THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND & WALES

Dialogue in corporate governance

Beyond the myth of Anglo-American corporate governance

Accounting dialogue

Disclosure responsibilities and building trust

Promoting transparent and reliable information

Dialogue in corporate governance

The globalisation of capital markets and capital flows, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance practices so as to reduce complexity and confusion. Dialogue can help facilitate a better understanding of different approaches to corporate governance and foster an appreciation of equivalent systems.

Difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and business. The ICAEW has launched the *Dialogue in corporate governance* initiative to challenge commonly held assumptions, identify fundamental questions, set challenges for future research and generate practical proposals. This will include:

- **Beyond the myth of Anglo-American corporate governance** – Contrasting US and UK securities markets and how they impact national and international policy, investment, business and accounting.
- **EU approaches to corporate governance** – Contrasting models of corporate governance in EU Member States, drawing out potential implications for future convergence.
- **Matching corporate governance to investor needs** – Exploring the different sources of finance as businesses evolve and the implications for corporate governance.

About the ICAEW

The ICAEW is the largest professional accountancy body in Europe and has over 128,000 members in 142 countries worldwide. Since the establishment of the Cadbury committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the UK.

If you would like to know more about *Dialogue in corporate governance* or *Beyond the myth of Anglo-American corporate governance* and relevant events and publications visit www.icaew.co.uk/dialogueincorpgov

This publication is based on law and regulation and related developments as at June 2006.

ISBN 1 8415 2 399 2

Disclosure responsibilities and building trust

Promoting transparent and reliable information

Contact the author

For more information about this paper or the *Beyond the myth of Anglo-American corporate governance* initiative please contact:

Andrew Gambier
Manager, Technical Strategy, ICAEW

Email: andrew.gambier@icaew.co.uk
Telephone: +44 (0)20 7920 8643

Acknowledgements

Thanks are given to those who advised on the preparation of this paper, including the ICAEW's Corporate Governance Committee and PCAOB Panel, participants of the ICAEW roundtable in Washington DC in December 2005, Robert Hodgkinson, Jonathan Hunt, Kerrie Waring and Debbie Homersham of the ICAEW, and Nick Toyas of NT&A.

Scope and use

Corporate governance is a broad discipline and this discussion paper is not intended to cover every aspect of corporate governance. It provides information on issues raised in the *Pressure Points* consultation paper and generally focuses on publicly quoted companies and institutional investors, particularly those operating internationally.

This discussion paper should be read in conjunction with the other papers in the *Beyond the myth of Anglo-American corporate governance* series focused on policy, investment and business issues and the *Pressure Points* consultation.

Beyond the myth of Anglo-American corporate governance

In June 2005, the Institute of Chartered Accountants in England & Wales (ICAEW) launched the *Beyond the myth of Anglo-American corporate governance* initiative. Its aim is to explore differences between US and UK corporate governance systems and the pressures these differences create for international business and investment. The intention is for this work to help inform policy makers on both sides of the Atlantic.

As part of the initiative the *Pressure Points* consultation paper was published in December 2005 and is relevant to boards, investors, the accountancy profession and policy makers. It highlights 21 questions representing some of the most challenging aspects of cross-border corporate governance and the comparability of US and UK governance systems.

As context for responses to the *Pressure Points* consultation, four discussion papers provide information on the current state of corporate governance in the US and the UK.

- **Policy dialogue:** ***Effective corporate governance frameworks – encouraging enterprise and market confidence***
- **Business dialogue:** ***Board responsibilities and creating value – demonstrating leadership and accountability***
- **Investment dialogue:** ***Shareholder responsibilities and the investing public – exercising ownership rights through engagement***
- **Accounting dialogue:** ***Disclosure responsibilities and building trust – promoting transparent and reliable information***

The initiative also encourages on-going dialogue through face-to-face meetings. At the ICAEW transatlantic roundtable in Washington DC in 2005, the importance of dialogue around corporate governance for global capital markets was emphasised by SEC Commissioner Cynthia A. Glassman:

'We have much to learn from each other on how to regulate wisely and make global markets efficient... Our analysis of regulatory policy needs to be rigorous, yet flexible. We need to be clear about our goals, but recognize that there is more than one way to achieve them.'[1]

A paper summarising the findings of the *Beyond the myth of Anglo-American corporate governance* initiative is expected to be finalised in late 2006. It will include evidence from responses to the *Pressure Points* consultation and feedback from face-to-face meetings and roundtable events on both sides of the Atlantic.

[1] Remarks of SEC Commissioner Cynthia A. Glassman at the ICAEW *Beyond the myth of Anglo-American corporate governance* roundtable, Washington DC, 6 December 2005.

Disclosure responsibilities and building trust

Promoting transparent and reliable information

Contents

Introduction

The reliability of corporate reporting and audit is vital if companies are to attract investors and maintain confidence in capital markets. Reporting is important as it allows shareholders to exercise their ownership rights on an informed basis. Shareholders can thus assess the stewardship of management and make decisions about the valuation, ownership and voting of shares. The importance of corporate reporting and governance was emphasised at the ICAEW corporate governance roundtable in Washington DC in 2005 by Paul Boyle, Chief Executive of the Financial Reporting Council (FRC) as follows:

'Corporate reporting and governance matters because it helps savers, investors and employees make informed choices and protects their interests. It underpins efficient capital markets and, ultimately, dishonest behaviour damages the interest and reputation of honest companies.'

Publicly listed companies in the US and the UK are required to publish annual reports and accounts. They also have responsibilities in relation to the effectiveness of audit. In the US, Section 303 of the Sarbanes-Oxley Act makes it a criminal offence to mislead an auditor of an SEC registered company and in the UK, directors must state in the annual report that they have provided the auditors with all of the information they require.

In the UK, the financial statements of all companies (except smaller companies) must be audited and the published accounts must contain a report from the auditors. This report must state whether, in the auditor's opinion, the annual accounts have been prepared in accordance with the Companies Act 1985; and whether the accounts present a true and fair view of the state of affairs of the company. In the US, there is no requirement for reporting on the substance of the 'state of affairs' as in the UK. In this sense, the objective of the US legal framework is to demonstrate compliance, for regulatory purposes, in terms of whether or not the financial statements have been prepared in accordance with SEC regulations. Because of this, the requirements in the US and UK can appear similar, yet have very different consequences.

This discussion paper provides information for the questions highlighted in the *Accounting dialogue* section of the *Pressure Points* consultation paper. These questions are reproduced below and cross-referenced to the relevant pages in this paper:

1. Internal control

Section 302 of the Sarbanes-Oxley Act 2002 requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of all Securities and Exchange Commission (SEC) registered companies to sign certifications on annual and quarterly filings. This has increased the involvement of executive management in so-called disclosure controls. Much more attention has been paid to Section 404 of the Sarbanes-Oxley Act. This contains requirements related to internal control, limited to financial reporting, that are very different to UK requirements supported by the Turnbull guidance.

The question in the *Pressure Points* consultation covered in this section is:

Q16. To what extent will new US requirements on disclosure controls increase the demands placed on non-SEC registrants?

In considering this question, the following areas are relevant:

- US requirements before the introduction of the Sarbanes-Oxley Act.
- Sections 302 and 404 of the Sarbanes-Oxley Act.
- UK practice.

1.1 Origin of US requirements prior to the Sarbanes-Oxley Act

The 1933 Securities Act (1933 Act) requires companies to provide investors with financial and other significant information in respect of securities being offered for public sale, and prohibits fraudulent misstatements. The 1933 Act focuses on establishing a standard for information provision for exchanges of shares in the secondary market, as opposed to establishing fundamental rights of ownership. Interstate trade in securities can be covered by federal legislation such as the 1933 Act. However, share ownership rights fall within the scope of state law, which does not provide for protection of shareholders through the provision of financial information, but relies upon directors exercising their fiduciary duties to protect shareholders.[2]

The 1933 Act and the 1934 Securities Exchange Act (1934 Act) which established the SEC represent the foundation of US securities law. Companies wishing to sell their shares to the public must submit to registration, which brings with it an ongoing disclosure regime with prescribed formats for presenting information. For US-based companies, known as domestic registrants, this includes a requirement to file publicly an annual report on Form 10-K and quarterly reports on Form 10-Q. Foreign registrants must file annual reports on Form 20-F but are not subject to a quarterly reporting requirement.

1.2 Section 302 of the Sarbanes-Oxley Act

In 2002, following corporate scandals in the US, an Act was passed 'to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes.' Known as the Sarbanes-Oxley Act, after its main Senate and House of Representatives sponsors respectively, this required the SEC to take several actions, including, in Section 302, to introduce rules to require the CEO and CFO of SEC registrant companies, or other officers performing in those functions, to produce certain certifications in respect of controls.

[2] See also *'Divided by common language' Where economics meets the law: US versus non-US financial reporting models*, Tim Bush, ICAEW, 2005.

