex and rapidly evolving public institutional arrangements has a particular significance in the context of international discussion relating to the equivalence of different national systems.

[149] Wymeersch, E, 'Enforcement of Corporate Governance Codes', note XXX.

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