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Viewpoint

'Divided by common language'

Where economics meets the law: US versus non-US financial reporting models

Tim Bush

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This publication is based on law and regulation and related developments as at June 2005.

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ISBN-13: 978-1-84152-359-0

TECPLN6431

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Where economics meets the law: US versus non-US financial reporting models

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Acknowledgements

Thanks are given to those who assisted with the preparation of this paper, including:

David Hatherly, Professor of Accounting, Head of the Accounting and Finance Group, University of Edinburgh Management School, former member of the United Kingdom and Ireland Auditing Practices Board; Robert Hodgkinson, Kerrie Waring and Debbie Homersham of the ICAEW; and Nick Toyas of NT&A.

References to British and UK reporting models

This paper refers to both the UK and the British models of reporting and corporate governance which reflect two different meanings.

The legal purpose of shareholder accounts developed across Europe in free markets from the nineteenth century onwards. In what was then known as Great Britain, commercial best practice was generally embedded in the Companies Acts and equivalent legislation in countries then under British influence. So many other countries have drawn from the British model, that the term 'British' model does not only refer to the current model operating in the country now known as the UK, but is a model of common influence.

Parallel developments in almost all of Continental Europe and British influence in what is now the Commonwealth as well as the Irish Republic have resulted in similar approaches to financial accounts and the audit of them, namely to serve the shareholder.

‘Divided by common language’

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Executive summary

Major differences exist between the United States and the rest of the world regarding both the preparation of financial statements and corporate governance matters.

The US regulatory reporting model, dictated by the 1933 Securities Act, was created because of inherent difficulties that stem from legal problems not present in most other jurisdictions. These difficulties still exist and reactions to recent events may be spawning new solutions that if copied in other jurisdictions may actually create problems where none existed before.

The US's difficulties are simple in origin, and not widely understood, but their impact is global. They are constitutionally rooted because the State of Delaware, the most common jurisdiction for the registration of publicly quoted companies in the US, has no framework for public/shareholder financial reporting or ongoing company accounting control frameworks. In addition, Delaware law offers comparatively weak shareholder rights. From these two causes stem difficulties with the US's financial reporting system, and mutually related problems with enforcing corporate governance matters.

It is especially pertinent to compare the US model with that of the UK. It was British law that Congress drew from to create the 1933 Securities Act in an effort to resolve problems then occurring with quoted companies incorporated in states such as Delaware. However, Congress had to tackle things in an incomplete and indirect way, as a result important parts of the 1929 British Companies Act were left out of the US legislation. The 1933 Act was constitutionally restricted in scope and created an entirely novel way of structuring financial reporting and corporate oversight based almost solely on market-pricing, but at the same time it divorced financial reporting from having a role in shareholder-based oversight.

The US securities laws are trying to do something entirely different to the financial reporting regimes of other countries because of the constitutional limitations of the US federal system. However, the common language of the UK and US can at times create a superficial similarity in both governance and reporting matters, when beneath the surface, the law is entirely different in intent and effect.

Because of a constitutional quirk, the US federal reporting model does not address in enforceable law the fundamental capitalist proposition 'do the accounts show how efficiently a company is run on its capital resources?' This proposition requires that internal accounting and external reporting address the intra vires objectives of a company (acting within the powers of the company). Instead the federal model poses a legally very different, and actually far more ambiguous question, 'are the accounts consistent in showing what a company might be worth when a share is exchanged?'

This creates a problem for those interested in shareholder value as distinct from those who trade shares or their derivatives. It is entirely possible to value a company 'correctly' despite a board acting inefficiently ultra vires (acting beyond the powers of the company). Even inefficient companies acting ultra vires can be correctly priced.

Therefore a complete framework of appropriate internal accounting and external reporting requirements in the best interest of shareholders, as owners of the company as distinct from people trading shares, falls outside of the scope of the US federal system. The history of the US financial reporting model is one of developing tangential solutions to problems rather direct ones.

Because of anomalies within the US federal reporting system, introducing aspects of a US-style regulatory financial reporting and corporate governance regime into other countries where the laws are actually different and not constitutionally restricted, is conceptually unsound. The regulation underpinning the US listed company model might be better described as federally regulated earnings disclosure ('earnings-ism') rather than shareholder-based capitalism.

In the absence of a contractual audit aimed at addressing the intrinsic objectives of the corporation, the shareholder in a US incorporated listed entity receives a regulatory audit instead. The shareholder interest as an owner of something with intrinsic value is therefore subordinated in terms of financial reporting to a range of other players, particularly regulators and standard setters. Instead of a commonsense commercial view of what is relevant accounting and truthful reporting for shareholders, the US regime has become rigid and rules based. Therefore Enron, with its seemingly acceptable accounting despite the predicament of its business model and hidden financing, was perhaps as much a creature fostered by the rules-based regulatory environment as a breach of it.

The US system will have sudden reporting failures seemingly simultaneous with sudden corporate collapse, because by the time bad news becomes unambiguously market relevant, there has probably been a period of ultra vires activity or inefficiency that was paradoxically legally acceptable under US federal reporting requirements. Unless US GAAP and the wider governance system can 'simulate' share owning as well as share trading objectives there will be a gap between best serving the intrinsic shareholder interest and a lower form of market acceptability according to the regulatory law. Given that different corporations may have different constitutional objectives in their articles, it is difficult to see how exogenous standards alone can substitute for a proper corporate audit tailored to the specific objectives of the corporation. The 1933 Act actually creates a dead-end street. Accounting and reporting goals, defined in terms of shareholder value and stewardship, are further along the street than the Act allows for. Common law systems such as that of the British model, and also codified systems in many countries in Continental Europe, set the goals further along the street.

Introduction and context

This paper focuses on US and UK comparisons in financial reporting, and governance aspects thereof, since there is often a presumption of a global convergence towards an Anglo-American model of capital market behaviour. In fact, US law diverged in a step change away from that of Britain in the 1930s, and in existing law the UK is historically closer to a Continental European model, and getting closer.

Countries whose civil company law is directly based on that of Britain include India, Canada (excluding Quebec), Australia, South Africa, Hong Kong, Malaysia, and Ireland. Quebec law draws from French Civil Code, which is similar to the wider European model.

Outside the US, financial reporting is becoming unnecessarily confused by aspects of convergence drawing from US practice, overlooking, and in some cases undermining, the more robust aspects of those systems elsewhere that do not have the idiosyncratic constitutional problems that have driven the US reporting system to where it is today.

Issues arising include:

- a focus on processes not outcomes in and around matters of financial reporting;
- trust and judgement being replaced by process;
- primary markets and shareholding being confused with secondary markets and share trading;
- companies being fined by market regulators for the alleged misdemeanours of their directors out of shareholders' funds;
- the US Securities and Exchange Commission (SEC) not giving full 'credit' for matters already well addressed in other financial reporting regimes, where a company needs to fulfil home country as well as US requirements;
- directors complaining of spending time on anodyne and commercially irrelevant matters of financial reporting instead of running the business;
- few people genuinely understanding financial accounts, due to the complexity of reporting more data according to 'standards', as distinct from displaying information in a more simple way according to the actual performance of a company;
- in attempting to tackle apparent conflicts of interest, some regulatory and code-led developments are actually creating conflicts of interest in ways that may matter more in terms of economic fact, not least directors and auditors reporting to or being accountable to parties outside of their civil lines of accountability for actual economic ends;
- members of a unitary board in law, being accountable to some other board members in a regulatory sense (especially audit committees) but collectively accountable with each other in civil law; and
- confusion of auditor accountability, with auditors reporting to shareholders in one capacity and audit committees and regulators in another.

At the time of writing, the problem is accelerating to the extent that a number of non-US SEC registrants with London and European prime listings have already de-listed, or are seeking to de-list, from the US market.

Unlike the US Securities Acts of the 1930s, which were introduced to fix a problem, British company law has tended to support good practices, not force new practice or tightly regulate. The US financial reporting system has contradictions, and creates contradictions, that do not necessarily make it the best model for other jurisdictions with different systems to follow. It is primarily a regulatory model whereas the UK, Continental Europe and Commonwealth countries use a predominantly civil model, even for listed companies.

Australia has drawn on the British model, and in many ways strengthened it in law and practice. Canada has the British model in law of incorporation, but in terms of practice the Canadian governance and financial reporting model appears to have been subsumed within the codes and practice of the SEC regulatory model, even though this does not necessarily fit with the framework of Canadian civil law.

Differences arise in pulling together international codes and regulatory regimes. While the aim is to create an appearance of a common cause in matters of process, there may in fact be no shared legal purpose. This is especially relevant when problems arise and the ultimate sanction on people who have transgressed is the law.

Many policy problems seem to stem from confusing civil law with regulation because of the pragmatic decision in the 1930s to regulate in the US, the twentieth century's largest, and fastest-growing economy. The tension between laws of rights and regulation is greatest at the interface between the real micro-economy of the company and the law: matters of financial reporting.

Financial reporting is especially problematic to regulate with certainty because it is something inherently uncertain, something economic. This emphasises the point of this paper – where economics meets the law.

1. When and why US financial reporting diverged from the UK model

Governance problems in the US in the 1920s

Prior to 1910, much of the capital that fed many early capital-intensive, US-based ventures such as railroads and steelmaking came from the London equity market and banks. However, in terms of company law and corporate governance, the US was still a frontier economy, essentially an emerging market. There was a marked absence of any state system of incorporation for the protection of shareholders' rights of the kind that British or German investors had in companies as a matter of course.

In Britain, the duty to deliver an annual account to shareholders was a basic requirement under the laws of incorporation. This was not the case in the US, and most state company law did not require financial reporting. There were attempts in the US to have high quality financial reporting requirements embedded in state company law, but these had little success.

During the 1920s, matters were so extreme that many US listed companies (up to 30 per cent of companies listed on the New York Stock Exchange) produced no accounts whatsoever for investors. US companies were subject to the law of trusts which presumed that directors acted for investors, but this happened with no effective shareholder oversight due to the absence of shareholder accounts. Furthermore, there was no proper accountability. Often, shareholder votes were more symbolic than substantive and were controlled by chairmen's discretion. It was also frequently the case that when accounts were presented, they were misleading.

> *And then there are the [company annual financial] reports, all obfuscated and darkened over with fuliginous matter. To the uninitiated, as we shall soon see in detail, they may tell too much that is not so, or too little of what they ought to tell.*
>
> *Whether by accident or design, such reports are drawn so as to withhold from the stockholder what he most desires to know.*
>
> **'From Main Street to Wall Street', William Z. Ripley, *The Atlantic Monthly*, 1926**

William Ripley, an economics Professor at Harvard and pioneer of US corporate governance, identified the problem in 1926, a problem that has re-emerged more than 70 years later in the US.

Ripley was concerned about two things: the lack of shareholder rights with regard to control over boards and the absence of a proper framework for financial reporting. He identified that both problems stemmed from poor laws of incorporation at state level.

But in the United States such public gifts [of incorporation] are scattered with a lavish hand by forty-eight different little sovereignties, more or less jealous of one another, both financially and prestigiously. Whence it comes about that the selection for purposes of incorporation of one or another from among this ardent band of states has become a matter of corporate largess, when it should rather be one of respectful petition. In other words, the normal relation of suitor and besought has become reversed. Confusion both of ideas and of policy at this point has hampered the whole business of incorporation in the United States.

What is the explanation for the neglect of this section of the existing law? It is partly, perhaps, because the Commissioners [of the Federal Trade Commission] have been legalistically rather than economically minded, preferring to institute proceedings rather than to set constructive inquiries and practices on foot.

Some of these matters, too, are quite differently handled under the British Companies Acts. There is perhaps something for us in the United States to learn in this connection.

'From Main Street to Wall Street', William Z. Ripley, *The Atlantic Monthly*, 1926

The single Harvard solution to two problems

The 'market-pricing' reporting and governance system of the 1933 Securities Act that Congress adopted after the Wall Street Crash was devised by colleagues of William Ripley at Harvard. The market pricing model of governance and financial reporting was intended to substitute the lack of shareholder rights in state law, as well as create a consistent framework for financial reporting.

The poor or non-existent reporting requirements of companies under highly protective and secretive state law, and weak rights of shareholders, were overlaid by one regulatory model. This was founded on a model of consistent financial reporting – not actually for shareholders as that was a protected state matter – but for those exchanging shares in secondary markets or for those subscribing to new share issues by companies. The external governance of US listed companies was envisaged as being largely overseen by market-pricing mechanisms, with little or only token shareholder involvement.

The new system [was planned] to revive a financial market which had been in the past a strong contributor to national economic prosperity. Central to this plan of recovery was a new vision of governance promoted by three former students of Harvard Law School Professor Felix Frankfurter: Benjamin V. Cohen, Thomas G. Corcoran and James M. Landis. These reformers recognized the interdependence of government power and professional knowledge in assuring the efficient functioning of the nation's financial markets. Two goals were foremost. First, to establish mechanisms to assure the dissemination of reliable information to the investing community. And secondly, to define the legal responsibilities of all professional groups whose actions supported the operation of the financial markets [McCraw, 1984, pp. 185-188; Parrish, 1970, pp. 57 and 62-64; Seligman, 1995, pp. 56-61].

The new federal legislation shifted the focus of corporate monitoring more directly on the performance of a professional process for disseminating reliable information to a broad, anonymous population of investors.

'US Financial Reporting Standardization, 1840-2000', Paul J. Miranti, Jr., School of Business, Rutgers University New Brunswick and Newark, NJ

Omission of key parts of the British Companies Act from the 1933 Securities Act

The drafters of the 1933 Securities Act modelled their work and actually took whole blocks of text directly from the public offering (prospectus) parts of the 1929 British Companies Act.

US Congress accepted that the 1933 Acts were largely modelled on British legislation. This is significant, even today, since the creators of the US 1933 Act did not intend to differ ideologically from the British model of financial reporting in the way that the declaration of independence had been a clear decision to break from Britain. The US Supreme Court confirms that this is the case.