Section 302 was implemented by the SEC in Rule 33-8124, 'Certification of Disclosure in Companies' Quarterly and Annual Reports.' This rule defines a new concept 'disclosure controls and procedures', which relate to controls and other procedures which are designed to ensure that information required to be disclosed by the registrant in its SEC filings is recorded, processed, summarised and reported in a timely fashion and communicated to management to allow for timely decisions about disclosure. It requires the CEO and CFO to certify in their 10-K or 10-Q filing or, for foreign registrants, in their 20-F filing that they have:

- designed appropriate disclosure controls and procedures to ensure that material information on the company and its subsidiaries has been made known to them;
- designed appropriate internal control over financial reporting to provide reasonable assurance over the reliability of financial reporting and the preparation of financial statements in accordance with GAAP;
- evaluated the effectiveness of the disclosure controls and procedures and disclosed their conclusions about their effectiveness as of the end of the reporting period; and
- disclosed any change in internal control during the reporting period that could subsequently affect the company's internal control over financial reporting.

Since its implementation, Section 302 has not been a major source of controversy. Many companies have reacted positively to the SEC's recommendation to establish a disclosure committee, comprising key accounting and operational staff, to consider the materiality of information and to advise on disclosures. This response is in contrast to the reaction to Section 404 of the Sarbanes-Oxley Act.

1.3 Section 404 of the Sarbanes-Oxley Act

Section 404 of the Sarbanes-Oxley Act relates to internal control over financial reporting. Section 404(a) directed the SEC to prescribe rules mandating issuers to include an internal control statement in their annual report. These requirements were implemented by the SEC within Rule 33-8238.[3] This rule requires registrants' management to:

- maintain control over financial reporting, reinforcing the internal control requirements of the 1977 Foreign Corrupt Practices Act;
- evaluate the effectiveness of internal control as of the end of the fiscal year; and
- evaluate any change in internal control that occurred during the year that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting.

Section 404(b) required that the external auditor attest to, and report on, management's assessment made under Section 404(a), as part of their audit, in accordance with standards prepared by the Public Company Accounting Oversight Board (PCAOB). The PCAOB subsequently issued Auditing Standard 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, in March 2004.

Section 404 became applicable for US domestic registrants, with some exceptions for smaller companies, from the first fiscal year ending on or after 15 November 2004, but only becomes applicable to foreign private issuers from the first fiscal year ending on or after 15 July 2006.

[3] Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC, 5 June 2003.

PCAOB Auditing Standard 2, at over 300 pages, is considerably longer than Rule 33-8238. The complexity of Auditing Standard 2, combined with the considerable penalties for auditors if they do not comply, meant that the implementation of Section 404 was not entirely smooth. As SEC Chairman Donaldson observed at the SEC's roundtable discussion on implementation of internal control reporting provisions in April 2005:

'[We] also understand that the process of implementing the requirements of Section 404, as well as the related SEC and PCAOB rules, has consumed considerable time, energy, resources and has generated intense debate. Our staff and the Commission and I have all heard stories, as I'm sure many of you have, of substantial and unanticipated expenses, including internal overhead, audit fees and software expenses, companies pulling staff from other strategic projects to help with internal control reporting, management and auditors talking past one another, and duplicative testing procedures with little or no reliance on prior work.'[4]

Shortly after the roundtable, in May 2005, the SEC and PCAOB each published statements[5] on the implementation by registrants and auditors of the Section 404 requirements. Both statements call for better integration of the company's financial statement and internal control audits and for a top-down approach to reviews of internal control over financial reporting.

In November 2005, the PCAOB followed up their May statement with a report on the initial implementation by audit firms of Auditing Standard 2.[6] The report was critical in a number of areas, where the PCAOB had identified that audit firms had undertaken their work inefficiently.

In February 2006, the SEC Advisory Committee on Smaller Public Companies issued consultation proposals that would reduce the regulations applicable to smaller registrants. In particular, the Committee proposed that small public companies should be exempted from the Section 404 audit requirements and the very smallest public companies should be exempted from the requirements of Section 404 altogether until a framework for assessing internal control that recognises the particular requirements of smaller public companies has been developed. This proposal would remove from some or all of the provisions of Section 404 approximately 80% of companies by number and 6% by market capitalisation.

The SEC and PCAOB held a second roundtable discussion in May 2006 to discuss second-year experiences with the reporting and auditing requirements of the Sarbanes-Oxley Act related to companies' internal control over financial reporting.

In the first year of reporting under the internal control reporting requirements of Section 404, almost 16% of the companies reporting on their internal control concluded that their internal control over financial reporting was not effective, with an equivalent rate of 7% for the second year to date.[7] Commentators have noted that many of the companies which reported that internal controls over financial reporting were not effective under Section 404 had recently reported that disclosure controls and procedures were effective under Section 302.[8] Although the scopes of Sections 302 and 404 are different, the distinction between the two may not be well understood by all market participants.

---

[4] Roundtable discussion on implementation of internal control reporting provisions, SEC, April 13, 2005.

[5] Commission statement on implementing internal control reporting requirements, SEC, May 16, 2005 and Policy Statement Regarding Implementation of Auditing Standard No.2, PCAOB, May 16, 2005.

[6] Report on the initial implementation of Auditing Standard No. 2 *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Release No. 2005-023, November 30, 2005.

[7] 'Panel discussion – implications of ICFR reporting for auditing', PCAOB Standing Advisory Group meeting paper, June 12-13, 2006.

[8] 'SOX 404 Deficiencies Preceded by 'Effective' 302 Reports', *Compliance Week*, July 26, 2005.

1.4 Accounting under UK company law

There is no direct equivalent to Sections 302 or 404 in the UK. Corporate reporting and disclosure in the UK have their origins in company law, primarily the Companies Acts, supplemented by accounting standards. The defining concept is that from *Salomon v Salomon & Co. Ltd.*, which reinforced the principle of a company as a distinct entity from its owners, as had originally been set out in the 1862 Companies Act. Company law has subsequently provided shareholders with various rights of ownership, including the right to regular financial information in the form of annual accounts, and voting rights.

Some of the fundamental provisions include section 221 of the Companies Act 1985, which requires companies to keep proper accounting records, sufficient to show and explain the company's transactions. Section 233 requires the board of directors to approve the annual accounts and a director to sign them publicly on the board's behalf. Section 235 requires that, with certain exemptions for smaller companies, external auditors must provide a report stating whether, in their opinion, the annual accounts give a true and fair view and have been prepared in accordance with the Companies Act.

Public reporting requirements apply to all limited companies, whether or not they are listed. In that sense, they are part of the price of incorporation – the company agrees to certain reporting requirements and other legal obligations in return for limited liability. A clear explanation of the purpose of financial reporting and the function of external auditors in the UK is set out in *Caparo Industries v Dickman and others* (Caparo), as the following extract from the Caparo judgement illustrates:

'The members, or shareholders, of the company are its owners. But they are too numerous, and in most cases too unskilled, to undertake the day to day management of that which they own. So responsibility for day to day management of the company is delegated to directors. The shareholders, despite their overall powers of control, are in most companies for most of the time investors and little more. But it would of course be unsatisfactory and open to abuse if the shareholders received no report on the financial stewardship of their investment save from those to whom the stewardship had been entrusted.'[9]

Other requirements contained within company law include the obligation to prepare a directors' report which, for financial years commencing on or after 1 April 2005, must contain an enhanced business review.

1.5 Additional requirements for UK listed companies

Listed companies are required to provide additional non-financial disclosures in accordance with the UKLA Listing Rules. The Combined Code,[10] which brings together several corporate governance guidelines, also requires other non-financial disclosures to be given, or an explanation to be provided as to why these disclosures have not been given. A fundamental principle of the Combined Code and the Listing Rules is 'comply-or-explain'. This means that listed companies must either comply with a Code provision throughout the period or provide a narrative description of why they have not complied.

In 1998, a working party established by the ICAEW chaired by Nigel Turnbull was commissioned to provide guidance to support the Combined Code principle that:

'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets',

and the provision that:

[9] *Caparo Industries v Dickman* [1990] 2 AC 605.

[10] Combined Code on Corporate Governance, Financial Reporting Council, 2003.

'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.'

The working party's report (the Turnbull guidance) confirmed the requirement for the board to undertake an internal assessment of effectiveness over all internal control, not just internal controls over financial reporting, and to report publicly that they had undertaken the review but not to report their conclusions. It also confirmed the board's ultimate responsibility for the company's system of internal control.

The Turnbull guidance was subject to a review by the Turnbull Review Group, appointed by the Financial Reporting Council (FRC) in July 2004, and was reissued in October 2005. Few changes were made to the original, in recognition of how well the existing Turnbull guidance had been working. In particular, the Turnbull Review Group considered whether the disclosure requirements of Section 404 constituted an appropriate model for disclosures made in the UK under the Combined Code and Turnbull guidance. It concluded that they do not. In part this is because of the broader scope of the Combined Code and Turnbull guidance. The Turnbull Review Group did not consider that the concept of 'effectiveness' would be meaningful for public reporting purposes when considering many operational risks, for example, where the company's response is determined by its risk appetite and cannot be mandated by reference to some objective standard. It did, however, add a requirement for boards to confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from their review of internal control.

