Financial regulation of public limited companies in the UK: A way forward post-Enron

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Abstract

On 16th April, 2002, the authors gave oral evidence to the House of Commons Treasury Committee Inquiry into Financial Regulation of Public Limited Companies which was set up following the collapse of Enron. This paper is adapted from the written submission to the Committee on which their oral evidence was based.

The authors argue that the Enron collapse provides an opportunity for regulators to stand back and consider fundamental issues associated with the regulatory framework for financial reporting, auditing and corporate governance in the UK.

They challenge the financial reporting framework as being muddled between the concepts of stewardship and decision usefulness. Company balance sheets are an amalgam of figures based on historical cost and accounting estimates. The increasing use of financial instruments and the inclusion of intangibles makes valuations complex and judgmental and therefore much more difficult to audit.

Incentives in the capital markets which drive the behaviour of all participants should be considered to ensure that the current system does not encourage dysfunctional outcomes and excessive rewards. The personal incentives for partners in audit firms are of particular interest as a potential key influence on auditor independence. It is suggested that non-executive directors should be mandated to protect the interests of investors.

The authors counsel against kneejerk reactions to the Enron collapse as a number of changes such as the transfer of regulation of securities listing to the Financial Services Authority (FSA) and the establishment of the Accountancy Foundation need time to settle down. They believe that auditor rotation will introduce costs without clearly identifiable benefits and are opposed to wholesale banning of auditors providing non-audit services to their clients.

INTRODUCTION

Effective financial regulation is a multifaceted function. It is not just about law and regulations which cover financial reporting, corporate governance and auditing. It is also about the balance between ethics and the incentives which drive all parties who are key players in capital markets. These parties include fund managers, analysts, investment banks, company directors, auditors, regulators and financial journalists, who all contribute in different ways to the effectiveness of the markets.

In this paper the focus is primarily on financial reporting, corporate governance and audit, subjects in which the authors have conducted extensive research, but they caution against any review of financial regulation being limited to these areas.

In order to maintain confidence in capital markets, a framework which sets standards for high-quality accounting, high-quality auditing and sound corporate governance is needed. To be effective, however, a framework also needs to encourage a culture of compliance with the standards set and have enforcement and oversight mechanisms in place which deter non-compliance and deal swiftly and effectively with abuse. A further key attribute of a regulatory framework is that it must be cost effective, ie the costs of compliance must not exceed the overall benefits to society from the regulations imposed.

There have been two periods of change to the UK framework since the early 1990s. A series of changes were introduced in 1991–92 emanating from UK-based changes to company law, from EU Directives and from financial scandals. Since 2000 significant changes have been seen which have arisen within the UK and which aim to strengthen financial regulation. Further changes arising both from within the UK and from EU requirements can be expected.

DEVELOPMENTS IN THE UK

Changes introduced in 1991–1992

Significant changes were introduced to the UK regulatory framework for financial reporting and auditing by the 1989 Companies Act. The establishment of the private sector regulator, the Financial Reporting Council[1] and its subsidiary bodies, the Accounting Standards Board which sets accounting standards, the Financial Reporting Review Panel which investigates company accounts for non-compliance with accounting standards and company law,[2] and the Urgent Issues Task Force, was in response to a recognised need to improve the quality of financial reporting in the UK. There was poor quality accounting (referred to by some as creative accounting) in the 1980s, and enforcement was weak. This change was led by the Department of Trade & Industry (DTI) which went through various consultation processes with interested parties.

A new system for the regulation of auditors was also introduced in 1991. This has its origins in the EU 8th directive, one objective of which was to enable mutual recognition of audit qualifications throughout the EU. Auditors must hold a recognised qualification and be able to show relevant experience. They must also be licensed and publicly registered. Additional provisions which were not required by the 8th directive were introduced in the UK.

In order to retain their licences audit firms are subject to regular monitoring of the quality of their work. Failure to perform work to a sufficient standard can lead to fines and possible removal of the licence for a firm or an individual. The system is operated under delegated authority from the DTI by the UK accounting bodies whose qualifications are recognised in law for statutory audit purposes.

