

House of Commons
Treasury Committee

**GOVERNMENT RESPONSE
TO THE COMMITTEE'S
SIXTH REPORT: THE
FINANCIAL REGULATION OF
PUBLIC LIMITED
COMPANIES**

Thirteenth Special Report of Session
2001–02

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Contacts

All correspondence for the Treasury Committee should be addressed to the Clerk of the Treasury Committee, 7 Millbank, House of Commons, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769. The Committee's email address is: treascom@parliament.uk.

THIRTEENTH SPECIAL REPORT

The Treasury Committee has agreed to the following Special Report:

GOVERNMENT RESPONSE TO THE COMMITTEE'S SIXTH REPORT: THE FINANCIAL REGULATION OF PUBLIC LIMITED COMPANIES

1. On 23rd July 2002, the Treasury Committee published a Report on the Financial Regulation of Public Limited Companies as its Sixth Report of Session 2001–02 (HC 758). On 25th September 2002, we received the Government response. This is reproduced as the Appendix to this Report, and incorporates additional material received on 15 October.

APPENDIX

General

(a) We believe that this evidence would repay careful analysis and assessment in the context of the Government's response to the events of Enron. We therefore commend it to the relevant bodies (paragraph 3).

(b) Although we recognise that we have rather different arrangements from the United States for the oversight of the accounting profession and for financial regulation, we believe that it would be dangerously complacent to assume this. What has happened in the United States has shaken confidence worldwide in matters such as the independence of auditors from company management. We agree with the Government that it is important to restore this confidence (paragraph 5).

(c) As our evidence demonstrates, a lot of work by Government, regulatory bodies, professional bodies and others, is currently in progress. This report therefore necessarily has something of an interim character to it. We shall continue to keep developments under review and will return to this matter in due course (paragraph 7).

The Government welcomes the Committee's report. The Government agrees with the Committee about the need to avoid complacency and acknowledges the interim nature of the Committee's report. As the Committee will be aware, the interim report of the Co-ordinating Group on Audit and Accounting issues (CGAA) was published on 24 July. The Government will consider carefully the Committee's conclusions and recommendations as part of the further work referred to in the CGAA report. The Government has asked the CGAA to deliver a final report around the end of the year.

Accounting

Rotation

(d) We note the array of arguments against auditor rotation. There would undoubtedly be additional costs and some potential risks. Nevertheless, the absence of any kind of rotation requirement leaves a perception—and almost certainly the reality—of an undesirable cosiness between some firms and their auditors. This poses even greater risks. We accept the need for auditor or audit firm rotation in principle, and we want the Government to produce proposals to implement it (paragraph 11).

(e) We note that re-tendering is a regular feature of many public sector appointments, and we have received no evidence that this operates to the detriment of the quality of work carried out. We consider that there is a good case for requiring audit committees to look explicitly at rotation of audit firms every five years. We believe that the audit committee should be obliged to make a statement to shareholders on those occasions when they decide to retain the existing auditor after conducting such a five yearly review.

(f) We recommend that the Ethics Standards Board considers urgently, in the light of the evidence we have received, whether the existing provisions are adequate. We believe that there is a good case for requiring rotation of the audit partner/manager on an audit every five years, rather than the present seven years. We also believe that there should be a time limit preventing auditors from being employed by a firm which they have audited. This should be at least one year (paragraph 13).

The Government accepts the principle that there should be rotation at least in respect of auditor partners. UK professional guidance currently requires the audit engagement partner for a listed company to be rotated at least every 7 years. The EU Recommendation on statutory auditor independence, published in May 2002, recommends as a minimum rotation of the key audit partners within 7 years of appointment to the engagement team. The Institute of Chartered Accountants in England and Wales (ICAEW) is changing its rules to comply with this aspect of the EU Recommendation. The CGAA has proposed that the maximum period before rotation of the audit engagement partner should be reduced from 7 years to 5. The Government agrees with this proposal and is discussing its implementation with the Consultative Committee of Accountancy Bodies (CCAB).