Some key extracts from the Turnbull guidance are reprinted below:

'24. Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board will need to form its own view on effectiveness based on the information and assurances provided to it, exercising the standard of care generally applicable to directors in the exercise of their duties. . .'

'26. Effective monitoring on a continuous basis is an essential component of a sound system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.'

'32. Should the board become aware at any time of a significant failing of weakness in internal control, it should determine how the failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.' [11]

[11] Internal Control: Revised Guidance for Directors on the Combined Code, Financial Reporting Council, October 2005.

2. Convergence of IFRS and US GAAP

It is common to distinguish UK principles-based, true and fair financial reporting from the more complex rules-based US system. Some supporters of the UK tradition are concerned that a rush to converge US GAAP and IFRS will mean that the UK's adoption of IFRS in line with EU regulation will lead to a deterioration in reporting quality.

The question in the *Pressure Points* consultation covered in this section is:

Q17. Is complete convergence between US GAAP and IFRS possible or will US standards always need to be different to reflect the US legal environment?

In considering this question, the following areas are relevant:

- Generally accepted accounting principles in the US.
- The legal environment in the US.
- International Financial Reporting Standards.
- The regulation requiring listed companies in the EU to adopt IFRS from 2005.
- Accounting standard convergence.

2.1 Generally accepted accounting principles in the United States

The sheer size and complexity of US GAAP is perhaps best summed up in a 1999 publication co-written by Bob Herz, prior to his appointment as Chairman of the FASB:

'The chairman and the chief accountant of the SEC often proclaim that the United States has the best financial reporting system in the world. If quality is measured by the sheer number of pronouncements, rules, and regulations and by their level of detail and complexity, then America certainly leads the rest of the world. U.S. Generally Accepted Accounting Principles represents a vast array of official pronouncements made over the past 40 years by various bodies, including the FASB and its predecessors, the Accounting Principles Board (APB) and the Committee on Accounting Procedure (CAP), the FASB Emerging Issues Task Force (EITF), and the Accounting Standards Executive Committee (AcSEC) of the AICPA. These pronouncements appear in various forms: FASB statements, interpretations, technical bulletins and implementation guides, EITF consensuses, AcSEC Statements of Position, and industry accounting and audit guides, just to name the principal ones. The FASB alone has issued more than 130 FASB statements, 44 FASB interpretations, more than 400 EITF consensuses, 7 concepts statements, more than 50 technical bulletins, and a number of special implementation guides containing hundreds of questions and answers. If this weren't sufficient, for public companies there is also another whole set of rules and regulations that interpret and supplement the GAAP rules.

Those interested will find them in the SEC's core rules, such as Regulations S-X and S-K, as well as in more than 100 specific Staff Accounting Bulletins, almost 50 Financial Reporting Releases, and hundreds of Accounting Series Releases. Had enough yet? In order to stay fully current with GAAP, it is not sufficient to know and understand just the official pronouncements; the SEC staff regularly deems it appropriate and important to proclaim their latest views on particular reporting and disclosure matters through speeches and comments at EITF and other professional meetings, which, although not official, effectively carry the same weight for anyone trying to comply with all the rules. All this effort ends up

as an extraordinarily detailed and complicated set of rules about what companies can and cannot do in their external financial reporting. These rules have become so complex that a rapidly decreasing number of CFOs and professional accountants can fully comprehend all the rules and how to apply them.' [12]

The complexity of US GAAP is further encapsulated by Don Nicolaisen, then Chief Accountant of the SEC, who observed in December 2004:

'Revenue recognition is a prime example. I've heard Mike Crooch [a member of the FASB Board] claim that revenue recognition appears in close to two hundred different pieces of accounting literature. And of course, these pieces of literature include many nuances, some of which are unique to particular transactions.' [13]

US GAAP refers to a body of literature issued by a number of authorities, including the Financial Accounting Standards Board (FASB) and certain predecessor bodies, the American Institute of Certified Public Accountants (AICPA), and other organisations. For public companies, accounting bulletins issued by the SEC are also considered GAAP. The standards issued by the FASB are known as Statements of Financial Accounting Standards (SFASs), of which there were 156 as at 30 June 2006. Predecessor body pronouncements include Accounting Research Bulletins (ARBs) and Accounting Principles Board Opinions (APB Opinions).

US companies that are not SEC registered have limited, if any, reporting requirements, although some may comply with US GAAP at the request of current or potential lenders, suppliers, customers or other contracting parties, or at the request of state regulators. Accordingly the standards and other pronouncements which constitute US GAAP mainly address larger, public company issues.

Many of these pronouncements overlap each other and require the use of professional judgement to determine how they interact. The relative hierarchy of the various pronouncements is established in AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of Presents Fairly In Accordance With GAAP*, which laid out four levels of importance, with SFASs at the highest level. For SEC registrants, SEC Staff Accounting Bulletins (SAB) are also considered to be at the highest level. These are summarised below.

Authoritative literature:

Level A – FASB's Statements of Financial Accounting Standards and Interpretations, APB Opinions, and ARBs, SEC Staff Accounting Bulletins (for SEC registrants)

Level B – FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides and Statements of Position

Level C – Emerging Issues Task Force Consensuses and AICPA Practice Bulletins

Level D – AICPA accounting interpretations, FASB staff Q&As, and industry practice

Other literature:

Statements of Financial Accounting Concepts, AICPA Issues Papers, International Financial Reporting Standards, textbooks, articles in professional journals, etc.

[12] *The ValueReporting Revolution: Moving Beyond the Earnings Game*, Robert G. Eccles, Robert H. Herz, E. Mary Keegan and David M. H. Phillips, John Wiley & Sons Ltd, 2001, p. 110.

[13] 'Speech by SEC Staff: Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments', Donald T. Nicolaisen, Washington DC, December 6, 2004.

The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the 1934 Act. Throughout its history, however, SEC policy has been largely to rely on private sector bodies, primarily the FASB, for this function to the extent that the private sector demonstrates ability to fulfil this responsibility in the public interest. However where necessary, the SEC issues guidance on the interpretation of securities law or standards as Staff Accounting Bulletins (SABs) or Staff Legal Bulletins (SLBs).

On rare occasions, the US Congress intervenes in the direction of FASB standard setting. In 1995, pressure from Congress convinced the FASB to dilute SFAS No. 123, *Accounting for Stock-Based Compensation*, so that it merely required disclosure of the fair value of options instead of their value being charged against profit. Commentators have observed that, had the FASB persisted with its standard, Congress may have passed legislation that would effectively have put the body out of business.[14] However, following the publication of the Sarbanes-Oxley Act 2002, the political climate had changed sufficiently that the FASB was able to issue SFAS No. 123(R), *Share-Based Payment*, despite lobbying from Silicon Valley employers.

In accordance with Section 108(d) of the Sarbanes-Oxley Act 2002, in 2003 the SEC undertook a project into the adoption by the US of a principles-based (or objectives-oriented) accounting standard system. This led to a number of proposals, including reviewing the conceptual framework, committing to accounting standard convergence with IFRS and modifying the GAAP hierarchy so that it is directed specifically at companies, rather than being defined within auditing standards. This project aims to give greater authority to FASB Concepts Statements, which rank below industry practice under SAS 69.

2.2 Accounting and the US legal environment

In the US, compliance with US GAAP is a requirement of the 1934 Act.[15] As with other elements of US securities law, enforcement of this requirement is the responsibility of the SEC's Division of Enforcement.

The Division of Enforcement can bring a variety of actions to rectify wrongdoing and to return money to shareholders who have been harmed by it. These include fines against companies and their directors, the ability to prohibit individuals from acting as a director and requiring companies to restate their filings.

Restatements, whether required by the SEC or made voluntarily, can have significant adverse consequences. Following a restatement, a fall in the company's share price can lead to a class action lawsuit on behalf of shareholders who bought at higher prices.

In light of the severity of the potential consequences of inaccurate reporting or restatements, it is perhaps unsurprising that in situations where there is doubt over an accounting treatment registrants seek guidance from the SEC on how it would be interpreted by SEC staff.

SABs are considered 'Level A' guidance in the GAAP hierarchy and, despite being non-binding, SLBs and telephone interpretations are considered to have persuasive authority.

[14] 'The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards', Stephen A Zeff, *CPA Journal*, February 2005.

[15] Securities Exchange Act, Section 13b (2).

