

STATEMENT OF Mr PAUL BOYLE
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BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

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Mr Chairman and Members of the Committee,

It is my privilege to appear here today as the first Chief Executive of the United Kingdom's new Financial Reporting Council (FRC), a position which I took up a few months ago. The aim of the FRC is to promote confidence in corporate reporting and governance in the UK. We believe in wealth creation. We believe that our role in promoting confidence in corporate reporting and governance can make the creation of wealth more likely.

I hope that our mission means that we are in a position to assist the Committee in its review of the impact of the Sarbanes-Oxley Act and developments concerning international convergence.

In my remarks this afternoon, I wanted to focus on three matters, which I think will be particularly relevant to the Committee's review:

- the new regulatory regime for accounting and audit in the UK, under the control of the FRC, which was designed following the Enron and WorldCom cases;

- the FRC's stance on international convergence of accounting and auditing regulation; and
- the UK's approach to promoting high standards of internal control in public listed companies.

The new regulatory regime in the UK

It is an indication of the increasingly global nature of the capital markets that the corporate scandals (including Enron and WorldCom and the related collapse of Andersen) which shocked US investors have also had a significant impact on the UK market, notwithstanding the fact that there have been no cases of comparable significance in the UK for some years.

In fact, the UK had experienced cases of similar impact a little over a decade earlier, in the late 1980s. At that time there were a number of examples of large and apparently profitable companies which suddenly collapsed into bankruptcy. These cases had prompted the UK Government to commission a review of the arrangements for the setting and enforcement of accounting standards in the UK.

This review led in 1990 to the removal of the responsibility for setting accounting standards from the accountancy profession and the establishment of an independent standard setting body (the Accounting Standards Board (ASB), whose first Chairman was David Tweedie). In addition, a new body, the Financial Reporting Review Panel (FRRP) was established to review cases of alleged failure to comply

with accounting standards and to ensure that financial statements which did not comply with those standards were corrected. The ASB and the FRRP were established as subsidiaries of a new organisation, the FRC, which was responsible for raising the funding for these new activities and for ensuring their independence. The FRC's Council was composed of a broad selection of representatives from the business community in the UK, including public companies, investors and the accountancy profession.

The new arrangements worked well during the 1990s. The ASB, led by Sir David, embarked on a major programme of reform of accounting standards in the UK. The main accounting abuses which had contributed to the corporate scandals of the 1980s were tackled. The new standards dealt with complex and politically sensitive topics including off-balance sheet finance, pensions, acquisitions and so-called "big bath" provisions. During this period the ASB demonstrated its ability to influence financial reporting internationally by working with the International Accounting Standards Committee, FASB and other national standard setters. The FRRP established its credibility by taking a firm stand in requiring a number of companies to re-state their financial statements or to undertake to amend their accounting practices in future. The true impact of the FRRP far exceeded the number of cases which it actually dealt with because once its credibility was established auditors used the unpleasantness of an FRRP investigation as a mechanism to persuade some clients to improve their accounting practices.

There were two other themes in corporate reporting and governance during the 1990s which are important to an understanding of the development of the regulatory regime in the UK.

The first theme was the progressive move away from entirely self-regulation of auditing by the accountancy profession towards independent regulation in a statutory framework. The initial moves were made in the early 1990s with a significant tightening of the long-standing restrictions on who could perform audits in the UK to those who were members of certain professional bodies. A statutory requirement was introduced for the professional bodies to be recognised by the Government against detailed requirements as to their audit qualifications and the rules and practices governing the conduct of their members. A requirement for registration of auditors was introduced. The effect of these changes was that the accountancy profession retained the primary responsibility for regulation of auditors but it was required to do so within a statutory framework and it was subject to oversight by the Government. In the early 1990s the accountancy profession also agreed that 50% of the members of the audit standard setting body should be non-auditors, which was a significant development at that time.

In the late 1990s the Government became increasingly persuaded that public expectations required greater independent oversight of the regulation of the profession. The Government agreed with the main professional bodies in the UK that certain key regulatory activities, including the setting of auditing standards and ethical standards, would be transferred to an independent but non-statutory

regulator, the Accountancy Foundation, which was to be entirely funded by the profession. The Foundation commenced operations in 2000.

