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Companies (Audit Investigations and Community Enterprise) Bill [HL]

Bill 142 of 2003-04

This Bill has two separate spheres of interest. First, it makes various changes to the organisation and regulation of auditors in the UK. It strengthens the procedures surrounding a company audit and provides stronger powers for auditors while at the same time increasing the transparency of the conditions under which they work.

The second aspect of the Bill is to establish a new form of company to be known as Community Interest Companies. These companies are often called social enterprise companies in that their main focus is to provide support or services to a defined group. They are a new form of but may share some characteristics of charities. The Bill establishes how they will be set up, run, and regulated and how existing companies can become one.

The Bill was introduced in the House of Lords on 3 December 2003 and is due to have its second reading in the House of Commons on 7 September 2004.

Timothy Edmonds

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Summary of main points

Clauses 1 to 23 of the Bill provide a response to the perceived weaknesses in company reporting and auditing spectacularly exposed by the collapse in the United States of the Enron Corporation.

The Bill strengthens the system of regulating auditors by imposing independent auditing standards, monitoring and disciplinary procedures on the professional accountancy bodies. They will be applied by a new independent professional body – the Financial Reporting Council (FRC) – and subsidiary bodies funded by industry, the accountancy profession and by the Government.

It strengthens the enforcement of accounting and reporting requirements by:

- extending the remit of the Financial Reporting Review Panel [FRRP] so that it can look at interim as well as annual accounts and reports; giving it a power to require information from companies it is investigating; and opening a gateway for the Inland Revenue to pass information on defective accounts to the FRRP;

- extending the Secretary of State's power to require more detailed disclosure of non-audit services provided by auditors to companies; giving additional powers to auditors to obtain information from companies; and requiring directors to state that they have not withheld relevant information from their auditors.

It strengthens the company investigations regime by:

- requiring any person to provide relevant information to company investigators; giving investigators the right to obtain entry and remain on the premises of a company under investigation; and providing protection from breach of confidence claims for people who voluntarily provide information in certain circumstances.

The second part of the Bill provides the framework for Community Interest Companies (CICs) which, it is hoped, will be useful for the voluntary sector.

CICs are a new form of company embodying social enterprise, charitable aspects of support and service. The new legal format will provide for a statutory "lock" on assets and profits of CICs. The Bill establishes:

- a "community interest test" which companies must pass in order to be registered as CICs;

- an annual community interest report which CICs must provide to show how their activities have benefited the community;

- a CIC regulator responsible for ensuring that CICs comply with their legal requirements;

- mechanisms for existing companies and bodies to transfer into CICs.

Most of the provisions in the Bill extend to England, Wales and to Scotland directly, but not to Northern Ireland. However, where N. Ireland legislation is different, the Bill amends the territorial legislation.

CONTENTS

I Introduction

This Bill has two completely different aims. First, it sets out a new framework of regulation and requirements of auditors. Secondly, it sets out the legal provisions creating a new form of company, which is meant to be more suited to the needs of non profit orientated companies: Community Interest Companies (CIC).

II The Audit provisions

The measures to improve confidence in companies and markets are mostly recommendations from post-Enron[1] reviews including the Co-ordinating Group on Audit and Accounting Issues chaired by Government Ministers Melanie Johnson and Ruth Kelly. They are the final part of the package, supporting other action already taken such as reform of the regulatory structure for the accountancy profession and changes to the Combined Code to strengthen the role of non-executive directors and audit committees.

A. The reform of auditing and auditors

Auditors are said to have originated in the practice of the sponsors of voyages of exploration and discovery in the 16th and 17th centuries placing their own man on board to record whatever the vessel brought back by way of discoveries or plunder. Today they are supposed to be the shareholders' men checking other 'on board' activities. Of course, in practice auditors need to form a close relationship with the people on the inside of the company, mainly the board of directors and the chief executive officer, in order to understand the business, to discuss alternative accounting treatments of transactions or the value of assets. The issue of 'whose side' are the auditors on is further confused by the fact that the auditors often provide non-audit services to the companies they audit, for example tax consultancy work. Thus, there has been a general suspicion for some time that auditors are too close to the people they audit and that they may wittingly or unwittingly be party to undesirable accounting practices.

The Enron case (see footnote below) prompted a massive review of accounting practice in the United States which culminated in the passing of the Sarbanes- Oxley Act.

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1 Enron was an energy company in the United States, the seventh largest company in the country. But its success was based on artificially inflated profits, dubious accounting practices, and, possibly, fraud. The failure of the auditors, Anderson, to notice or reveal the scale of the misreporting of financial results lead to their eventual cessation as an audit group. Enron is the largest bankruptcy in United States corporate history.

1. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act was brought into force in the USA on 30 July 2002. It deals with the oversight of accountancy firms that provide audit services to companies that are quoted on a US market and governance requirements for those companies. Some of its provisions took effect immediately but many depend for their implementation on other bodies which have to draw up detailed rules to give effect to the Act's requirements. The main rule-making bodies are the Securities and Exchange Commission (SEC) and the new Public Company Accounting Oversight Board (PCAOB), although some rules will be made at exchange-level too.

Non-US companies, including UK companies, are quoted on a variety of US exchanges as a way of accessing US capital.[2] US securities laws give scope for the SEC to exempt non-US companies from aspects of securities laws. The SEC has hitherto permitted non-US issuers a number of derogations from its filing and reporting obligations. It is however uncertain to what extent exemptions will be given for specific Sarbanes-Oxley requirements.

Some of the concern relates to the stringent criminal penalties which are being introduced for certain transgressions of the Act. It is argued by some that these should not be applied extra-territorially and that if they were they would represent an improper extension of US securities laws. On the other hand, others think that some of these penalties are unlikely to be enforced or enforceable outside the US jurisdiction.

Perhaps a more practical concern is the effect of new US governance requirements which though often equivalent to UK requirements may cause UK companies that have a US listing additional and potentially problematic disclosure obligations. Difficulties have been foreseen where US requirements overlap with or are in conflict with the way in which non-US governance structures address the same underlying problem. Some areas where European and US practices are clearly in conflict have already received exemptions. A brief account of the Sarbanes- Oxley Act follows.[3]

a. Accountants and auditors

- The Act creates a new accounting regulator, the Public Company Accounting Oversight Board (PCAOB), under the tutelage of the Securities and Exchange Commission (SEC). Accountancy firms that audit US-quoted companies

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2 Non-US companies report annually to the SEC using Form 20-F (these accounts have to be reconciled with US accounting practice - US GAAP). They also disclose routinely information that they have released in their home markets, using Form 6-K (less strict obligations apply to those disclosures).

3 Sources: The principal sources used in compiling this account were Clifford Chance US LLP, *Application of the Sarbanes-Oxley Act to non-US companies*, September 2002; Mayer Brown Rowe & Maw, *Overview of the Sarbanes-Oxley Act of 2002*, July 2002; Hermsen, Niehoff and Uhrynuk (of Mayer Brown), 'Dramatic changes', *Accountancy*, May 2003; Hermsen, Niehoff and Uhrynuk (of Mayer Brown), 'An extraordinary expansion', *Accountancy*, October 2002.

('issuers') have to register with the Board and thereafter will be under an obligation to comply with the Board's requests for information and assistance. The Board will set a range of standards for preparers of audit reports and will inspect firms on a regular basis.

- Audit firms will be required to rotate the lead audit partner and audit reviewer every five years.[4] They will not be allowed to provide audit services to companies if key personnel at the company were recently employed by the auditing firm.[5]

- Controls on the provision of non-audit services to a company by its auditor will prohibit absolutely the supply of specified services that could conflict with the independence of the audit (including actuarial services, internal audit services and legal services).[6] Other non-audit work (including tax advice) may be provided but only after prior approval from the audit committee.[7]

b. Audit committees

- Companies will be required to establish an audit committee, made up of independent members, one of whom is expected to be a financial expert. (Strictly firms are only required to state whether one of the audit committee's members is a financial expert.)[8] The audit committee manages the relationship with the company's auditors, including determining their remuneration and giving prior approval to the purchase of both audit and non-audit services. The audit committee will have to set up systems to allow it to act as a conduit for whistle blowing reports by employees on auditing and accounting matters. Whistleblowers are given additional protections from discrimination.[9]

c. Directors and officers

- The Chief Executive Officer (CEO) and Chief Financial Officer (CFO) are obliged to certify that they have reviewed the annual and quarterly financial reports and that to their knowledge they are materially accurate and show the financial and operational state of the company.[10] A second certification requirement imposes criminal liability on CEOs and CFOs if they certify a

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4 Sec. 203
5 Sec. 206
6 Sec. 201
7 It had been feared at one point that auditors would be barred from giving tax advice: the accountants lobbied hard against that proposal.
8 Sec. 301. Some exemptions from the details of this rule have been made for non-US issuers by the SEC.
9 Sec. 806
10 Sec. 302

'periodic' report as complying with SEC requirements when they know that it does not.[11]

- Companies will be prohibited from making loans or extending credit to their directors and executives (subject to some exceptions for certain types of credit).[12] While there is an exemption from the prohibition for US-authorised banks (which are subject to other controls on lending to staff), non-US banks have argued that they are unfairly discriminated against in not being covered by that exemption.

- If a company is required to re-state its financial reports because of non-compliance with US reporting requirements (due to misconduct), the CEO and CFO have to repay to the company any bonus or incentive they received in remuneration for the year following the issue of the defective report.

- Directors and officers will be able to be disqualified by the federal courts from holding office on the basis of their 'unfitness' to act rather than the current standard of 'substantial unfitness'.[13] The SEC will also be able to disqualify directors on grounds of unfitness.[14]

- Companies will need to consider adopting a code of ethics for their senior financial officers.[15] Any changes or waivers to such codes have to be notified to the SEC. It is not an absolute requirement to implement such a code: companies are required merely to disclose whether they have adopted a code.

d. Lawyers

- Corporate lawyers will be placed under a duty to report breaches of US securities laws to the company's CEO or chief legal counsel, and thereafter to the audit committee or full board if appropriate action is not taken.[16] Some commentators foresee problems with this obligation since the requirements of securities law may not always be clear-cut.

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[11] Sec. 906
[12] Sec. 402
[13] Sec. 305
[14] Sec. 1105
[15] Sec. 406. Non-US issuers have to make the code disclosure but are not obliged to disclose changes to their codes immediately.
[16] Sec. 307

e. Financial disclosures

- Companies will be obliged to disclose off-balance sheet transactions and obligations with unconsolidated entities that could materially affect the company.[17] This addresses an issue highlighted in the collapse of Enron.

- When companies present financial data in standardised or 'normalised' ways ('pro-forma') they will be under an obligation to make sure that it is not misleading and must reconcile the pro-forma information with the financial condition of the company as it would be presented using normal accounting principles.[18] This addresses a trend in the US to present headline financial data to investors in a sanitised manner that tends to emphasise growth and stability by stripping out as 'one-off' or 'exceptional' items that would distort that picture.