A further significant non-statutory change was set in train following major corporate collapses, particularly the Polly Peck and Maxwell affairs. The quality of corporate governance is recognised to have a major influence on the integrity of auditing and financial reporting (particularly the influence of audit committees) and a series of codes were developed which set out best practice. From December, 1998 the Stock Exchange made it a requirement of the Listing Rules that companies should disclose the extent of their compliance with what had become the Combined Code of the Cadbury, Greenbury and Hampel Reports. From December, 2000 directors have also been required to report to shareholders on their review of the effectiveness of internal control and risk management.[3]

Changes introduced in 2000–2002

After a period of relative stability, two further significant changes to the UK framework have been introduced.

First, because of concerns both from members and the public about the dual role of professional accounting bodies as regulators and as members' service organisations, following a period of negotiation with the DTI, the UK professional accountancy bodies[4] combined to set up The Accountancy Foundation. The Accountancy Foundation and its subsidiaries provide independent oversight of regulatory activities and ethical standards of the accountancy profession, set standards for auditing and conduct investigations into public interest cases where accountants are involved. A key feature is that the membership of these bodies does not have a majority of practising accountants. The Review Board will oversee the regulatory responsibilities of the accounting bodies. The existing Auditing Practices Board is being reformed. A new Ethics Standards Board oversees the setting of ethics standards for all the professional bodies; and an Investigation and Discipline Board will replace the current Joint Disciplinary Scheme operated by only two of the six bodies, the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland. The Accountancy Foundation was set up in 2000. The Review Board and Ethics Standards Board were set up in 2001 and the establishment of the other two bodies is still to be finalised. Given the newness of this structure, it is not yet possible for any sensible assessment to be made of its impact on the UK professional accountancy bodies' regulatory activities, the quality of standards setting in audit and ethics or the investigation of the role of accountants in corporate collapses.

Secondly, a major change took place in May, 2000 when the regulatory activities of the London Stock Exchange were transferred to the UK Listing Authority, part of the Financial Services Authority. State responsibility for oversight of financial reporting and auditing lies with the DTI. The responsibility of the UK Listing Authority is to regulate the admission of securities to listing, investigate market abuse and insider dealing and ensure that registrants comply with the requirements of the UK Listing Rules. Since 1st December, 2001, the UK Listing Authority has acquired additional powers to investigate and prosecute directors of companies which are found to have breached the Listing Rules.[5] A review of the Listing Rules is currently being carried out. Statements

have been made by the chairman of the FSA and the Chief Executive of the UK Listing Authority about the future possibility of the UK Listing Rules containing provisions relating to audit matters.[6] As these changes have also been very recently introduced no sensible assessment of their impact can be made and it is not possible to assess how the future role of the UK Listing Authority will yet develop.

Future developments

Two significant developments are planned for the future. First, following a comprehensive review of UK company law from first principles, and a lengthy consultation process, a new Companies Bill is being prepared. Included in the suggested provisions are a much clearer statement of directors' responsibilities, which would facilitate action against directors who abuse their position, and a mandatory operating and financial review for larger companies, which will encourage greater transparency in financial reporting.

Secondly, progress is well advanced within the European Commission for the adoption of International Accounting Standards by listed companies throughout the EU by 2005. The purpose of this is to bring about common standards of financial reporting throughout capital markets in the EU. This will also facilitate cross-border listings and transactions. The changeover to International Accounting Standards for listed companies in the UK will require considerable effort for the companies involved. It is as yet unclear how this change will affect unlisted companies.

REVIEW OF THE CURRENT FRAMEWORK

In this section the authors review the effectiveness of the UK framework in the light of their research findings. Comments mainly arise from their book 'Behind closed doors: what company audit is really about', a copy of which was sent to the Select Committee, and other research studies they have carried out. Comments are divided into those relating to corporate governance, financial reporting, auditing and motivation and personal incentives.

Corporate governance

In 'Behind closed doors' the authors find, in six case studies, different patterns of behaviour among non-executive directors who are seen as key to the effectiveness of the corporate governance framework. Examples are found of non-executive directors supporting best practice in internal control and financial reporting. Examples are also found of non-executive directors who are in the pocket of the chairman, who are therefore not independent, and examples of domineering and bullying chairmen, who intimidate both their own staff and their auditor to try to show the company's results the way they want. The pattern of behaviour is varied. The authors have, however, been encouraged by other research[7] which indicates a belief among audit partners, finance directors and financial journalists that an audit committee, composed of non-executive directors, a majority of whom are independent, strongly enhances auditor independence. The mere fact that a company has non-executive directors on its board does not mean that they are either independent or effective.