> *Far from suggesting an intent to depart in a dramatic way from the balance struck in the British Companies Act, the legislative history [of the 1933 Securities Act] suggests an intent to maintain it.*
>
> *'Similar requirements have for years attended the business of issuing securities in other industrialized nations'. House of Representatives Report. No. 85. So, too, the Report provided: 'The committee is fortified in these sections [that is, 11 and 12] by similar safeguards in the English Companies Act of 1929. What is deemed necessary for sound financing in conservative England ought not to be unnecessary for the more feverish pace which American finance has developed.' These passages confirm that the civil liability provisions of the 1933 Act, 11 and 12, impose obligations on those engaged in 'the business of issuing securities,' in conformance, not in contradiction to, the British example.*
>
> *The drafters of the Securities Act modelled this federal legislation on the British Companies Act. See Landis, The Legislative History of the Securities Act of 1933. Landis and the other drafters 'determined to take as the base of [their] work the English Companies Act'; characterizing the Companies Act as a 'statutory antecedent' of federal securities laws.*
>
> *The Companies Act defined 'prospectus' as 'any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company.'*
>
> ***Gustafson v. Alloyd Co*, 1995. Contained within the judgement of the US Supreme Court, 1995.**

But the US's constitutional problem regarding any federal intrusion into state reserved matters prevented the drafters from using the greater part of the British 1929 Companies Act. The areas omitted included such matters an expected standard for the internal financial control of companies, as well as shareholder annual financial statements, which are wholly different in principle to the type of information required under prospectus reporting. Those parts of the British reporting and governance model that the US federal model has omitted in deference to states, set out in the requirements for a true and fair view and other central features of the British financial reporting and corporate governance model.

Congress could not adopt a federal model of incorporation equivalent to that of Britain, as many including William Ripley wanted, as this would have created competition with states. Therefore in deferring to states and being unable to compete with them in the alternative form of proper federal laws of incorporation, the 1933 Securities Act was rather incomplete compromised legislation. It was then known by its creators to be a tangential solution rather than a direct one. But limiting the US's financial reporting regime to one based on a prospectus model creates enormous practical and technical difficulties, as the rest of this paper explores.

Current situation

Many US states, as in 1926, still do not have any financial reporting requirements. Also in states such as Delaware with weak shareholder rights, boards can be for all practical purposes self-perpetuating. Instead of being able to vote against a director's reappointment, for most companies a negative vote only counts as a vote withheld, therefore one share voted in favour can carry any election. Shareholders in Delaware companies can take cases of shareholder abuse to the Commercial Courts retrospectively. However, that requires evidence that is not possible without a statutory shareholder-based reporting and auditing regime revealing to shareholders what is actually happening.

There is no equivalent of statutory or incorporation accounts for shareholders of most US listed companies for an ongoing proprietorial stewardship purpose. 'Market' accounts may appear to mimic them but they are not the same thing. Shareholder-focused accounts are things that UK shareholders take for granted.

To this day the US 1933 Act is still trying to do two entirely different things in a rather inelegant way: to regulate the sale of securities; and indirectly to regulate the governance of companies. However, it is using what is essentially only one small part of the British 1929 Companies Act to do this. As a result, the US reporting model is in global terms almost uniquely anomalous, and rather ironically at odds with the British model from which it was developed.

Whereas the British reporting model has been based on the principle of the 'right to have' information, the US model is very much one of a 'need to know' basis only. This is an utterly different philosophy and has resulted in totally different outcomes.

It is precisely those parts left out of the US federal reporting and governance model of the 1933 Act that have supported the stability of the British corporate governance and financial reporting system. Indeed the SEC was set up by the 1934 Securities Act in part because the 1933 Act is incapable of working without a regulator.

The introduction of a 'prospectus' dimension into annual financial reporting in place of shareholder accounts confuses accounting for what has happened as a mechanism for accountability, with forward-looking information used as a means of valuation. It is from this seemingly innocuous cause that reporting and accounting problems arise inside the US and, because of cultural confusion about things that deceptively appear and sound similar in English, that problems are also being exported outside the US.

2. US and UK financial reporting since 1933

Aren't accounts just accounts requiring the same rules to get the 'numbers right'?

Financial accounts of companies are not fact but contain judgements about the affairs of micro-economic entities. Therefore, a clear understanding of the context and purpose of financial reporting is key to reaching the best judgement for the intended purpose.

Purpose matters: tax accounts will differ from management accounts; management accounts differ from financial accounts; receivership accounts differ from financial accounts. Given that there will be times when matters are not straightforward and frank and truthful external financial reporting will be embarrassing to boards, and possibly jeopardise a director's position there will be occasions when auditors will need to negotiate with certainty and strength of purpose. Therefore defining the purpose of financial reporting and properly defining the purpose and goals for those auditing financial statements is crucial to achieving optimal outcomes in financial reporting.

It is surprising that the legal repercussions of things going wrong in financial reporting are not widely understood. This is particularly the case in the UK regarding the UK's own regime where the legal sanctions governing annual financial reporting if things go wrong with the business as a result, can in monetary terms be far harsher on the parties responsible than those in the US.

US SEC financial statements are for a 'general purpose' function

As determined by US Congress, the audited annual financial statements required by the dominant law, the 1933 Securities Act, are primarily concerned with a market-pricing function, described as a 'general purpose'. The objectives, based on the economic theory behind the federal law, are to ensure an efficient secondary market and an efficient primary issue market in stocks of companies issuing new capital. They do this by ensuring that companies, in their reporting for secondary markets, do not make fraudulently misleading statements. The SEC for constitutional reasons avoids matters relating to laws of property and actual corporate objectives and shareholder rights. Though the SEC requirements and US GAAP mimic shareholder accounts they do not create a direct parallel. The US basis for financial statements is ironically more legalistic than economic.

The key principles, determining a breach of US securities laws are that there must be:

- misrepresentation of a material fact; and
- scienter (fraudulent conduct).

And these principles are relevant at the time that a security is exchanged, i.e. these as principles must be linked in some way to the share price.

Matters other than those directly linked to market-pricing are deemed to be essentially private matters, under the determination of state laws of incorporation, where there are generally no financial reporting requirements.

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.

The UK financial accounting and reporting system provides a stewardship function, aligned with the goals of the corporation

Like US SEC financial statements, UK listed company accounts are published and audited. However, in contrast to US federal regulations, Companies Act section 235 (s235) requires that auditors are appointed by and report to shareholders as an obligation of the privilege of incorporation. They, and the financial accounts that they audit, primarily serve a stewardship function, but their utility goes beyond that.

The contractual purpose of the s235 audit is quite simple, namely 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.

Shareholder accounts provide information in the investment chain for direct accountability purposes and this transparency brings self-discipline on boards of directors and management alike. This accounting goal, i.e. financial statements which are relevant and as free of self-serving bias as possible for shareholders, should actually be good for all users, for a range of decision-making purposes, though the defining purpose is a proprietorial stewardship purpose, for holders not just share traders.

Therefore a British auditor primarily performs a civil law function under contract whereas the US auditor principally reports for the requirements of SEC enforced regulation.

Figure 1: Reporting responsibilities under UK company law

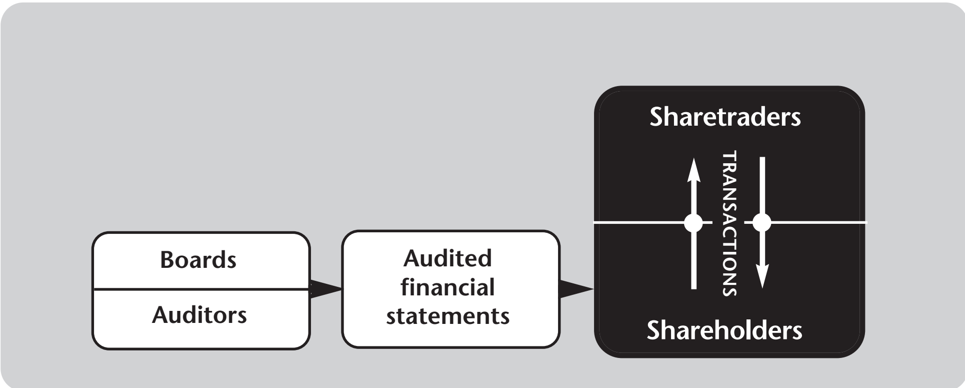
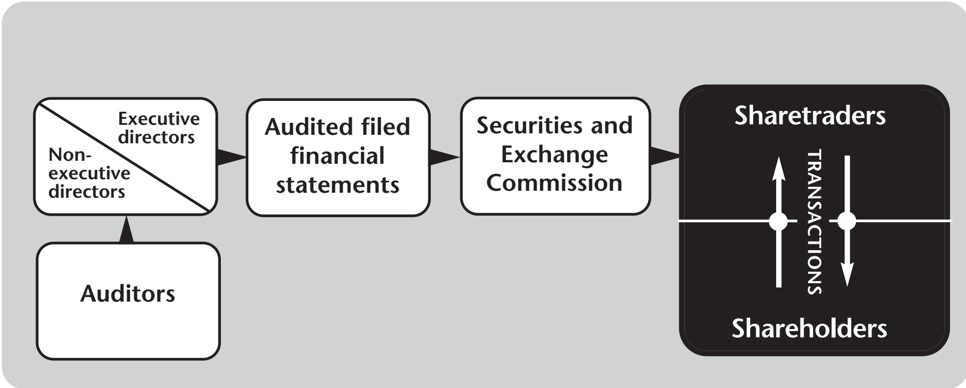


Figure 2: Reporting responsibilities under US securities regulation



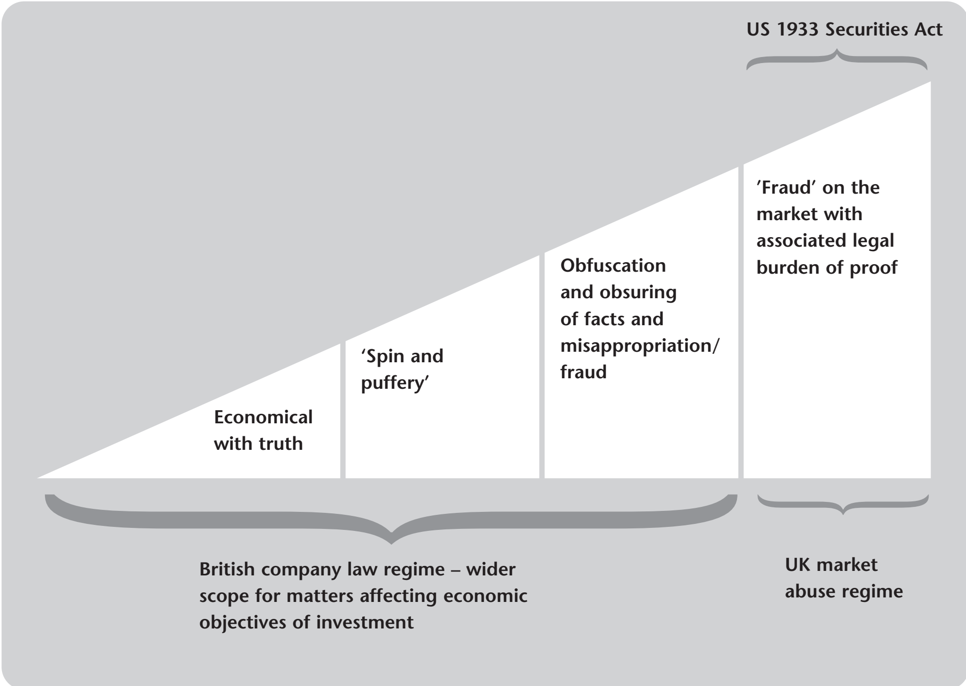
The implications of different core reporting objectives

The British financial reporting model in law recognises that an informational imbalance exists between directors of companies on the inside and their shareholders on the outside. In turn this imbalance is assumed to result in a degree of self-serving bias by company insiders including all of the directors collectively. The test for relevance of information is not just the absence or presence of fraud, and especially not just the absence or presence of fraud on the secondary market which is the dominant US test. In terms of shareholder risk both fraud and self-serving bias are economic threats.

The design of the US federal reporting model is restricted by the law to address informational asymmetry between companies and secondary markets when a share is exchanged or issued. Informational asymmetry between shareholders and companies when shares are not exchanged is a matter for state law, and in most states in the US is not addressed by a financial reporting regime.

Compared to the US federal regulatory regime, the British financial reporting regime and model of incorporation address a far broader range of investor risk, framed in both statute and case law. This is illustrated in Figure 3 overleaf.

Figure 3: Levels of bias in financial reporting



This two-jurisdictional approach in the US means that state and federal requirements can conflict, rather than fit together harmoniously, and create real problems for public financial reporting. There is essentially a tension between privacy and relevance.

The goals of corporations in the UK are defined by corporate constitutions. That activity and expenditure which further the aims of the corporation are intra vires (within the powers and objects) and that which do not are ultra vires (outside the powers and objects). The shareholder interest in financial reporting is that the financial statements address the outputs and position of the company in order to hold those in charge of the corporation to account by its shareholders for all company activity. But under the US model, for a company incorporated in a state without any financial reporting requirements, the delivery by the board of the constitutional objectives of a corporation is a private matter, it is even private from shareholders who part own the company.

The US model creates a paradox. A company that is incurring expenditure beyond the economic needs of the business may not be defrauding the secondary market by strict federal legal definition. If earnings are depressed due to operational inefficiency which includes egregious ultra vires expenditure, the market price will reflect this, because residual recurring earnings drive market pricing. Technically, the market is not misled, but the interests of the shareholders are not well served nor do shareholders have access to the private information necessary to identify and remedy any problem. Efficient markets and efficient companies are not the same thing. Markets can price and trade inefficient companies perfectly well but the expectations of those trading shares and the expectations of owners can be entirely different things. So long as the share price is legally 'right', then the accounting may be legally 'right' according to the tests of the 1933 Act. This circularity is just one of the accounting problems created by the US federal test of fraud on the market in its literal form. Other examples are provided in Appendix 1.

The British reporting model should treat any self-serving expenditure inefficiency as relevant information for shareholders, ahead of anything that needs to be prescribed for disclosure by additional accounting standards.

Under British company law the *purpose* and the *authority* in financial reporting matters stems from the same source, namely the shareholder base and their corporate objectives. Investors require a return on their capital invested for a transparent business objective and carrying an appropriate and transparent level of commercial risk. Taking a view on a corporation's objectives enables a principles-based assessment of what is the most appropriate accounting treatment, even in situations where the answers are not immediately obvious. Under the British governance and reporting model, the end customer and the enforcement mechanism are in each case the body of shareholders. There is a unity of purpose, authority and enforcement.

The US reporting, enforcement and governance regimes are handled in a way the British regime is not. The US federal law created the 1933 Act as the purpose for financial reporting, and the Securities and Exchange Commission (SEC) was set up under the 1934 Act as the regulatory enforcement agency for financial reporting matters. At the same time, privacy and relevance are divided between two different jurisdictions. Governance of company behaviour is wholly a state matter and because of weak rights of shareholders in certain US states, shareholders most often have few enforceable rights.

Future and past can become confused in the US model of reporting

As the US reporting model is focused largely on market pricing tests, this can lead to a confusion of financial reporting objectives in addition to the paradox referred to above. Accounting for things that have taken place and valuation, which is predominantly forward-looking, were recognised as different prior to 1933.