The second theme was the emergence of a consensus about the importance of corporate governance. This consensus (which is considerably stronger now than it was when the subject was first aired) has been built up around a series of reviews, starting with the Cadbury Report which was published in 1992 and which was extended by two further reviews later in the decade. These further reviews led to a consolidation of the various recommendations in a document known as the Combined Code on Corporate Governance.

The key propositions in the Combined Code are that it is important to avoid an undue concentration of power at the top of a company, that Boards of Directors should have a strong group of non-executive directors who are considered to be independent, that Boards need to be properly organised to ensure that companies are run for the benefit of their shareholders rather than for the management and that there ought to be full disclosure of Directors' remuneration. A distinctive feature of the Combined Code is that it recognises that recommendations on best practice in corporate governance may not be appropriate in all circumstances. The Code, therefore, operates on a "comply or explain" basis which means that public listed companies are expected to follow the provisions of the Code in full or to explain in what respects they have departed from it.

One specific recommendation of the 1992 Cadbury Report which may be of particular relevance to the Committee relates to internal control. I will return to this topic in the third section of my remarks.

The 1990s was, therefore, a decade in which there had been considerable change in the regulatory regime for financial reporting, auditing and corporate governance in the UK. By the end of the decade the UK arrangements were in many respects more developed than those in other major financial markets.

This was the position in the UK when the major corporate scandals in the US and the collapse of Andersen occurred. Although it had been some years since there had been scandals of equivalent significance in the UK, the Government decided that it would be prudent to consider whether further strengthening of the regime in the UK would be appropriate. During 2002 the Government commissioned four reports on different aspects of the regime and the results of these reviews were announced in January 2003. One direct result of these reviews was a significant widening and deepening of the role of the FRC, including taking over the functions of the Accountancy Foundation with effect from 1 April 2004. It is, however, a feature of the new regime in the UK that the accountancy profession is still expected to contribute to the regulation of its members.

The FRC is now a unified, independent regulator which:

- sets, monitors and enforces accounting and auditing standards;

- oversees the regulatory activities of the professional accountancy bodies and has specific statutory responsibilities in relation to the regulation of audit; and
- promotes high standards of corporate governance.

The main changes in the FRC's role have been:

- The FRRP has changed from being complaints-driven to actively looking in a risk-based way for failures by UK public listed companies to comply with accounting standards.
- The FRRP will also now review interim financial statements rather than merely annual reports.
- An oversight board will take over the Government's role in monitoring the regulatory activities of the professional bodies, including determining whether their procedures are adequate for their members to retain their statutory status as qualified auditors.
- A new audit inspection unit will monitor the auditors of all listed companies and major public interest entities, with the scope of its work including the "tone at the top" of the major firms and the appropriateness of the judgements on individual audit assignments.
- The board which is responsible for the setting of auditing standards has been given the additional responsibility for setting ethical standards for auditors and is now totally independent of the accountancy profession.
- A new scheme will investigate and, where appropriate, discipline audit firms and individual accountants in cases which involve public interest issues.

- We will keep under review the Combined Code on Corporate Governance which has already been strengthened to increase the influence of independent non-executive directors and the professionalism of the way in which Boards operate with, in particular, increased responsibilities of audit committees.

The FRC only assumed its new functions on 1 April and so we are in the early stages of establishing our credibility and authority as a unified regulator. We have already commenced each of our new functions, although some of our new statutory powers await the enactment, likely to be later this year, of a Bill which is currently before the UK Parliament.

We believe that the issues of corporate reporting, auditing, professional standards of accountants and corporate governance are all closely related. The capability to look at the issues in a joined-up manner was the rationale for the FRC's new range of responsibilities, which we believe is broader than any of our international counterparts. It means that we are well-placed to implement an effective regulatory regime for the UK which we hope will command respect in other countries. We believe that our aims are very much aligned with the aims which Congress had in mind when it passed the Sarbanes-Oxley Act.

We are, however, very clear that no system of regulation can ever eliminate the possibility of corporate reporting failures: we believe that it is impossible to achieve

zero failure and any attempt to do so would destroy wealth rather than facilitate its creation.

International convergence of accounting and auditing regulation

The FRC is committed to working towards international convergence of accounting and auditing regulation. This reflects the long history of the UK as a country whose economic success has been based on international trade. This remains true even though international financial services are now much more important to our economy than the heavy industries of ship-building and steel-making which were once at the heart of the UK's economic power.