Financial reporting

The authors' surveys of finance directors, audit partners and financial journalists show a strong belief that the integrity of the UK financial reporting process has been enhanced[8] by the new accounting standards set by the Accounting Standards Board, by the enforcement activities of the Financial Reporting Review Panel and the pronouncements of the Urgent Issues Task Force.[9] There is also a belief that improved

accounting standards have to some extent enhanced auditor independence.[10] The authors' research also indicates that the Financial Reporting Review Panel, which was an innovation in UK financial reporting, has changed attitudes to accounting compliance in larger audit firms, who act for the vast majority of listed companies. It was also found that the Review Panel has enhanced auditor independence because of the costs and reputation risks for audit firms if their clients' accounts are publicly criticised by the Review Panel.

In 'Behind closed doors' the authors find further support for the Review Panel as neither the auditors nor the companies were prepared to lend their names to accounts which showed visible evidence of non-compliance with law or accounting standards. There can always be room for improvement in financial reporting standards, but the UK framework has three particular strengths. First, it is based on principles rather than detailed rules, and it is more difficult to avoid compliance with a principle than a specific rule. Secondly, UK company law provides for a true and fair override to be applied to accounts so that where compliance with the framework does not lead to the accounts showing a true and fair view, alternative accounting treatments should be adopted, but must be fully disclosed. These two strengths leave limited scope in UK accounting for claims that materially misstated accounting information complies with accounting rules. A third strength is that UK accounting standards, the development of which are subject to rigorous due process, have not up to now been subject to political interference. It is essential that, to retain the integrity of the system, powerful lobby groups and politicians should not be able to influence accounting practices to suit their own interests.

There are issues in accounting which are subject to judgmental decisions, such as stock valuations and bad debt provisions to which precise numbers cannot be attached. Also some accounting practices are now immensely complicated, particularly relating to certain types of financial instrument. It is becoming increasingly difficult, therefore, to attach values to assets and liabilities related to financial instruments at a fixed date and to quantify the associated risk. The large corporate entity's balance sheet and profit and loss account have become an amalgam of fact and judgment, represented by numbers made up partly of historical cost and partly of estimates and valuations. The present day purpose of company accounts has also become a muddle between the principles of stewardship (directors giving an account of how they have managed the business) and decision usefulness (future investment and cash flows). In the authors' view the time has come for all parties to stand back and consider for whom and for what purpose company accounts are prepared in their present form.

Auditing

The impact of regulation

Since the introduction of audit regulation in 1991, the authors' research indicates that audit firms of all sizes believe that the standard of their audit work has improved.[11] The large firms have found it easier to ensure all their partners comply with their own internal standards and the regulatory framework, and the smaller firms have been more thorough in their work.[12] There are also beliefs that the risk of loss of audit licence either for a firm or an individual has enhanced auditor independence.[13]

Independence and non-audit services

The authors' survey work indicates beliefs among audit partners, finance directors and financial journalists that the factors which

most undermine auditor independence[14] are linked to the economic dependence on the client of the audit firm and in particular the individual partner. The two highest ranking factors which undermine independence for all three groups are first, where the partner's income is dependent on the retention of a client, and second, where the partner does not wish to lose status by losing a key client. The other factor ranked highly by audit partners and finance directors is where more than 10 per cent of a firm's revenues come from one client. (This level of economic dependence is currently permitted in the UK.)

Interestingly, the financial journalists ranked a high level of non-audit services as a more serious threat to independence than did either the finance directors or the audit partners. The authors believe that this difference of views between financial journalists and audit partners and finance directors arises from the difference, which is not widely understood outside the accounting profession, between independence in appearance and independence in fact. Audit would have no value to the regulatory framework which supports capital markets if auditors are not independent of management. Because the audit process is not generally observable to those who rely on it, public confidence in audit derives from beliefs that auditors are independent.

