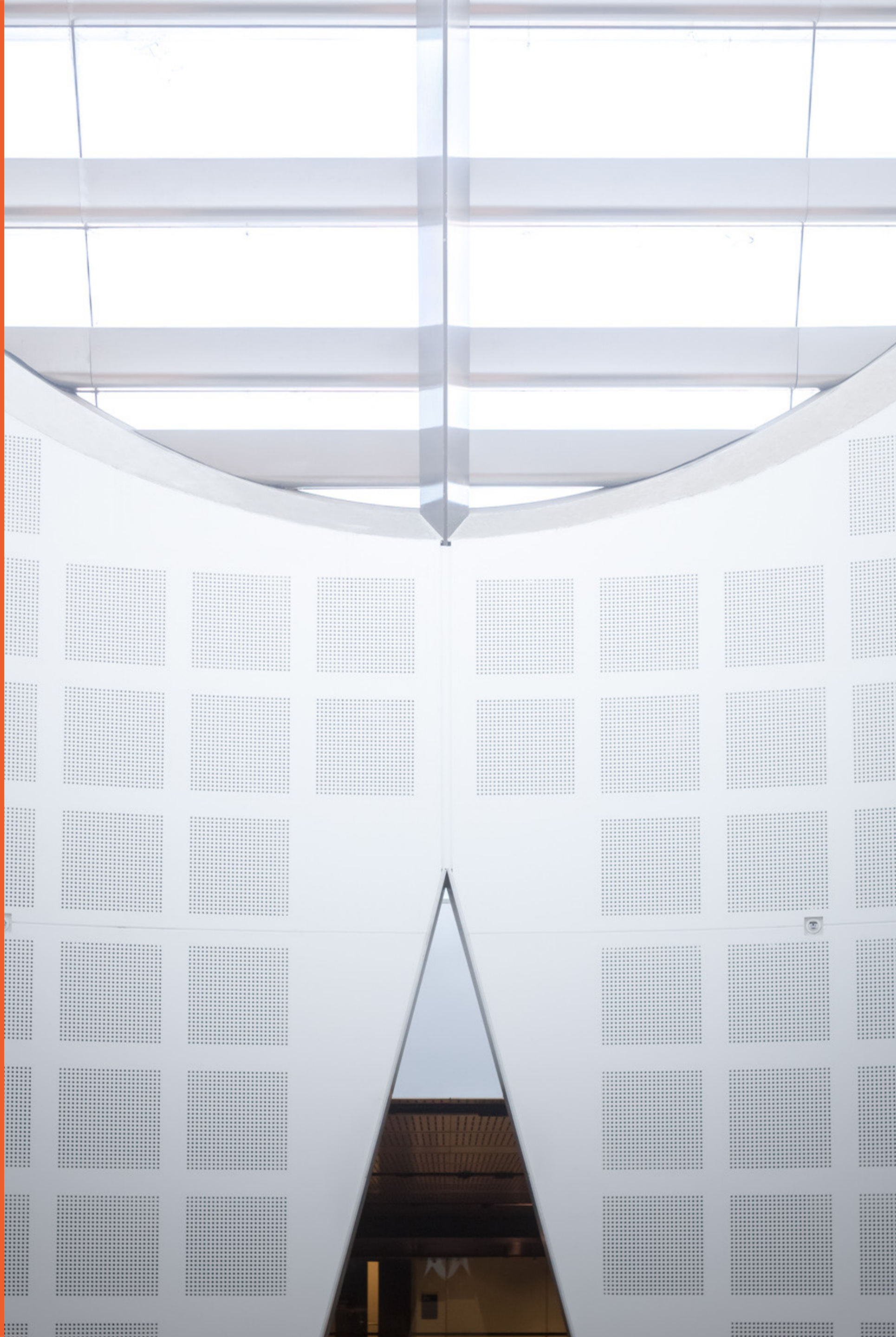
ACCT 6002:
Accountability and Enforcement



THE UNIVERSITY OF
SYDNEY

Accountability and Enforcement

- **Text readings:**
- *Comparative International Accounting*: Chapter 20

- **Academic paper, on Canvas:** P. Brown and A. Tarca, 'Achieving high quality comparable financial reporting: a comparison of enforcement bodies in Australia and the UK', *Abacus*, 43, 4, 2007.

- **Self-Study Questions:** See Canvas for instructions

Auditing the Auditors – the problems with the sector?

- https://www.youtube.com/watch?v=z_kRy6PRqiA
  - Interview with Grant Thornton CEO

- https://www.youtube.com/watch?v=_2lek28Mw3k
  - The accounting oligopoly: What's next for the Big Four?