On audit firm rotation, the CGAA concluded in its interim report that the case for mandatory firm rotation as a solution to the problems of auditor independence has not yet been made. The CGAA has recommended that the evidence and the arguments for and against mandatory firm rotation should be examined further and that the case for mandatory re-tendering should be further considered at the same time. The Government has asked the CGAA to report on this further examination in its final report.

Independence

(g) Confidence in the independence of the auditor is central to the integrity of the audit. Independence is clearly open to question when auditors also perform a significant consultancy role—especially when the audit contract may have served as a loss-leader to acquire this more lucrative business. We therefore believe that there is a strong case for disclosure in relation to non-audit work. We believe that the Audit Committee should be required to assess the extent of non-audit work and should be required to notify shareholders of any potential conflicts of auditor interest. We recommend that the audit committees of listed companies be required to publish details of audit and non-audit contracts, giving a detailed justification of the arrangements to shareholders (paragraph 17).

(h) We believe that, as a general principle, auditors should not be permitted to audit work done by themselves. We recommend that certain non-audit-related services should not be provided by a company's auditors and we want the Government to produce proposals to enforce this, including a strict definition of such services (paragraph 19).

The Government agrees that auditors must not only be independent, they must be seen to be independent. A key recommendation of the CGAA's interim report is that there need to be tougher mechanisms to underpin auditor independence.

The Government agrees with the general principle set out both by the Committee and the CGAA that auditors should not audit their own work. The Government also agrees with the principle put forward in the CGAA interim report that auditors should not perform management functions or make management decisions. These are among the principles that underpin the EU Recommendation on Auditor Independence. They also already form part of the practice regulations of the bodies recognised for the supervision of auditors under the Companies Act 1989. The CGAA has recommended that further work should be taken forward to look at how these principles are best delivered in practice. The Government agrees with this recommendation, which could lead to a further tightening of the work that auditors should not carry out for their audit clients. This will be covered in the CGAA's final report.

The Government agrees with the Committee's recommendation, also proposed by the CGAA, that there should be a greater role for audit committees in assessing and approving the purchase of non-audit services from the auditor. The Financial Reporting Council (FRC) has set up a group to develop the existing guidance in the Combined Code for audit committees.

This group is liaising closely with Derek Higgs as part of his review of the role and effectiveness of non-executive directors, as well as taking into account the proposals to strengthen the role and membership of audit committees set out in the CGAA interim report.

The Government agrees that there should be greater disclosure of information about the nature and value of non-audit services provided to audit clients. The Government will be consulting on changes to regulations under the Companies Act to improve the disclosure by companies of audit and non-audit services provided by their auditors.

Accounting Standards

(i) We believe that an Accounting Standard on revenue recognition and to control aggressive earnings management should be introduced, on a national or an international basis, at an early date (paragraph 22).

(j) We were disappointed at the leisurely approach of the Accounting Standards Board. We believe that there are issues for the Board that require action before 2005 (paragraph 27).

(k) Sir David expressed concern that the current method of funding of the IASB could lead to indirect pressure, through withdrawal of funding. He cited an example of a threatened withdrawal of cash when American industrialists expressed disagreements with IASB thinking on accounting for share options and other areas where there are, or were likely to be, differences of view between the Board and American interests. He considered that "ideally the best way of funding us...would be to put a levy on registrations around the world". We strongly support Sir David Tweedie's robust stance in resisting such pressures (paragraph 28).

(l) We are generally opposed to the use of share options as a significant source of remuneration in public companies. We shall wish to take evidence on this later. We agree with Sir David Tweedie that an International Accounting Standard that properly reflects the value of such options should be agreed. We believe that share options used for executive and other remuneration and payment should be prudently accounted for as future negative net income on a company's profit and loss account (paragraph 31).

(m) We support the concept of international standards, a view apparently shared by a large majority of institutional investors worldwide. We believe that Sir David Tweedie's evidence indicates that there may be real difficulties in securing their acceptance in some major areas, although we are heartened by Sir David's view that all the core international standards should be in place by 2005. Pressures to agree a comprehensive range of Standards by 2005 must not dilute standards applicable in the United Kingdom, particularly in relation to a 'true and fair' view (paragraph 32).