Much of the regulatory framework relating to auditor independence is focused on providing assurance about the appearance of independence because the fact is unobservable. The only circumstances where evidence of independence in fact (or lack of it) emerges is from reports of the small number of cases of corporate collapse and audit failure where there has been gross negligence or misconduct, and where the findings are made public either via DTI reports or by the findings of the Accountants' Joint Disciplinary Scheme. It would be entirely inappropriate to take these cases as representative of auditors as a whole.

In 'Behind closed doors', the authors find much evidence of independence in fact and some evidence of lack of it. What does emerge from 'Behind closed doors' (and from a subsequent study which deals specifically with the independence issues therein)[15] is that the quality of a firm's internal management and the personal integrity of the individual partners are vital influences on independence in fact. In the cases where problems are found these arise from a combination of circumstances: the weakness in the personal characteristics of the individual audit partner; lack of clarity in the regulatory framework; an inexperienced partner being allocated to an older and difficult client; a bullying chairman; poor corporate governance; and a disorganised firm. There is no single factor involved.

As referred to above, there is a perception among journalists (and others) that the provision of non-audit services *de facto* undermines independence. Academics have studied this subject for many years and no-one has yet succeeded in establishing conclusively whether the provision of non-audit services undermines independence or not. The authors have found no evidence from their case studies in 'Behind closed doors' of non-audit services undermining independence in fact. What they do find, however, are concerns about losing a client — not concerns about the mix of fees associated with that client. This supports the authors' survey work that the most significant factors which undermine auditor independence are loss of income for an audit partner as a result of client loss, and loss of personal status within the firm.

Regardless of the lack of evidence about non-audit services undermining independence, the perception remains and it cannot be ignored if confidence in audit is to be maintained. In the authors' view, there are

two fundamental issues to be addressed: the first relates to the nature of non-audit services; the second relates to the auditor independence framework itself.

First, the nature of what non-audit services comprise needs to be better understood. The authors' survey work[16] indicates that non-audit services include compliance-related work which is economically, and in some cases legally, inseparable from audit. Services which are closely related to financial reporting, such as advice on implementation of new accounting standards and other regulatory requirements or the accounting treatment of complex transactions, may not be part of the quoted audit fee, but there would be no sense in other parties being involved. Other services require the involvement of the company's auditor, eg reports on some class 1 circulars. There are other services, such as tax advice, which are closely associated with financial reporting that companies may prefer their auditors to do because of knowledge spillovers. The authors find that once the services are not closely associated with annual reporting, companies will seek the best supplier, which may or may not be the auditor. Ignorance about the nature of non-audit services can be easily resolved by more detailed disclosure in company accounts, as is already done by some companies.

Secondly, the UK independence framework recognises that the provision of non-audit services and undue dependence on an audit client are a threat to independence. But in respect of listed companies the authors believe the framework needs to be reviewed to ensure strict observance of two fundamental principles: auditors should not take management decisions; and they should not audit their own firm's work.[17,18] The authors also suggest that the UK framework should be reviewed for undue dependence on an audit client by the partner and the firm.[19]

Auditor rotation

Introduction of auditor rotation has also been discussed by some regulators and journalists. The authors' research indicates that in the past this has not ranked as a high priority issue with journalists and has little support from finance directors and audit partners. The authors are not aware of evidence from the UK that rotation would enhance independence. Their research on auditor changes demonstrates that auditor change is a costly exercise both for audit firms and companies.[20] They estimate the annualised rate of auditor change among listed companies to be around 4 per cent.[21] There are approximately 2,200 UK domestic companies registered with the UK Listing Authority. The introduction of auditor rotation on a five-yearly cycle, which has been mooted by the Chairman of the FSA (see Ref. 6) would force 352 listed companies, which would not otherwise have done so, to change their auditors each year. Before such a high cost is imposed on companies and audit firms the benefits would have to be clearly demonstrable.