Scott Taub, Acting Chief Accountant at the SEC, observed in December 2005:

'It's fair at this point for me to acknowledge that the SEC staff has played a role in increasing complexity. Because of actions we have taken in the past, we have been accused of being unwilling to accept judgments that differ from our own, of relying on bright-line rules, including some that don't exist in the literature, and of being unwilling to accept reasonable diversity in practice. I could tell you, over and over again, that we don't as matter of policy, do any of those things. But the fact of the matter is that the belief that the SEC staff does these things has certainly helped to encourage requests for more guidance, for exceptions that specifically allow certain treatments, and for specific delineation of what is acceptable and what is not.'[16]

And Robert Herz summarises this as follows:

'[There is] a palpable fear of the potential consequences of being second-guessed by regulators, enforcers, and the trial bar. And in our culture, many of these forces create a constant demand for detailed rules, exceptions, bright lines, and safe harbors; deter preparers, auditors, audit committees and boards from exercising professional judgement; and result in disclosures that while lengthy and dense, all too often are boilerplate, overly legalistic, and fail to effectively communicate important information.'[17]

2.3 International Financial Reporting Standards

IFRS refers to the standards and interpretations adopted by the International Accounting Standards Board (IASB). These comprise International Financial Reporting Standards (IFRSs), International Accounting Standards (IAS) and Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).[18] Use of IFRS is increasing globally, with some 100 countries either using or preparing to use IFRS on a voluntary or mandatory basis.

The IASB was preceded by the Board of the International Accounting Standards Committee (IASC), which issued IAS from 1973 until 2001. The IASC was founded in June 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland and the United States, and these countries constituted the Board of IASC at that time.

The IASB is governed by the International Accounting Standards Committee Foundation (IASC Foundation). The IASC Foundation's objectives recognise the needs of unlisted companies, smaller companies and countries without their own GAAP:

'2. The objectives of the IASC Foundation are:

(a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

(b) to promote the use and rigorous application of those standards; and

---

[16] 'Speech by SEC Staff: Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments', Scott A. Taub, Washington DC, December 5, 2005.

[17] '2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments, remarks by Robert Herz', December 6, 2005.

[18] IAS 1, *Presentation of Financial Statements*, paragraph 11.

(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

(d) to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.'

However, it can be argued that not all IFRS is consistent with these objectives. In response to a requirement from the International Organization of Securities Commissions (IOSCO) that IFRS should have a comprehensive standard for accounting for financial instruments by 1999, the IASB issued IAS 39 *Financial Instruments: Recognition and Measurement*, which adopted the approach of the US GAAP standard for financial instruments, SFAS No. 133. This standard is therefore more rules-based in nature than other IFRS standards. There are also concerns at the increasing volume of IFRS, which already extends to over 2,200 pages.

2.4 EU regulation on international accounting standards

UK listed companies are subject to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. This requires listed companies in the European Union to adopt IFRS in their consolidated financial statements for years commencing on or after 1 January 2005.

Two bodies have been established to facilitate the formal adoption of IFRS in Europe.

- The European Financial Reporting Advisory Group (EFRAG) provides technical advice concerning the use of IFRS within the European legal environment. It participates actively in the international accounting standard setting process and organises the coordination within the EU of views concerning international accounting standards.

- The Accounting Regulatory Committee of the European Commission (ARC) exists to provide an opinion on whether to endorse an international accounting standard as envisaged under Article 3 of the IAS Regulation.

As with US GAAP, this process is not immune to political interference. In 2003, Jacques Chirac, President of France, intervened to warn of the harm that IAS 32 and IAS 39 would cause to EU banks and national economies. In response, the ARC recommended endorsement for all existing IFRS, except IAS 32 and IAS 39. These were subsequently endorsed in an amended form.

In the UK, IFRS has replaced UK Generally Accepted Accounting Practice (UK GAAP) as the accounting standards to be applied by listed entities, although UK GAAP continues to be used by unlisted entities. UK GAAP has been developed over more than 30 years by the Accounting Standards Board (ASB) and its predecessor body, the Accounting Standards Committee. It is predominantly principles-based in nature, an approach that is particularly reflected in such standards as FRS 5 *Reporting the Substance of Transactions*, which mandates 'substance over form' accounting for complex transactions. The ASB has embarked on a programme to converge UK GAAP with IFRS over the medium term.

2.5 Accounting standard convergence

Accounting standard convergence is a process whereby standard setters are committed to eliminating differences in how they require similar transactions to be accounted for. There are two key drivers for convergence:

- Establishing confidence in the quality of global reporting. Currently SEC foreign registrants are required to present, at a minimum, a reconciliation of net equity and profit under their home country GAAP to US GAAP. Convergence may allow the SEC to reduce or remove this requirement, which would in turn lead to lower costs of preparation and compliance.

- At a conceptual level, it is asserted that for any transaction there is a single 'best' accounting treatment and that accounting standard setters should write standards that mandate this best treatment.[19]

At a joint meeting in Norwalk, Connecticut, USA on 18 September 2002, the FASB and the IASB pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as practicable, and coordinate their future work programmes to ensure that, once achieved, compatibility is maintained. To achieve compatibility, both bodies agreed, in what is commonly referred to as the Norwalk Agreement, to:

- undertake a short-term project aimed at removing a variety of individual differences between US GAAP and IFRS;

- remove other differences between IFRS and US GAAP that remained at 1 January 2005, through coordination of their future work programmes;

- continue progress on the joint projects that they are currently undertaking; and

- encourage their respective interpretative bodies to coordinate their activities.

Subsequently the FASB and the IASB have reaffirmed this commitment in several joint statements. On 27 February 2006, they committed to a convergence programme for 2006-2008 which would examine convergence in a number of areas, including the fair value option for financial instruments, impairment, income tax, investment properties, government grants, joint ventures, research and development, subsequent events and segment reporting.

Preliminary moves towards convergence are already underway in the areas of business combinations, consolidations, fair value measurement guidance, distinctions between liabilities and equity, performance reporting, post-retirement benefits (including pensions) and revenue recognition, with measurable progress expected to be made on these projects by 2008.

However, there is increasing recognition that financial reporting is only part of a broader system of governance. Even if accounting standards were to be perfectly aligned, other codes and regulations may not be, and expectations may be changing. Mutual recognition or equivalence, as an alternative to full convergence, may be more achievable in the medium term. Confidence in the quality and integrity of IFRS could see the SEC remove the reconciliation requirement before IFRS and US GAAP are fully converged. In the words

[19] Scott A. Taub, SEC, in a speech given in Amman, Jordan in May 2004.

of SEC Commissioner Paul Atkins in a speech at the 4th Annual Financial Services Conference in January 2006:

'I do not believe it is necessary to impose a single set of accounting rules on all participants in the global marketplace in order to allow competition across borders. In fact, due to differences in culture, legal systems, and liability regimes, true equivalence in accounting standards may be an impractical objective. What is critical, however, is that accounting standards be clearly stated and evenly applied by all nations and companies adopting those standards'.[20]

[20] 'Speech by SEC Commissioner: Remarks before the 4th Annual Financial Services Conference', Commissioner Paul S. Atkins, SEC, Brussels, Belgium, 31 January 2006.

3. Timeliness of financial reporting

Companies in the US and the UK are required to publish annual reports and accounts. In addition, the UK requires half-yearly reporting within 90 days, while in the US, quarterly reporting is required within 40 days.

The question in the *Pressure Points* consultation covered in this section is:

Q18. To what extent does quarterly reporting either improve market efficiency or encourage short-termism and compromise reporting quality?

In considering this question, the following areas are relevant:

- Quarterly reporting requirements in the US.
- Perceived difficulties with quarterly reporting requirements.
- Other methods of regular disclosure in the US.
- The UK approach to timely disclosure.

3.1 Quarterly reporting in the US

Domestic registrants in the US are required by Section 13(a) of the Securities Exchange Act 1934 to file periodic reports with the SEC. Annual reports are filed on Form 10-K and quarterly reports are filed on Form 10-Q.

On 5 September 2002, the SEC issued Rule 33-8128, which forms part of its initiative to modernise and improve the regulatory system for periodic disclosure. The rule proposed that annual reports and quarterly reports should be filed on an accelerated basis and that information about the website availability of 1934 Act reports should be provided in these reports. The original rule proposed that, following a three-year transitional period, annual reports should be filed within 60 days of year-end and quarterly reports within 35 days of quarter-end.

Rule 33-8128 was followed by a series of modifying rules that have changed or deferred its impact. Rule 33-8644, issued on 21 December 2005, defines a 'large accelerated filer' as a company with a market value of $700 million or more and an 'accelerated filer' as a company with a market value between $50 million and $700 million. Starting with the first fiscal year ending on or after 15 December 2006, annual reports on Form 10-K will be due within 60 days for large accelerated filers and 75 days for accelerated filers. Until then, both types of accelerated filer must file their annual report within 75 days. Quarterly reports for large accelerated filers and accelerated filers will be due within a 40 day deadline, rather than the 35 day deadline proposed in Rule 33-8128. Rule 33-8644 also includes a mechanism to reclassify large accelerated filers or accelerated filers to a lower level of obligation, should their market value fall beneath the corresponding threshold.