A share price is only a one-time perception of value and is one step removed from the reality of the actual micro-economy of the company. Focusing on a share price in financial reporting matters can create an extra level of unnecessary uncertainty in addition to the judgment required in reporting what a company has already done.

S.P. Kothari, Gordon Y. Billard Professor of Accounting at MIT Sloan, says that the actual role of accountants is to communicate whether financial statements summarise the results of activities corporations have already engaged in.

> *I often think people have an unreasonable expectation of what auditors or accountants can tell you. Their job is not to set a value; they are, at most, providing input that is helpful in setting value. If auditors could tell you what the value of a company is, then we wouldn't need exchanges and markets, where billions of dollars are spent with regard to setting market values.*
>
> *In contrast stock prices are almost invariably forward-looking in the sense that prices go up and down based on market participants' expectations of the financial consequences of the future activities. Accountants have very limited things to say about that; that's not the role of an auditor.*
>
> **'Can we stop another Enron?' S.P. Kothari, MIT Sloan School of Accounting**

Past factors not related to historic financial reporting have an effect in any company valuation. Such factors might include rumour of an event or even intuitive judgment by those trading shares in the market of a company's problems that have not been formally reported to markets; such things may be factored into the share price nonetheless irrespective of the accounting. Therefore, accounting omissions in difficult situations may not actually affect a share price. Reference to the 1933 Act 'accounting question' creates difficulties if there needs to be legal judgement on the quality of the accounting.

Risk of events or risk from inside?

The US reporting system requires the disclosure of risk factors in a generalised way where the British model does not, i.e. something might be disclosed in the US as an external risk, rather than booking it as a provision, or disclosing it as a contingency. Whilst on the face of it the differences may appear to be irrelevant, there is actually a difference between the relevance of risk factors to shareholders interested in how well the company has been run in the past by those still entrusted with running it and the relevance to those only interested in what the risk factors say about what a business might be worth. At a practical level, this means that disclosure for future value purposes can become divorced from substantive accountability for what has happened or been set in motion.

An example would be an insurance company disclosing that it is exposed to potentially unquantified claims for asbestos-related liabilities and leaving it at that. Under a US-style market pricing model of reporting, the fact that the liabilities might crystalise in the future is the point of relevance for pricing purposes – such disclosure may discharge the legal requirements of the 1933 Act. But, under a stewardship model the further facts that the liabilities arose as a result of a relatively recent acquisition by the current board are also relevant, as common sense says that this reflects something about the quality of the management, and is a reflection of their past stewardship, in addition to anything it also says about the forward value of the company.

The British reporting model insulates the accounting from any likely market reaction and instead gives the shareholders the right to know, in a more concrete evidential way, of anything that is a significant reflection of stewardship, as distinct from forward valuation.

Case law comparisons of the differences in financial reporting

The US and UK share the same basis of a common law legal system. Case law is quoted from either jurisdiction in another. However, since 1933, this is not the case in most financial reporting matters.

The definitive UK case law on annual financial reporting, the Caparo case of 1990, can be contrasted with a representative judgement from the US relating to Cable & Wireless plc. These two judgments say almost all that needs to be said to illustrate the entirely different philosophies driving the two reporting systems. In Caparo, the Law Lords created no new law. They merely set out in a very simple form the prime purpose of financial reporting and the function of shareholder auditors. Caparo is applied across the common law countries but not the US.

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.

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:

It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

***Caparo v Dickman* (1990) 1 All ER 568**

A recent US Court decision about alleged misreporting by Cable & Wireless plc (Court of the Eastern District of Virginia – June 2004), concludes the precise opposite about the purpose of audited SEC financial statements.

Congress did not intend the US Securities laws to be used by investors to play Monday morning quarterback on (i.e. challenge) the legitimate business decisions of directors, however bad, poor management is a risk that every investor takes.

Defendants Lerwill and Wallace's behaviour may reflect bad business judgement. However, as executives and officers of C&W, Defendants Lerwill and Wallace were within their rights not to publicise this information.

This is a remarkably different decision. It is even more remarkable since it related to a UK incorporated company, Cable & Wireless plc, which is listed on the London and New York Stock Exchanges. That is not to say it is not a good outcome for the specific case, but the important factor in this judgement is the wholly different logic applied by US courts compared to courts in the UK. The US Federal Court was applying federal law to its limits and this case clearly sets the boundary for acceptable standards of reporting at a place that the UK courts go well beyond. The case covers neither the shareholder protection aspect of the Caparo decision, nor does it recognise a duty in reporting to shareholders for stewardship purposes.

Other implications flow from this where there is undetected damage inside a company, for example, actual monetary fraud. The British model of reporting and auditing is unambiguous in that the directors are responsible for preventing (and the auditor should aim to detect) any loss to the company property that is outside of the normal scope of risk-based enterprise (ultra vires) irrespective of whether it is fraudulent. The US federal model creates complexity by linking damage from misreporting with a share price, and requires determining whether directors of companies were aware of the matter when a security was exchanged, i.e. it creates a complex test of intent around the mischief of fraud.

Contested court cases in the UK on financial reporting matters are extremely rare. Settlements happen but, because the law is so clear about the purpose of the financial statements and the role of the auditors, very few cases ever need to be contested in courts. The Barings case settled in 2003, arising from the collapse of Barings Bank plc, was a rare example of a contested case.

A summary of key differences between the UK and US reporting frameworks and shareholder rights is included as Appendix 2.

3. The need for ‘standards’ for accounting and auditing

It is often said that the US has a rules-based financial reporting regime, whereas the UK has a principles-based regime. This is partly wrong. The US does have a principles-based reporting regime, but it is centred on the legal principle of scienter (fraud) on the market. It is the legally defined link between accounting and a share price that has and still does cause problems, and required the US accounting profession to establish prescriptive rules commonly called ‘standards’. This again can create confusion, the word ‘standard’ can mean conformity or it can relate to excellence.

The principle underpinning the UK financial reporting regime is intuitively more straightforward as it relates to the furtherance of the aims of the corporation. The accounting disclosure question to be answered is ‘what would the shareholder want to know about how well a company is being run on its resources?’ This is very different, legally and economically, from the US principle of fraud on the market. To comply with the 1933 Securities Act, the question to be answered is ‘what does the market need to know?’

In situations where the answers to accounting questions are not immediately obvious (e.g. a borderline case for making a provision, unusual cost items, segmental disclosures, or unusual off balance sheet transactions) it is always sensible to revert to first principles. In the UK this means asking what is the goal of an enterprise and how does this drive the objectives of financial reporting. The US reporting regime creates accounting reference problems that the UK reporting regime does not.

US legal cases involving accounting questions

Court cases in the US are far more common than in the UK, but the following US court case highlights some of the problems for US courts.

> In *re Calpine Corp.Sec. Litig.,* 288 F.Supp. 2d 1054 (N.D. Cal. 2003):
>
> *Plaintiffs brought suit against the defendant and its directors and officers under Sections 11 and 15 of the Securities Act of 1933, and Sections 10(b) and 20(a) of the 1934 Securities Exchange Act. In support of their claims, plaintiffs asserted that the defendants employed a variety of improper accounting methods in order to conceal the true state of their financial results. First, plaintiffs alleged that defendants overcapitalised interest on debt. However, the court found that the complaint failed to allege how this practice violated any accounting standard, such as GAAP and, thus, the court could not determine whether this accounting practice was improper.*
>
> **‘Securities Litigator Survey 2003-2004’, Joseph Allerhand and Paul Ferrillo, Weil, Gotshal and Manges**

Failings in the US reporting model can occur where ‘creative compliance’ with highly legalistic federal law may override the best shareholder outcomes, and this has not already been addressed by the US Financial Accounting Standards Board (FASB). It is not a fault of the FASB that the legal framework in the US creates gaps. There is no underlying state company law to set out principles in financial reporting to better align with company objectives, and it is difficult under the federal model to encroach into the affairs of states.

The accounting standards setters

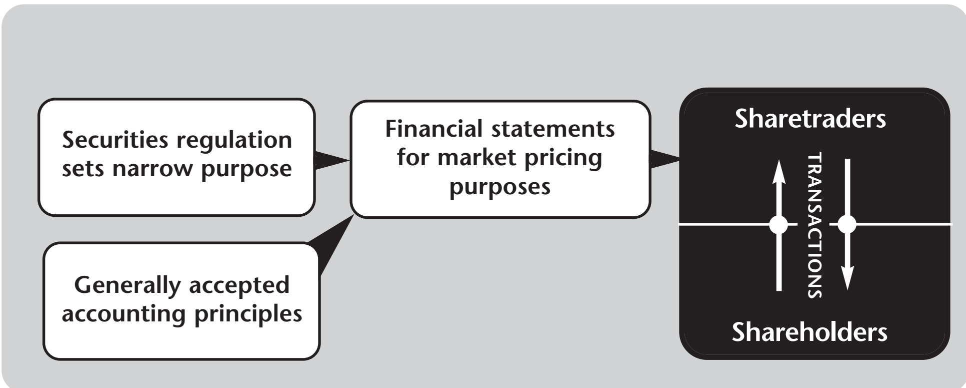
The frameworks of the Accounting Standards Board (ASB) for the UK and Ireland and the FASB for the US differ not because of the intellectual choices of the standard setters, but because of the influences of the principles in national law. For listed companies in the UK, the role of the ASB has in effect been superseded by that of the International Accounting Standards Board (IASB), but the corporate governance framework of financial reporting in the UK is not affected by this change.

US GAAP

To accommodate 'commonsense' accounting alongside the limited steer of the 1933 Securities Act, the US developed Generally Accepted Accounting Principles (GAAP) as a point of reference. GAAP creates an additional framework alongside the principles of the 1933 Act but without any overarching principles of its own. GAAP has gaps, and it is these gaps that can be exploited in some situations, because GAAP does not have any guiding compass based in federal law.

Standards of US GAAP are therefore substitutes for any unambiguous reference in federal or state law for accounting matters. US GAAP is actually attempting to create something akin to law in the absence of the key federal law giving any sensible guiding accounting and reporting principles. For this reason overriding US FASB standards, which is sometimes suggested, may sound compelling but would create confusion since there is no alternative steer or compass in ultimate law to justify non-adherence to the quasi-law of GAAP. The role of GAAP within the US financial reporting model is set out in Figure 4 below.

Figure 4: The role of GAAP in the US securities regulation model



Due to the inherent tension between transparency (federal GAAP) and privacy (state law) it can be difficult to create GAAP preemptively, therefore the standard setting process in GAAP will tend to lag actual misdemeanour rather than preempt it. Hence, Enron-type problems occur and standards are only, but not always, written after a problem has happened. Whereas the US has a freedom of information regime in respect of the affairs of its government, US listed corporations (if registered in most US states) are almost totally protected by the inherent privacy surrounding matters of incorporation, even though this means withholding key financial data from a corporation's own shareholders. The current politicised debate on the expensing of stock options is evidence of this scheme in progress.

The reference to GAAP presumes the existence of GAAP and we know that the gaps in GAAP are both numerous and consequential.

There are important cross-currents involved here. To mention just one, under the Securities Acts, management is primarily responsible for the financial statements; if they violate any of the prohibitions in the Acts, management bears the brunt of the legal or other disciplinary proceedings. Management knows this, and uses it to keep the auditors in their place. The auditors know it, and react in different ways to the situation.

The dilemma this creates for auditors does not excuse their shortcomings but it does help explain why they, unassisted, are limited in the steps they can take in those instances where they disagree on substantive grounds with their clients. One of the constructive steps that may come from reports such as those of the Moss and Metcalf Subcommittees of the U.S. Congress is a thoroughgoing review of the manner in which we regulate securities and the securities' markets.

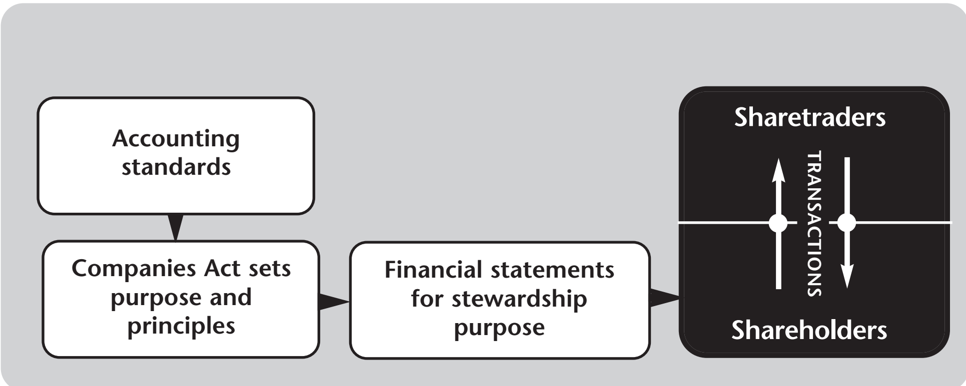
'Auditing Standards', Professor Maurice Moonitz, The Saxe Lectures in Accounting, 1977, University of California, Berkeley

Moonitz in this statement recognises the lack of a clear 'compass' in the US laws for financial reporting and also highlights problems with the weakened authority of US auditors because they report to boards. He also identified problems with the federal regulatory regime which is essentially unchanged even today.

UK accounting principles

In contrast to the US approach which applies to listed companies only, UK accounting standards are generally applicable to any company – they supplement the law – not create it as illustrated in Figure 5 below.

Figure 5: The role of accounting standards in the UK company law model



The UK law does not have the problems that the US has for handling the accounting of exchange-listed companies because the UK does not have problems addressing the accounting of any limited company. The Companies Act applies to companies irrespective of whether a company is listed or not and the UK's core accounting and reporting framework is set out in the Companies Act itself. The framework in the Act sets out the requirements for the accounts to show a true and fair view, and sets out key accounting principles.

As well as setting out accounting principles, the Act also sets out firm requirements for the disclosure of any financial commitments or other obligations that may have a bearing on the shareholders' view of the financial position of the company to which they have subscribed risk capital.

Whereas in the US, accounting standards have been essential to make up for problems in the basic reporting standards framework, in the UK have, until the introduction of International Financial Reporting Standards (IFRS), been more for guidance than instruction, since the basic Companies Act framework itself is unambiguous as to the need for economically relevant information relating to stewardship. Beyond what the accounting might say about what the company might be worth, the key test under British law is what the accounts say about how the company has been run on its resources for furthering the goals of the corporation.