Value added audits

The authors' research into audit changes indicates that some company directors see little value in audit. They have labelled these directors as 'grudgers'.[22] These buyer types seek to purchase audit services at as low a price as possible, and increasing competition in the market for audit services has enabled such buyers to bring the price of audit down. The authors have argued that the principal of *caveat emptor* in relation to price does not apply in the case of the purchase of audit services. This is because audit is a regulated activity and standards must be met by the audit firm regardless of the price of the service. The purchase of audit from a reputable firm is a risk-free activity for directors as it is the shareholders and the audit firm who suffer in the event of a failure.[23]

'Behind closed doors', however, indicates the importance of the primary relationship between the audit partner and the finance director of a company, which influences the quality of audit outcomes. The authors therefore see no obvious alternative to directors playing a key role in the auditor selection process. Nevertheless they believe two issues in respect of auditor choice could be considered.

First, a culture change must be encouraged about who obtains value from audit. Since competition within the market for audit services has increased, directors have complained that they receive no value from audit, and auditors, knowing the directors are the effective purchasers are offering audits which they claim add value to the company and management. The authors suggest that this is misdirected as the true value of audit to the company and the directors is the signalling to investors and other users that the accounts prepared by the directors have been audited and show a true and fair view. The rest is irrelevant. The authors believe it would be far better for audit to return to its roots rather than purport to be a service to management.

The second point follows on from the first. If the culture change in thinking can be achieved then the price of audit should be viewed not in terms of the value to the management but in terms of the value to the investors, and should be properly priced to reflect this. The cost of audit in the totality of corporate throughput is minimal and it should be incumbent on non-executive directors and shareholders to ensure that a proper and responsible balance between price agreed for audit and the value to the shareholders is achieved. The authors have found evidence of fee pressure being used to intimidate auditors, a practice which they believe to be unacceptable. One possible solution to this is disclosure to investors that both directors and auditors believe that the audit fee properly reflects the value of the audit to the investors and intimidation has not been used to bring the fee down. This is a difficult area as the authors do not believe that auditors should have *carte blanche* to charge what they like, but more importantly directors should not have *carte blanche* to drive the price of audit down as part of a power game when this is not in the best interests of the investors.

Auditing standards

In line with the comments about the mixed objectives of the current corporate annual report and the difficulties of valuation and risk assessment, the authors believe that a review of the purpose of the annual report to users should be accompanied by a review of the levels of assurance which can be provided by auditors on some of the more complex valuations. At the moment an opinion is given on the whole of the financial statements but the levels of assurance which an auditor can provide on different parts of the accounts may vary widely. It is suggested that debate should be opened as to whether investors should be provided with much more information about levels of assurance.

Motivation and personal incentives

Reference has already been made to the need for audit firms and those regulating them to review the internal management of audit firms to ensure that audit partners are not incentivised by personal considerations of money and status to compromise their personal independence and thereby compromise their firm.

It is not just auditors who may be in a structure which encourages dysfunctional behaviour. A proper review of financial regulation in the UK must include consideration not only of whether the personal incentives available to all parties can motivate dysfunctional outcomes, but also

whether the incentives offered are disproportionate to the achievements of the individuals. For example, fund managers may receive incentives to achieve growth targets, investment analysts may receive incentives to encourage share trading, directors may have incentives to achieve a certain level of results because this triggers additional benefits to them, or they may find themselves under pressure if results are below expectations. A full understanding of the incentivisation process throughout capital markets is essential before one-off and potentially irreversible regulatory changes are introduced in any specific areas.

ENFORCEMENT

Any framework for regulation needs to have an effective enforcement mechanism both to deter and to punish offenders. There is always room for improvement in these areas and the authors have had concerns for some time about the length of time it can take to bring offenders to justice. They have been encouraged by the DTI's actions in disqualifying increasing numbers of delinquent directors and the planned provisions in the Companies Law Review should further facilitate swift action against abuse. Furthermore, the enforcement powers vested in the FSA from 1st December will also help to bring offenders to justice.

In terms of financial reporting and auditing, the Financial Reporting Review Panel has proved a success in enforcement of compliance with accounting standards, to the extent that it is being considered as a model for other countries in the EU. The establishment of the Accountancy Foundation with its Review Board overseeing the regulatory activities of the accountancy bodies and the reform of the Joint Disciplinary Scheme should expose any deficiencies in these areas and bring about improvements.

There is no room for complacency in any of the areas of enforcement and the process and procedures must be kept under review.