The UK is a major international financial centre, with a share of global capital markets which far exceeds its relative size as an economy: some aspects of our approach to the operation of those markets must be working well.

International convergence is most commonly discussed in relation to accounting standard-setting, and I will set out the FRC's position on that topic, but there are other aspects of accounting and auditing regulation for which there will be benefits from international convergence.

We share the vision that there should be a single set of high quality accounting standards for use in all of the world's capital markets. We believe that it is

important that those standards are set by independent standard setters, following due process and free from political influence. In this regard we fully support the work of the International Accounting Standards Board (IASB).

As the Committee will be aware, within the European Union (EU) a Regulation requires listed companies to apply international accounting standards, as endorsed by the EU, in their consolidated financial statements for financial years commencing on or after 1 January 2005. The FRC has a clear and public commitment to the proposition that this means that listed companies should be required to use the full suite of accounting standards published by the IASB.

The process by which international accounting standards will be implemented in the consolidated financial statements of public listed companies in the UK is wholly dependent on the endorsement of those standards by the EU. The European endorsement process has generally been proceeding well but has run into some difficulties concerning the particular standard on the measurement of financial instruments and at this stage the eventual outcome in relation to that standard remains unclear.

The responsibility in the UK for the conduct of the negotiations with our European partners rests with the UK Government and the FRC has no direct involvement. However, our advice to the Government is that in principle the best outcome is full and immediate endorsement of all of the IASB's standards. In the event that such an

outcome is not possible to achieve we have significant concerns about outcomes which involve amending the provisions or scope of the standards published by the IASB. Should one of the IASB's standards not command sufficient support in Europe then a preferred alternative to amending that standard may be to leave it as unendorsed. In either case it is important that those companies who wish to implement them are permitted to do so. We believe that many British companies will choose to implement the full set of international standards even if they are not required to do so.

We are very encouraged by the expressions of commitment on the part of the authorities in the US to the process of international convergence. We are supportive of the "Norwalk" agreement between FASB and the IASB which sets out their joint "commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting". We very much hope that the US can remain committed to that goal, which we believe will be strongly to the long-term benefit of companies and investors in all markets.

The FRC's Accounting Standards Board remains responsible for the standards which apply to entities other than public listed companies. The ASB is committed to full convergence to international standards for UK domestic reporting purposes and has been consulting on how best to achieve this goal.

The FRC is also committed to international auditing standards, notwithstanding the fact that there is not yet full support for an international harmonisation project comparable to that for international accounting standards. The FRC's Auditing Practices Board (APB) has in recent years devoted considerable resource to assisting the International Auditing and Assurance Standards Board (IAASB) in its efforts to improve the quality of the international standards.

In order to take advantage of the improved protection against fraudulent financial reporting and aggressive earnings management which recently issued international standards offer, the APB has announced its intention to implement International Standards on Auditing (ISAs) issued by the IAASB in the UK for 2005 financial statements. The APB believes that adopting the ISAs is a more effective means of improving auditing standards in the UK than the alternative of re-writing the existing suite of UK standards.

The APB recognises that some international standards remain to be revised and it is contributing to that work. In the meantime, the APB also believes that in some respects the existing UK standards are stronger than the equivalent ISA. In order to avoid a reduction in the quality of UK standards the APB will incorporate some additional material from existing UK standards into the ISAs. Examples of areas in which the APB has found it necessary to supplement the international standards include:

- Going concern

- Related party transactions
- Reporting to audit committees

This additional material will be clearly differentiated from the international material and, over time, the APB hopes to be able to withdraw the additional material as the relevant ISAs are updated by the IAASB.

We believe that there is a risk that the absence of a widely-shared commitment to international auditing standards convergence could lead to a waste of resources on standard-setting around the world plus subsequent inefficiencies caused by audit firms and their clients having to adhere to several sets of standards.

We acknowledge that some jurisdictions may be unwilling to accept auditing standards such as ISAs which do not contain the level of detailed requirements to which they have become accustomed. We believe that the UK's solution to this problem (ie taking the ISAs as the foundations for UK standards but supplementing them with additional requirements which are believed to be appropriate in the domestic market) is a model which other jurisdictions may find attractive. If this model were to be adopted more widely it would have three main advantages:

- improved comparability of standards in different countries;
- reduced cost of domestic standard setting; and
- an easier path to future international convergence.