It is section 226(2) of the Companies Act, which drove the 'substance' over 'form' approach of ASB standards. Therefore it is this clause in law, not the decisions of standard setters, that allows any standards in force to be overridden, because it is complete law that sets the conceptual framework for reporting to shareholders with no jurisdictional gaps. By contrast, the IASB has no legal jurisdiction of its own. In obtaining jurisdictional recognition in the European Union, via the EU Accounting Regulatory Committee, to give it democratic accountability, the IASB has found that one of its standards, IAS 39, has been subject to carve-outs, for what appears to include political factors. The ASB has recommended ignoring the restricted IAS 39, and adopting IAS 39 in full for companies incorporated in the UK and Ireland. This approach of the ASB is wholly consistent with the as yet unchanged UK or Irish law. Shareholder-relevant information for a UK or Irish company cannot be censored by a party external to the financial reporting contract. In this respect the UK financial reporting regime is based on a right to know, not a licence to have.

The core point of reference being the real audience of the body of shareholders creates few if any accounting contradictions. The UK reporting model is solely focused on actual economic outcomes. There is no holding back of the truth, from the company's owners, within reasonable bounds of investment relevance. The failure of Enron is as much about an environment of secrecy due to state law giving privacy to corporations, rather than complex technical nuances. Under the British model if an accounting issue is argued about by a company defensively; it is probably highly relevant for disclosure purposes.

> *It is a brave standard setter indeed who can be certain to have covered every possible situation, both current and potential, and to have provided a detailed rule for it. A set of principles can cover every situation whether foreseen or unforeseen. As I said in my earlier talk, rules encourage avoidance, whereas principles encourage compliance.*
>
> *By background, I am a tax specialist; I know how tax laws are exploited wherever possible. I also know that from time to time tax laws produce inequitable results. Unfortunately, the taxing system requires the certainty which can only be produced by rules and it is accepted by all parties that from time to time the wrong answer will result. Financial reporting, on the other hand, does not require the level of certainty which can only be obtained from detailed rules; the imperative, unlike for a taxing system, is to produce the right answer.*
>
> *Unless International Accounting Standards are developed with a substance over form concept and on a principles rather than rules based approach, there must be a significant risk that they will not be adopted in full in Europe or, alternatively, by adopting them the UK and, indeed, many other European countries, will see a significant step backwards in the quality of financial reporting.*
>
> **'Accounting Standards and Financial Reporting' Peter Wyman, Past President of the ICAEW, speech at the ICAEW/ICAI Joint Conference 2002**

Forms of audit opinion – UK versus US

Very few users of accounts read an audit opinion in full, if at all. But a comparison between a UK and a US auditors' report is a worthwhile exercise. UK financial reporting, unlike US financial reporting, requires two different auditor opinions, one on substance (appropriateness), and another one on form (presentation and compilation).

The objective of the UK legal framework for corporate reporting is to *communicate to shareholders*, as illustrated in Figure 6, opposite.

The US audit report for a Delaware company is quite limited, with the opinion being only on the form of the financial statements, not the substance of the 'state of affairs' as in the UK. The objective of the US legal framework is to *demonstrate compliance, for regulatory purposes* as illustrated in Figure 7, opposite.

Figure 6: UK model of corporate reporting and audit opinion

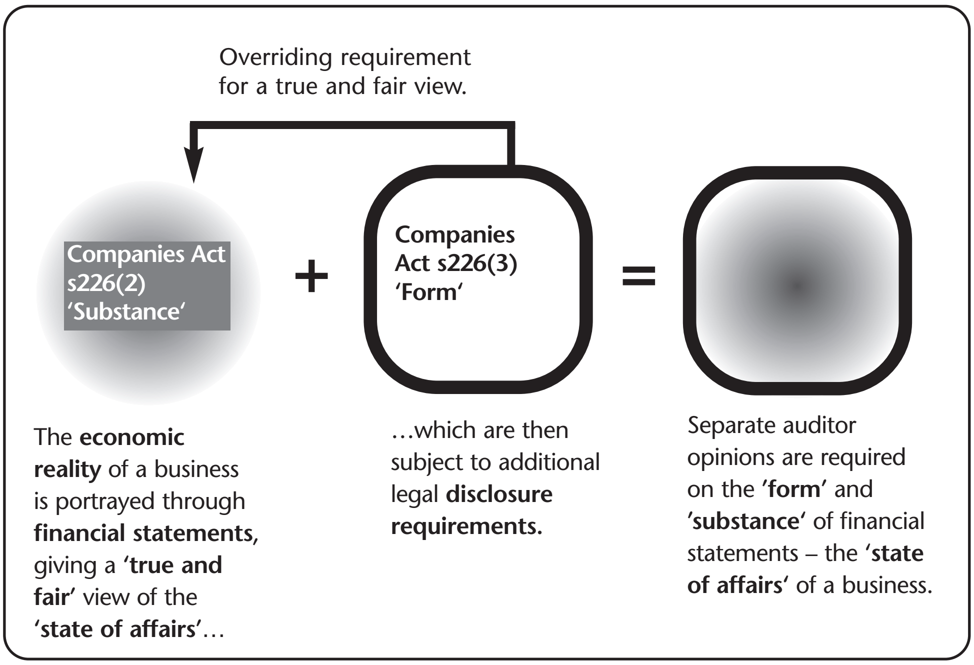
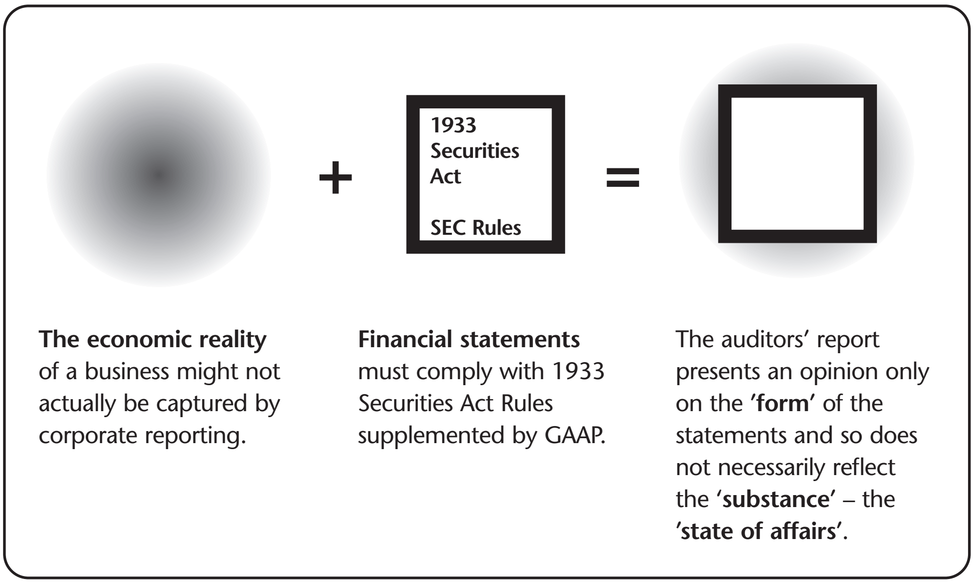


Figure 7: US model of corporate reporting and audit opinion



Two audit opinions were applied in the US between 1946 and 1962 by one firm

Arthur Andersen & Co., from 1946 to 1962, voluntarily followed a two-opinion approach similar to that of the British model, i.e. substance as well as form for its audit reports. The logic of this, from Arthur Andersen himself, was that technical compliance with 'generally accepted' principles might be misleading.

> *"The reputation and standing of the firm [Andersen] have been built upon a foursquare policy of honesty and forthrightness. If, after the most thorough investigation and careful consideration, we are convinced that a certain accounting policy is fundamentally unsound and that its application will result in financial statements that are materially misleading, we must take exception to the policy in our certificate; we will not avail ourselves of the technicality that the principles to which we object may be quite generally accepted."*
>
> *This policy reflected the view of Arthur Andersen himself that the partners in the firm, no less than other members of the profession, should use their independent judgement when assessing the propriety of accounting principles, and should not <u>unquestioningly</u> subordinate their professional opinions to the rules and procedures approved by a committee.*
>
> **'Arthur Andersen & Co. and The Two-Part Opinion in the Auditor's Report: 1 946-1962', Stephen A. Zeff, *Contemporary Accounting Research*, Vol. 8 No.2, pp. 443-467, Spring, 1992**

Other firms did not follow this approach and the practice was abandoned in 1962.

> *On May 8, 1958, two senior partners of Arthur Andersen & Co. met in Washington with Andrew Barr, the SEC's chief accountant, and three of his aides. The firm sought to ascertain the accounting staff's reaction to the form of its audit opinion. According to the firm's report of the meeting, Barr said it was 'unfortunate that [the firm] adopted this wording because it created dissension in the profession'. (Arthur Andersen & Co, 1958, p. 1.)*
>
> **'Arthur Andersen & Co. and The Two-Part Opinion in the Auditor's Report: 1946-1962', Stephen A. Zeff, *Contemporary Accounting Research*, Vol. 8 No. 2, pp.443-476, Spring, 1992**

In the wake of recent events, there is a deep irony in the fact that it was Arthur Andersen, with an independent free-thinking approach immediately post-war, that was later to sign off the accounts of Enron, which did appear, on the basis of the statement below, to meet all of the rules. It might be concluded that the firm was right on both occasions, but wrong by virtue of political timing.

How could this energy giant have gone from number seven on the Fortune 500 to bankruptcy court almost overnight? The answer, of course, is that it didn't. The problems that ultimately brought Enron down were a long time in the making. They were simply hidden from investors' eyes. That revelation has prompted an even more pressing question, since it has broader implications for investors in all publicly traded companies: Given all the safeguards in our system designed to ensure investors receive full and fair disclosure, how could Enron have succeeded for so long in presenting a false picture of financial health? The disturbing answer is that, in this case as in others, all the safeguards designed to protect investors failed, and failed miserably.

The rules that dictate what information companies have to disclose and how they have to disclose it failed to produce an accurate picture of Enron finances, even where the company complied with the rules.

The Honorable Howard M. Metzenbaum, Chairman, Consumer Federation of America, Former US Senator, to a committee of the US Senate, 20 March 2002

Problems in auditing practice

Conceptual confusion and complexity around financial reporting in the US, seem also to affect auditing practice, as might be expected with a conceptually ambiguous goal which lawyerly approaches can work around.

As stated earlier, the 'scienter in market pricing' principle creates inherent accounting contradictions, given that factors other than historical audited information affect a share price, but share prices are expected to be accurate. This does not give especially intuitive outcomes for preparers of accounts, or an auditor, if followed as a base line for a compliance-only purpose. Compared to the UK model, a US audit reflects in its conception and execution a limitation of scope.

'US-influenced audit standards are heavily influenced by the 'tick box' approach which has the aim of demonstrating that the auditor has not been negligent. In our view, this reduces the essential technical quality of an audit.'

The Association of Chartered Certified Accountants (ACCA), London, extract from its response to the Department of Trade and Industry's consultative document 'Director and Auditor Liability', March 2004

The comfort in process and volume of work in the US, as the ACCA implies, is demonstrated in the case outlined over. Again this may not be the wrong trial outcome in terms of penalty, but the message it conveys is that process is a protection.

In this case, the Third Circuit granted summary judgement in favour of the defendant auditor, Ernst & Young, rejecting allegations that it either knew or was reckless in failing to discover deficiencies in the financial statements of IKON Office Solutions. The court pointed to an extensive pre-audit checklist of factors which the auditor followed, along with the massive scope of the actual audit performed, as evidence that the auditor was not reckless in the audit of the company. In re Ikon Office Solutions, Inc.Sec.Litig., 277 F.3d 658 (3 Cir. 2002)

'Securities Litigator Survey 2003-2004', Joseph Allerhand and Paul Ferrillo, July 2004, Weil, Gotshal and Manges

A clearer purpose from a civil contract, and the terms of engagement

Unlike the US reporting model, under which even experts can become confused or disagree as to the right accounting approaches, the principle set out in the Caparo decision of 'reliable intelligence' for the members gives a very clear sense of purpose for auditors.

The UK auditor is actually engaged as an agent under contract not a regulatory functionary. Beyond the numbers themselves, UK auditors are able to report and comment freely in audit opinions, especially if there is uncertainty. A key feature of the US model of financial reporting is that it virtually disallows free-form reporting by an auditor, since it regards it as indicative of him as potentially shirking his certification responsibility.

The civil model of UK law is less restrictive. There are times when economic matters are uncertain and shareholders will want to know this, especially to use their available powers as owners. Secondary capital markets and shareholders may handle news of financial uncertainty entirely differently. Not every shareholder will sell. Many will be unable to, but share prices at times of crisis can imply that they all have.

4. Economic differences arising from legal divergence

What is actually regulated by the 1933 Act?

The thing that is most prominently regulated in the US financial reporting model is the concept of 'earnings', because earnings feed into share price valuations. However earnings are for all but the simplest of companies, a matter of cumulative judgements. Earnings are also the easiest thing to manipulate via cumulative judgements, and are, in any case, a crude indication of value, since the value of any company is the net present value of all future cash flows not accruals-based earnings. The US reporting model has been intentionally driven by the law towards an earnings-focused model.

Conversely, in the development of the British Companies Acts, the requirements for balance sheet disclosure came some years before any statement of earnings. Actual returns were evidenced in cash dividends, and re-invested assets. Reported earnings can be transient in a way that cash and real capital assets are not.

What the 1933 Securities Act core legal accounting test lacks is an unambiguous way of addressing balance sheet matters. Because many of the factors related to assets, debt, risk and efficiency (board composition especially) fall under the jurisdiction of state law, the US federal system is very tightly regulating the most ephemeral feature of the shareholder interest, i.e. earnings, whilst leaving more substantive aspects under state law, with no reporting requirements whatsoever.

For all of the resource devoted to regulating earnings disclosure it is remarkable that the US has had no unambiguous requirement for companies to disclose their financial obligations. Enron is a good example of 'ask a silly question (restricted to the form of the 1933 Securities Act) and get a silly answer'.

> *So Enron showed a financial statement that was a great deal healthier than, in fact, it really was, because of this creative device to hide the obligations of the parent in subsidiary corporations.*
>
> *The investment bankers came to Enron and said, "Look, we can really create a structure which will hide your obligations from the general public by creating subsidiaries. Those subsidiaries will borrow, and those borrowings, under our interpretation of the accounting rules, will not flow up to the parent."*
>
> **Arthur Levitt, Chairman of the SEC 1993-2000, interview with PBS Television**

Capitalism or earnings-ism?

Under the US regulatory model, share purchasers in effect acquire a right to one-time earnings. The future, including the composition of the board, and the commitments and obligations that the corporation may secretly enter into, is substantially all shareholder risk. By contrast, the British model is automatically able to be asset-focused as much as earnings-focused, and future risk is mitigated by a broad governance framework which has as its foundation in substantive financial reporting.