THE WAY FORWARD POST-ENRON

The authors believe the Enron case has caused great consternation for two reasons. First, it happened in the USA whose capital markets have long been regarded as the strongest and best regulated in the world, and inevitably concerns have spread as to whether such a major collapse could happen elsewhere. Secondly, the auditors are facing criminal charges for destruction of evidence, and as a result have suffered reputation damage on such a scale that the firm is breaking up.

Two observations are made about these events. First, it is extraordinary that the US regulatory framework for accounting standard setting, disclosure and oversight of securities, as managed by the Securities and Exchange Commission (SEC), could have failed to identify accounting defects on such a scale in such a large company. Secondly, it is equally extraordinary that the auditors should destroy records. Beyond this, there is little to be said which is factually based until the results of proper inquiries are available.

Andersen are currently bearing the brunt of the opprobrium, and this in itself will be a salutary lesson for other audit firms as they perceive how quickly a reputation for integrity built up over many years can be destroyed.

No regulatory framework is perfect and no framework can eliminate corporate collapses, greed, fraud and professional negligence. The costs of doing so would be too great and would stifle the capital markets. The authors' research shows clear evidence of beliefs that the reforms in 1991 have improved the integrity of financial reporting, corporate governance and audit. But frameworks need to be kept under constant

review to close obvious loopholes and make improvements. The authors believe that the Enron collapse provides an opportunity for a wide-ranging review while there is political will to consider it. They therefore make the following suggestions which are drawn from this paper and from their research:

— a review could be carried out of the purpose of the current financial reporting process in the UK, as it seems to be muddled between stewardship and decision usefulness. As more valuations are included in company accounts and the numbers move further away from historical cost, a reconsideration of the level of assurance which auditors can reasonably provide may be needed. At the very least users need to understand the nature of the judgments which are being made
— the nature and extent of incentives which drive all key participants in the capital markets should be understood and reviewed to ensure that they do not encourage dysfunctional outcomes and that the rewards are in proportion to the efforts and performance of the individuals
— in order to function properly in the corporate governance framework, non-executive directors should be properly independent of management and be clearly mandated to protect the interests of shareholders. The proposals in the Company Law Review, and the Combined Code go some way to achieving this, but could go further
— efforts should be made to bring about a culture change in attitudes to audit among some company directors. Audit is not a commodity to be bought by directors who see no value in it to themselves, nor is it, as some firms would have us believe, a value added service to directors. The primary value of audit is in its signalling value to markets and shareholders. Directors benefit themselves from the signalling that their accounts show a true and fair view and comply with law and regulations
— it is a concern that directors can use fee pressure to intimidate auditors. There is some merit in disclosure to investors that both auditors and directors believe the audit fee is fair for the benefit provided to investors
— a review should be carried out of the UK auditor independence framework to ensure that the principal threats to independence identified in the authors' research, ie the personal incentives for an audit partner to compromise independence to protect his or her personal position are adequately addressed within the audit firms
— the current UK independence framework permits an audit firm to be economically dependent on one listed company client to the extent of 10 per cent of its gross fees. This is believed to be too high and should be reduced to below 5 per cent
— the independence framework, in respect of listed companies, should also be reviewed to ensure that the provision of non-audit services does not involve an audit firm taking management decisions or auditing its own work. Other than addressing the non-audit services issue in this respect, the authors do not support the banning of other services, as the case for enhancing independence by doing so is not established
— the composition of non-audit fees in company accounts should be disclosed to enable users better to understand what the number comprises
— auditor rotation should not even be considered as a serious option. There are large costs and no obvious benefits

finally, the authors caution against any hasty post-Enron action. There have been considerable changes to the UK framework since 1991. The recent changes, ie the enhanced powers of the UK Listing Authority and the establishment of the Accountancy Foundation should be given time to settle down. Further major changes, in the form of a Companies Bill and the change to International Accounting Standards are forthcoming. Now is not the time to take hasty measures because something has gone seriously wrong in the USA.

References

(1) The Financial Reporting Council receives its funding from the accountancy bodies, the Department of Trade & Industry (DTI) and City of London institutions.