- Companies will have to include an assessment of their internal controls in their annual reports and make a declaration that management takes responsibility for internal financial controls.[19] Their auditors will in addition have to report on the companies' assessment.

- Companies will be expected to report material changes in their financial condition on a 'rapid and current' basis, in plain English.[20] This is designed to encourage faster or 'real-time' reporting of significant corporate news which investors would want to know.

f. Criminal offences

- In addition to the criminal offences of knowingly providing false financial information to the markets (see 'Directors and officers' above), the Act also introduces stiff criminal penalties for knowingly altering and destroying corporate documents in the context of a federal investigation or insolvency, taking steps which make documents unavailable for official proceedings and for taking retaliation against whistleblowers.[21]

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17 Sec. 401
18 Sec. 401. Non-US issuers have been partially exempted from this rule for disclosures which are primarily made outside the US.
19 Sec. 404
20 Sec. 409
21 Secs. 802, 1102, and 1107

B. The UK's Response

1. The nature and recent history of UK regulation

It is worth recalling that the UK's response to perceived defects of the auditing and accounting framework go well beyond the legislative provisions contained in this Bill. As far back as 1998, the DTI issued a consultation document - *A framework of independent regulation for the accountancy profession.*[22] This ultimately led to a number of reforms. In April 1999, the Government announced plans for the independent regulation of the accountancy profession.

> This will provide for independent oversight of what have been termed the 'public interest' activities of the main accountancy bodies. These activities are the investigation and prosecution of the more important disciplinary cases, and the setting of auditing and ethical standards. Three boards – one for each of these public interest areas – will be set up, under the oversight of a body to be known as 'The Foundation'. The Foundation will have a majority of members who represent the interests of consumers and non-accountants. There will also be a third body, the Review Board, which will act as a watchdog for the work of the new bodies, and for some of the work of the existing accountancy bodies.[23]

The current Bill amends relevant provisions of the *Companies Acts 1985* and *1989*, but it is also intended to complement other non-legislative measures already in place designed to strengthen corporate governance and audit practice. Foremost amongst these is the review by Derek Higgs on the role and effectiveness of non-executive directors which led amongst other things to changes to the Combined Code on Corporate Governance in July 2003. Another development has been the Financial Reporting Council taking over the functions of the former Accountancy Foundation.

It is important to bear in mind the distinction between the various City codes and legislation. For larger companies, there are significant obligations which are placed on both executive and non-executive directors through corporate governance codes. Since the Cadbury report (on the financial aspects of corporate governance) in 1992, the role of voluntary codes in corporate governance has increased steadily.[24]

Cadbury was followed in 1995 by the Greenbury report which focused exclusively on executive remuneration.[25] The two codes produced by these reports were subsequently

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[22] DTI November 1998

[23] 'Accountancy profession for the new millennium', Department of Trade and Industry press release P/99/348, 28 April 1999

[24] *Report of the Committee on the financial aspects of corporate governance*, 1 December 1992, 'Cadbury Report'

[25] *Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury*, 17 July 1995, 'Greenbury Report'

revisited in 1998 by the Hampel committee.[26] It then consolidated its report and the earlier codes into the 'Combined Code' which provides guidance on good governance standards for listed companies. It is annexed to the Listing Rules which are issued by the Financial Services Authority acting, in a role which it acquired from the London Stock Exchange, as the UK Listing Authority.[27]

Unlike the Listing Rules, which prescribe mandatory disclosures for companies that are on the Official List of securities, compliance with the Code is formally voluntary. However, listed companies are required to state whether they comply with the Code and to justify any departures from its standards. This approach is sometimes described as 'comply or explain'.

The Company Law Review Steering Group[28] and the Government's company law White Paper published in July 2001 recommended that the Code should retain its status as the principal but non-statutory source of governance rules for listed companies.[29]

Much has been made of the role of non-executive directors and individual conduct in the course of events where failings have been identified. An example would be Equitable Life. The Hampel report reflects the dual nature of duties and responsibilities which are placed upon individuals in this capacity:

> 3.8 The Cadbury committee raised the profile of the non-executive director, and this has been very beneficial. An unintended side effect has been to overemphasise the monitoring role. The Cadbury committee themselves recognised the danger:
>
> 'The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company'. (Report, 4.10.)
>
> Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have both a strategic and a monitoring function. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives. What matters in every case is that the non-executive directors should command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests.
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> 3.9 The Cadbury committee recommended that a majority of non-executive directors should be independent and defined this as 'independent of management

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26 *Committee on corporate governance: Final Report*, 28 January 1998, 'Hampel Report'
27 www.fsa.gov.uk/ukla
28 Report of the Steering Group, *Modern company law for a competitive economy*, published July 2001
29 White paper, *Modernising Company Law*, Cm 5553, paras 3.28, 5.11-14

> and free from any business or other relationship which could materially interfere with the exercise of their independent judgement' (report, 4.12). We agree with this definition, and after careful consideration we do not consider that it is practicable to lay down more precise criteria for independence. We agree with Cadbury that it should be for the board to take a view on whether an individual director is independent in the above sense. The corollary is that boards should disclose in the annual report which of the directors are considered to be independent and be prepared to justify their view if challenged. We recognise, however that non-executive directors who are not in this sense 'independent' may nonetheless make a useful contribution to the board.
>
> 3.10 Some smaller companies have claimed that they cannot find a sufficient, number of independent non-executive directors of suitable calibre. This is a real difficulty, but the need for a robust independent voice on the board is as strong in smaller companies as in large ones. In many smaller companies, the executives are also major shareholders; and the level of external scrutiny by other shareholders and the market is low. Non-executive directors do a vital job in safeguarding minority interests and ensuring good governance. We have already noted (1.10) the need to consider the governance arrangements of smaller companies with flexibility and proper regard to individual circumstances.[30]

Hampel went on to make a number of detailed recommendations on the role of non executive directors, some of which are discussed in more detail below in the sections on Higgs' recommendations.

2. The Higgs report

In February 2002, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry announced an independent review of the role and effectiveness of non-executive company directors.[31] Speaking at the Mansion House, Patricia Hewitt said:

> Non-executive directors play a key role in British companies by helping to drive up performance. It is in all our interests that they do their job as effectively as possible. We need stronger, more independent and more active non-executives drawn from a wider pool of talent to play their part in raising productivity. This review will look at how this aim can be delivered and will build on the work of the Company Law Review and the Myners review, including the Government's recent proposal to strengthen the duties of institutional investors.[32]

Derek Higgs, a banker and company director, was later asked to lead the review.[33] In the published terms of reference, the Government set out a twin mission of reporting on the

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[30] Hampel, paras 3.08-10

[31] Department of Trade and Industry press release P/2002/128, *Hewitt announces plans to strengthen UK business*, 27 February 2002

[32] Ibid

[33] Department of Trade and Industry press release P/2002/234, *Derek Higgs appointed to lead review of non executive directors*, 15 April 2002. At the time, Higgs was Chairman of Partnerships UK, and a non

current position and of making recommendations for the future. The Review would focus on:

- the population of non-executive directors in the UK
- who are they, how are they appointed, how the pool might be widened etc;
- their "independence";
- their effectiveness;
- accountability; their relationship — actual and potential — with institutional investors;
- issues relating to non-executive directors' remuneration;
- the role of the Combined Code;
- what, if anything, could be done by individual boards, by institutional investors, by the Government or otherwise to strengthen the quality, independence and effectiveness of non- executive directors.[34]

The report was published on 20 January 2003.[35] Stressing that his recommendations were a 'counsel of best practice that can be intelligently applied' rather than a box-ticking blueprint, Higgs said:

> While it is not my conclusion that the UK framework of corporate governance is seriously flawed, it can clearly be improved. My view – echoed in many submissions – is that progressive strengthening of the existing architecture is strongly desirable, both to increase corporate accountability and to maximise sustainable wealth creation.[36]

As well as Higgs, which the Government 'warmly welcomed', the DTI and Treasury had also set up a separate, contemporaneous review into the UK's arrangements for financial reporting and auditing, the Co-ordinating Group on Audit and Accounting Issues. This group was part of the Government's response to the collapse of the American energy firm Enron. It reported in January 2003.[37]

3. Accountancy & Audit Issues

At an interim stage, this Group had asked the Financial Reporting Council (FRC) to draw up guidance for audit committees. Its work was led by Sir Robert Smith and fed into the Higgs Report.

The Financial Reporting Council is an independent body, established in 1988, which draws funding from the Government, industry and the financial sector. It oversees the work of the two oversight boards, the Accounting Standards Board and the Financial Reporting Review Panel and also co-ordinates work on revising the Combined Code. Most of the recommendations of the Higgs report (and Sir Robert Smith's audit

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executive director at Egg plc, the British Land Company plc, Allied Irish Banks plc, Jones Lang La Salle Inc, London Regional Transport and Coventry City Football Club. He had previously worked at Prudential plc and SG Warburg.

34 ibid

35 Derek Higgs, *Review of the role and effectiveness of non-executive directors*, Department of Trade and Industry, 20 January 2003

36 Higgs Report, para 1.13.

37 Co-ordinating Group on Audit and Accounting issues, *Final report*, 29 January 2003, URN 03/567

committee group) were addressed to the Financial Reporting Council and concerned changes to the Code. These revisions were to come into force on 1 July 2003 following a short period of consultation. However, due to the strength of negative feeling from industry and practitioners implementation was more convoluted than was first imagined.

The FRC set up a working party in May 2003 to draw up a revised Code.[38] While still based on Higgs' own draft, a more extensive re-working than that seemingly envisaged was carried out by the group in order to address criticisms which had been voiced both in responses to the consultation and in the press. Many of those criticisms had been targeted at a small number of recommendations which seemed particularly sensitive (such as the proposed role of senior independent director in meeting shareholders and chairing meetings of the non-executives, or the recommendation that former chief executives should not become chairman at the same company). There was also a more general objection that the Code was becoming too prescriptive, and that the voluntary principle of 'comply and explain' might be overtaken by a more rule-based, 'box-ticking' interpretation.

The new version of the Combined Code was issued by the FRC in July 2003. Although very few of Higgs' recommendations had been substantially changed, the drafting was modified in places, and the 'principles' were finessed into 'main principles' and 'supporting principles'. The result is a Code which contains more detailed guidance and commentary on the interpretation of the key requirements. Initial reaction suggested that the main participants were content that an appropriate balance had been struck between improving the effectiveness of boards and their accountability to investors, without unduly constraining their freedom to operate.

Not all of the recommendations which emanated from the plethora of review bodies and discussion and working groups established in the 2001-2003 period could find expression in the new Combined Code, even though it is significantly longer than its 1998 predecessor. Hence the new legislation.

C. Current Regulation of Audits and Auditors

1. Who can be an auditor?

Who can be an auditor is determined by law – the *Companies Act 1989* (CA 1989). Auditors have to be members of a recognised supervisory body (RSB). In order to accommodate the EU Eighth Council Directive on company law, individuals who are members of a recognised qualifying body (RQB), through which membership of an RSB is made possible, can also be auditors.