The success of a US company, generally, is probably a testament to the basic honesty of most American people, despite such a problematic reporting system. The lesson for securities regulators may be that it is not appropriate to regulate all companies as if they were all run by crooks. Regulating earnings may actually be creating the game of earnings 'chase'.

In a literal 'Adam Smith' view of capitalism, the US listed company model is not actually free-market capitalism but something else, federally regulated 'earnings-ism'. It is difficult to conclude which model is better for the generation of value. Both are different and different models may be appropriate for different cultures and different stages in economic development. However, it is undoubtedly the case that the US model can create onerous problems in financial reporting. They are not necessarily flaws in total national economic terms, but they are the flip-side of having no reporting requirements at state level.

5. The need for rules and exactitude in the US today

It is quite common for US commentators to recognise problems with requiring reporting exactitude.

> *There must be recognition that the concept of exactitude and precision in an audit is, as the Economist described it as 'little more than a brittle illusion [of accounting exactitude]'*
>
> *and … too many members of the investing public believe financial statements can portray – with precision – the assets, liabilities and financial performance of an issuer. In fact they are the result of a long series of judgments by managers, accountants and auditors.*
>
> **'The Future of Accounting' the American Assembly, Columbia University November 2003**

It is far less common to recognise the root of the problem stems from the limited reach of the securities laws. It is even less common to see an analytical comparison with models outside the US that do not suffer similar problems. The following is a rare example.

> *This is a peculiarity of the American scene, because the American auditor is required to state his opinion whether financial statements are in accordance with generally accepted accounting principles. The auditors in the British sphere of influence are not required to make any such assertion. The auditors in the British sphere are less concerned with accounting principles. The British rules require disclosure of the method used, but no further comment by the auditor, as long as the auditor is sure, in his subjective judgement, that the financial statements are true and fair, whatever that means in that particular setting. The cases mentioned turn on this very important distinction between accounting principles and auditing standards.*
>
> *A modernized set of securities acts could, of course, include provisions to make auditors more independent of their clients and therefore in a stronger position to make sure that financial statements do fairly present financial position and results of operations, and not merely that they are in accordance with a vague, inconsistent, and incomplete set of generally accepted accounting principles.*
>
> *The members of the [US] profession have most of the tools they need to operate in a truly creditable manner, but on all too many occasions they lack the will to use them at precisely those times when to do so would tell the rest of society that the profession really means what it says about its high standards and especially about its independence.*
>
> **'Auditing Standards', Professor Maurice Moonitz, The Saxe Lectures in Accounting, University of California, Berkeley, 1977**

Financial reporting for capital markets only, or for a genuinely more general purpose use?

Though US financial statements are legally called ‘general purpose financial statements’, their utility is actually quite limited beyond share pricing for the secondary market.

The term ‘general purpose financial statements’ is in fact an overstatement, more aspiration rather than fact, not least as they are not tacitly shareholder-focused accounts in their preparation. The stewardship goal set around shareholder objectives may sound arcane or overly technical. However, in terms of the whole approach to financial reporting, for defining purpose of, and for ease of preparation, auditing, interpretation by readers and enforcement, no one has found a simpler more cost-effective system.

Because SEC audits only apply to listed companies with a share price, the mindset of participants in the US model is increasingly guided by wanting something from accounting standards that relates, however imperfectly, to the share price, and increasingly more ‘accurate earnings’ rather than the governance oversight function for which the 1933 Act was intended to be a substitute.

Is the British model deficient for users in capital markets, as distinct from shareholders?

The British reporting model with its core purpose of stewardship is perfectly capable of bettering that of the US model with its core purpose of market pricing. Good companies incorporated in the UK but also listed in the US, are perfectly able to submit good SEC compliant financial statements. Telling the truth to shareholders means that markets are not misled either. Shareholder relevant information is useful to a wide range of users who make decisions based on the shareholder accounts, as is the case in the UK for tax authorities, creditors and banks. Indeed, combining a statutory purpose with a purpose that is useful for tax authorities too, creates a natural cash flow disincentive to earnings exaggeration.

It is precisely the stewardship goal which the British model pursues, and that the US does not, which is in danger of being squeezed out by ‘convergence’ of some financial reporting and auditing practice towards a ‘general purpose’ rather than the simple statutory approach for annual reporting. Given that the US in 1933 adopted what was a restricted version of the British model of reporting, for the UK to adopt aspects of the US regime that has problems due to constitutional reasons would be a good example of ‘throwing the baby out with the bathwater’.

UK companies are able to release information to shareholders and markets outside of the Companies Act regime of audit. The purpose, and hence timing of the statutory statements, is only to give the independent view of the company for each ‘formal holding to account’, i.e. ahead of annual general meetings. This provides a helpful check whether the truth was told voluntarily for the rest of the time whilst interim reporting was unchecked.

In the US, the regulator dominates the process of all reporting, not just the process of financial disclosure, but the timing of all ongoing information too, which given the deemed importance for a secondary market purpose is ironically less timely than occurs in the UK. In the UK, quoted companies have a continuing obligation to disclose to markets, any price-sensitive information immediately.

In regulating and controlling the accuracy of reporting there is clearly a major difference in the philosophy of the SEC model compared to the UK. But because the US model is federally extraterritorial by design, it can cause problems for foreign companies listed in the US that do not actually have the problems that the 1933 model was designed to correct in the first place.

> *The federal securities laws that the SEC administers focus primarily, although not exclusively, on the regulation of disclosure, the proxy process for shareholders meetings, accounting and auditing. In our federal system, corporate governance matters are still largely left to the states. The State of Delaware has the most settled body of corporate law, and most large public U.S. companies are incorporated in Delaware. In other respects, the SEC plays a dominant role in setting or overseeing standards for the U.S. markets and for enforcing them, even where there is involvement of a number of other actors.*
>
> *The SEC in taking this approach decided not to follow the approach adopted in England, which now has a requirement for current disclosure of material developments generally. The SEC chose its approach in part because of the US enforcement scheme and because of concerns that a more general requirement would cause excessive compliance burdens and costs and would have to be accompanied by an exception for non-disclosure for valid business purposes (such as ongoing material but preliminary merger negotiations), which would threaten to swallow up the rule.*
>
> **Alan L. Beller, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, American Academy in Berlin, 20 April 2004**

Squaring the circle

The problems occurring in US financial reporting are inherently more political and legal than technical in origin, though the apparent technical nature of accounting problems can obscure this. People are seen as part of the problem, and steps are being taken to address behavioural issues by creating new corporate governance constructs, but this seems to be happening without first considering the causative effect of the US financial reporting system itself on people's behaviour. Quarterly earnings disclosure is a good example of this, elevating and making more frequent the reporting of something that is intrinsically ephemeral but expected to be 'right'.

It is worth noting that the 1933 Act was drafted during the period of prohibition. In seeking to resolve some problems, prohibition created new ones. The same might be said of the 1933 Securities Act.

Until the legal purpose of financial reporting and audit in the US can be described more broadly than in the 1933 Act in a way that is 'acceptably imprecise' but sufficiently 'guiding' about matters of substance, and free of external interference, the US model of financial reporting is almost bound to tread a more complex path of exactitude by adding ever more rules relating to earnings.

The debate in the US post-Enron continues. The 2002 Sarbanes-Oxley Act is loading burdens on companies, largely involving process. Standard setters are also involved. It is worth comparing all of this effort to one small section of the UK Companies Act that has long been able to avoid the problem that occurred in the case of Enron.

Commitments within any of sub-paragraphs (1) to (5) of paragraph 50 (guarantees and other financial commitments) which are undertaken on behalf of or for the benefit of:

(a) any parent undertaking or fellow subsidiary undertaking, or

(b) any subsidiary undertaking of the company,

shall be stated separately from the other commitments within that sub-paragraph, and commitments within paragraph (a) shall also be stated separately from those within paragraph (b).

Section 59A, Schedule 4, to the UK Companies Acts

6. Law and behaviour

Civil law versus regulation

In the UK and US it is law that sets the ultimate framework for financial reporting. But one reporting framework (UK) is civil law enforced by the public and protected by the judiciary and government and the other (US) is regulation enforced by government. The two reporting regimes may lead to differences in behaviour too. People do not always act purely in accordance with the laws of economics, especially where there may be different lines of reporting and responsibilities under the law, and different methods of enforcement too.

Investor risk in the UK is not regulated, as such. It is essentially self-policed by strong civil law requiring clear substantial financial reporting in the shareholder interest, with a degree of practical flexibility and a liberal but responsible 'licence' within which to operate. The US regime is regulated, one consequence of this being a near criminal burden of proof which creates an entirely different licence within which to operate.

Auditor behaviour and investor risk

UK auditing and financial reporting legally have a proprietorial ('stewardship') purpose for director accountability which in extremis affects whether or not board members individually or collectively are reappointed. Financial reporting in difficult circumstances is not intended to just affect share price but change behaviour. In light of this, the challenges that the statutorily defined shareholder audit addresses are as much behavioural as technical. Though auditors need to be technically competent, their job is part of a reporting framework which exists to resolve an agency conflict in *any* company, not fraud or scienter occurring in some.

Bias under the British model is not necessarily seen as malign or a seldom-met rarity which requires special treatment when it is found. Being a director of a risk-based venture requires an unusual combination of care and optimism. Self-judgment of your own bias for any board member is impossible where it is legally a unitary board that takes any collective decisions, since such business decisions should logically affect performance.

In addition to the self-discipline that the s235 audit places on companies by its execution, in practice this protection is also of value because it provides the members of the company with financial evidence in the form of the accounts. The accounts are sufficient to allow members to assess what is going on with their property in the company, and to reward, control or remove those to whom the stewardship is entrusted, through binding voting and calling extraordinary general meetings.

The British reporting model is not at all unusual. The legal purpose of shareholder accounts and the auditor duty of care developed across Europe in free markets from the nineteenth century onwards. Commercial best practice was generally embedded in the Companies Acts in Britain and equivalent legislation elsewhere. In almost all of Europe, and in the Commonwealth, financial accounts and the audit share a common purpose, namely to serve the shareholder.

Responsibilities under the British model of reporting

The UK auditor is not serving dematerialised markets of anonymous people but the real shareholding public. They may have purchased shares in the market, but the auditor's sole duty to them relates to the manner in which the financial statements inform the shareholders' voting and questioning and provides self-discipline to companies, not how or whether shares are bought and sold. The benefit compared to the US model, is a far more value-adding role, if done properly.

The UK auditor is a witness for the shareholder interest, not a judge or certifier for market exactitude. Furthermore, unlike in the US, where the share price is of concern, due to their duty of care being different, UK auditors need not concern themselves with the impact of their work on the share price.

Investing in the equity of a company, which is the residual interest in the venture after all other claims, is inherently risky. For that reason in the US the word 'security' is a rather misleading word to use and 'insecurity' might be a more appropriate term. The UK model does not insulate investors from risk, but gives them, once they have invested, the annual accounts. These provide the information necessary to mitigate real economic risk not just trigger a sale if they don't like the shares.

In the UK, the roles of all parties are clear:

- the directors: to manage the company and to report to shareholders, according to their best abilities.
- the auditors: to report, according to their best abilities and professional standards, on the accounts of the directors for the members of the company.

The secondary markets in the UK are regulated by a different model than the US though the statutory auditor has some responsibilities under Listing Rules that relate to compliance with corporate governance codes.[1]

US reporting lines are different too

Rather than solving an agency conflict, the model of SEC 1933 auditing – where an auditor reports to boards – may have actually created new agency problems, including over-closeness to 'the client'. Identifying the client as the board rather than the shareholders, results 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. However, it is still the case that the prime mischief envisaged by the US reporting system is boards suffering deception of a fraudulent nature by their own management. It does not work as a very effective check in the interest of shareholders when the independent directors themselves are underperforming in their roles or loyally backing poor management because they actually chose to appoint them.

Sarbanes-Oxley

Since the passing of the Securities Act in 1933 to address information asymmetry between capital markets and companies, the emphasis in the US since the Treadway Commission in the 1980s has been progressively shifting auditors towards tackling problems of informational asymmetry between independent directors and management. Independent directors in theory are expected to act as a proxy for absent owners, refereeing the imbalance of information between investors and companies.

Given the role that independent directors have in appointing, remunerating and assenting to the strategic decisions of the executives, as part of a unitary board, they are not wholly independent. It is therefore not unreasonable to assume that a degree of reciprocal mediocrity applies, meaning that poor companies (those failing to deliver corporate objectives) are likely to also have poor audit committees. An analogy would be

[1] New issues of shares in the UK are handled differently to the statutory regime in that independent accountants act as 'reporting accountants' under the UK's prospectus regime (which is what Congress in 1933 based the whole US annual financial reporting model upon). When new issues of securities are being marketed, the concept of 'fraud on the market' is addressed by the UK prospectus regime.

the decisions of a government driving test examiner, being overseen by the driving school tutor of a poor driver put forward for examination, and having been taught by, that tutor. For companies with unitary boards, there are aspects of reporting, which reflect collective stewardship decisions by boards where no independent director can ever be properly disinterested in the story that the financial statements convey.

A regulatory view of financial reporting being essentially a compliance activity, might regard poor financial reporting as something that occurs with equal chance across all companies. If that is the case, regulators are setting themselves up for dealing with erstwhile good companies (those who are delivering corporate objectives in value terms) who make the occasional regulatory reporting error but may get penalised nonetheless.

A more realistic view is that poor financial reporting is not a random occurrence, but coincides more often with poor corporate performance since companies that are performing well will have nothing to hide. On this view, there is a logical flow in creating a regulatory framework where the key check in the system is the audit committee. The key check will inevitably be a poor one when most needed – when underperforming – whilst good companies with good audit committees will be burdened with more and more process for little if any benefit.

'The concept that an auditor who has a greater financial incentive to please management than to criticize it will tend to find ways to avoid negative comment is intuitive and obvious. I can offer some anecdotal evidence.

As part of CalPERS' own investment operations through our corporate governance program, we annually identify those few select companies that are the poorest performers within our over 1,500 U.S. companies and we use screens that look for the conveyance of poor performance with regard to stock performance, economic value added, and corporate governance practices.

At least during the past two years when CalPERS ourselves have been focussing on audit standards and auditor independence in each of these companies that we've identified as having the biggest problems with regard to performance, they've also had problems with regard to the quality of their financial statements and a seemingly meek auditor.

This is not proof that the poor performance was the result of the non-independent auditors, but it certainly feeds into the investment community's concern about this issue.

It's not only the reality of biased auditing, but also the perception that a biased practice is possible that erodes investor confidence.'