Standard-setting is, however, only one element of accounting and auditing regulation. Monitoring and enforcement of standards are equally important. Although there have been accounting and auditing standard-setting arrangements for many years, monitoring and enforcement are much less well-established, particularly independent monitoring and enforcement of auditing standards. It is only a year or so since the Sarbanes-Oxley Act established an independent regulator in the US. It is less than six months since the FRC became the independent regulator in the UK.

The arguments in favour of international standards convergence (ie the benefits to companies and investors of lowering the costs of cross-border transactions) apply equally to monitoring and enforcement activities. Indeed, it could be argued that much of the effort devoted to international standards convergence will be wasteful if there are inconsistent or duplicative national approaches to monitoring and enforcement. Inconsistency will constrain the improvements in investor confidence; duplication will increase costs for both companies and investors.

The FRC believes that, whereas a very high degree of international standards convergence is attainable over not too long a period (ie it is possible to envision a single set of accounting standards in use in all of the world's major capital markets), the nature of the issues to be resolved in relation to monitoring and enforcement convergence mean that our ambitions for international convergence need to be different. The national differences in the factors affecting the design and intensity of

monitoring and enforcement activities (eg companies and securities law, the strength of the accounting profession, the extent to which investors are able to exert influence over companies, etc) are likely to persist for a long time.

Despite these limitations, we believe that there is merit in pursuing convergence of monitoring and enforcement activities. We believe that there would be considerable benefits for companies and investors if national authorities could take account of the monitoring and enforcement arrangements in other countries when considering what additional procedures need to be applied to foreign registrants and their auditors. Although national authorities will need to make an assessment of the equivalence of the foreign country arrangements, we do not believe that it is either necessary or desirable for those arrangements to be identical in order to be of value. There is, however, no doubt that international agreement on common principles would greatly facilitate cross-border regulatory co-operation.

Given the recent creation of independent audit regulators in a number of countries, and the likelihood of this number increasing in future, we believe that there would be merit in the establishment of an international mechanism to facilitate exchange of information and the development of common principles which would help to reduce the risk of inconsistency or duplication. Such a mechanism would perform a similar role in relation to audit regulation to that performed by the Basel Committee in relation to banking regulation and IOSCO in relation to securities regulation.

Promoting high standards of internal control

One specific recommendation of the 1992 Cadbury Report was that Boards of Directors should “maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets”. It is worth noting that for this purpose internal control includes not only controls over financial reporting but “all controls, including financial, operational, compliance controls and risk management”. The Code also requires Boards to conduct an annual review of the effectiveness of their internal control system and report to shareholders that they have done so.

In 1999 a group convened by the Institute of Chartered Accountants in England & Wales published guidance (known as the “Turnbull Guidance”) for companies on how to implement the provisions of the Combined Code. The Turnbull Guidance is formally annexed to the Code.

The inclusion of a requirement in the Cadbury Report for companies to assess the effectiveness of their internal controls was controversial and there was initially considerable uncertainty and nervousness on the part of companies about the practical implications. As time has past many companies have taken the requirement seriously and we believe that the Combined Code requirement has led to improvements in risk management practices in public companies.

There are two key differences between the requirements of the Combined Code and that of s404 of the Sarbanes-Oxley Act. Firstly, under the Combined Code, Boards of directors are not required to report to shareholders on the effectiveness of internal control, although they are required to disclose the process applied to deal with material internal control aspects of significant problems disclosed elsewhere in the financial statements. Secondly, there is no requirement in the Combined Code for auditors to review and report on the effectiveness of the internal control system.

At present in the UK, although there remains general commitment to the merits of high standards of internal control, there would be considerable anxiety on the part of both companies and investors about the cost implications of any proposal that these requirements be introduced. We will, however, keep the position under review.

The FRC is pleased that the SEC has concluded that the Turnbull Guidance is a framework which is suitable for evaluating internal controls as required by s404, even though it is somewhat less detailed in its contents than the COSO framework.

The FRC is aware that there have been a number of developments of best practice in relation to internal control both in the UK and internationally, particularly as a result of the Sarbanes-Oxley Act, since the Turnbull Guidance was published. In the light of this the FRC has recently announced a review of the guidance. The review group will be chaired by Douglas Flint, Group Finance Director of HSBC Holdings plc who I understand will be appearing before the Committee later today.