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38 Financial Reporting Council press release PN/74, *The Higgs and Smith reports: Next steps towards a revised combined code following consultation*, 14 May 2003

Qualification as an RSB is set out in Section 30 of CA 1989 and recognition is from the Secretary of State. Conditions for recognition and revocation of recognition are set out in Sch. 11 CA 1989. Within the profession, the three main chartered accountancy bodies (the Institute of Chartered Accountants in England & Wales, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland) set up a Joint Monitoring Unit to check standards of work by their members.

In order to act as an auditor, individuals must hold a qualification from a RQB. Individuals with accountancy qualifications before the CA 1989 were allowed to maintain their professional status. The RQB recognition procedure is also subject to Secretary of State approval and is set out in Sch. 12 CA 1989. The length and content of the syllabus is also prescribed.

Members of the following organisations are eligible to be company auditors:

- Institute of Chartered Accountants in England & Wales (ICAEW);
- the Institute of Chartered Accountants of Scotland (ICAS);
- the Institute of Chartered Accountants in Ireland (ICAI);
- the Association of Chartered Certified Accountants;
- the Association of Authorised Public Accountants; and
- the Association of International Accountants

2. Existing regulatory organisations

The main overarching body has been the Accountancy Foundation, which has operated though four subsidiary bodies – the Review Board, the Auditing Practices Board, the Ethics Standards Board and the Investigation and Disciplinary board. The individual role of these bodies is described briefly below.

1. *The Review Board*

The Review Board's task is to monitor the operation of the independent regulation system of the accountancy profession to ensure that it is fully meeting the public interest. Its remit extends to the work of the other Foundation subsidiary bodies and to the continuing responsibilities of the accountancy bodies.

2. *APB: Auditing Practices Board*

Established in 1991 (when it replaced the Auditing Practices Committee) to develop and issue professional standards for auditors in the UK and the Republic of Ireland. It has around 15 members. No more than 40% of the APB's membership may be accountants who are eligible for appointment as company auditors. The remaining 60% of the APB may, at the Accountancy Foundation's discretion, include accountants not eligible for appointment as company auditors.

3. *ESB: Ethics Standards Board*

The ESB has the role of securing the development, on a profession-wide basis, of ethical standards for all accountants, whether in practice, industry and commerce, or the public sector. The ESB's role is to specify what standards are needed and the issues that need to be covered in them, rather than to draft detailed standards. It will then be for the CCAB bodies to prepare an appropriate standard. The ESB consists of ten members, six of whom are non-accountants.

4. *IDB: Investigation and Disciplinary Board*

The IDB focuses on disciplinary cases of public interest; other cases continue to be dealt with by the individual accountancy body of the member concerned.

In addition to the above bodies the UK and Irish professional Institutes have made their own arrangements to pool resources to carry out certain functions in joint organisations. These include:

1. *JDS: Joint Disciplinary Scheme*

The JDS covers the ICAEW and ICAS. It carries out independent investigations into matters of public concern affecting the professional and business conduct, efficiency and competence of individuals and firms who are members of the participating professional bodies.

2. *The Consultative Committee of Accountancy Bodies (CCAB) Ethics Group*

Recently created to provide a common point of contact for the Ethics Standards Board.

3. *JMU: Joint Monitoring Unit*

The JMU monitors firms for compliance with audit regulations on behalf of the ICAEW, ICAS and ICAI. It also monitors firms authorised for investment business.

4. *FRC: Financial Reporting Council*

The FRC is a private sector body whose role was to promote good financial reporting and to act as the overarching and facilitating body for its (originally) two operational bodies, the ASB and the Financial Reporting Review Panel.

However, following the recommendations contained in the Government's report on its review of the regulatory regime of the accountancy profession, published in January 2003, the FRC has taken on the functions of the Accountancy Foundation. The new FRC includes five Boards formed by subsidiary companies of the FRC. These Boards will have three areas of responsibility:

- the setting of accounting and audit standards (through the Accounting Standards Board (ASB) and the Auditing Practices Board (APB));

- their enforcement or monitoring (through the FRRP, the Accountancy Investigation and Discipline Board, and the new audit inspection unit reporting to the Professional Oversight Board for Accountancy (POBA)); and
- the oversight of the major professional accountancy bodies (through the POBA).

Not inconsiderable parts of the new Bill exist to transfer the new statutory rights and responsibilities upon the new Financial Reporting Council and its subsidiary bodies.

3. Who needs an audit?

Ever since 1967 private companies have been required to file annual accounts at Companies House and to have these accounts audited by a qualified independent auditor. However, in 1993, when an EC Directive was being implemented, the UK took advantage of the scope for audit exemptions for small and medium companies. Companies with turnovers of £90,000 or less became exempt from the audit requirement; companies with turnovers above this threshold, but not above £350,000, could opt to prepare a simpler evaluation, the Audit Exemption Report (AER).

In 1997, the regime was simplified by abolishing the AER, and extending the exemption from audit to all companies with a turnover of not more than £350,000.[39] Provisions to allow shareholders to require an audit on request despite entitlement to exemption exist as a safeguard for minority shareholders. As the DTI's consultation on increasing the thresholds noted, whilst an audit by a regulated auditor is not required where an exemption exists, the directors nevertheless still have to prepare and file accounts which present a true and fair account of the company's financial position.

Certain types of small company are unable to take advantage of the exemption, including banks, insurance companies and financial services companies; companies which hold significant assets on their balance sheets; and companies which are part of groups (unless the whole group falls below the audit threshold). Charitable small companies have an overlapping regime: where such companies have annual income of between £90,000 and £250,000 an Audit Exemption Report is required. If their income exceeds £250,000, a full audit is required.

The thresholds have subsequently been increased and the current limits and thresholds are set out in the *Companies Act 1985 (Accounts of Small and Medium Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004* ('the Regulations'). Most companies with a turnover of £5.6 million and or a balance sheet total of £2.8 million or less are exempt from the statutory audit requirement.

[39] *The Companies Act 1985 (Audit Exemption) (Amendment) Regulations 1997* SI 1997 No 936

III The Bill

A. Part 1: Auditors, Accounts & Investigations

1. Introduction

There is a considerable amount of material available about the Bill on the DTI website at: http://www.dti.gov.uk/cld/, including the Bill itself, notes on particular clauses, fact sheets and the regulatory impact assessments. Several documents have both informed and provided significant support for the measures in the proposed legislation. They include: the *Final Report of the Co-ordinating Group on Audit and Accounting Issues* to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer (January 2003),[40] the *Review of the Regulatory Regime of the Accountancy Profession*: Legislative Proposals (March 2003);[41] *Company Investigations: Powers for the 21st Century*.[42] The executive summary of the *Review of the Regulatory Regime of the Accountancy Profession* paper is reproduced in an annexe to this paper (see below).
A paper deposited in the house of Commons Library (deposited paper 04/565) shows how the new legislation will amend existing companies' legislation.

This section of this Research Paper does not attempt to reproduce this material en masse. The general format is that the explanatory notes for a particular clause are reproduced,[43] either entirely or in part, followed by particularly contentious or illuminating debate from the proceedings in the Lords Grand Committee (the Committee) and any other commentary.

The bill received its second reading in the Lords on 8 January 2004 and was debated in Grand Committee between 16 March and 29 March 2004. Report Stage was on 7 July 2004.

2. The Bill

Part 1 of the Bill contains 22 clauses. Their impact is not always clear: Lord Hodgson of Astley Abbots (Conservative spokesperson) speaking on the first day of the committee stage in the Lords said:

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40 Available on the DTI website at: http://www.dti.gov.uk/cld/cgaai-final.pdf
41 Available on the DTI website at: http://www.dti.gov.uk/cld/accountancy-review.pdf

42 Available on the DTI Website at: http://www.dti.gov.uk/cld/company_investigations.pdf

43 Available from house of Commons internet at:
http://pubs1.tso.parliament.uk/pa/cm200304/cmbills/142/en/04142x--.htm

> The first 22 clauses create another layer of amendments in three specific areas of company law: auditors, accounts and reports and investigations. I have spent the past two months or so trying to get my head around those 22 clauses. It is a bewildering and at times a depressing activity. In some places one is required to turn to the Companies Act 1989, which itself amended parts of the 1985 Act. Unless one has immersed oneself in company law since the 1985 Act and can therefore track the changes and the evolution process of which the Bill is the culmination, it is very difficult to comprehend.[44]

The Government Spokesman, Lord Sainsbury of Turville, for his part noted at the outset that:

> Perhaps I, too, may use the clause to make one or two general points about the way we are approaching the Bill. I want to make it clear that the objective of the provisions is to protect and improve the quality of accounts and audit by ensuring that the audit profession is regulated in the most effective way. The role of independent auditors is extremely important in ensuring high standards of financial reporting. It is therefore important that the public can have confidence in their impartiality and effectiveness.
>
> When deciding whether to legislate, the Government recognise that action should be taken only where it is appropriate and that it should be proportionate. In particular, we took account of the fact that the review of the regulatory regime of the accountancy profession found no evidence that the current regulatory system was seriously flawed. We therefore have not tried to bring forward heavy-handed and disproportionate regulation but rather to concentrate on the concerns which the review found about the perceived independence of the key aspects of the current arrangements.[45]

Clauses 1 & 2 of the Bill makes provision for additional requirements for existing supervisory bodies or deal with the definition of, and the circumstances in which, powers may be delegated by the Secretary of State. The clauses amend Part 2 of Schedule 11 to the CA1989 (see Section C (1) of this Paper above) which sets out the detailed requirements which RSBs (the main accountancy Institutes) must observe in carrying out their supervision role. The Department's explanatory notes state:

> The new requirements are designed principally to ensure the independence of the regulation of major public interest audit work, and to permit delegation of the Secretary of State's powers under Part 2 of the Companies Act 1989 (principally the power to recognise accountancy bodies as recognised supervisory bodies for auditors) to a wider category of persons than at present.[46]

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[44] HL Deb 16 March 2004 c15GC

[45] ibid c22GC

[46] Notes on clauses at; http://www.publications.parliament.uk/pa/ld200304/ldbills/008/en/04008x--.htm, point 16

One example of the impact of the legislation is the additional requirement that the RSB must

> Have rules designed to ensure that members of the body who perform any company audit functions in respect of major audits take such steps as may be reasonably required of them to enable their performance of any such functions to be monitored by means of inspections carried out under the arrangements.[47]

The legislation defines 'major audit' in clause 2 as

> A company any of whose securities have been admitted to the official list (within the meaning of the Financial Services and Markets Act 2000), or
>
> Any other company in whose financial condition there is a major public interest.[48]

According to the Minister, the audit of approximately 1,200 companies will be covered by the definition of major audit. Companies on the Alternative Investment Market (AIM) are excluded.