Foreign private issuers are not required to file quarterly reports, although some release quarterly information on a voluntary basis. Annual reports, on Form 20-F, are due within six months of the registrant's year-end.[21] Additionally, foreign private issuers must furnish, on Form 6-K, any information that they have provided to shareholders locally, for example half-year results.

[21] General Instructions A(b) to Form 20-F, SEC.

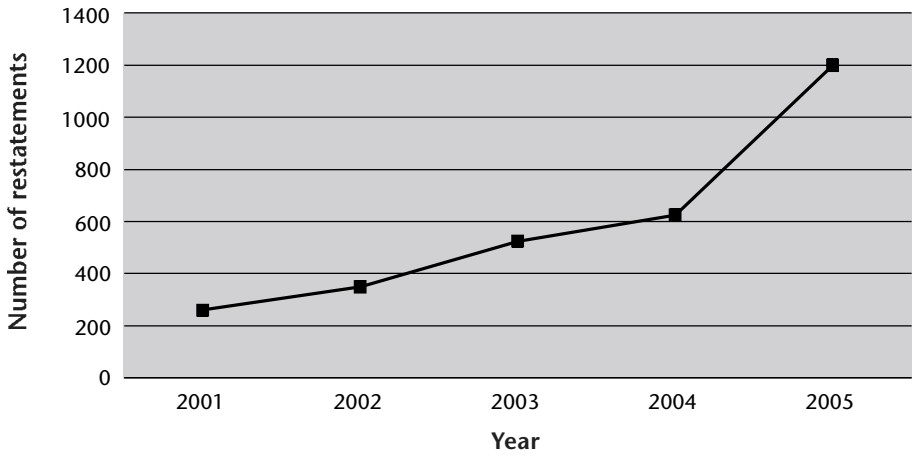
3.2 Perceived difficulties with quarterly reporting

An objective of quarterly reporting is to improve the relevance of financial reports provided by registrants, so that financial information no more than three months old is always available. However, it is accepted that there is a tradeoff between relevance and reliability. The IASB Framework states that:

'If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim.'[22]

In the US, errors in financial reports must be corrected by reissuing reports with the errors corrected in what is commonly known as a 'restatement'. An analysis[23] by Glass, Lewis & Co., LLC, shows that the restatement rate for US domestic registrants was approximately one for every 12 registrants in 2005 (2004: 1 for every 23 registrants). Glass, Lewis's findings can be summarised as follows:

Figure 1: Number of restatements by US domestic registrants 2001-2005



There are a number of possible explanations for the increase in restatements:

- it could be a consequence of accelerated reporting;
- it could be a consequence of increasing complexity;
- it could be a transitional effect of the Sarbanes-Oxley Act; and/or
- it could be a consequence of increased transparency.

Accordingly, faster disclosure may adversely impact the reliability of financial disclosures. Furthermore, critics have argued that financial reports do not convey all the information that investors need. In this context, more regular reports actually may be unhelpful, if markets follow financial reports to the exclusion of other, non-financial information.

[22] IASB Framework, paragraph 43, International Accounting Standards Committee Foundation, adopted April 2001.

[23] 'Getting it Wrong the First Time', Glass, Lewis & Co., LLC, 2 March 2006.

Obsession with financial reports can lead to what PricewaterhouseCoopers calls the 'earnings game'.[24] This is the obsession of management and analysts with quarterly earnings targets and whether the company meets them. This can encourage short-termism and manipulation of the results by management.

Recently, a number of high-profile US public companies have stated that they will no longer issue quarterly earnings guidance to the market. Although prompted in part by Regulation FD (as explained below), it perhaps also demonstrates a growing willingness of registrants to escape the earnings game. Further encouragement has come from the analyst community, with Candace Browning, head of Global Securities Research and Economics at Merrill Lynch, in her evidence to the House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises in March 2006 saying:

'Merrill Lynch believes it would be in the best interests of investors if companies dropped quarterly earnings guidance.'

3.3 Other methods of regular disclosure in the US

Applicable to domestic registrants, but not foreign registrants, is Regulation FD (Fair Disclosure). This was established by SEC Rule 33-7881, issued on 23 October 2000. The rule is designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading. Regulation FD requires that material non-public information, if disclosed, must be disclosed to all market participants at once. This must be simultaneous if disclosed intentionally, or prompt if disclosed unintentionally.

There is however no overall duty in US securities law to disclose material information[25] although specific rules and regulations requiring disclosure are wide-ranging in their effects. The SEC requires details to be provided on Form 8-K if one of a number of specified events takes place. The number and scope of reportable events were increased substantially by Rule 33-8400, issued by the SEC on 23 August 2004. The reason for the rule, as explained in its introduction, was that:

'Under the previous Form 8-K regime, companies were required to report very few significant corporate events. The limited number of Form 8-K disclosure items permitted a public company to delay disclosure of many significant events until the due date for its next periodic report. During such a delay, the market was unable to assimilate such undisclosed information into the value of a company's securities. The revisions... will benefit markets by increasing the number of unquestionably or presumptively material events that must be disclosed currently. They will also provide investors with better and more timely disclosure of important corporate events.'[26]

Following the rule, generally a reportable event must be reported on Form 8-K within four business days. In addition to the mandatory requirements, Section 8.01 of Form 8-K permits, but does not mandate, a registrant to disclose any events that it deems of importance to security holders. Foreign private issuers are not required to report on Form 8-K. Instead they must issue, on Form 6-K, all material information that the issuer:

- makes or is required to make public pursuant to the laws of its country of incorporation;

[24] *The ValueReporting Revolution: Moving Beyond the Earnings Game*, Robert G. Eccles, Robert H. Herz, E. Mary Keegan and David M. H. Phillips, John Wiley & Sons Ltd, 2001.

[25] *US Securities Offerings: An overview for non-US issuers*, Latham & Watkins LLP, 2005.

[26] Rule 33-8400, Section I, Background, SEC.

- files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange; or

- distributes or is required to distribute to its security holders.

3.4 UK approach to timely disclosure

UK company law requires limited companies, both private and public, to produce annual accounts and file them with Companies House.[27] In addition, the UKLA Listing Rules require listed companies to prepare a six month (or interim) report, but they do not require quarterly reports. In addition to the period reporting requirements, the UKLA Listing Rules set out six principles for listing, with which issuers must comply. Principles 4 and 5 mean that there is a fundamental requirement to disclose price-sensitive information to the market on a basis that does not differentiate between market participants.

> Principle 4 — A listed company must communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity securities.
>
> Principle 5 — A listed company must ensure that it treats all holders of the same class of its listed equity securities that are in the same position equally in respect of the rights attaching to such listed equity securities.

The disclosure of price-sensitive information is taken very seriously by market participants and the Financial Services Authority, as regulator. As an example, the FSA issued a statement in 2003 detailing Marconi plc's failure to comply with its Listing Rule obligation to make price-sensitive information available immediately and, in doing this, drew the attention of listed companies to the importance of these requirements. Marconi should have made information available by, at the latest, the evening of 3 July 2001 but delayed notification until the evening of 4 July 2001. The FSA's statement makes it clear that 'save in exceptional circumstances, a listed company must prioritise its disclosure obligations under the Listing Rules.'

The European Union's Transparency Directive, part of its Financial Services Action Plan, originally proposed to mandate quarterly reporting across the European Union. However the requirement for quarterly reporting was removed during the consultation process and instead a requirement for interim management statements was introduced. This will require companies to issue a trading statement (or equivalent) twice a year between the company's ordinary year-end and half-yearly reporting. The implementation of the Transparency Directive into UK company law is currently under consultation.

[27] Companies Act 1985, s242.

4. Convergence of auditing standards

The UK has recently anticipated new EU requirements by adopting International Standards on Auditing (ISAs). The US, through the PCAOB, is developing its own detailed standards which address US legislative requirements, including the internal control over financial reporting requirements of Section 404 of the Sarbanes-Oxley Act.

The question in the *Pressure Points* consultation covered in this section is:

Q19. How are US auditing standards likely to influence the development of principle-based ISAs?

In considering this question, the following areas are relevant:

- Auditing standards in the US.
- ISAs issued by the International Auditing and Assurance Standards Board (IAASB).
- Regulation of auditors in the US, UK and Europe.

4.1 US auditing standards

In general, only the consolidated financial statements of SEC-registered companies require audits. These are conducted in accordance with auditing standards set by the PCAOB. On 16 April 2003, the PCAOB incorporated Generally Accepted Auditing Standards in the United States (US GAAS) as its interim standards to be used on an initial, transitional basis.