The Government, like the Committee, supports the concept of international standards and the need to ensure that there is a robust set of standards in place by 2005. The Government agrees with the CGAA that progress is needed in a number of key areas of accounting as soon as possible. It very much welcomes the positive engagement of the Accounting Standards Board (ASB) with the International Accounting Standards Board (IASB) to improve existing standards and develop new ones as quickly as possible, whilst continuing to consult on proposals as required by due process. It also notes that the ASB has a heavy workload in actively pursuing a convergence agenda to align UK standards with international ones as they are agreed and that it has issued a large number of exposure drafts of new or revised standards for public comment.

Regulation of the Accountancy Profession

(n) The regulatory structure of the accountancy profession raises questions about rigour and independence. These arise as a result of the regulatory process being funded by the industry itself, and, in particular, in the way these funds are collected. We welcome the efforts being made by the Accountancy Foundation to improve the industry's regulatory regime. We recommend that the Government give this issue urgent examination, and that it considers the introduction of industry funding arrangements similar to those which operate in the case of the Financial Services Authority (paragraph 36).

(o) We believe, though, that the existing regulatory framework of the accountancy profession is cumbersome and excessively complicated. We consider that there is a strong case for a single, independent, regulator, which is not only independent but seen to be independent (paragraph 37).

The Government has announced, in response to the interim report of the CGAA, an immediate review of the way the accountancy profession is regulated, including the role of the Accountancy Foundation and its related bodies. The terms of reference of this review¹ were published on 9 September.

¹ Page 9.

Corporate Governance

(p) In the context of our current inquiry, a number of witnesses have proposed a much more proactive role for the non-executive directors in relation to the auditing function. Sir John Bourn suggested that non-executive directors should report on a range of matters relating to the audit. He added “the external auditors should know that this discussion with the non-executive directors is an important part of his work, and that his ability to satisfy the non-executive directors is crucial in the determination of whether he stays the external auditor.” We support this idea. We also agree with Lord Sharman that the role and responsibilities of non-executive directors might benefit from clarification (paragraph 39).

(q) We believe that there is a good case for an audit committee composed of non-executive directors, rather than the board as a whole, to be responsible, in the case of quoted companies, for selecting the firm of auditors to be put to the shareholders for appointment, and for fixing the auditors’ remuneration (paragraph 40).

(r) We expect the Higgs Review to produce proposals which cover these important matters. We recognise that there have been serious abuses of the practice of non-executive directors undertaking paid work with the same company. We expect the Higgs Review to address this issue positively (paragraph 41).

The Government agrees that it is important for companies to have strong, effective non-executive directors. That is why the Government asked Derek Higgs to review the role and effectiveness of non-executive directors. The Government looks forward to receiving his report. The CGAA has proposed in its interim report—and the Government agrees—that the role of audit committees must be strengthened and enhanced. As noted above, the FRC is taking forward work to develop the Combined Code guidance on audit committees.

Other Matters

(s) We welcome the fact that the Government has now responded to the Company Law Review, but remain concerned that there is no definite Parliamentary timetable for its implementation. If it becomes clear that action is needed in the light of Enron affair, we would not be happy for this to be delayed until comprehensive legislation can be introduced. We consider that the Government should give higher priority to this matter, not least because of the threat identified by the Chairman of the FSA and arising from the current proposals for the EU Prospectus Directive, to the use of the Listing Particulars as a means of imposing new requirements on listed companies. We recommend that, as a minimum, the Government gives a commitment to publish draft legislation in full in the course of the next Session of Parliament (paragraph 44).

The Government welcomes the Committee’s support to modernising the framework of company law. This is a task of great scale and complexity. The Government is consulting on proposals for a draft Companies Bill as they are developed and intends to bring forward legislation as soon as practicable. However, the precise timing will depend on the Parliamentary timetable.

(t) We recommend that the Government refer the United Kingdom operations of the ‘Big Four’ to the Competition Commission. We also recommend that it give careful consideration to whether it could assist in reducing concentration by placing more of its work with suitably qualified and experienced firms outside the ‘Big Four’ (paragraph 48).