Clarification of the new system came in proceedings on clause 1 in the Grand Committee. Lord Sainsbury began:

> I was distraught to hear that the noble Lord did not find ploughing through the initial clauses of the Bill to be a life-enhancing experience. Until I heard him speak I thought I had eventually got the matter clear. But let me see if I can explain. I refer to the chart he referred to, which I think is the only possible way for those who are not in the thick of it to understand what the new structure is and how it relates to the previous one.[49]

The chart mentioned is shown on the following page:[50]

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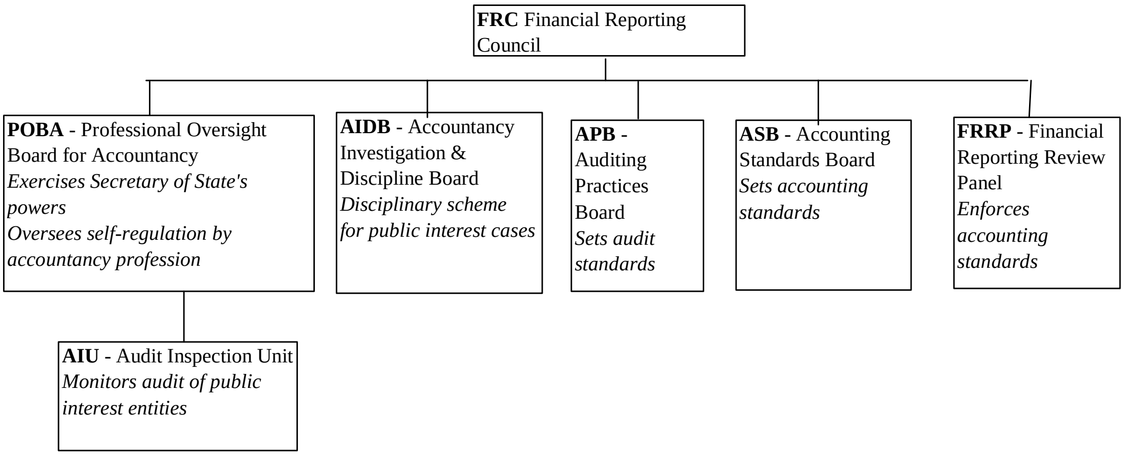
47 Clause 1 (10(2))
48 Clause 2
49 HL Deb 16 March 2004 c23GC
50 Source: Dep 04/565 p 10



Lord Sainsbury continued:

> The key issue is the concept of the recognised supervisory bodies having funded arrangements with the regulatory structure, which has now been put in place and which involves the Financial Reporting Council and the boards which report. They are the Professional Oversight Board for Accountancy, the Accountancy Investigation and Discipline Board, the Auditing Practices Board, the Accounting Standards Board and the Financial Reporting Review Panel Ltd. That structure has essentially been put in place. It has a heavy independent element to it, which I think we all feel is right. The recognised supervisory body reaches a funding arrangement with the regulatory framework. In that way, we gain the necessary independence.[51]

Clauses 3 to 5 deal with the circumstances in which the Secretary of State can delegate her powers with respect to the control of auditors to a new or existing body.

Currently section 46 of the CA1989 empowers the Secretary of State to establish a body corporate to exercise her powers relating to company auditors and the recognition of bodies which supervise auditors and/or provide a professional qualification; and Schedule 13 sets out a number of supplementary provisions relating to the delegation of these functions. Section 46 does not allow the Secretary of State to delegate her functions to anyone other than a body corporate actually established by the delegation order.

The intention of clause 3 is to end this restriction and that the functions should be delegated to the Professional Oversight Board for Accountancy (POBA – one of the Boards set up under the Financial Reporting Council). By definition POBA, which already exists, cannot be established by a delegation order under the 1989 Act.

[51] HL Deb 16 March 2004 c23GC

The make-up of POBA is not specified in any detail in the Bill, however, any delegation order made under the Act would be subject to an affirmative resolution in the House, thus there is an opportunity in the future to debate its make up powers, constitution etc.[52]

Debate

The POBA's role and its legislative background were described in the Lords by Lord Sainsbury:

> We envisage that the functions will be delegated to the Professional Oversight Board for Accountancy, or POBA, of the Financial Reporting Council. POBA is the successor to the Review Board of the old Accountancy Foundation, although its remit has been significantly changed. Its other functions will be to oversee the self-regulatory activities of the major professional accountancy bodies and the new Audit Inspection Unit that is being established to monitor major audit work.
>
> The current delegation power in Section 46 has never been used. It was right for its time, but needs to be changed as there is a body already in existence which could carry out the Secretary of State's functions effectively. The change that we are proposing to the existing delegation power will enable decisions on the recognition of supervisory bodies and audit qualifications to be taken by a body that also has responsibility for oversight of the major accountancy bodies. I believe that the synergies that will be achieved will significantly improve the overall independence of the regime and the effectiveness of oversight of the supervisory bodies. That is part of a framework that we have put in place, which, without creating too heavy a superstructure, gives the independence that we are seeking.[53]

Clause 4 inserts a *new section 46A* into the *Companies Act 1989*. The new section sets out the circumstances in which the Secretary of State may delegate functions to an existing body. *Subsection (2)* provides that the body to whom the functions are to be delegated must be willing and able to exercise the functions and must meet certain other conditions set out in *subsection (3)*. The purpose of *subsection (5)* is to deal with the case of a body that has (non-statutory) functions relating to arrangements in which recognised supervisory bodies may participate in order to meet the new criteria for recognition introduced by *clauses 1* and *2*. Under this subsection, such a body may also exercise the delegated functions of the Secretary of State. The aim of this provision is to ensure that the POBA (which is expected to be the body to be designated by the first delegation order, provided it fulfils the requirements for designation) is not precluded from exercising any delegated function on the basis of its involvement with the arrangements set out in *clause 2*.

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[52] ibid c48GC
[53] ibid, c52GC

Clause 5 amends Schedule 13 to the Companies Act 1989 to reflect the extension of the delegation power at section 46. Essentially, this clause specifies which provisions in Schedule 13 apply to a body created by the delegation order and which apply to an existing body. *Subsection (5)* provides that where the body is an unincorporated association (as the POBA will be) any proceedings brought in connection with the exercise of the delegated functions by the body may be brought in the name of the body corporate whose constitution provides for the establishment of the association.

Clause 5 was agreed without discussion in Grand Committee in the Lords.

Clause 6 Section 33 of the *Companies Act 1989* allows the Secretary of State to recognise overseas qualifications as equivalent in the UK. Under section 33, it is only possible to recognise either all or none of the people who hold a particular overseas qualification (for example, all those who hold a particular accounting diploma). However, there are circumstances where it would in fact only be appropriate to recognise some of those people. For example, where an overseas qualification originally fell below the criteria for approval in section 33 but was subsequently changed so that it met those criteria, the Secretary of State may wish to recognise the qualification, provided that it was gained after the date when the change was made. Similarly, where different combinations of learning modules and examinations offer alternative routes to the same qualification, the Secretary of State may wish to recognise the qualification provided that the audit-related modules and examinations have been undertaken.

At present, section 33 does not allow the Secretary of State to do either of these things and she therefore has to refuse recognition to the qualification as a whole. *Clause 6* would amend section 33 to remedy this, by providing that persons who hold a specified professional qualification *and meet other specific requirements* may be regarded as holding an approved overseas qualification.

Debate

In Committee, two issues were raised. First, the Government declared that the Secretary of State would not be able to retrospectively de-recognise qualifications of auditors – thus removing uncertainty from business. Secondly, the general issue of overseas accountants was raised:

> While we are discussing the clause, I raise some concerns of the professional bodies. They welcome the changes being made to Clause 6, but they believe the method by which overseas audit qualifications are approved and recognised in the UK should be looked at again. With the exception of individuals and qualifications covered by the European Union mutual recognition directive, only one overseas qualification outside Europe—that of the Institute of Chartered Accounts of Australia—has been recognised by the Secretary of State under Section 33 of the Companies Act. This long-standing failure to allow appropriately qualified members from overseas institutes to audit in the UK has led to a damaging impasse. The UK accountancy bodies have reciprocal

> membership arrangements with overseas institutes. It is clearly an unsustainable position that UK accountants are allowed to audit in overseas territories while accountants from those territories are barred from auditing in the UK.
>
> A recent consequence of this problem has been brought to our attention. In Canada the authorities have removed the recognition of UK chartered accountants. More jurisdictions may follow. The problem stems from the way recognition is decided upon and granted by the Secretary of State. To date, the UK has required a professional level of recognition rather than individual recognition agreements between recognised qualified bodies in different countries.
>
> Given that there are five recognised qualifying bodies of audit in the UK, each with a different member composition and viewed differently by overseas authorities, it has proved to date impossible in most cases to arrive at a situation where an overseas authority is willing to do what the Secretary of State here requires and agree to recognise members of all the bodies recognised for audit by the United Kingdom Government. It would be helpful if the Minister could make a few comments on this when addressing the amendment. I beg to move.[54]

The Minister promised to reply to this point outside of the debate proceedings.

Clause 7 addresses a long standing problem. Achieving the right balance in the relationship between the auditor and the audited is not easy. The auditor relies on the management of the company for much of its information and, in practice at least, the recommendation for continued appointment as auditor. The company may well see advantages in using the auditor for various non audit functions such as consultancy, tax planning, actuarial advice etc. A beneficial arrangement devised by the auditor, approved of by the company and then checked by the auditor does not meet the aspired to levels of openness and transparency that is the underlying aim of this part of the Bill. Under existing legislation, the Secretary of State already has the power to require companies to disclose the total value of their non-audit services and the amount of remuneration paid for audit services.[55]

Under the new law the Secretary of State, by regulations, will be able to require companies to publish more information about the types of services they and their associates have purchased from their auditors and their associates.

Debate

This clause was debated at length in Committee. Various issues emerged such as

[54] Lord Hodgson, ibid c57 GC
[55] CA 1989, Section 390B and 390A (3)

- the definition of 'associates' and were they associates of the company or the auditors
- the level at which disclosure took place, was it at company level or group (of companies)
- the differentiation between services provided, would it be tax and auditing or tax computation, tax planning, overseas tax work etc.