At the core of US GAAS are 10 standards, which originated in 1947-48 but which remain relevant and essential auditing requirements.[28] The 10 standards are:

'General Standards

1. *The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.*
2. *In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.*
3. *Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.*

Standards of Field Work

1. *The work is to be adequately planned and assistants, if any, are to be properly supervised.*
2. *A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.*
3. *Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.*

[28] According to the PCAOB's Standing Advisory Group, meeting dated November 17-18, 2004.

Standards of Reporting

1. *The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.*

2. *The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.*

3. *Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.*

4. *The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.'*

In addition to this, AICPA professional standards require AICPA members undertaking audits to comply with auditing standards issued by the AICPA Auditing Standards Board.

Section 103 of the Sarbanes-Oxley Act gave the PCAOB power over the setting of auditing standards for public companies in the US. The PCAOB has issued four auditing standards since 2002, including Auditing Standard 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*. Auditing Standard 2 addresses the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. It also introduces the concept of the 'integrated audit', covering both the audit of financial statements and an audit of internal control over financial reporting.

To the extent that they have not been superseded by new standards, pre-existing AICPA standards remain in force for the audits of SEC-registered companies.

4.2 International Standards on Auditing

ISAs are issued by the IAASB. The objective of the IAASB is:

'to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.'

The IAASB's fulfilment of its role is overseen by the Public Interest Oversight Board (PIOB) of the International Federation of Accountants (IFAC). IAASB's broad agenda is overseen by a Consultative Advisory Group, at which the PCAOB has observer status.

In 2004 the IAASB commenced a project to consider, among others matters, the clarity of the language used in IAASB standards to describe the responsibilities of the auditor, the authority attaching to those sections of ISAs printed in bold and those printed in ordinary type and the use of the present tense in IAASB standards.

Known as the 'clarity project,' it is, in addition, to consider other aspects of the clarity and structure of IAASB standards and will reinforce IAASB standards as principles-based. Nevertheless, the IAASB's clarity project seems likely to increase the number of required audit procedures.

In 2003, the European Commission committed itself in principle to the introduction of ISAs in Europe.[29] However in the UK, the Auditing Practices Board anticipated the introduction of ISAs by adopting them and issuing ISA (UK and Ireland) standards which contain additional material aimed at assisting with the application of ISAs in a national context.

4.3 PCAOB regulation of audit firms

Section 105 of the Sarbanes-Oxley Act of 2002 grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and their employees. Accordingly, the PCAOB established procedures for the investigation and discipline of registered public accounting firms on 29 September 2003, and these were approved by the SEC on 14 May 2004.

The PCAOB's rules allow it to undertake regular inspections of registered firms to review their audit, supervisory and quality control procedures. The PCAOB aims to review every registered firm at least once every three years.

The PCAOB and its staff may also conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms or their employees that may violate US securities law relating to the preparation and issuance of audit reports. The PCAOB's rules require registered public accounting firms to co-operate with investigations, including producing documents and providing testimony. The rules also permit the PCAOB to seek information from others, including the firm's clients.

The PCAOB's role as the body with responsibility for enforcing auditing standards arguably appears to have an influence on the style and approach of the standards it writes. This is due to the inherent tension between principles-based standards, which require auditors to exercise professional judgement, and enforcement actions, for which it is necessary to demonstrate that a particular step was not performed adequately. From a regulator's point of view, enforcement may be easier where there are required procedures rather than with principles-based procedures.

In 2004 the PCAOB issued Auditing Standard 3 addressing audit documentation. At the heart of this standard is the concept that, if an auditor cannot point to documentary evidence of testing or other work to support an audit opinion, it is reasonable to conclude that the work was not carried out. This has required auditors to step up their approach to documentation, since the onus of proof is upon them and the largest US audit firms are subject to inspections of their audit files by the PCAOB every year.

When violations are detected, the PCAOB can hold a hearing and can impose sanctions on offenders. The sanctions may be as severe as revoking a firm's registration or barring a person from participating in audits of public companies. Lesser sanctions include monetary penalties and requirements for remedial measures, such as training, new quality control procedures, and the appointment of an independent monitor.

4.4 UK regulation of auditors

The responsibility for audit regulation in the UK is divided between the government, the FRC and the professional accountancy bodies, in their role as 'recognised supervisory bodies' and 'recognised qualifying bodies'. The ICAEW is by far the largest of these bodies.

Ultimate responsibility for regulation lies with the Department of Trade & Industry (DTI). However the DTI has delegated the direct responsibility for oversight to the Professional Oversight Board (POB, formerly the Professional Oversight Board for Accountancy), a subsidiary body of the FRC. POB has three main roles:

[29] 'Reinforcing the Statutory audit in the European Union', Press Release, COM (2003) 286 final, 21 May 2003.

- a statutory obligation to oversee the regulation of auditors by the recognised accountancy bodies. In particular POB is responsible for the recognition, supervision and de-recognition of those accountancy bodies responsible for supervising the work of auditors or offering an audit qualification;

- through its Audit Inspection Unit (AIU) to monitor, independently of the professional bodies, the quality of auditing of listed and other major public interest entities; and

- in addition, by agreement with the principal accountancy bodies, to exercise independent oversight of the way in which the bodies carry out their own regulatory responsibilities.

The professional accountancy bodies continue to have the primary regulatory responsibility for the supervision of their members acting in their professional capacity. In relation to audit, as 'recognised qualifying bodies', they must have effective arrangements in place to ensure that their audit qualifications meet the statutory requirements; and, as 'recognised supervisory bodies', they must have in place, amongst other things, effective arrangements for registration, monitoring and disciplining of auditors. Monitoring of major public interest entities is the audits of carried out by the AIU and for other entities by the recognised body. It is envisaged that the PCAOB and POB will seek to coordinate their work in respect of firms falling under the jurisdiction of both regulators.

The retention of an element of self-regulation by professional bodies provides contrast between the UK and US frameworks. The US system has rejected its previous self-regulatory model in favour of the PCAOB as external regulator.

Both auditing standards and audit regulation in the European Union remain on a national level. The Revised 8th Company Law Directive would require international standards to be adopted. However, the EU first needs to establish the procedures for formally endorsing these standards. The process of EU endorsement will necessarily involve regulators and on 14 December 2005, a European Commission press release announced that it had set up a 'European Group of Auditors' Oversight Bodies' (EGAOB). The UK is represented on the EGAOB by the DTI and POB.

'The press release stated that the Group will ensure effective coordination of new public oversight systems of statutory auditors and audit firms within the European Union. It may also provide technical input to the preparation of possible measures of the Commission implementing the 8th Company Law Directive, such as endorsement of the International Standards on Auditing or assessment of third countries' public oversight systems.'

5. Narrative disclosure

Preparations for the UK's mandatory Operating and Financial Review (OFR), which was abolished before it came into force, emphasised the role of principles and judgement in reporting. However, experience with the US Management Discussion and Analysis (MD&A) suggests that in a litigious environment, SEC registrants will use formulaic drafting and caveats to protect management from risk.

The question in the *Pressure Points* consultation covered in this section is:

Q20. Is it realistic to expect non-financial disclosure to evolve beyond current US practice?

In considering this question, the following areas are relevant:

- Current US requirements for narrative disclosure.
- The impact of the US legal environment.
- Expectations of how narrative disclosures should evolve, with reference to UK experiences.

5.1 Current US practice

SEC registrants must provide in 10-K and 10-Q filings a narrative explanation of the financial statements, known as the 'management discussion and analysis' (MD&A). The requirement for an MD&A originated in 1968[30] and was supplemented by the SEC in 1989 in response to growing concern that a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance.[31]

The implementing rule, 33-6835, sets out the basic principles of the MD&A. The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future. Disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on the registrant's financial condition or results of operations. Accordingly, the development of MD&A disclosure should begin with management's identification and evaluation of what information, including the potential effects of known trends, commitments, events, and uncertainties, is important to providing investors and others with an accurate understanding of the company's current and prospective financial position and operating results.[32]

In order to encourage registrants to disclose the forward-looking information required by the rules and to provide protection against litigation, the SEC extended Safe Harbor provisions to cover forward-looking statements made in the MD&A.[33] US Safe Harbor legislation provides that in general a director or company shall not be liable in any private action with respect to forward-looking statements. The Safe Harbor applies where the

[30] Securities Act Release No. 4936, SEC, December 9, 1968.

[31] Securities Act Release No. 6711, SEC, April 24, 1987.

[32] Commission Statement about management's discussion and analysis of financial condition and results of operation, SEC, January 22, 2002.

[33] Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, SEC, May 18, 1989.

statement is identified as a forward-looking statement and is accompanied by meaningful cautionary words that set out important factors that could cause actual results to differ materially from those in the forward-looking statement.

The instructions for compiling the MD&A are included in Section 303 of Regulation S-K, including the general requirement to include information necessary to understand the financial condition, changes in financial condition and results of operations of the registrant.