Learning objectives

After this week's studies, you should be able to:

- discuss the various elements which make up good corporate governance
- explain the differences between rule-making, monitoring and enforcement
- outline the various ways in which the application of financial reporting standards by listed companies can be monitored and enforced; and
- compare and contrast the monitoring and enforcement bodies in the USA, the EU and Pacific-rim countries

Overview

- Introduction and background
- International monitoring and enforcement of financial reporting
- Example countries for monitoring/enforcement
- The example of UK corporate governance system
- US corporate governance
  - Sarbanes-Oxley Act 2002
- Summary

The whole system of reporting

- The company's accountants use technical rules and ethical requirements, but the Board is in charge
- The Board should be following a compulsory or voluntary code of corporate governance
- The auditors have technical rules and independence requirements. They work for the shareholders (in Australia or UK), but are appointed by the Board
- Further monitoring can be done by state agencies (e.g. ASIC or the SEC) or by private sector bodies (see the UK and Germany)
- Enforcement needs state intervention
- There is a much greater emphasis now placed on corporate governance

Good financial reporting requires enforcement

- Good financial reporting relies on:

"a cascade of different elements including

(1) clear accounting standards

(2) timely interpretations and implementational guidance

(3) statutory audit

(4) monitoring by supervisors and

(5) effective sanctions.

Each of these must work efficiently: the system will be as strong as its weakest part in delivering strong investor and creditor protection."

Commission of the European Communities, 2000

But what is enforcement?

- Hope (2003) compiled a country enforcement index with 5 elements:
  - Audit spending
  - Judicial efficiency
  - Rule of law
  - Insider trading laws
  - Shareholder protections
- He calculated the index for 21 countries:
  - US had highest value, followed by UK, Canada, Norway, Sweden and Japan
  - Italy had lowest value, followed by Spain, South Africa, Portugal

Models of Enforcement

- Enforcement can be carried out by several different bodies:
  - Stock exchanges
  - Regulators of stock exchanges
  - Government departments
  - Private sector bodies

- No ‘perfect’ model
  - The model chosen depends on the overall regulatory system of the country
  - This includes the culture and the political/legal context. These can change over time

- For some countries, the only ‘monitoring’ occurs through audits

- It is important to monitor compliance, and then act when needed

Choices for the regulator

- Which companies should be monitored?
- Which company documents to monitor and when?
- Proactively or reactively?
- How much should the audit provide oversight?
- What action to take in the event of non-compliance?

Rule-making, monitoring and enforcement

- Rule-making is conceptually separate from rule-monitoring and rule-enforcing
- Rule-making is increasingly *international*, but monitoring/enforcing still sits in *national* legal and regulatory systems
- Bodies involved in rule-making only:
  - IASB:
    - independent private-sector body
    - IFRS now almost global for consolidated statements
    - no power of enforcement
- Monitoring only:
  - Financial Reporting Review Panel (FRRP) in the UK
- Monitoring and enforcing:
  - Autorité des Marchés Financiers (AMF) in France
- All three tasks:
  - SEC in the US (makes some accounting rules, oversees FASB, then monitors and then enforces)

Monitoring/enforcement bodies

- Types of bodies involved:
  - Stock exchanges (Norway, Sweden, Switzerland)
  - Regulators of stock exchanges (US – SEC*, Australia, China, Japan; Belgium, France, Italy, Portugal, Spain)
  - Government departments and agencies (Denmark, Czech Republic)
  - Private sector bodies (UK – FRRP – Financial Reporting Review Panel*)

Table 20.1
Comparison of five enforcement bodies (2019)

	US	UK	France	Germany	Australia
	SEC	**FRRP**	**AMF**	**BaFin/FREP**	**ASIC**
Type of body	Stock exchange regulator	Mixed sector	Stock exchange regulator	Mixed sector	Stock exchange regulator
Date established	1934	1991	1967	2004	1998
Procedures					
Reactive investigation	Yes	Yes	Yes	Yes	Yes
Proactive surveillance	Yes	Yes	Yes	Yes	Yes
Advance clearance	Yes	No	Yes	No	No
Powers					
Publicity	Yes	Yes	Yes	Yes	Yes
Fines	Yes	No	Yes	Yes	No
Court referral	Yes	Yes	Yes	Yes	Yes
De-listing	Yes	No	No	No	No

Source: Adapted and updated from Brown, P. and Tarca, A. (2005a) 'A commentary on issues relating to the enforcement of international financial reporting standards in the EU', *European Accounting Review,* Vol. 14, No. 1.