These questions arose since, as Lord Hodgson put it:

> After reading Clause 7, I find myself almost completely in the dark, since every one of the five principal subsections begins with that most elusive phrase "regulations may provide".[56]

Lord Sainsbury replied

> Before I explain why, in the Government's view, these amendments should be resisted, I would like briefly to explain what the existing requirements are and how this clause extends them.
>
> Under existing Section 390A of the Companies Act 1985, companies are already required to set out in their accounts the amount they have paid their auditors for audit work and, through regulations made under Section 390B, the amount they have paid them for any non-audit work. But there is currently no requirement for the company to explain what different types of non-audit service have been purchased, nor to give anything other than a single, aggregate figure for the amount spent. This clause remedies that by giving the Secretary of State the power to make regulations requiring the company to set out more detail about the cost and nature of the non-audit services.
>
> The reason we consider that to be important is simple. We recognise that the provision of certain services by the auditors could potentially compromise their independence—for example, through the provision of tax services. However, that depends on the type and scale of the service provided, and therefore we wish such information to be made public by the company. The alternative would have been to ban such services altogether. But we prefer proper disclosure and transparency, and that approach probably has cross-party support. [57]

The general point put forward by the Minister was that the regulations would follow the 'best – practice' document published by the Institute of Chartered Accountants in England and Wales on disclosure. Put simply, work done by associates of the main audit group would normally need to be disclosed whereas the work done for associates of the main company being audited would not although:

[56] HL Deb 16 March 2004 c60 GC
[57] ibid c61GC

> The argument about the associates of the company is slightly different. Under the existing regulations, an associated undertaking in relation to a company means its UK subsidiary undertakings. Again, I quote from the guidance on disclosure from the Institute of Chartered Accountants in England and Wales on the nature and cost of services provided by the auditor, as the regulations made under Clause 7 are likely to reflect the guidance:
>
> > "Fees for work performed during the period for associates and joint ventures would not normally be disclosed. However, this should be considered on a case-by-case basis and additional disclosure would be appropriate if associates and joint ventures form a particularly large part of the group financial statements".
>
> We agree with that. The primary legislation is therefore drafted in such a way that we can, if we decide it is necessary to do so, require additional disclosure about associates and joint ventures in the regulations.[58]

The delineation of different services, upon which disclosure was needed, anticipated in the bill was set out by Lord Sainsbury:

> The noble Lord is also seeking a broad categorisation of the classes and description of the services provided by the auditor. I can assure him that we envisage a broad classification of types of non-audit services. We will draw on the categories in the ICAEW guidance which are themselves in line with those in the European Commission's recommendations on auditor independence.
>
> We will want to be sure that the categories are effective and clear. We expect the categories to be: audit services, broken down into statutory audit and audit-related regulatory reporting; further assurance services; tax services, broken down into compliance services and advisory services; and other non-audit services, which will be broken down under a series of headings, such as financial information technology, internal audit, valuation, litigation and recruitment.[59]

The Minister made a related point in answer to a question about the balance between disclosure and confidentiality, that:

> If the company really does not want to have to disclose any information at all in this regard, the answer is simple—go to anyone else other than the auditor for this service. I must remind Members of the Committee that the objective is only to require disclosure when the firm carrying out the audit is also carrying out other work—nothing else.[60]

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[58] ibid c62GC
[59] ibid c66GC
[60] ibid c67GC

The remaining item of interest that emerged from the Committee debate on this clause was that it is intended that various exemptions from the disclosure requirements will be allowed for small firms.

Clause 8 - Auditors' rights to information

Under existing legislation (section 389A of the Companies Act 1985) a company's auditors are entitled to require from the company's officers such information and explanations as they think necessary for the performance of their duties as auditors. It is a criminal offence for an officer of the company to provide misleading, false or deceptive information or explanations. However, it is not an offence for them to fail to provide any information or explanation that the auditors require of them.

This clause is intended to help auditors to carry out their duties by strengthening their right to require information or explanations. It does this in two ways:

- it entitles the auditor to require information and explanations from employees as well as company officers (directors etc).[61]
- it makes it a criminal offence to fail to provide information or explanations required by the auditor.

Debate

The debate touched several issues, including that of the position of possibly quite lowly employees being 'forced' to talk to auditors when they might perceive there to be a contradiction between their duty to auditors and their loyalty to their company and, in extremis, to the preservation of their own jobs. Lord Sainsbury responded:

> I emphasise that there are important protections for the employee. The employee does not commit an offence simply by giving information that turns out to be false or by failing to give that information. The information must be false in a material particular. The employee must have known that the statement was false or have been reckless as to whether it was false. The employee is protected against self-incrimination, and the employee is able to show by way of defence that it was not reasonably practicable to provide the information.
>
> There is another issue. The employee may still be in an impossible position when, for example, a manager makes it clear that he does not expect employees to co-operate with the auditor. There may be circumstances in which it proves difficult for the employee. However, those are likely to be cases where the management has something important to hide from the auditor. Placing an obligation on the

[61] This reflects a recommendation made in the Company Law Review (*Modern Company Law for a Competitive Economy*, Final Report July 2001, URN 01/942, paragraph 8.119 first bullet);

> employee, as this clause does, overrides any duties of confidentiality that the employee might otherwise owe to the company.
>
> Employment law has, of course, long allowed employees, subject to qualifying service, to complain to an employment tribunal if they believe that they have been dismissed unfairly. A dismissal where the employee is simply fulfilling his legal obligation under this clause would almost certainly be an unfair one.[62]

Clause 9 - Statement in directors' report as to disclosure of information to auditors

This requires the directors' report to contain a statement that each director is aware of no relevant audit information of which the auditors are unaware and that the director has taken all the steps he should have taken as a director to make himself aware of such information and to establish that the auditors are aware of it.

The aim of clause 9 is to ensure that each director will have to think hard about whether there is any information that he knows about or could ascertain which is needed by the auditors in connection with preparing their report.[63] Further, directors should be required to volunteer information to the auditors in certain circumstances. There are safeguards for the directors in terms of the information covered and the offence where the directors make a false statement.

Debate

The general requirement of this clause was resisted in Committee. Some of the criticism was definitional, whether it was possible to define phrases such as ‘reasonable’ and ‘ought to know’ sufficiently clearly for the law to be certain. Other criticisms emerged over the general regulation of non-executive directors. While the government was, on the one hand encouraging their use and adoption, on the other it was creating a barrier of regulations and criminal sanctions that appeared increasingly daunting to such volunteers. The opposition spokesman summed up this view:

> The difficulty with the proposal is that it places on directors, under sanction of serious criminal penalties, a duty of onerous and obscure extent. This is despite the fact that the directors are already under a duty which ought to be sufficient to meet the recommended objective. The warranty which, in effect, each director is required to give by the inclusion of the proposed new statement in the directors' report, is not only that he has himself given to the auditors any relevant information fitting the descriptions in paragraphs (a) and (b) of Section 234ZA(2), but also that each and every other director of the company has also given to the auditor the information he or she should have. In other words, not only are directors bound to search out what they know, or should know, is

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[62] HL Deb 17 March 2004 c83GC

[63] Again this is a recommendation of the Company Law Review (*Modern Company Law for a Competitive Economy*, Final Report July 2001, URN 01/942, paragraph 8.119 second bullet).

> relevant to the audit, and make sure that the auditors know about it, they are also bound to search out and make sure that each and every other of their fellow directors has done the same thing.[64]

The Minister's response was that the proposed new law was reasonable and fair:

> The best way in which I can explain why the provisions are balanced and fair is simply to outline what a director would need to do to fall foul of the requirements. The statement of disclosure of information that is required to be in the directors' report applies only to information that meets all the following three criteria. First, the director must be aware of the information, or it must be reasonable for him to obtain the information by making enquiries.
>
> Secondly, the director either must know or ought to know that the information is relevant for the auditor's determination of his report under Section 235; that it is relevant to the auditor reaching a view that the accounts meet the requirements of the Act. In particular, it must fulfil the requirement that the accounts give a true and fair view. Again, there is a separate amendment on what we mean by "ought to know".
>
> Thirdly, the director must know or ought to know that the auditors are not aware of the information. If information exists which comes within the above criteria and which is not disclosed to the auditors, the statement in the directors' report will be false. However, a director does not commit an offence simply by virtue of the statement in the directors' report being false. He or she must know that it is false—for example, because of knowledge that other directors are withholding information—or must be reckless as to whether it was false—for example, because a director does not care whether or not it is false. This is already, deliberately, a stiff test for the prosecution to show is the case.
>
> In addition, the director must have failed to take all reasonable steps to prevent the directors' report being approved. Again, there is a separate amendment to explore that specific provision. The clause does not mean that every director is guilty of an offence simply because one of the directors has concealed key information. Nor does it mean that all directors are treated the same regardless of their function; quite the opposite. What it is reasonable to expect, for example, the finance director to inquire into is likely to be different to what it is reasonable to expect a non-executive director to inquire into. As the clause explicitly makes clear in new Section 234ZA(3), what a director ought to know relates both to the knowledge, skill and experience that can be reasonably expected of someone carrying out their functions and to their actual knowledge, skill and experience.[65]

Lord MacGregor (Conservative) of Pulham Market was unconvinced:

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[64] Lord Hodgson, HL Deb 17 March 2004 c98GC

[65] ibid c100GC

> I noted that the Minister referred to the fact that a reasonably diligent director has nothing to fear. I like to feel that I am a reasonably diligent director and I certainly have no intention of letting directors off the hook. I should like to explain from where my worries about how this is put together come. I start from the view that I am finding it increasingly difficult to recruit extremely good people to be non-executive directors, particularly for companies that are in regulated industries.
>
> The risk/reward ratio has undoubtedly altered over recent years. The amount of work involved has increased considerably. Therefore, the amount of time that a director has to take, particularly if he is on the audit committee, is now quite substantial and, undoubtedly, has put a lot of people off wishing to do it. My concern is that these issues are exacerbated by parts of this clause. I am not yet reassured by the Minister that I am wrong. I hope that he will be able to do so.
>
> My main concern is that the phrase "ought to know"—"reasonable" is another issue—seems to apply as equally to the non-executive directors as to the finance director. As a non-executive director with an inevitably limited amount of time to spend on the company's affairs—and I spend a great deal of time on audit committees already—am I expected to delve even further to establish what I ought to know? I am certainly concerned that everything I know should be revealed to the auditors, but I do not know how I will actually know what I "ought to know". I am certainly not in the same position as a finance director, on whom I rely very considerably in these matters.
>
> Even if the non-executive director has the knowledge, skill and experience, I doubt whether he will have the time or scope to delve into all the details in an audit report—they are now voluminous—to ensure that he has not missed something which he ought not to have missed. I am therefore concerned about the introduction of "ought to know". Inevitably, a non-executive director relies very considerably on the executive directors and, in large companies, cannot get round the whole company.[66]

Baroness Noakes (Conservative) supported this view with a practical example:

> Overall, this clause is bringing in the benefit of hindsight in a context in which the specific duties are not well understood or codified. The concept of different standards for different functions of directors is a very novel one. We are not only going into the territory of liability attaching to the individual director, with all the difficulties expressed by my noble friend; we are effectively picking up the liability for all other directors. That is what many of those I have spoken to are particularly worried about.
>
> The benefit of hindsight is a wonderful thing. The people I have been speaking to recently have been appalled, for example, at the way in which non-executive

[66] ibid c102GC

> directors at Equitable have been castigated for what they did. I do not want to discuss the substance of that, but it is very clear that the benefit of hindsight has been used extensively there. The concern is that the benefit of hindsight would be used, not only to damn one's own activities but also to damn one in relation to everybody else's activities.[67]

The Minister denied that increased regulation, or higher standards as he put it, harmed the recruitment of non- executive directors. On the legal question of joint or several liability for the wrongdoings of one or more directors on the rest the Minister, Lord Evans, stated that:

> Before we move on, it may be helpful to the Committee if I say a word about joint and several liability so that it is in the record for the noble Lord, Lord Hodgson to read, along with everything else.
>
> The offence in new Section 234(7) applies to every director to whom paragraphs (a) and (b) in that subsection apply. Accordingly, just because one director commits an offence under new Section 234(7), it does not necessarily mean that the offence is committed by all of the directors.[68]

This was one of the clauses most debated in the Committee and it was dominated by discussion about how references to capability and expertise of directors should be phrased.