In December 2001, the then Big Five firms of accountants petitioned the SEC to provide further interpretive guidance on Section 303 to address three perceived areas of weakness: liquidity and capital resources, including off-balance sheet arrangements; trading activities involving non-exchange traded contracts accounted for at fair value; and related party transactions. This guidance was issued as Rule 33-8056[34] on 22 January 2002.

Subsequent releases have urged registrants to provide information on critical accounting policies and estimates and to take a fresh look at the MD&A each year, rather than simply bringing forward accumulated prior period disclosures.

5.2 The impact of the US legal environment

The prescriptive nature of the US MD&A regulations is widely regarded as establishing very high minimum standards. This view is reinforced by recent research by Vivien Beattie and Bill McInnes.[35] Their work, based on review of the relative disclosures in SEC filings and UK annual reports, concludes that *'mandatory rules in relation to narratives can produce disclosures of higher quality than a voluntary, principles-based system'* and that *'at least for some topics, the greater accuracy with which standard-setters can communicate their requirements using rules outweigh the potential dangers of a rule-based systems (creative compliance and boilerplate reporting).'*

However these requirements are perceived by some, including SEC Commissioner Glassman, as creating problems. In a speech in 2003, Commissioner Glassman stated that *'lawyers – because of their defensive posture – are part of the problem with the poor state of corporate disclosures.'*[36] Despite repeated urging by the SEC to provide more discursive, meaningful disclosure, and less boilerplate, registrants appear unwilling to provide more disclosure in case this may expose them to risk. As she observed in that speech:

'What roles can lawyers play? First and foremost, lawyers can identify the requirements and risks and encourage business management to make the actual decisions as to what disclosures are important to investors. As Alan Beller, the Commission's Director of Corporation Finance, and a lawyer himself, has said on several occasions, "Disclosure is too important to be left solely to lawyers." With respect to GAAP, lawyers should recognize it is not the outer limit of accounting disclosure, but rather a starting point. Lawyers should also accept that the best way for companies to stay in the good graces of the Commission and investors is to make complete, accurate and understandable disclosures in the MD&A. Help management to tell a good and fair story – and don't hinder management with boilerplate, wordiness and incomprehensible statements. Even if the story doesn't have a happy ending, telling the story accurately is important for the company's long-term credibility.'[37]

---

[34] Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC, January 22, 2002.

[35] *Narrative reporting in the UK and the US – which system works best?* Vivien Beattie and Bill McInnes, ICAEW, April 2006.

[36] Improving Corporate Disclosure: Improving Shareholder Value, Commissioner Cynthia Glassman, SEC, April 10, 2003.

[37] Improving Corporate Disclosure: Improving Shareholder Value, Commissioner Cynthia Glassman, SEC, April 10, 2003.

As an example, the guidance in 33-8056, produced as a response to the Big Five petition, did not introduce new requirements but clarified how, in the SEC's opinion, the provisions of Section 303 of Regulation S-K should be interpreted. The problems caused by the legalistic approach are further exposed by some SEC-registered UK companies, which report being advised to remove disclosures given in their UK annual reports and accounts in preparing the MD&A for their 20-F filings.

5.3 The evolution of narrative disclosure in the UK

The UK experience provides an alternative perspective on how narrative disclosure could evolve. The Cadbury report established as a general duty the principle that directors should present a balanced and understandable assessment of a company's position. To assist boards of directors in fulfilling this requirement, the Accounting Standards Board (ASB) issued the Statement 'Operating and Financial Review' in July 1993. It has become a market expectation for larger listed companies with many producing disclosures voluntarily in their annual reports. Best practice disclosures have developed within the framework of recommended practice. This was issued with persuasive, rather than mandatory, force. An updated version was published in 2003, still based on a voluntary regime.

In May 2004, the UK Government announced proposals for a statutory OFR. The ASB developed Reporting Standard 1 *Operating and Financial Review* (RS 1) to assist companies in meeting the new requirements. RS 1 required directors to prepare an OFR addressed to shareholders, setting out an analysis of the business through the eyes of the board, with a forward-looking orientation in order to assist shareholders to assess the strategies adopted by the entity and the potential for those strategies to succeed. It also set out a number of other principles regarded as essential to the preparation of an OFR, namely that the review shall: both complement and supplement the financial statements; be comprehensive and understandable; be balanced and neutral; and be comparable over time.

On 27 October 2005, the IASB published a discussion paper, with a closing date for comment of 28 April 2006, entitled 'Management Commentary' that assesses the role the IASB could play in improving the quality of the management commentary that accompanies financial statements. The discussion paper was prepared for the IASB by staff of its partner standard-setters from Canada, Germany, New Zealand and the UK. The paper reviews existing national requirements or principles on management commentary and offers recommendations on how the IASB might promote the wider adoption of best practice in the interests of investors and others who use financial reports.

In November 2005 the UK Government announced it was to repeal the statutory OFR and the ASB reissued RS 1 as a best practice, non-mandatory Reporting Statement in January 2006. Despite the demise of the statutory OFR, UK listed companies will still be required to produce additional narrative disclosures as a result of the EU Accounts Modernisation Directive. This requires an enhanced business review to be included as part of the directors' report, for financial years ending on or after 1 April 2005. An enhanced business review must include a fair review of the business of the company, to the extent necessary to allow an understanding of the development, performance or position of the business of the company, making use of financial key performance indicators. It should, where appropriate, make use of non-financial key performance indicators, including those relating to employee or environmental matters, and should include a description of the principal risks and uncertainties facing the company.

Following the consultation on the UK implementation of the Directive, it has been decided to add back certain aspects of the OFR and to create a safe harbour for forward-looking statements unless made in bad faith or recklessly.

6. External audit and the role of audit committees

The UK Companies Act 1985 requires that auditors are appointed by and report to shareholders. In the US, auditors are employed by and report to the board's audit committee, under federal securities legislation.

The question in the *Pressure Points* consultation covered in this section is:

Q21. What are the practical implications of differing external auditor reporting lines and how do the roles of audit committees in the US and UK differ?

In considering this question, the following areas are relevant:

- External auditor reporting lines in the US and UK.
- The respective roles of audit committees in the US and UK.

6.1 External auditor reporting lines in the US and UK

Section 202 of the Sarbanes-Oxley Act 2002 requires all work undertaken by the external auditors to be approved by the registrant's audit committee. Section 204 further requires the principal communications between the external auditor and registrant to be reported to the audit committee.

Under section 235 of the UK Companies Act 1985, external auditors must make a report to the company's members on all annual accounts of the company of which copies are to be laid before the company in general meeting during their tenure of office, stating whether, in the auditors' opinion, the accounts have been properly prepared in accordance with the Companies Act and whether they give a true and fair view. Other than in certain specific circumstances, for instance to fill a casual vacancy, the appointment of external auditors is by the shareholders of the company in general meeting.

The Caparo judgement summarised the responsibility of the auditor as follows:

'In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client. But he is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment. No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them.' [38]

A key difference between the two approaches is that, in the case of the US, external auditors report to the board's audit committee to comply with securities legislation, whereas in the UK the auditors report to shareholders. In this sense, the law in the US puts more emphasis on promoting efficiency in the securities markets than on enhancing board accountability to shareholders. These differences were described by Tim Bush from Hermes Pensions Management Ltd as follows:

[38] *Caparo Industries v Dickman* [1990] 2 AC 605.

'In the UK the Companies Act (s235) requires that auditors are appointed by and report to shareholders as an obligation of the privilege of incorporation. The contractual purpose of the s235 audit is to address an agency problem. Those people charged with looking after other people's property should be accountable to the owners. In giving an account of their performance and stewardship under that accountability, they will have an inherent tendency towards a bias, not necessarily malign, in presenting an account of their performance and stewardship, on their terms, in a way that suits their agenda. Hence the need for an independent agent who is not biased – the shareholders' auditor.

US financial statements are prepared, and auditors are employed by and report to boards, principally under the regulation established for market pricing purposes by the 1933 Securities Act. This closeness with the client, being the board and not the body of shareholders, can create an agency conflict resulting in a lack of independence of mind and a somewhat inhibited ability to act. It is issues of auditor independence that the Sarbanes-Oxley Act is now seeking to address with increased focus on audit committees overseeing auditors.'[39]

The introduction of the Sarbanes-Oxley Act in 2002 had a number of implications for the US audit profession, including a number of new requirements around the integrity and accuracy of financial reporting, and the roles of auditors and audit committees. The Act sought to focus on auditor independence and the integrity of financial statements by addressing perceived issues such as:

- over-reliance of an external auditor on fees from non-audit services especially where there was concern that audit services may have been sold as a 'loss leader' in an effort to attract more lucrative fees from consultancy services.

- over-reliance of audit firms on particular corporate clients possibly leading to situations where auditors may be less likely to challenge management. This continued a trend towards tighter independence requirements.

New regulations have mitigated these problems with a more robust structure for audit committees to enable them to perform more effectively; restrictions or bans on the provision of non-audit services; the rotation of audit partners; and auditor regulation through the Public Company Accounting Oversight Board (under the SEC) which has issued ethical standards.