In its interim report, the CGAA recommended that the Department of Trade and Industry and HM Treasury consider with the Office of Fair Trading whether there are any competition implications of the high concentration in the market for audit and accountancy services and whether any of the other proposals in its report have competition implications. The Government has accepted this recommendation and discussions are on-going. The Committee's views will be considered as part of those discussions.

The allocation of Government work for accounting and other assignments is made on the basis of open and fair competition in line with Government procurement policy, based on value for money, and EC rules. The general principles are set out in Chapter 22 of *Government Accounting*. Specific advice on the appointment of accountancy firms to audit and other assignments in the public sector is set out in Dear Accounting Officer (DAO) letter DAO(GEN)13/99, a copy of which has been submitted to the Committee. This makes clear that, in principle, appointments to audit and other accountancy assignments are no different from any other public procurement.

International Dimension

(u) It is clear that the EU expects to be a serious player in the ongoing debate about the role and regulation of auditors, and the development of corporate governance standards within the EU. We urge the Government to ensure that United Kingdom interests, and regulatory standards, are fully protected in developing common European approaches. In this context, we were concerned by Sir Howard Davies' comments that the proposed Prospectus Directive could undermine the present role played by the Listing Rules in enforcing corporate governance requirements on listed companies. Other groups have also expressed concern. We recommend that the Treasury seek to ensure that the United Kingdom's standards of financial disclosure and corporate governance are fully safeguarded during negotiations on the Directive (paragraph 53).

The Government takes full account of the importance of the international dimension in these areas and of the need to protect and safeguard UK interests.

(v) We intend to follow the progress of the proposals in the United States for a Public Company Accounting Oversight Board and to consider whether a similar body would be appropriate in the United Kingdom, possibly with reciprocal powers (paragraph 55).

The Government notes the Committee's conclusion. The Government is also monitoring closely developments in the United States.

(w) We share concerns about the problems of 'revolving doors', whereby personnel involved in public sector contracts move from the public sector to the profession, and vice versa. We recommend a cooling-off period between employment in accountancy or consulting firms or contracts with the Government (paragraph 61).

The Treasury will discuss this recommendation with the Cabinet Office and the Office of the Civil Service Commissioners, as part of the further work being taken forward under the auspices of the Co-ordinating Group on Audit and Accounting issues (CGAA).

GOVERNMENT REVIEW OF THE REGULATORY REGIME OF THE ACCOUNTANCY PROFESSION

TERMS OF REFERENCE

To review the current arrangements for the regulation of the accountancy and audit professions; to consider whether revised arrangements and structures are necessary to provide assurance to the public that these are effective; and, if so, to recommend what form they should take.

In particular, the review should look at:

- the regulatory functions that are necessary in the public interest, and how they should be carried out, including desirable simplification
- the balance between professional self regulation and independent regulation in carrying out these functions; and the extent to which these should be on a statutory basis
- the case for taking a different approach to the regulation of the accountancy profession in general and to the regulation of auditors in particular
- the funding arrangements and in particular whether these are consistent with the concept of independent regulation
- the responsibilities and accountabilities of the various bodies, including the process of making appointments

In considering these issues, the review should also have regard to:

- the principles of good regulation established by the Better Regulation Task Force
- international developments, especially in the United States and the European Union
- the requirements of the 8th EU Company Law Directive and the Companies Act 1989 on the regulation of auditors
- the relationship between these arrangements and the work of the Financial Reporting Council (FRC) and its subsidiary bodies,² and the responsibilities of the Financial Services Authority in relation to listed companies.
- the other work being carried out following the interim report by the Coordinating Group on Accounting and Audit, and the Secretary of State's Statement to Parliament of 24 July 2002.

The review should report by January 2003.

² The Government's White Paper "Modernising Company Law (Cm 5553-I) published in July 2002 makes proposals for building on the existing framework of the FRC to enable company reporting requirements and enforcement to be kept up to date. Whilst this Review must have regard also to the White Paper proposals, it is not the intention that it will revisit those proposals.

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