Clauses 10 - 12

The next set of clauses deal with defective accounts and the enforcement of accounting requirements, and in particular, with strengthening the enforcement role of the person authorised under section 245C of the *Companies Act 1985* currently the Financial Review and Reporting Panel (FRRP).

At present, the statutory role of the FRRP is restricted to examining companies' annual accounts for departures from the accounting requirements of the Act and applying to the courts to order the preparation of revised accounts as necessary. In future, this role will be taken up by a body set up under the FRRP to be known as the Review Panel.

Clause 10 - Persons authorised to apply to court in connection with defective accounts

This provides that when the Review Panel takes over as the body charged with bringing to court defective accounts any proceedings it brings may be brought in the name of the

[67] ibid c103GC
[68] ibid c108GC

body corporate whose constitution provides for the establishment of the association i.e. the FRRP. This clause was not discussed in committee.

Clause 11 - Disclosure of tax information by Inland Revenue (IR) to facilitate application for declaration that accounts are defective

This clause adds new sections after section 245C of the *Companies Act 1985* and Article 253C of the *Companies (Northern Ireland) Order 1986*, in order to permit the disclosure of information by the IR to the Review Panel. The clause also provides restrictions on the use and further disclosure of the information.

Debate

In Committee Lords were anxious to balance the right to confidentiality between the IR and the taxpayer that exist and the aim of the clause to promote a 'gateway' of information between the IR and the Panel responsible for maintaining the probity of company documents. By way of assurance as to the limited extent of the IR's future powers Lord Sainsbury, the Minister, said that:

> I remind the noble Lord of the reassurance given by the Inland Revenue to its Large Business Forum. The Revenue will only be dealing with information that has come to it in the course of normal business. The reassurance goes further—we expect that information to be shared with the company before it is disclosed to the FRRP. The company would have ample opportunity to clarify its position and correct any misunderstandings rather than being a passive bystander as information passes from the Inland Revenue to the FRRP. If the Revenue ever considered that there was doubt about the lawfulness under which it was holding certain information, it would not disclose this information to the FRRP until this question had been resolved. I hope that this gives the noble Lord the assurance he was seeking.[69]

Opposition to the principle however, remained. Lord Hodgson commented:

> The gateways for Inland Revenue disclosure were listed in a Written Answer given in the other place on 20 February 1990. There were then about 14 grounds for disclosure, which are contained in several Acts. At least some of these 14 or so gateways have subsequently been altered by legislation. Recent legislation creating new gateways has included the Tax Credits Act 1999, the Anti-terrorism, Crime and Security Act 2001, and the Proceeds of Crime Act 2002. However, as regards company law, the principle of Revenue confidentiality has to date escaped unscathed by these incursions. It is one thing to erode the principle of Inland Revenue confidentiality in pursuance of serious crime, but another thing to do so in supporting auditing standards.[70]

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69 HL Deb 22 March 2004 c205GC

70 ibid c210GC

Clause 12 - Power of person authorised to require documents and information; and Schedule 1 - New Schedule 7B to the Companies Act 1985

The FRRP (as the person authorised under section 245C of the *Companies Act 1985*) currently has no power to require a company to provide it with the information it needs to carry out its functions. To date, it has relied on the voluntary co-operation of the company in question to provide explanations and documents which are not publicly available. The view of the Government and the FRRP is that with the move to a more proactive approach, in which the FRRP will be considering more cases, such co-operation cannot be relied on in every instance. Moreover, the Committee of European Securities Regulators has recently set out a number of key enforcement principles, including that any competent enforcement authority should have adequate powers. Clause 12 therefore provides the FRRP with a statutory power to obtain relevant material.

Debate

The Minister accepted that there had been no case to date where the FRRP had not received what it wanted. Debate centred upon the extent to which giving the FRRP this power would encourage it to ask for more and more documents. As Lord Freeman put it "if there is a hint of trouble but it is not sure where, then it will ask for all documents".[71] Another peer, Lord Sharman, pointed to the experience in the United States where the enforcement agency there had to substantially increase its staffing following the passage of the Sarbanes-Oxley Act.[72] The Minister, Lord Evans, pointed out that:

> Although the clause in its present form indeed allows the FRRP to obtain documents, it does so within strict legal parameters. Those are set out in subsection (2). In short, that says that such information can be sought by the FRRP only if it is reasonably required by the panel to carry out its statutory function. Otherwise, it would have no power to require the information in question and, under subsection (5), I would not expect a court to make an order ensuring compliance with the FRRP's purported requirement.[73]

Clause 13 - Power to specify bodies who may issue reporting standards

Clause 13 amends section 257 of the *Companies Act 1985* which confers power on the Secretary of State to amend the accounting and audit provisions in Part 7 of the Act.

New subsection (4A)(a) gives the Secretary of State the power to specify a body to issue standards relating to reports which the directors are required to prepare under Part 7 of the Companies Act 1985. Directors are currently required to prepare a directors' report and,

[71] ibid c217GC
[72] ibid c214GC
[73] ibid c221GC

for the directors of a quoted company, the directors' remuneration report. This clause would allow standards to be drawn up for these reports, which are not covered by the "accounting standards" issued by bodies prescribed under section 256 of the Companies Act 1985.

The provision is, however, primarily intended as a paving device to allow a specified body to issue a standard in relation to a new report, the operating and financial review, which it is proposed to require of directors in due course by regulations under section 257. Such reporting standards would not have the "true and fair" authority of accounting standards.

Regulations under section 257 introducing the new requirement for an operating and financial review will be subject to affirmative resolution. *New subsection (4B)* stipulates that the order to be made by the Secretary of State specifying the body or bodies authorised to issue the new reporting standards will be subject to negative resolution.

Debate

The ‘operating and financial review’ is the product of a long period of consultation over the best, or alternative, way in which the prospects and aspirations of a quoted company might be expressed. The DTI press notice which announced it described it thus:

> THE OFR will be the directors’ view of the business. Directors will need to report on all factors that significantly affect the company and its future performance. These are likely to include the company’s impact on the environment and the wider community as well as its relationships with employees, customers and suppliers
>
> In July 2003, the Government announced that it intended to implement its proposals on a statutory OFR by secondary legislation under existing company law. This consultative document seeks views on the detailed implementation of this new requirement. Also includes are details of the changes required to the directors’ report as stipulated by the Modernisation Directive, and which will apply to all medium and large UK companies. The directors’ report already requires “a fair review of the development of the business of the company”.
>
> The directive expands that requirement by defining the fair review as “a balanced and comprehensive analysis of the development and performance of the company’s business and of its position, consistent with the size and complexity of the business” including, where necessary, financial and non-financial key performance indicators including information relating to environmental and employee matters. The Government proposes to take up the option allowed by the directive of excluding medium-sized companies from the requirement to provide non-financial information.[74]

[74] DTI News Release 5 May 2004, available at: http://www.dti.gov.uk/cld/pdfs/pn177.pdf

The OFR is popularly seen as a way in which companies could set out some of their environmental, social and community policies alongside the more traditional financial ones. There was little debate in the Committee on this clause.

Clause 14 - Supervision of periodic accounts and reports of issuers of listed securities

Clause 14 provides the Secretary of State with the power to appoint a body (intended to be the Review Panel of the FRRP) to monitor compliance by issuers of listed securities, or certain classes of these issuers, with accounting requirements of the Listing Rules.

These rules are made and enforced by the Financial Services Authority (FSA). Under section 74(1) of the *Financial Services and Markets Act 2000* (FSMA), the FSA is required to maintain an official list. Under sections 74(4) and 96 of that Act, the FSA may make Listing Rules governing the admission of securities to the official list and specifying the requirements on companies and other entities which list securities.

The clause will allow the Government to create a role for the Review Panel in checking the financial information contained in some of the documents which are required to be produced periodically under Listing Rules: namely, the half yearly (interim) report and the annual report. Currently, the FRRP checks the annual reports of Companies Act companies only (it performs a similar function under Northern Ireland companies legislation). The clause thus allows the Secretary of State to extend the scope of the FRRP's activities in two directions:

- she may appoint the Review Panel to look at interim reports and any other periodic reports required by Listing Rules, in addition to annual reports;
- she may appoint the Review Panel to look at annual and interim reports of entities which are on the official list but are not Companies Act companies; this covers entities whose securities are listed in the UK but which are not UK companies, such as some UK building societies, as well as overseas companies and other entities. By virtue of *subsection (5)*, the body may be appointed in respect of certain classes of issuer only, and in respect of certain types of reports and accounts. For example, the power could be used to extend the Review Panel's remit to cover the accounts of overseas companies which have a primary listing in the UK, and the accounts of UK issuers which are not companies but which issue equities or domestic debt.

The clause also allows the FSA to refer individual cases which may not fall within the Review Panel's remit (for example issuers of specialist debt) to the Review Panel for it to review. The FSA would conduct their own assessments and refer cases to the Review Panel only where they identified a risk in respect of the reports and accounts.

The clause is drafted to allow maximum flexibility in these regards: ongoing negotiations in Europe (for example in the Committee of European Securities Regulators, and on the

Transparency Directive) and internationally (on international accounting standards) may have an impact on the precise remit which will be set out in the order.

The Review Panel's function under this clause will be to check that the accounting information contained in the accounts and reports complies with the accounting requirements of the Listing Rules, and to inform the FSA of any conclusions it reaches. The FSA will then decide what further action should be taken, and has a range of sanctions available to it under FSMA 2000.

Debate

The Minister neatly summed up the whole purpose behind this complicated clause when he said:

> That is why we need Clause 14. We need the markets to know that while the FSA keeps overall responsibility for enforcing the listing rules, it will for the first time be able to use the FRRP's expertise in checking accounts against the accounting requirements of those rules.[75]

The legislative complexity derives from bringing together two sets of regulations (company law and financial services law) and provding some sort of pathway and cooperative element between them. The matter of costs exercised their Lordships, as the FSA would appear to have a free rein to pass on investigations to the FRRP. Estimates of the budget of the FRRP are that it will rise from £2.8 million to around £12 million by 2006.[76] It has been the experience so far that the cost of the financial regulation system has been higher than was first predicted. Some of their Lordships thought that the £12 million figure did not look very substantial compared to the tasks being given to it.

Clause 15 The effect of this clause is that the Review Panel will have the same power, and the same access to IR information, in respect of its activity under *clause 14* (checking interim reports and reporting to the FSA) as it will when exercising its remit under section 245C of the Companies Act 1985 (checking annual reports of Companies Act companies).