Kayla Gillan, General Counsel, California Public Employeees' Retirement System, public hearing on proposed auditor independence rules, Securities and Exchange Commission, Pace University, New York, 13 September 2000

Capital market regulators seem to be confused, viewing financial results as if they are something that 'happens' to boards as if boards were fully independent 'spectators' in the running of the business when in fact, financial results are something that has involved whole boards as the key decision makers in the running of the corporation.

Section 404 and internal control

Sarbanes-Oxley addresses internal controls through section 404. However, there is still the jurisdictional problem between state law and the federal system. As elsewhere in the US reporting system, the nomenclature is a somewhat misleading exaggeration of actual scope in substance compared to other systems. Section 404 focuses only on controls over the process by which federally regulated financial reporting is compiled and communicated.

Internal controls for the sole purpose of financial reporting and controls for the safeguarding of assets are different objectives. It is possible to lose company assets during a year due to poor *ongoing* accounting and/or business controls, but still report the effect of this loss correctly in financial statements at a period end, due to good 'controls' over financial reporting.

An example would be large stock (or inventory) losses that are picked up in physical counts for reporting purposes but repeat operationally due to systemic error. Such losses are reported within earnings in a financial reporting sense, but are not actually corrected in a business control sense, i.e. they become an enduring non-business cost. Conversely, a company can make a reporting error that does not involve monetary loss to the company itself, the misstatement in SEC filings of Shell's oil reserves in 2004 being an example of this.

The UK reporting and accounting model covers *both* objectives through reporting controls and business relevant financial controls. Company law is concerned with ongoing stewardship, as well as period end reporting, not least for creditor as well as shareholder protection. Information for market integrity, under the UK listing regime sits alongside the stewardship objectives of accounting and control, not instead of them. Auditors and directors are jointly and severally liable for actual loss of company property, other than that incurred as part of normal enterprise risk. Auditors are not liable for first loss, that is the directors' responsibility, but negligent failure to detect first loss is the responsibility of the auditor.

> *'The directors are responsible for maintaining adequate accounting records and sufficient internal controls to safeguard the assets of the Group and to prevent and detect fraud or any other irregularities'.*
>
> **Example statement of directors' responsibilities, from Marks and Spencer Plc – Annual Report 2004**

The US reporting, accounting and auditing model does not cover stewardship control over assets. Delaware law has no company audit requirements. Federal law is drafted to be *instead* of state reporting and accounting requirements. But Sarbanes-Oxley controls are only those controls relating to financial reporting since that is the only thing that federal law can cover for constitutional reasons.

Sarbanes-Oxley, also 'demotes' the responsibility for such controls to management as distinct from the whole board of directors. This creates a mismatch, between the fiduciary duty at state level of a unitary board of directors, for the running of the business, and what amounts to a quasi two-tier board at the federal regulatory level for responsibility for financial reporting purposes.

> *SEC. SARB-OX. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.*
>
> *(a) RULES REQUIRED.–The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall–*
>
> *(1) state the responsibility of **management** for establishing and maintaining an adequate internal control structure and procedures **for financial reporting**; and*
>
> *(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer **for financial reporting**.*

All this may seem like semantics. But it is not semantics in a highly legalistic US environment where these things do matter. Law sets the framework for human behaviour, and onerous law with loopholes will drive avoidance or evasion.

Conflicts of interest between market regulators and long-term shareholders

Shareholders who take a long-term view and do not trade shares would, given a choice, prefer good controls over actual business operations since financial reporting errors themselves do not involve actual monetary loss to the company. Market regulators on the other hand are more concerned with the accuracy of financial statements, rather than the quality of the corporation itself. This creates scope for conflict between the interest of long-term shareholders and those who are trading shares.

Shell plc in 2004 was a case where the company did not make a monetary loss, but misstated disclosed reserves and as a result the company was fined by regulators. There is deep irony that something that did not involve monetary loss, did end up as such, with fines on the company, borne by shareholders. The cost of market regulation on companies, borne by shareholders, as distinct from those who trade short-term price differences, is beginning to be recognised as a burden rather than a benefit.

Pharmaceutical giant AstraZeneca has admitted it will cost 'tens of millions' of dollars for the company to comply with the strict requirements of the Sarbanes-Oxley Act, as more companies look for a way out of US listings.

Speaking exclusively to Accountancy Age, chief financial officer Jon Symonds admitted that, although there were aspects of the rules that would benefit AstraZeneca, 'Sarbanes-Oxley has all the hallmarks of using a sledgehammer to crack a nut'.

He added that the costs of complying with the act clearly outweighed the benefits and that, for AstraZeneca, 'we are talking in the tens of millions'.

***Accountancy Age*, 3 February 2005**

Board responsibility and regulatory conflict

The 1933 and 1934 Acts place a higher duty of care by the board on SEC-enforced reporting requirements than on running the business in the interests of shareholders.

Because, logically, external reporting should be part of running a business an odd behavioural tension is created by having different duties of care between what you say according to accounting rules, and what you actually do in economic substance as a director delegating and undertaking the management of a business. This is especially problematic since the 1933 Act relates the duty of care to a derived perception of value – the share price – rather than the actual value in efficiently utilising and protecting the assets of the company itself.

This contrasts with the UK Companies Act financial reporting model which regards reporting by boards to owners a part of running the business. There is no different duty of care between reporting and running the business since both are part of the same function under a unitary board. In most respects, boards are expected to run the business (and hence report) to the best of their abilities. UK boards are essentially giving an annual insight into what they are really doing, not 'putting on make-up' for a special occasion.

Despite the fact that a comprehensive review of business relevant controls insofar as they affect financial reporting is already embedded in the UK Companies Act requirements for all companies for stewardship purposes, this appears to create some confusion in the US where SEC financial reporting has tended to be driven by only 'top-down' thinking about financial reporting.

The argument that under corporation law different officers or directors have [other legal] responsibilities that should be taken into account misses the point – under the corporation laws of the various states in the US there is also no responsibility of the sort imposed by the certification requirements [of Sarbanes-Oxley].

Alan L. Beller, Director, Division of Corporation Finance, US Securities and Exchange Commission, American Academy in Berlin, 20 April 2004

The US reporting model has perhaps created a situation so artificially onerous in matters of financial reporting that the role of independent directors has become increasingly focused on compliance. Some directors may even spend more time on financial reporting as an occupation itself, than properly thinking about the business, creating conflicts between their duties in directing the business and those in relation to reporting requirements.

Since the test of compliance with financial reporting requirements is increasingly one of technical complexity, which is beyond many board directors' skills, they will inevitably require auditors acting more as consultants to them to explain reporting requirements that they are responsible for but do not understand. This deprives shareholders and other users, from having truly independent auditors ensuring a best presentation (true and fair view) of the outputs of the enterprise, as distinct from one that is compliant with the rules.

Sarbanes-Oxley also set up the Public Accounting and Oversight Board (PCAOB). If the PCAOB is able to direct the US auditing profession towards substantive goals similar to a statutory model, with the duty of care to shareholders in financial reporting matters as well as secondary markets at the point of exchange, then matters of shareholder protection in the US should improve tremendously with benefit to all market users.

Liability as an impact on auditor behaviour

Until as late as 1931, where accounts and audits did exist or were required, US Courts followed the principles of English common law decisions. The 1931 *New York Appeals Court Ultramares v Touche Niven* decision was, and is still, referred to in English cases, as it predated the 1933 Act. Judge Cardozo was particularly concerned about the implications of auditors having a duty of care extended beyond the members of the company.

> *If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.*

But the duty of care established for auditors by the 1933 and 1934 US securities laws is not to shareholders, it is to buyers and sellers based on the market price. Given that Judge Cardozo was so specific about an auditor being exposed to 'an indeterminate amount for an indeterminate time to an indeterminate class' it is ironic that the US 1933 Securities Act did just that within two years. Since then, US auditors have managed to exclude almost all duty to the company in engagement letters, but are still exposed to claims for price movements.

It might be assumed that liability fears give a US auditor a strong incentive to ensure open reporting. But bearing in mind that the situation in which the auditor is most likely to suffer claims is after a fall in the share price, reporting bad news is not a particularly attractive option. Aside from any problems this may create for the auditor's commercial position with the board and management team who employ the auditor, what incentive is there to precipitate the very share price fall that might cause harm when 'trading on' may resolve the matter?

UK liability regime – very different but harsh in a different way

In the UK the liability regime is not to an indeterminate class but to the company of members. UK auditor liability reflects the auditor's accountability and function very clearly. The UK auditor is responsible when through negligence or deliberate omission the auditor causes a breakdown in the pattern of expected accountability that should come from accounts that give a true and fair view to the owners and reliable information for the directors.

An auditor of a UK registered company is not responsible for poor management, and certainly not for a fall in share price. But auditors of a UK registered company who do not execute their duties in the envisaged way are exposed to considerable risk. When an enterprise incurs actual monetary loss where the auditors' misreporting contributed to the perpetuation of an avoidably poor financial control situation, the auditor is jointly and severally liable with all board members responsible for all of the loss to the enterprise thenceforth, unless diligent members are excluded.

An example would be that an auditor can be jointly liable with directors where the auditor fails to identify system failures, for example not billing a large quantity of customers, that leads to a *perpetuation* of a loss of income to the company, irrespective of whether the earnings disclosed publicly, correctly reflect the loss.

The UK civil liability regime for auditors creates a situation so onerous in terms of their duty of care to the body of shareholders and to directors that it is very difficult to envisage why auditors would want to jeopardise their independence by being 'captured' by any member or part of the board.

Indeed the UK auditor, wholly independent of the economic decisions of unitary boards, is in the position that some policy initiatives seem to be trying to place independent directors. But unlike independent directors, the auditor is not legally bound by collective board responsibility.

7. The confusion of cultural exchange without legal change

The legal basis for financial reporting is clearly different between the US and the UK. The lines of accountability of boards and auditors are different, and the authority under which the financial accounts are prepared is different. Consequently, the interchanging of aspects of the two regimes that look or sound superficially similar is harmful.

A major risk for non-US jurisdictions arises from importing elements of the US model of financial reporting and auditing that are introspectively over-technical, process-led, and unnecessarily legalistic. There has been a marginalisation of the more judgemental test of bias required in other systems where stock market fraud is less of a problem than other factors including poor business judgement and economic inefficiency.

Audit committees – the confusion of auditor power and board accountability

Under the British model the auditor is fully accountable to the body of shareholders and can be appointed or removed by them. A tough auditor in difficult situations may affect whether any board member might lose their job. Under the US model the auditor is accountable to boards, where the worry is the impact of financial statements on the share price.

It is interesting that the stated public policy objective of the Treadway Commission in recommending audit committees in the 1980s was to prevent or lessen the occurrence of financial fraud. But by the time of the Blue Ribbon report of 1998 the policy objective of US audit committees had shifted. It was recognised that audit committees would only be effective if the non-executive directors were good. This begs the question, 'What is the protection if the independent directors are not good and the auditor is subordinated to them?' If in a practical situation, some audit committees are poor and biased towards their view of their appointed management, but their auditors are in fact adequate, the Treadway model of audit committees overseeing auditors, may not just be ineffective but actually harmful to best reporting outcomes.

Did financial reporting in the US actually get better in the post-Treadway era in terms of outcomes? The events across the millennium must make it difficult to conclude that it did. Rather than tackling poor auditing and reporting properly, the reforms of the late 1980s and 1990s may have led to complacency that the Treadway medicine was achieving something, that it actually could not ever do, due to conceptual flaws.

There is a problem of logic in having any auditor being accountable to part of a board, when the same auditor by his appointment is holding the board collectively to account for governance purposes. This was described by David Hatherly in 1995.

It [the audit committee] is in effect a committee of the board, accountable to the board and delegated the task of ensuring that the board properly discharges its reporting responsibilities. Its constitutional position and composition makes it an appropriate body to influence the appointment and remuneration of the auditors if it is the role of the auditor to report to, and be accountable to the directors.

However, this is not the current statutory role of the external auditor. As a means of facilitating the current statutory role whereby the auditor is accountable to members, the audit committee is both conceptually unsound and practically difficult.

Once these conceptual problems come under the sharper focus of academics and commentators, it is possible that the audit committee will not be seen to enhance the independence of the auditors from the board or the accountability of auditors to the members, even if many executives carry out their supervising role diligently and effectively.

The trend towards multiple executive directorships in response to the demand for non-executives has the effect that any auditor upsetting a non-executive director on an audit committee may be diminishing the audit firm's acceptability in a number of other major companies, thus reducing the auditor's willingness to go against the wishes of the audit committee.

'The Case for the Shareholder Panel in the UK', David Hatherly, University of Edinburgh, *The European Accounting Review* 1995, 4:3, 535-553

It is precisely a shift in relationships to match US practice that has begun to confuse the role of auditors outside the US. If auditors report to audit committees, who is responsible for overseeing the audit committee? An auditor who reports to boards for its purposes is not an external auditor performing a shareholder function, but an external auditor performing an internalised audit function. The UK Cadbury Committee made it very clear that the audit committee model it envisaged did not usurp the role of the auditor as the shareholder auditor. Some models of corporate governance seem to do just that.

There are also inconsistencies in relation to regulatory regimes. If public oversight boards are being set up to oversee the independence of auditors, why have audit committees been doing the same thing?

Over-familiarity is a risk to anyone's independence. Attempts to have audit committees oversee auditor independence may at times have the opposite effect to that intended. It may undermine independence in fact, despite striving for independence in appearance. Furthermore, oversight by any of those whom the auditor is intended to oversee under the UK reporting model, creates a circularity in accountability.

An example of the challenges in delineating responsibilities between auditors and audit committees is displayed in the Department of Trade and Industry report into the collapse of TransTec plc.

We said earlier in this chapter that the audit of the 1993 accounts, the first audit involving the newly created audit committee, set the scene for later events. Having considered all the evidence, we think that in that year Mr Lander [audit partner] must have felt that he had been criticised unfairly by the non-executive directors just for doing his job. Having interviewed Mr Lander on three occasions and the review partner, Mr Woods-Scawen, on two, we suspect that they are not the type of people who would take kindly to that, or be able easily to deal with it. We think that they were disinclined to allow it to happen again.

DTI Inspectors' Report into the collapse of TransTec plc, The Stationery Office, 2003

The actual legal power that the UK auditor has under company law may be artificially subordinated to audit committees if there is any sense that an auditor is accountable to them in the way of the US model. Regulatory requirements for matching UK with US practice can confuse the US SEC regulatory auditor role with that of the UK statutory role which is different. This is not a semantic difference. The balance of power between auditors and whole boards is embedded in UK law, whereas the auditor's power has been deficient in the US since 1933. The power of the auditor relative to boards is most likely to be relevant when things are going wrong and firm action, via shareholder reporting, is needed.