(2) The Financial Reporting Review Panel is a reactive body which investigates cases of non-compliance which come to its attention, either through press reports, complaints or referrals from other regulators. The Panel seeks to secure voluntary remedial action from directors whose accounts are found deficient. It has powers to apply to the courts to enforce remedial action if the directors decline to cooperate. After ten years' operations no such action has been necessary. Voluntary compliance has been secured in all cases. The Review Panel publicises all cases where company accounts have been found defective.

(3) Reporting on these provisions in the Combined Code was deferred from 1998, pending further guidance, which was issued by the ICAEW in 1999, 'Internal control: Guidance for Directors on the Combined Code'.

(4) The Accountancy Foundation is entirely funded by the UK accounting bodies.

(5) The powers acquired by the UK Listing Authority are included in the N2 implementation date of the Financial Services and Markets Act 2000.

(6) Two public statements by the chairman of the FSA and the CEO of the UK Listing Authority (UKLA) have indicated that the UKLA believes that the listing rules may pronounce in the future on matters concerning auditors, see *Accountancy Age*, 14th February, 2002, pp. 22–23, 26–27, London or FSA website for the speech by the Chairman, Sir Howard Davies, to the World Economic Forum, 31st January–4th February, 2002.

(7) In their paper 'Perceptions of auditor independence: UK evidence', (1999) *Journal of International Accounting, Auditing and Taxation*, Vol. 8, No. 1, pp. 67–107, the existence of an audit committee composed of non-executive directors, a majority of whom are independent, is cited by finance directors and audit partners as the most significant factor (out of 25) enhancing auditor independence, and the second most significant factor by financial jour-nalists.

(8) See book chapter 'The Financial Reporting Review Panel: An Analysis of its Activities', 'Financial Reporting Today: Current and emerging issues', 1998 edition, Accountancy Books, London, pp. 27–54.

(9) The Urgent Issues Task Force pronounces on emerging issues for which no accounting standards have yet been developed.

(10) See paper cited in Ref. 7.

(11) See Fearnley and Page (1994) 'Audit Regulation in the UK: Some preliminary observations', *Journal of Financial Regulation and Compliance*, Vol. 2, No. 2, pp. 125–132.

(12) This caused problems initially as smaller audits became more expensive and this led to exemptions from audit being allowed by the DTI for the smallest companies.

(13) See paper cited in ref. 7 and also 'Auditor independence and the expectations gap: Some evidence of changing user perceptions' (1998) *Journal of Financial Regulation and Compliance*, Vol. 6, No 2, pp. 159–170.

(14) See paper cited in Ref. 7.

(15) The authors' paper 'Auditor independence and audit risk in the UK: A reconceptualisation' was presented at the National Auditing Conference, organised by the University of Stirling in March, 2002.

(16) See Beattie, Brandt and Fearnley (1996) 'Non-audit services: Consulting? More like compliance', *Accountancy*, November, pp. 126–127.

(17) The authors restrict these principles to listed companies because in smaller companies the auditors inevitably carry out accounting work and provide extensive advisory services for their clients. In these cases there is little public interest risk as the businesses are mainly owner managed.

(18) The UK independence framework recognises these issues but the authors believe they should be much more clearly defined. For example, there is no ban on audit firms installing accounting systems for their clients. The framework simply says that the same people should not be involved.

(19) The framework recognises the issue of undue dependence on a client as a threat to objectivity but stops short of discussing remuneration schemes for partners. It does suggest that where a partner's income is dependent on the profits of one office and one client contributes more than 10 per cent of gross income for that office, another partner should take final responsibility for reports.

(20) Beattie and Fearnley (1998) 'Audit market competition: Auditor changes and the impact of tendering', *British Accounting Review*', Vol. 30, pp. 261–289.

(21) Beattie and Fearnley (1994) 'The changing structure of the market for audit services in the UK: A descriptive study', *British Accounting Review*, Vol. 26, pp. 301–322.

(22) Beattie and Fearnley (1998) 'What companies want (and don't want) from their auditors', ICAEW, London.

(23) Beattie and Fearnley (1998) 'Auditor changes and tendering; UK interview evidence', *Accounting, Audit and Accountability Journal*, Vol. 11, No. 1, pp. 72–96.

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