Debate

Debate on this clause was remarkable solely for the exchange on its complexity. Lord Hodgson of Astley Abbots, for the opposition, remarked:

> Within the first three subsections of Clause 15 there is reference to no fewer than seven different pieces of legislation—two different Acts of Parliament and five different statutory instruments. To understand the relevance of the first 20 lines of this clause one would have had to have absorbed five different sections of the

[75] Lord Sainsbury, 22 March 2004 c230GC
[76] ibid c234GC

> Companies Act 1985, checked to see whether they have since been updated in the Companies Act 1989, and then apply them to three of the previous clauses of this Bill. Additionally, the same would have to be done with five different paragraphs from the Companies (Northern Ireland) Order 1986.
>
> When I first discussed this Bill at Second Reading I said that we should measure the Government's proposals against four tests—the third of which was that the proposals were clear and workable. Clause 15 would not pass such a test. The clause does not modernise and reform company law, as Patricia Hewitt put it; it merely has the effect of highlighting just how imperative it is to initiate a complete overhaul of company law. I invite the Minister to explain the clause without, in the words of that famous panel game, deviation, repetition or hesitation.[77]

The Minister, Lord Evans of Temple Guiting's, response was part sympathy part threat:

> I will rise to the challenge if the noble Lord, Lord Hodgson, wants me to. However, I had better warn him that I have a long speaking note followed by a defensive briefing, the first page of which reads, "There must be easier ways of saying this". Later, if he is still interested, I have another page entitled, "I don't understand a word of this provision. Take me through it subsection by subsection".[78]

Clause 16 provides the Secretary of State power to make grants to 'bodies concerned with accounting standards'. It was not discussed in Committee. **Clause 17** provides for the Secretary of State to levy companies and the accountancy firms to pay for the regulatory system led by the Financial Reporting Council. It is intended that the costs of regulation will be met in equal part by the Government, listed companies and by the profession. There was only limited discussion of the clause. **Clause 18** was a new clause introduced by the government on Report. It exempts a body receiving a grant under clause 16, its subsidiary bodies and their members, officers and staff from liability in damages for things done or not done for the purposes of, or in connection with, the activities listed in *clause 16*. It supersedes two existing exemptions: that enjoyed by a body authorised to apply to the courts in respect of defective accounts (currently the FRRP) under s245C(6) of the *Companies Act 1985*; and that available to a body to which the Secretary of State delegates her functions under Part 2 of the *Companies Act 1989* (expected to be the Professional Oversight Board for Accountancy of the FRC) under s48(3) of that Act. These two exemptions are therefore repealed.

Clause 19 - Power to require documents and information

This clause replaces section 447 of the *Companies Act 1985*. That section contains the powers which are used to carry out the majority of company investigations. In almost all

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77 ibid c239GC
78 ibid c239GC

cases, investigations under section 447 are carried out by DTI investigators authorised for that purpose by the Secretary of State. Their investigatory powers currently comprise:

- a power to require a company to produce documents specified by the investigator;
- where any other person appears to be in possession of documents which the investigator could require the company to produce, a power to require that person to produce those documents;
- a power to copy or take extracts from documents produced;
- a power to require an explanation of documents produced from the person who produced them or from any past or present officer or employee of the company; and
- where a person does not produce specified documents as required, a power to require information from that person about their whereabouts.

These powers are limited in ways which are capable of slowing down investigations and undermining investigators' ability to uncover the facts, particularly in cases where companies are prepared to do no more than comply strictly with their legal obligations, narrowly interpreted. First, there is no general power to require answers to questions which are unrelated to documents produced. Second, while it is clear that persons other than the company under investigation can be required to produce company documents in their possession and other documents held to the order of the company, the question of what other kinds of documents they can be required to produce is open to argument. The primary purpose of *new section 447* is to remove these limitations.

Existing section 447 also confers document-gathering powers on the Secretary of State. The Secretary of State has powers to direct a company to produce documents, to require other persons to produce documents (where she could require the company to produce them), to copy or take extracts from documents produced, to require explanations of documents produced from certain persons and to ask where documents are which have not been produced. The same limitations apply to the Secretary of State's powers as apply to those of investigators, but the main purpose of *new section 447* in this regard is only to give the Secretary of State a new, general power to require answers to questions from companies.

Under existing section 447, the Secretary of State can exercise her powers (including her power to authorise the exercise of powers by an investigator) where there is "good reason" to do so. This restriction allows the Secretary of State to act except on a trivial or irrelevant ground, and accordingly does not add to the restrictions that apply to the exercise of the Secretary of State's power under general administrative law provisions as a general rule.

Debate

The debate began with a discussion as to whether the new formulation of existing powers gave the Secretary of State too much power. The Minister, Lord Sainsbury, thought not:

> Although it may appear at first sight that the Secretary of State can use her powers under new Section 447 on a whim, and for no good reason at all, she is of course constrained in the exercise of these powers, as she is in the exercise of her existing powers, by the usual principles of administrative law. Her use of these powers can be challenged in the courts. The courts can be asked to determine, in particular: whether a decision to use these powers was within the legal scope of the provision; whether it was made in pursuit of the policy and objects of the Act; and whether it was reasonable. As a matter of administrative law, the Secretary of State will need a good reason to act because she cannot act lawfully if she has a bad reason. She cannot act on grounds which are trivial, irrelevant or irrational.[79]

The same concern was expressed over the Secretary of State's powers to demand to see documents both of the company and about it held by third party companies such as its auditors or accountants and how this power would impact upon professional duties of confidentiality. The opposition relied extensively upon briefings from the Law Society to outline these points.[80] The Minister replied that under the new law no documents could be required to be surrendered if they "could be withheld in civil proceedings on the grounds of legal professional privilege".[81] Despite this the opposition 'remained to be convinced that the increased powers for the DTI investigators are necessary'.[82]

Clause 20 - Protection in relation to certain disclosures

Statutory powers are not generally used by the DTI for enquiries carried out when vetting complaints about companies. The vetting process is non-statutory and its purpose is to establish whether a formal investigation (usually under section 447) is appropriate. The process therefore precedes the appointment of investigators with formal powers. In the vetting situation, there are no statutory provisions guaranteeing immunity from legal liability to a person who, in breach of a contractual or other duty of confidence, provides information in response to an informal DTI enquiry.

This is not necessarily to say that a person would not have a defence to a breach of confidence claim in such circumstances. However, the aim of this clause is to remove the potential deterrent of having to argue such a defence so that individuals and businesses feel more able to volunteer information in response to an informal DTI enquiry. The clause was not debated.

Clause 21 - Power to enter and remain on premises

It is often very useful for inspectors or investigators to be able to gain access to company premises or to other premises where records of the company are held or its business is

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[79] ibid c247GC
[80] ibid c249GC
[81] ibid c252GC
[82] Lord Hodgson, ibid c253GC

carried on. In particular, it enables inspectors or investigators to exercise more effectively their powers to require the production of documents and information under sections 434 and 447 of the *Companies Act 1985*. More generally, it also offers inspectors and investigators the opportunity to see the company's operations in practice.

Inspectors have relied for this purpose on their power to require, and the directors' duty to give, reasonable assistance in connection with an investigation, which are provided for by section 434. But investigators authorised under section 447 have no similar power and can only enter and remain on premises by agreement with the company. They may be asked to leave the premises at any time and would be trespassing if they did not do so. *Clause 21* therefore inserts *new sections 453A* and *453B* into the *Companies Act 1985* to provide powers for inspectors and investigators to require access to and to remain on premises which they believe are used for the purposes of the business of the company they are investigating.

Debate

Again the focus of the opposition's amendments was that the new powers gave too much latitude to the inspectors.

> As currently drafted, the new clause increases considerably the search and entry powers under Section 448 of the Companies Act 1985. Under the existing powers, an inspector or investigator must obtain a search warrant on the basis of information given on oath by, or on behalf of, the Secretary of State, or by the investigator. The new powers are exercisable unilaterally by the inspector or investigator, if he thinks that they will materially assist his investigation of a company. In those circumstances, we believe that the use of the word "thinks" is too wide a definition and thus open to abuse. The test of reasonable belief is well established in law and would be a better test in the circumstances. I beg to move.[83]

Lord Sainsbury pointed out that the inspectors were subject to the general restraints imposed by administrative law and:

> We are not seeking to give inspectors and investigators unlimited powers or to lay down entirely subjective tests for the exercise of those powers which would render such exercise effectively unchallengeable. But it would be undesirable to write express tests of reasonableness into this clause. That would have an uncertain effect on other powers in this part of the Bill which are not expressly qualified in that way.
>
> Perhaps I should add that the power is not one of search and seizure, and no force can be used. That is why there is no question of a search warrant. In the light of what I have said, I ask the noble Lord to withdraw the amendment.[84]

[83] Lord Hodgson, ibid c257GC
[84] ibid c258GC

The remainder of this part of the Bill dealt with powers of entry to premises and minor consequential amendments. Neither was debated.

Part 2 of the Bill establishes community interest companies (CIC).

B. Part II: Community Interest Companies

1. Introduction

The explanatory notes to the Bill set out what the Bill hopes to achieve:

> *Part 2* of the Bill establishes a new type of company, the community interest company, for use by social enterprises wishing to operate as companies. This Part of the Bill also establishes the Regulator of Community Interest Companies ("the Regulator"), whose role will be to maintain public confidence in the CIC model.
>
> The CIC is intended to be used by non-profit-distributing enterprises providing benefit to a community. Such businesses are presently active in areas such as childcare, social housing, leisure and community transport. Many of them already incorporate as companies, either as a company limited by guarantee ("CLG") or a company limited by shares ("CLS"). The special characteristics of the CIC are intended to make it a particularly suitable vehicle for some types of social enterprise - essentially, those that wish to work for community benefit within the relative freedom of the non-charitable company form, but with a clear assurance of non-profit-distribution status.
>
> Companies that are formed as, or become, CICs will continue to be subject to the general framework of company law. In particular, CICs and directors of CICs will have to comply with their obligations and duties under the Companies Acts and the common law, as modified by this Bill. The CIC will be a new variant of existing forms of company. It can take the form of a CLG or CLS, and existing companies limited by guarantee with a share capital will also be able to become a CIC. CICs will be registered as companies with the registrar of companies in the usual way, and will be subject to the usual regulatory constraints and powers associated with company status, including the oversight of the Department of Trade and Industry's Companies Investigation Branch.
>
> The distinguishing features of the CIC will be:
>
> in order to become a CIC, a company will have to satisfy a community interest test, confirming that it will pursue purposes beneficial to the community and will not serve an unduly restricted group of beneficiaries. The test is whether a reasonable person could consider the CIC's activities to benefit the community - it is therefore wider and simpler than the charitable test of public benefit;

companies of a particular description may be excluded from CIC status by regulations; it is anticipated that political parties, companies controlled by political parties, and political campaigning organisations will be excluded in this way;