Country Examples

Now, some country examples of monitoring/enforcement in more detail

USA

- SEC (Securities & Exchange Commission) established 1934
- Independent federal regulatory agency
- Strict enforcement of standards
- Registration documents of new companies reviewed in detail
- Other companies reviewed on a three-year cycle
- Power to levy fines and de-register companies
- Because standards, once established, are so strictly enforced, lobbying of the standard-setter (FASB) is very intense

UK

- FRC – Financial Reporting Council – independent of government & accounting profession. Sets accounting standards and also runs:
  - Financial Reporting Review Panel (FRRP) – 1991
  - Did not monitor all companies, nor seek to be proactive
  - Investigated companies brought to its attention
  - Achieved its aims by persuasion
- Hines *et al*. (2000) concluded FRRP was effective regulator
- Peasnell *et al*. (2001) examined companies deemed defective by FRRP
    - More likely when having financial difficulties
    - Less likely to have Big 5 auditor
    - Less likely to have audit committee, high proportion of outside directors

UK (contd)

- FRRP post-Enron 2005 to 2022
  - Greater powers
    - Interim statements, directors' report
    - Both proactive and reactive
    - Looks at difficult sectors
    - Collaborates closely with Financial Services Authority
    - No fines, de-listing or advance clearance
    - Will 'name and shame' companies

- FRC* takes over FRRP with its Supervision Committee which can exercise the FRC's delegated powers to secure the necessary revision of the accounts through a court order.
- The Supervision Committee is responsible for overseeing the FRC's delegated statutory supervisory and oversight functions and its non-statutory monitoring work.
- (see https://www.frc.org.uk/accountants/corporate-reporting-review)
- *FRC is undergoing transition to the Audit, Reporting & Governance Authority.

Carillion collapse 2018

- https://www.independent.co.uk/news/business/news/carillion-collapse-kpmg-deloitte-mps-worthless-accounts-business-committee-rachel-reeves-a8223626.html

- https://www.reuters.com/article/us-carillion-collapse/kpmgs-audits-of-carillion-to-be-investigated-uk-watchdog-idUSKBN1FI0MB

- https://www.youtube.com/watch?v=G4bkw5tehvU

France

- Autorité des Marchés Financiers (AMF, Financial Markets Authority)
  - Compliance with standards
  - Examines documents of listed companies and quality of audit
  - Proactive, and reactive to complaints and press comment, advance clearance
  - Like the SEC (unlike FRRP) – no press releases, no naming of companies
- Notorious example of advance clearance:
  - 2008 – Société Générale - £6.4 billion loss in **2008** due to 'rogue trading' to be charged in **2007**
  - Invoke 'fair presentation' override under IAS 1, but breaking IAS 10, IAS 37 and IAS 39. This over-ride *very* rarely used in Europe & almost never in the US
  - They do not give reasons, but it was agreed by the Regulators, and by EY and Deloitte
  - Created much furore. Appeared to be charging loss in prior year where it could be better absorbed, and the affair put behind them.
  - ➢ Ding *et al*. (2003) – in France on a pick-and-choose basis

Germany

- Enforcement was weak
- Before 1985, only AGs (public companies) and very large companies required to publish financial statements
- After 1985, EU 4th Directive – more companies required to publish, but many failed to do so
- 1998-2005, all large companies were permitted to apply either US GAAP or IASs in consolidated statements instead of German rules. Glaum and Street (2003) found much non-compliance with IASs – greatest compliance those with Big-5 auditors or NYSE listing.
- Since 2004, greater enforcement (BaFin/FREP), but compromise between US (heavy) and UK (lighter touch) systems – regulation as a deterrent
  - Fines – but small
  - No de-listing; no advance clearance

  ➢ Heilmann (2004) – poor compliance in Germany (about cash flow statements)

West Pacific enforcers: All based on US/SEC

Australia

- Proactive surveillance by the ASIC (Australian Securities & Investments Commission) 1998 – each listed company every 4 years + targeted risk areas, eg. high tech companies in 2001
- ASIC attracts much publicity; takes companies to court; requires revised accounts
- ASIC also oversees audit quality

China

- China Securities Regulatory Commission 1992. Wide monitoring and enforcement powers

Japan

- Financial Services Agency of Japan 1998. Very similar to SEC.
- Includes an Accountants and Auditing Oversight Board

Corporate Governance

Discussion (Padlet)

- You will be allocated to one of the breakout room groups.

- Discuss and answer the question.

- Go to https://sydney.padlet.org/taijookoh/vo5mjuo1jcdftbjv to write your group's answers.

Background to corporate governance

- Corporate scandals (before the codes, or despite them) – examples:
  - Maxwell
  - BCCI
  - Barings
  - Enron/Arthur Andersen
  - WorldCom
  - CPA Australia
- Major development in corporate governance since first code in UK - Cadbury 1992
- Globalisation/complexity requires greater attention to ‘guides’ around corporate governance
- Impact on stock markets put pressure on firms to develop/improve corporate governance

Corporate governance - overview

- Three sources of ‘discipline’/’oversight’:
  - Shareholders
  - Directors
  - Auditors
- Key concepts
  - Control
  - Independence
- Basis of code
  - Recommendations
  - Comply or explain
- There is research that suggests good corporate governance adds to shareholder value?