The expectation of the role of the actual auditor of a UK registered company is also displayed in the conclusions of the Department of Trade and Industry Inspectors into the failure of TransTec plc.

At heart the story is about bad management of an engineering group by top executives who were not suited to the jobs they had taken on, and about a board of directors who failed to grasp what was happening and change that management. The events also involve lack of integrity, deception, lies, cover up and financial misstatements. In this sense the situation was indeed, quoting from section 432(2)(d) of the Companies Act 1985 referred to in paragraph 1.4, that 'the company's members [had] not been given all the information with respect to its affairs which they might reasonably expect'.

In our view, therefore, TransTec's demise was due to fundamental failings of executive leadership exacerbated by poor corporate governance. It is an illustration of a dysfunctional and passive board of directors. It is also a fascinating example of audit failure. TransTec provides a story that we believe is very relevant to the current debate about how to improve the governance of businesses.

We are of the view that auditors need to realign their contribution so that they not only reach an independent opinion but, in doing so, assist the board in serving the interests of shareholders, and the way shareholders see the company, rather than serving the interests of management.

DTI Inspectors' Report into the collapse of TransTec plc, The Stationery Office, 2003

The cost of regulatory confusion

Another problem with inappropriate cultural exchange from the US into the UK is the cost effectiveness of process and regulation, especially when the regulation itself may be confusing entirely different legal objectives and actually leading to counterproductive behaviour. It is of note that the French model of the statutory audit, which in terms of legal concept is much closer to that in the UK, has not been greatly affected by a 'voluntary' cultural exchange.

The most critical problem may be that financial reporting is getting so complex that very few people genuinely understand the accounts any more. There may be direct relationships between clear civil law and simple but fulsome reporting (UK), and between weaker civil law – with strong but incomplete trans-jurisdictional regulation – and the need for complex rules and processes in financial reporting (US).

If it is indeed ever possible to construct a robust conceptual framework for financial reporting and auditing around the aims of the 1933 Securities Act, it seems fair to conclude that this has yet to be achieved, or if it were achievable, it is unlikely to sit easily with conceptual frameworks of other systems based on entirely different legally defined goals. The problems with having a framework for auditing based on the US regulatory model, or following elements of current US practice, is expressed below from a German perspective in a letter to the International Auditing and Assurance Standards Board (IAASB).

> *We consider it necessary for the IAASB to create a solid foundation for audits. Current standards have evolved based on best or normal practice, rather than having been based on solid reasoning and empirical evidence*
>
> *The list of "Fundamental Principles Underlying the Objective of an ISA Audit" in the Consultation Paper appears to represent a list of topics covered by the ISAs rather than a reasoned foundation resulting from the application of a systematic approach. As we pointed out previously, the current list appears to be based solely on current auditing practice as opposed to being based on a proper conceptual foundation.*
>
> **Institut der Wirtschaftsprüfer in Deutschland (German Institute of Auditors): extract from its response to the IAASB Clarity Project, December 2004**

The practical considerations that flow from a statutory (incorporated) basis of auditing that must cost effectively work for all audits of incorporated entities irrespective of size or listed status, are again well expressed from a German perspective.

> *The issue here is whether the IAASB wants standards to control auditor input or output. We believe that controlling auditor output (the objectives to be achieved) using a principles-based approach is more effective, efficient and robust (i.e., not subject to constant change) than trying to control auditor input (procedures to be performed) by means of detailed rules. To put it bluntly, in this context, sometimes less is more. Nevertheless, we are not suggesting that standards gloss over complex matters: the standards should be as simple as possible – but not simpler. On this basis, we support the notion that "an audit is an audit" – regardless of the size of the entity – and that in developing objectives and principles upon which to base auditing standards, it may be useful to "think small first".*
>
> **Institut der Wirtschaftsprüfer in Deutschland (German Institute of Auditors): extract from its response to the IAASB Clarity Project, December 2004**

Dual registered companies where the two systems can clash

There are a number of dual registered companies, incorporated in the UK but registered in both London and US markets, or with American Depository Receipts listed in the US. As the Cable & Wireless plc case referred to earlier shows, the requirements in law of the place of incorporation (UK) go well beyond the more limited remit of the US securities laws.

Because the auditors of a UK registered company report to shareholders for their interest, they should not have any problem reporting in a way that may, in rare cases, lead to the dismissal of perhaps the whole board. US auditors do not have the same freedom. They are reporting to boards for themselves. Unless they feel that a board is blatantly fraudulent or deceptive, it is difficult to envisage the auditors having any obligation other than working all matters through with non-executive directors, who for failing companies, may be part of the problem.

Given that the UK model of auditing requires reporting truth and the US model requires market certification, there may be cases where the two objectives are difficult to meet in one set of statements.

It is unfortunate that audit committees, often driven by volumes of contradictory guidance have become process driven, rather than business output focused. In many respects the process can create a task that is actually fruitless in terms of creating real shareholder value since many of them have been contemplating the increasingly anodyne and complex. Shareholder value is created from serving the prime objective of earning a surplus in excess of the cost of capital, not setting one's prime objective as ensuring accurate reporting for market regulators.

8. Investor behaviour and corporate governance

Buy-sell or stockholding?

The model of 'buy-sell' behaviour is so embedded in the US that it makes the self-governing civil ownership perspective of stockholding difficult to envisage as an alternative to SEC regulation. Large US investors are beginning to use ownership rights but these are limited rights in the US and the political framework does not encourage them.

By contrast, governance oversight by shareholders of UK registered companies is well embedded in the UK system. UK investors have fought for years to maintain it, and the UK government is positively encouraging it, especially in initiatives such as the Myners Review (2001) examining the stewardship responsibilities of institutional investors. The UK courts countenance no other method of corporate accountability.

Limitations of the market-pricing system

The market-pricing model in practice is highly dependent on broker-based analysis and is highly driven by news flow and changing expectations about a company to generate the buyers and sellers for the next trade. Given that every secondary market share sale does actually have a matched buyer, market messages to boards can be highly ambiguous.

The developers of the 1933 Securities Act envisaged market-pricing 'governance' working for growing companies with the need to raise new money. This is clearly not the case where a company is perhaps best incentivised to live off its current capital, gear up with debt, or buy back its own stock or contract. Few companies now need to raise new capital in the way that Congress in the 1930s envisaged. But the US model, since it is primarily based on a prospectus regime for new issues, presumes all companies are embarking on new issues into perpetuity. Without this a key assumption of the '1933 model' is missing.

In the UK, in a capacity as 'reporting accountants', independent accountants do report to boards for new capital issues, so as to advise boards that they are not defrauding the market. In these situations the focus of work is different to that of the statutory auditors. It does then become rightly legalistic.

Irrespective of any benefit of a market pricing system of corporate governance in the US at a macro-economic level, it would appear to create inbuilt victims of failure/loss. Economic arguments that there is no net loss to the system from inevitable corporate failure, since companies will get taken over, are often incomplete. More often than not, a failing company will fall into the hands of creditors, with a one-hundred percent loss of existing shareholder value and no bounce-back potential.

Applying the 1933 Act literally means that rather than reporting performance to protect property, a US listed company is only obliged to enable the wider public to track its rise or its decline, as they join or leave the company. When most companies in the capital markets are not actually raising net new money from equity investors but reinvesting profits, does the recycling of shares in markets from one party to another actually constitute investment as envisaged by Congress in the 1930s? Indeed as the supply of new capital becomes less plentiful than the US has experienced historically, will the US be a market of choice for more discerning providers of capital?

9. Convergence with the US or recognition of the differences?

Because of the great differences that now exist between the US and the UK financial reporting and corporate governance systems, there are conceptual, legal and practical difficulties with convergence of aspects of those systems.

The British reporting model created accounts for accountability purposes and sets accountability as the driver of their preparation. Under the British model, governance and financial reporting are directly linked. This is evident and most relevant in the clear legal responsibilities placed on the preparers of accounts and their auditors.

The 1933 Securities Act actually divorced financial reporting from direct corporate governance, giving it instead a market-pricing purpose. The result was the creation of a different purpose for accounts, a different goal and different legal responsibilities in their preparation, and a special regulator, the SEC.

The creators of the 1933 Act may have assumed that auditors of public companies would not behave differently because of the 1933 Act. The 1933 Act was intended to deal primarily with problems of poor governance and non-existent reporting, rather than deal with auditing matters. However, given the highly unusual accounting question embedded in the 1933 Securities Act, auditing in the US may have actually deteriorated in part because of this complication, something that Congress in 1933 is unlikely to have envisaged. In tightly regulating auditing, the Sarbanes-Oxley Act may have missed an opportunity to unambiguously define auditing purpose, relieving some of the problems created by the accounting difficulties stemming from the 1933 Act itself.

Capital market regulators in particular, can assume that the dominant US model is 'the only model' for financial reporting, and overlook the crucial link between the British model of financial reporting and the wider British corporate governance framework. The superficially similar language can also assume that the 'actors' with similar names (especially auditors) have the same function in both systems. It is of note that what British-English speakers call a 'bathroom' does not accord with the US-English usage of the same word. US 'bathrooms' do not actually contain a bath. A similar but less obvious parallel might apply to the use of the words 'audit' and 'auditing'. It is often overlooked, but since 1933 auditors of US listed companies have not been performing the same functions as auditors in much of the rest of the world.

Indeed, had auditing in the US been an attractive commercial proposition at all stages of an economic cycle, having been based on a credible conceptual proposition suited to all stages of an economic cycle, it is worth contemplating whether there would have been any drift towards auditing firms adopting business models that may have led to compromised independence.

Words versus numbers

The trading of shares is often driven by single numbers, such as headline earnings, taken out of context. But UK financial reporting is in many ways as demanding on the inclusion of words as numbers. This is especially relevant for legal commitments with potential future economic consequences, which may not be reflected in the numbers that are presented in the balance sheet included in the earnings figure.

> *Those who analyse the company's performance will look at the numbers rather than the words, because they appear to facilitate comparisons with past performance, with other firms in the sector, and with the market as a whole. There is a relentless pressure to replace judgement with formulae, so as to be able to replace the skilled by the semi-skilled. This rests in part on the fallacy that numbers are more precise and accurate than words. As anyone who has compiled a set of accounts knows, almost every number is a judgement.*
>
> ***'Fair Shares: the future of shareholder power and responsibility'* Jonathan Charkham and Anne Simpson, p207, Oxford University Press, London 1999**

A review of any US financial statements will highlight the extent to which the use of words under the US reporting model tends to be to disclaim rather than inform. As recent events have shown, a set of financial statements produced under the US legalistic regulatory model, rather than being instruments of good communication, may in fact be a barrier to it.

International auditing standards and 'assurance'

The European Commission has long favoured adopting International Standards on Auditing (ISAs) developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) across the EU. However these standards were drafted at a time when it was assumed that a model of global auditing and governance convergence could be based on a US model of reporting and auditing for secondary capital markets. Recent problems post-Enron and Worldcom have led to a rethink.

The UK's Auditing Practices Board (APB) adopted ISAs only after major amendments to reflect statutory differences. In fact, the efforts of the APB to make ISAs relevant for actual national legal situations show how attempting to find a common denominator description of auditing and reporting is fraught with difficulty.

Perhaps the most relevant addition to ISAs is in UK and Ireland ISA 520, which drew from an existing UK and Ireland Statement of Auditing Standards for which there is no ISA equivalent. It arises against a background of UK law where section 432(2)(d) of the Companies Act 1985 refers to 'information with respect to its affairs which they [the members] might reasonably expect'. It requires auditors to consider 'whether the presentation adopted in the financial statements may have been unduly influenced by the desire of those charged with governance (i.e. the whole board not just the management) to present matters in a favourable or unfavourable light.' It will be interesting to see whether the US is able to add this simple paragraph, or if legal interpretation is that the 1933/34 Acts do not require it and it is constitutionally unacceptable as an addition.

One style of convergence envisaged in ISAs is the replacement of the legally defined concept of a shareholder 'audit' with something not defined in law called 'an assurance engagement'. Definitions of an assurance engagement come close to the situation that Moonitz was critical of, defining an assurance engagement as a process of following the standards without in any way defining the purpose of the mission.

There are other problems with the concept of an audit as assurance. What is assurance? Who is being assured? Boards assured about management, shareholders assured about boards, or secondary markets assured about the share price?

Assurance is probably most unsound where it implies a directed outcome. Shareholders may not actually want 'assurance'. Truth and assurance are not the same things. 'Truth' to hold to account in a UK system, and certification for a market pricing system are not the same thing. Truth may be bad news, and bad news is not assurance. An analogy of a similar directed outcome would be renaming the 'profit and loss account' the 'profit account'.

ISAs envisage 'general purpose' financial statements (i.e. those predominantly for a secondary market purpose) as a global standard. This has been despite the fact that including market pricing objectives in matters of financial reporting can create significant accounting difficulties with corresponding corporate governance problems flowing from this. In assuming one global model of capital market behaviour based on that of the US, ISAs also make an extended but incorrect assumption that there is a similar global model of underlying corporate governance and law when there clearly is not.

Public interest issues with the ISA model of 'one size' global convergence seem to have been picked up by the Australian Financial Reporting Council in a question posed in a recent open consultation.

"Should the objective of having highest quality auditing standards take precedence over an objective of having minimal divergence from the International Standards on Auditing (ISA), particularly given the role of auditing standards in the broader governance framework and the need to ensure standards have regard to the public interest?"

Invitation to Comment on the Strategic Direction of the Auditing & Assurance Standards Board. Australian Financial Reporting Council, September 2004

There are also important contractual issues not addressed clearly by ISAs. Auditors in statutory company law-based regimes are involved in what is a private contract between company and auditor. Incumbent in such a contract is a best execution requirement. Auditors and shareholders have a direct financial interest in the contract working with maximum efficiency in terms of actual economic outcomes.

Regulators on the other hand tend not to work by contract but operate unilaterally. Indeed unlike an independent judiciary enforcing civil law, the vigilance of regulators may vary according to a combination of political will and funding and resources.

Auditing for secondary markets, as in the US, is a different legal and economic objective to auditing for shareholders. Share trading in secondary markets is a zero sum game, a series of wealth transfers, but shareholders carry the actual outcome of actual wealth creation or destruction. This has implications that securities regulators may not always understand. But an auditor having a duty of care to a regulator such as the SEC is placed in a wholly different situation to an auditor having a civil contract based duty of care to a body of shareholders.

Harmonisation also raises questions regarding the position and responsibility of international standard setters, whether for accounting or auditing standards. Setters of standards sitting outside any national jurisdiction may have acquired considerable power and influence over things that will have economic outcomes for others whilst not actually having any financial accountability ('duty of care') to the affected parties themselves.