These matters are also in the sights of the APB which issued ISA (UK and Ireland) 260 *Communication of Audit Matters With Those Charged With Governance*. This built on the earlier UK standard SAS 610, which established certain key requirements for auditors to communicate to audit committees, in addition to fulfilling their statutory requirement to prepare their audit report for shareholders. These communications include:

- all relationships between the audit firm and the company that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff and the related safeguards;

- at the start of the engagement, an outline of the scope of the audit work the auditors propose to undertake and the form of the reports they expect to make;

[39] *'Divided by Common Language' Where economics meets the law: US versus non-US financial reporting models,* Tim Bush, ICAEW, 2005.

- expected modifications to the audit report, unadjusted misstatements, material weaknesses in the accounting and internal control systems identified during the audit, views on the qualitative aspects of the company's accounting practices and financial reporting and any other relevant matters identified during the audit; and

- other reporting requirements as required by other auditing standards.[40]

Although UK and US reporting lines may appear similar, there are differences. Importantly, despite the requirement on UK auditors to report certain matters to audit committees, their ultimate obligation is to the company's shareholders. In the light of this responsibility, where the audit committee fails to take appropriate action after matters have been communicated to them, the auditor would be expected to take legal advice on whether to disclose this directly to shareholders.

6.2 Roles of audit committees in the US and UK

In the US, the audit committee was given a central role following the Sarbanes-Oxley Act. Section 301 required the SEC to introduce rules governing the independence of audit committee members and the relationship between the external auditor and the audit committee.

The SEC duly issued Rule 33-8220, with effect from 25 April 2003. This rule requires, as a condition of listing, that:

- every US domestic registrant must have an audit committee;

- every audit committee member must be 'independent', with certain exemptions for foreign private issuers;

- the audit committee be directly responsible for the appointment, compensation, oversight and retention of the external auditors;

- non-audit services provided by the external auditors must be pre-approved;

- the audit committee must receive reports on critical accounting policies and practices as well as alternative accounting treatments;

- the audit committee must have the authority and appropriate funding to engage outside advisors; and

- the audit committee must establish procedures for handling complaints from whistleblowers.

In the UK, the role of the audit committee was considered by the FRC-appointed committee chaired by Sir Robert Smith. The main recommendations of its report, 'Audit Committees – Combined Code Guidance', form Section C.3 (Audit Committee and Auditors) of the 2003 revision of the Combined Code on Corporate Governance. In line with the rest of the Combined Code, the main provisions in this section apply to listed entities on a 'comply-or-explain' basis.

The Smith guidance states that audit committees should be comprised of at least three (or in the case of smaller listed companies two) independent non-executive directors and

[40] A summary of relevant requirements is given in the Appendix to ISA (UK and Ireland) 260, Auditing Practices Board, December 2004.

at least one member should have 'recent and relevant' financial experience. The role of the audit committee, as recommended by the Combined Code, is summarised as follows:

- Monitor the integrity of financial statements.
- Review internal financial controls.
- Monitor and review the effectiveness of the internal audit function.
- Recommend to the board whether to appoint, re-appoint or remove the external auditors.
- Review and monitor the external auditors' independence.
- Develop a policy regarding the engagement of the external auditor to supply non-audit services.[41]

A further provision of the Smith guidance is that it gives audit committees the right, where a disagreement with the rest of the board cannot be resolved, to communicate directly to shareholders in a separate section of the directors' report in the annual report and accounts.

The implementation of new audit committee requirements, particularly for at least one member to have 'recent and relevant' financial experience, could be difficult and reinforce concerns over a lack of willingness of individuals to serve on audit committees. However, Article 39 of the European Commission's Revised 8th Company Law Directive will require audit committees to include an individual with 'competence in accounting and auditing' and this will become a legal requirement in the UK, over and above the recommendations outlined in the Combined Code.

[41] Combined Code on Corporate Governance, Provision C.3.2, Financial Reporting Council, 2003.

Useful contacts

United Kingdom

Accounting Standards Board – www.frc.org.uk/asb

Association of British Insurers – www.abi.org.uk

Auditing Practices Board – www.frc.org.uk/apb

Bank of England – www.bankofengland.com

Companies House – www.companieshouse.gov.uk

Confederation of British Industry – www.cbi.org.uk

Department of Trade & Industry – www.dti.gov.uk

Financial Reporting Council – www.frc.org.uk

Financial Reporting Review Panel – www.frc.org.uk/frrp

Financial Services Authority – www.fsa.gov.uk

Her Majesty's Treasury – www.hm-treasury.gov.uk

Hermes Pensions Management Ltd – www.hermes.co.uk

Institute of Chartered Accountants in England & Wales – www.icaew.co.uk

Institute of Chartered Secretaries and Administrators – www.icsa.org.uk

Institute of Directors – www.iod.com

Investment Management Association – www.investmentuk.org

London Stock Exchange – www.londonstockexchange.com

National Association of Pension Funds – www.napf.co.uk

Pensions & Investment Research Consultants Limited – www.pirc.co.uk

United States

American Bar Association – www.abanet.org

American Institute of Certified of Public Accountants – www.aicpa.org

American Stock Exchange – www.amex.com

Business Roundtable – www.brtable.org

CalPERS – www.calpers.ca.gov

Caux Round Table – www.cauxroundtable.org

Conference Board – www.conference-board.org

Corporate Library – www.thecorporatelibrary.com

Council of Institutional Investors – www.cii.org

Financial Accounting Standards Board – www.fasb.org

Global Proxy Watch – www.davisglobal.com

Governance Metrics International – www.governancemetrics.com

Institutional Shareholder Services – www.issproxy.com

Investor Responsibility Research Consultancy – www.irrc.org

NASDAQ – www.nasdaq.com

National Association of Corporate Directors – www.nacdonline.org

National Association of Securities Dealers – www.nasd.com

National Association of State Boards of Accountancy – www.nasba.org

New York Stock Exchange – www.nyse.com

Public Company Accounting Oversight Board – www.pcaob.org

Securities and Exchange Commission – www.sec.gov

Securities Lawyer's Deskbook – www.law.uc.edu/CCL

TIAA-CREF – www.tiaa-crefinstitute.org

International

Commonwealth Secretariat – www.thecommonwealth.org

European Commission – http://ec.europa.eu/index_en.htm

European Corporate Governance Institute – www.ecgi.org

Global Corporate Governance Forum – www.gcgf.org

Global Reporting Initiative – www.globalreporting.org

International Accounting Standards Board – www.iasb.org

International Corporate Governance Network – www.icgn.org

International Finance Corporation – www.ifc.org

International Monetary Fund – www.imf.org

Organisation for Economic Co-operation and Development – www.oecd.org

World Bank Group – www.worldbank.org

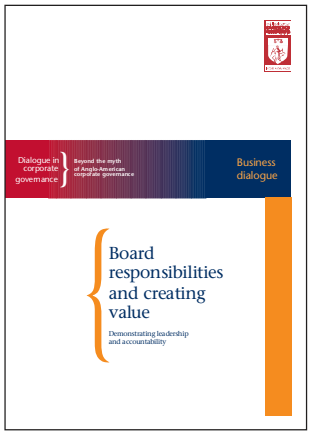
Pressure Points consultation and other discussion papers

Pressure Points: Contrasting US and UK securities markets: How they impact international policy, investment, business and accounting

Discussion around the similarities and differences between US and UK systems of corporate governance challenges the commonly held presumption of an Anglo-American model. This consultation paper summarises key questions around how policy makers encourage business and investor confidence; how companies are directed and controlled; and how disclosure and reporting requirements are framed and enforced.

Policy dialogue:
Effective corporate governance frameworks – encouraging enterprise and market confidence

Effective corporate governance frameworks promote prosperity, market confidence and public trust. The US and the UK are amongst the world's most successful economies, each with a strong tradition of corporate governance. This paper explores how policy makers are challenged with striking the right balance between market forces and regulation in supporting internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.



Business dialogue:
Board responsibilities and creating value – demonstrating leadership and accountability

Boards of directors are responsible for acting in the long-term best interests of the company for the benefit of shareholders. Effective boards require skilled leadership, balanced decision-making, informed risk-taking, good judgement and integrity. This paper explores how US and UK boards operate differently, and the role, responsibilities and powers of directors in each jurisdiction.

Investment dialogue:
Shareholder responsibilities and the investing public – exercising ownership rights through engagement

Institutional investors play a significant role in the governance of companies in the US and the UK. They are the guardians of other people's money through the management of pensions, insurance and savings products and are expected to act responsibly in exercising their ownership rights. This paper explores the role of shareholders in corporate governance and their responsibilities.

Dialogue in corporate governance

Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8100 **Fax** 020 7638 6009 **www.icaew.co.uk**
July 2006

TECPLN5442