Typical committees in a listed company

- The Board sets up committees with various responsibilities:
  - Nominating committee: appointment of directors
  - Remuneration committee: directors' pay
  - Audit committee:
    - Oversees independence of audit function and audit fees
    - Liaison with external auditors

Example country: overview of UK codes

- UK corporate governance has changed over time, responding to new demands and new scandals:
  - Cadbury 1992
  - Greenbury 1995
  - Hampel 1998
  - Higgs 2003
  - Smith 2003
  - Combined Code 2003, 2006, 2008, 2010; Corporate Governance Code 2012

Cadbury Report 1992

- Board:
  - Should meet regularly
  - Separate chair and CEO
  - Sufficient Non-executive Directors (NEDs)
- Non Executive Directors:
  - To provide independent views
  - Independent of directors and other business relationships
- Executive Directors :
  - Contracts no more than 3 years
  - Disclosure of emoluments
  - Remuneration committee
- Reporting and controls:
  - Audit committee 3+ NEDs
  - Report on internal control

Greenbury Report 1995

- In response to
  - Size of directors' pay
  - Incomplete disclosure of pay

- Two main recommendations:
  - Remuneration committee composed of NEDs to report to shareholders
  - Adoption of performance measures linking rewards to performance of company + individuals
  - Attempt to align interests of shareholders & directors

Hampel Report 1998

- Chair/CEO separate (stronger)
- Directors' contracts to be for 1 year, renewable, but not a *fait accompli*
- Remuneration committee of NEDs
  - *Directors still deciding own pay.*
  - *Not independent of company.*
  - *No shareholders on committee.*
  - *Also, there were complicated relationships between directors on different boards.*
- NEDs may be paid in shares
- Greater training of directors
- Role of institutional investors

Higgs Report 2003 - NEDs

- Board
  - Annual Report should state number of meetings of Board + committees + attendance
  - At least 50% of Board should be independent NEDs
    - *May be beneficial.*
    - *May lead to splits.*
    - *May be too cautious, inhibit profitability.*
    - *Would they have courage to override execs?*
  - CEO should not become Chair
  - One individual may not chair more than one company

Higgs Report 2003 - NEDs (contd)

- NEDs
  - Should have knowledge, skills
  - Induction
  - Meet at least once a year without Chair or Executives
  - May hold shares but not share options
  - A full-time ED should not have more than one NED & should not be Chair of major company
  - Remuneration committee 3+, all NEDs

Smith Report 2003: Audit Committees

- Membership -
  - At least 3 members, all NEDs
  - At least 1 has significant, relevant financial experience
- Duties
  - Review accounts
  - Monitor internal controls & internal audit
  - Monitor external auditor appointment & independence
  - Develop & implement policy on non-audit services

Combined Code 2003

- Brings together elements from all the foregoing
- Annual Report must state and explain the company's compliance with the Combined Code or departure from it

UK Corporate Governance Code 2012

- All directors should be re-elected annually
- There should be diversity on the Board, in particular gender diversity, to avoid ‘group think’
- Board evaluation every three years for FTSE 350 companies by an independent facilitator
- Added emphasis on the role of the Chairman:
  - responsible for the effective composition, training and operation of the Board
- Chairman and all NEDs must devote more time to their duties
- Annual Report to explain basis of company’s long-term value generation

US corporate governance

- US similar to the UK in having well developed capital market with diverse shareholder base
- US also has many of the agency problems associated with separation of ownership and corporate control
- Yet corporate governance code was less well defined until 2002

Sarbanes-Oxley Act 2002

- In response to Enron and Worldcom, which revealed close relationship between companies and auditors. Sweeping changes. Global impact.
- CEOs/CFOs to certify quarterly & annual reports
  - Had to be fully competent financially
- Prohibition of many non-audit services to audit clients
  - Restrictions on the extended commercial relationships between auditors and firms
- Mandatory rotation of audit partners
  - To ensure practices were not hidden or entrenched
- Audit reports - effectiveness of internal controls
- Auditors report to audit committee

Academic article: Brown and Tarca (2007)

- Ann Tarca is on the IASB 2017-2022
- Reviews UK's Financial Reporting Review Panel (FRRP) and Australia's Australian Securities and Investment Commission (ASIC)
- They argue both types of bodies can achieve enforcement
- But ASIC is political, so scope is likely to be affected by the views held within governments over time
- Enforcement issues tended to relate to recognition and measurement where interpretation is critical

- "irrespective of IFRS adoption, enforcement remains a national matter" p.441