True and fair view

ISAs also make statements to the effect that 'fairly presents in all material respects' (US opinion) is equivalent to 'true and fair view' (UK opinion). This again is rather doubtful in fact.

Such matters of law in the UK are decided by the courts. The IAASB makes such statements without having any power or jurisdiction of its own. However if the two statements are equivalent, then it would surely be logical for 'true and fair view' to be the required form of global standard opinion instead of 'fairly presents in all material respects'.

What else do harmonised reporting standards affect?

This question is particularly relevant for those countries with a statutory reporting regime that applies to all companies; listed, might be listed, owner-managed, will-never-be-listed. Under the UK reporting model, until the introduction of IFRS, the same standards of auditing and financial reporting standards were common to all entities irrespective of whether they were listed or not-listed.

Adapting auditing standards for all companies, including hundreds of thousands of non-listed companies, for the sake of problems largely arising due to difficulties in a few states of incorporation in the US seems a cumbersome and inefficient way of progressing things.

It would seem far more logical for US issuers and auditors to learn from those places where statutory regimes work well and encourage the few listed companies that are causing problems to adopt statutory equivalent standards of reporting. The aim would be to overlay the bare bones of the 'general purpose' determined by the US Congress in the 1930s, for what were, after all, reasons of constitutional limitation.

Conclusions

Key principles for strong and sensible financial reporting, and its effective auditing, are a clear sense of purpose, authority and enforcement.

These three things are needed for the preparers of accounts to determine objectives in preparing accounts but also so that auditors can challenge with authority. Difficult situations require clarity of purpose for auditors to negotiate, force disclosure, and resign if appropriate. All of these things feature under the current UK Companies Act regime. The regulatory regime of the US does things differently.

The solutions to achieving best outcomes in financial reporting will differ by jurisdiction according to what existing actual law allows for.

UK solutions and issues are also largely applicable to Continental Europe

To date, EU harmonisation initiatives have been built onto the existing UK regime without difficulty. This is because Continental European and UK company law actually have had more in common than does the UK with the much weaker US framework of state company law interacting with federal regulations. However, certain current and pending EU harmonisation initiatives could be a major threat to the strengths of the UK/European model, detracting from its core features by inappropriately drawing from the entirely different regulatory model of the US.

One example is the IAASB model of auditing harmonisation proposed by the European Commission and which the APB has at least for the time being adapted and improved upon by substantial clarification. The IAASB model of harmonisation to what is a heavily US influenced model of auditing and reporting is conceptually odd in law but in the wake of Enron and other problems in the US rather questionable in practical terms too.

As evidenced over a number of years statutory accounting frameworks actually appear to be more robust and less cumbersome than has been the case with the US's 'general purpose' post-1933 model. This might also be expected taking account of the history of the problems with the formulation of the 1933 Securities Act. In the UK, the world's second largest capital market, the secondary market regulatory regime has worked perfectly well without requirements for 'general purpose' statements or the apparatus of the SEC, as the UK model is stemming from a wholly different approach.

A simpler model for harmonisation

A simple solution to the harmonisation question would be for the IAASB model of auditing standards to be inverted. Rather than statutory reporting being given the status of an incidental sub-set of a US style audit, 'general purpose' financial statements, statutory (shareholder) regimes should be recognised as giving clear purpose and authority, in a way that the US model still has not achieved.

On this basis the US would finally get what it has never had, a proper form of shareholder-focused financial reporting and auditing, the absence of which has led to a repeating cycle of more standards, corporate failure, reputational loss and one of the most complexly regulated activities in the world today, financial reporting.

As a result the rest of the world would maintain what has broadly worked well, in a far simpler way. The British model in particular has worked well with listed company requirements being an overlay to the basic statutory purpose for shareholders.

If it isn't broken don't fix it

In choosing to move away from this simple concept of shareholder-focused reporting, both accounting and auditing standard setters risk creating a situation where the practical and tested is subordinated to the theoretical and untested.

The shareholder interest in a company is not theoretical. It is what remains after all other claims have been settled. Some traders of shares with diversified portfolio holdings may be satisfied with financial reporting for secondary markets based on the theoretical economics of the probable. However, longer-term and undiversified shareholders in particular have an interest that includes managing and mitigating the possible risk in companies in which they are invested in ways that do not involve trading stock on to another party.

Other parties who may take a similar view, to a long-term shareholder as distinct from a sharetrader, include banking regulators.

> *I suggest later that, despite intensive work to improve accounting standards for financial instruments in recent years, fundamental issues with financial stability implications remain to be resolved. One crucial question is: 'Who and what are accounts for?'*
>
> *These illustrations suggest that different users of accounts may, at least to an extent, want information produced on different bases. And the simple fact is that we will not be able to make progress if different users all assert that their way of calculating or presenting the numbers is uniquely correct. I suggest, therefore, that the users of accounts should recognise that they may in reality need to adjust them to suit their particular purposes – something ratings agencies and other analysts have done for many years.*
>
> **Sir Andrew Large, Deputy Governor of the Bank of England, speech to Central Banking Conference, London, November 2004**

The purpose and authority in a statutory regime stems from the shareholders and their interest. General purpose statements wherever required should overlay good systems of statutory/shareholder financial reporting, not replace them, and certainly not drive them out of existence.

IASB standards provide a good framework for accounting, but any accounting or auditing standards framework must provide for override in the interest of the corporate objective (shareholder interest), as distinct from any standards setter's or regulator's self-serving objectives. IASB standards are already suffering from political interference in their setting, in a way that the ASB did not. Indeed the conceptual framework of the IASB, based not on a specific use for shareholders but something more general called 'decision usefulness', has introduced a multi-stakeholder concept, one result of which might be that the prime stakeholders' interest, that of the shareholders may be subordinated to that of others, as recent political interference has borne out.

In short, regulation in some circumstances, especially that affecting auditing and financial reporting, may be detrimental to the model that is intended to be delivered by a civil contract.

Global convergence of governance will not happen by any levelling down of shareholder rights. As a weaker rights regime, the US system is not one to level with but level up from.

Its financial reporting 'solutions' have been solutions to its specific constitutional problems. Civil law elsewhere is not an externality that can be ignored. Shareholders with strong rights and protections are highly unlikely to assent to their removal.

Statutory company law-based regimes have specific lines of legal accountability through unitary boards and shareholder auditors. These cannot be overlaid by codes to create a form that does not accord with legal substance.

'True and fair' is not equivalent to 'fairly presents in all material respects'. 'Truth' implies completeness. 'Fairly presents' is more suggestive of basic compliance.

Auditor liability, as determined in law, shapes and defines accountability in substance. Professional and regulatory regimes should recognise this, in setting standards or practice. Audit committees should not usurp or hinder the role or the accountability of the shareholder auditor. Their utility in a statutory model such as in the UK is to execute the duties of the board, not to take on any function of, nor to preside over, independent auditors thereby affecting their independence.

Other regimes based on the British model of company law

Australia has drawn on the British model of company law, and in many ways strengthened it in law and practice. One recent addition has been the right for shareholders to put questions to auditors in order to get answers ahead of annual general meetings. In some respects there would appear to be a greater understanding of the British financial reporting model in Australia than in the UK.

Canada has the British model in law of incorporation. Auditors are still described as 'shareholder auditors' in audit reports, but in terms of practice the Canadian model appears to have been subsumed within the codes and practice of the US-SEC regulatory model, even though this does not necessarily fit with the framework of Canadian civil law. Market regulators and codes seem to overlook the fact that the SEC model of regulation was created as a replacement for strong rights of incorporation, but Canadian laws of incorporation did not have the same deficiencies as those of states such as Delaware.

US specific matters and solutions

There is much that is good about the US disclosure regime that has developed since 1933. Features such as cash flow statements and comprehensive segmental reporting developed in the US first and were adopted elsewhere afterwards.

There are various ways in which matters in the US might be simplified, to focus more on outcomes rather than process in financial reporting.

- Changes at state level, e.g. supporting the principle of the shareholder interest under shareholder authority by including financial reporting requirements (such as IFRS) under state law of incorporation (especially in Delaware) or in individual corporate articles.

- Regulatory changes, e.g. supporting the principle of the shareholder interest and the shareholder authority through the public oversight system set up under the Sarbanes-Oxley Act by changing the opinions expressed by the US auditing profession (as Andersen intended from 1946 to 1962) and creating auditing standards under a statutory-based conceptual framework for the auditing of all listed companies irrespective of the requirements in the domicile of the company audited.

- The SEC should deregulate financial reporting at the same time as encouraging states like Delaware to increase shareholder rights to financial information in the market that operate in other jurisdictions.

Appendix 1: Real loss versus information loss: examples of problems arising from ambiguities in financial reporting systems

A Information loss	B Real and consequential loss
Exaggerated sales: by bringing forwards sales recognition From the perspective of the company this is actually only a timing difference, in reporting terms. The reality of the company is unaffected. The actual sales made are still real. What shareholders end up with is less than they thought, due to the 'lie', but no less in outcome than they would have got if the truth had been told earlier. **The economic 'losers' in this situation are purchasers at a false price, not shareholders who held for the whole period.**	**Diverted sales, not booked by the business but transferred to another entity by, for example, a controlling director** Earnings will be depressed. This creates a permanent loss of shareholder value. Sales are permanently lost and the reality of the business is harmed. The shareholders get less than they should, actual value is lost to them permanently, but the market will get the right earnings for that situation. **The economic 'losers' in this situation are shareholders who did not trade.**
Deferred expenses (invoices held back) This again is only a timing difference. At worst there is a temporary delay in actually paying creditors. The company is unaffected in actual value terms. Again, what shareholders end up with is earnings are misstated but no less than they would have got if the truth had been told earlier. **The economic 'losers' in this situation are purchasers who bought at a false price, not shareholders who held for the whole period.**	**Excessive expenditure that does not benefit the business** Earnings will be depressed. This creates a permanent loss of shareholder value. The shareholders get less than they should, but the market gets the right earnings for that situation. **The economic 'losers' in this situation are shareholders who did not trade.**

A Affects purchasers/sellers (and flatters boards' performance if their incumbency is an issue).

B Affects long-term holders, by a permanent loss in value.

Europe regulates situation **B**, under one form company law, and **A** under company law and capital markets oversight.

Under a 'European model' where **B** occurs, the primary civil/statutory duty of care of auditors is to the shareholders. Situations where **A** occurs are covered by professional standards and civil/statutory duty of care to holders of shares.

Under a market regulatory model such as the 1933 Securities Act the duty of care is to the purchasers and sellers as described in situation **A**.

In the US, the objectives related to situation **B** are not unambiguously market pricing objectives by reference to the 1933 Securities Act. They are 'common-law objectives' and involve actual corporate loss. Their impact can be limited by auditor engagement letter exclusion in those states whose legal frameworks allow this.

Rather than having enforcement to prevent loss of shareholder value, the 1933 model presumes that companies are seeking share-price maximisation. The 1933 Act did not create a shareholder focused financial reporting model.

Appendix 2: Key differences between UK and US reporting frameworks and shareholder rights

Attribute	UK	US-SEC
Basis of laws affecting the core framework of financial reporting.	UK company law – civil law, generally law of contract/property.	Federal regulation – with tort-based remedies stemming from breaches (not contract/property law).
Purpose of audit.	Agency conflict Protection of the company itself 'Stewardship'.	Agency conflict Conveying of false information to the market influencing the pricing of shares 'General purpose'.
History of company law.	Companies Acts have evolved by following accepted existing best practice.	1933/34 Securities Acts. Big bang federal legislation to address governance *deficiencies* and the lack of financial reporting requirements in state law – but *without impinging on state law in matters of governance*.
Applicability of laws affecting audits of companies.	All companies irrespective of status of listing.	Only SEC listed entities for market pricing.
Primary purpose of audited accounts.	Accountability.	Pricing of shares
Pre-emptive protection of property available to members.	Yes. Body of members is sovereign. Civil freedom to act prospectively or reactively in binding way.	No. Delaware Courts tend to judge *retrospectively*; e.g. Hollinger. Boards are sovereign, and self-appointed. *Voting on director reappointment non-binding.*
Model intended to address failing companies ahead of potential crisis.	Yes.	Not so long as inefficiencies in the micro-economy of the company are 'priced'.
Who is overseeing who?	Auditors act for shareholders.	Auditors act for boards.
Auditor 'independence' in law.	Independent of whole board.	Only independent of executive board and management.
What is the intended path of accountability?	Shareholders to judge whole board, and the self-discipline of frank public disclosure.	Independent directors to assess management's presentation free of 'scienter', in order to fulfil regulatory requirements.
Legal basis underpinning accounting standards.	Principles – 'economics'.	Rules – 'letter of law'.
Development of accounting/auditing practice, as led by the law.	'Rounded'. Income and balance sheets. Returns seen in terms of capital efficiency, not mere 'pricing'.	Focused heavily on earnings. Record in practice of being weak on off balance sheet risk.

Attribute	UK	US-SEC
Form of opinion.	True and fair view.	Fairly presents.
True and fair over-ride.	Yes.	No.
Status of audit report.	Evidence from a trusted objective expert.	Certification.
Auditor liability.	Contractual.	Mainly tort.
Do *investors* have any responsibility to read/use accounts.	Yes.	No.
External points of reference where difficulty.	Actual members. (section 390, section 392, section 394).	With dematerialised markets, only lawyers and SEC.
Expression by an auditor of uncertainty in 'audit' reports.	Allowed.	Disallowed (counter to certification objectives).
'Bias' other than fraud to be tested as part of audit.	Yes SAS 470, now included in ISA UK and Ireland ISA 520.	No, and *not* in ISAs.
Additional work for new issues handled under a specialised non-audit assignment.	Yes. Reporting Accountant role. Different to statutory auditing.	No, unless IPO.
Role of audit committees.	Execution of responsibility of *whole* unitary board in presenting financial statements – for shareholders. And *for internal purposes*.	Oversight of management with insider access to accounting systems.'1 1/2 tier boards'.
Oversight of audit committee by shareholders.	Normal director accountability of each member of audit committee.	Limited binding rights of shareholders in Delaware to alter composition of audit committee.
Right to call EGMs.	Yes.	Not Delaware.
Binding re-election of individual directors.	Yes.	Delaware votes non-binding.
Compliant with OECD principles (2004).	Yes.	Not Delaware.
Pre-emption rights for new issues.	Yes.	Not Delaware.
Rights to audited financial information.	Companies Act.	Not Delaware.
Protection of parties afforded by core reporting/governance regime.	Holders of shares. A large majority of UK equity is not traded in any one year.	Buyers and sellers in capital markets. Not holders who did not trade.

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