CICs will not be able to have charitable status, even if their objects are entirely charitable. However, charities (and all other organisations except political parties) will be able to establish CICs as subsidiaries;

each CIC will be required to produce an annual community interest company report containing key information relevant to CIC status. The report will be placed on the public register of companies;

CICs will have an asset lock - that is, they will ordinarily be prohibited from distributing any profits they make to their members;

however, it is intended that regulations will allow CICs that are limited by shares to issue dividend-paying "investor shares". The dividend payable on such shares will be subject to a cap;

when a CIC is wound up, its residual assets will not be distributed to its members. Instead, they will pass to another suitable organisation that has restrictions on the distribution of its profits, for example another CIC or a charity;

the Regulator will approve applications for CIC status, receive copies of the community interest company reports and police the requirements of CIC status, including compliance with the asset lock. He will have close links with the registrar of companies. The key role of the Regulator will be to maintain public confidence in the CIC model. He will aim to impose the minimum necessary regulatory burden on CICs, but will have powers to investigate abuses of CIC status and to take action where necessary, for instance to remove directors, freeze assets or apply to the courts for a CIC to be wound up. He will also set the cap on CIC dividends.[85]

The social enterprise sector is already well established in the UK. It is represented by the Social Enterprise Coalition (SEC) which has a considerable amount of material about the sector on its website at: http://www.socialenterprise.org.uk. SEC defines social enterprises as:

Social enterprises are businesses that trade in the market with a social purpose. They use business tools and techniques to achieve social aims and include an incredibly wide range of organisations, for example co-operatives, development

[85] Explanatory notes available on DTI website at: Companies (Audit, Investigations and Community Enterprise) Bill [HL]

> trusts, community enterprises, housing associations, social firms, and leisure trusts.[86]

The examples given of well known social enterprises include Welsh Water, Café Direct, The Big Issue, the Co-Operative Group and Loch Fyne Oysters. A recent report by the London Business School found that:[87]

- 7% of the UK population are engaged in some form of community or social entrepreneurial activity (SEA).
- SEA activity was highest in London and lowest in the North East.
- Women are far better represented in SEA than in traditional entrepreneurial activity.
- Compared to levels in the white British population, social enterprise start up activity is four times higher in the Black population, three times higher amongst mixed ethnic origin individuals and more than twice as high amongst Bangladeshi, Pakistani and Indian people
- SEA has become more economically significant in recent years. The average SEA start up employs more people and has a higher turnover than the average mainstream start up. Furthermore, the clear trend is for work in this sector to be paid rather than voluntary.

Also of interest in the context of the Bill is the DTI report from the consultation process – *Enterprise For Communities: Proposals For a Community Interest Company* available on the DTI's website at: http://www.dti.gov.uk/cics/pdfs/cicreport.pdf. Finally, in February 2004, the Department produced a set of draft regulations which it was envisaged would follow the enactment of the Bill. These were published, together with explanatory notes on these draft regulations, and have been subject to amendment throughout the course of the Bill's progress in the Lords due to amendments made to the Bill. The regulations, as published, are available at: http://www.dti.gov.uk/cics/pdfs/DraftCICregulations.pdf and the explanatory notes are available at:
http://www.dti.gov.uk/cics/pdfs/ExnotesondraftCICregulations.pdf .

2. The Bill

Clause 24 - Community interest companies

This clause establishes the concept of the CIC. It provides that the CIC is to be a new type of company ('company' here meaning a company registered under the Companies Act 1985 or a former Companies Act). New organisations applying to be incorporated as a CIC will incorporate as a company limited by shares (CLS) or a company limited by

86 See website

87 London Business School, *Social Entrepreneurship Monitor UK 2004*

guarantee (CLG). Existing registered companies limited by shares or guarantee can also apply to become CICs, and a company limited by guarantee having a share capital can convert to a CIC.
Even if a CIC has charitable purposes, it will be treated as not being established for such purposes, so it will not be a charity either in England or under Scottish law. Therefore, CICs will not be subject to the benefits or obligations of charitable status, nor will they be subject to regulation by the Charity Commission or the charitable jurisdiction of the High Court.

Debate

The main issue debated on this clause was whether a CIC should be given the opportunity to become a charity. In favour was the argument that there was no reason for denying charities what they would find most useful; charities already had a range of legal formats that they could adopt, another one would present no legal disadvantages; grant giving bodies find it easier to make grants to charities. Lord Phillips of Sudbury (Liberal Democrat) claimed that the Charity Law Association and the Social Enterprise Coalition[88] both supported the principle that CICs should be able to be charities.[89] Lord Glentoran (Conservative) illustrated his support by saying:

> As the noble Lord, Lord Phillips, has already pointed out, it is something of an anomaly for CICs to be denied charitable status. That is particularly so when subsection (3) of Clause 23 reads:
>
> > "A community interest company established for charitable purposes—
> >
> > (a) is to be treated as not being a charity".
>
> That is almost a paradoxical statement.[90]

The Minister, Lord Sainsbury, went into great detail explaining the contrary view:

> In a nutshell, the provision on CICs and charitable status in Clause 23 is intended to ensure that there will be a clear distinction between this new type of company on the one hand, and charities on the other. I should emphasise that the CIC is not designed for use by charities, and it is not a part of the revision of the charity law which our colleagues in the Home Office are preparing. However, it is part of the same overall process of modernising the legal environment for the voluntary and social enterprise sectors. It will certainly not remove any of the existing options for charities, which will of course be updated and improved in the forthcoming draft charities Bill.

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88 In fact the SEC was silent on this point, see HL Deb 7 July c850
89 HL Deb 25 March 2004 c318GC
90 ibid c319GC

> The key point here is that the CIC has been designed as an alternative to charitable status. We expect that CICs will wish to use the freedom of company law to pursue a wide variety of purposes, some of which may be charitable, while others will not. CICs will certainly wish to trade and to behave as enterprises, in a way that is difficult for charities. They will have the freedom to pay their directors and to change the nature of their activities, subject to the requirements of this part of the Bill.
> […]
> We have concluded that a change of policy, to allow CICs to have charitable status, would not be of benefit to the charitable sector. Nor would it carry any benefit for social enterprises which are not charitable, who are the intended users of the CIC. However, it could adversely affect the value of the CIC to that latter group. It would also be likely to raise increased concerns about confusion between CICs and charities.
>
> That seems to me the nub of the argument—that in practice it is very difficult to see what the advantages of the amendment would be to charities. They have perfectly good forms in which to do what is needed, and it would require quite a distortion to the CIC form to make it charitable. Against that, one has to weigh the unpredictable, which is where confusion might come in. For those charities that wish to use the company form to incorporate—and the noble Lord, Lord Phillips, has said that there are many charities which welcome the certainty of company law—the CIC will offer no practical advantage over existing forms of company. The fact that it offers a statutory asset lock backed up by regulation will be of no value to charities, because charitable status already provides that.
> […]
> In practice, of course, a charity that wanted to use CIC status would face the prospect of meeting three new sets of requirements: first, the reporting and accounting requirements of being a company; secondly, the requirements of CIC status; and, finally, the charity regulation regime.
>
> The CIC proposals are designed to avoid unnecessary or overlapping regulation. But surely all these requirements, coupled with a lack of practical benefit to a charity from being a CIC, will deter any charity that might find the CIC brand of interest.[91]

The clause was agreed to.

Clause 25 - Regulator; and Schedule 3 - Regulator of Community Interest Companies

This clause creates the office of the Regulator and makes some general provisions about the Regulator's functions and the way in which they are to be carried out.

Debate

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91 ibid c321-323GC

Lord Glentoran (Conservative) listed 18 functions of the Regulator:

> The functions include: the provision of guidance and assistance; the setting of caps and limits on distributions and interest—although the Secretary of State appears to have quite broad powers to intervene; the determination of the eligibility of bodies to become, or cease to be, CICs; investigating the affairs of a CIC or appointing another to do so on his behalf; requiring a CIC to submit its accounts to an auditor appointed by the regulator; bringing civil proceedings in the name and on behalf of the CIC, for which he must indemnify the CIC against costs; appointing a director of a CIC by order, which cannot be removed by the company; removing or suspending a director of a CIC; appointing a manager of a CIC and supervising him; transferring CIC property to the official property holder or requiring a CIC to do so; preventing disposals of CIC assets; preventing debtors making payments to CICs; restricting by order the transactions which may be entered into by a CIC and the nature and amount of payments they may make, including the ability to inhibit any payment or transaction made without the consent of the regulator; transferring shares in a CIC by order; removing members of a CIC company limited by guarantee, or appointing new ones; petitioning for the winding up of a CIC; applying to have a dissolution or striking-off in relation to a CIC withdrawn; and releasing any information received to any other public authority for use in connection with its duties. That is 18, which we have listed. The exercise of powers 4 to 18 is limited by the requirement that the regulator should make use of them,
>
> "only to the extent necessary to maintain confidence in CICs".
>
> There is an additional restriction on the use of powers 7 to 13, which can be used only when the CIC has met "the company default condition". That is, first, that there has been misconduct or mismanagement; secondly, the CIC's property, or its proper application, must be secured; thirdly, the CIC is not satisfying community interest tests, or if the company has community interest objects but is not carrying them out; and, finally, powers 14 and 15 may be used only when the CIC appears to the regulator to be an excluded company, ie ineligible for the status of CIC.[92]

Lord Glentoran made the point that there was nothing in the Bill which would indicate the criteria that would be used to appoint such an important figure for the new forms of company; nor was there any mention of the salary or term of office expected of the Regulator. The Minister's reply contrasted quite strongly with the opening remarks of Lord Glentoran:

> The noble Lord, Lord Glentoran, was also interested in the onerous powers that the regulator would have. It is our view that the regulator will operate with a light touch. We will set up a small-scale operation that will primarily register CICs,

92 ibid c329GC

> receive copies of the community interest company reports and investigate where there are stakeholder concerns.
>
> The manner in which the regulator can discharge his functions and exercise his powers is restricted by the requirements set out in subsection (4) and by the general principles of administrative law. The supervisory powers are further restricted by the requirements in Clause 38, in particular the requirement that the regulator must only exercise those powers to the extent necessary to maintain confidence in CICs. The powers available to the regulator are necessary to ensure that the asset lock has integrity and that CICs can be made to comply with their obligations under the Bill. This is vital to ensure confidence in CICs and the protection of the community interest.[93]

The Minister confirmed that details such as length of term of office and salary had not been decided upon except to the extent that the office would not continue beyond ten years and the salary would be that of "senior – but not the most senior- civil servants".[94]

Despite the opposition's concern at the onerous duties which the Bill placed on the Regulator they were keen to add a further role: namely that the Regulator should be able to give general advice to groups seeking to become CICs rather than be limited to factual answers as to their possibility of becoming one. This was based upon the experience of previous regulators of financial services who were unable to give advice at the outset and then had to admonish companies when they went wrong. The minister claimed that *clause 25* allowed the Regulator to give advice in several areas and that advice was available from other sources too, he quoted the establishment of the Skoll Centre of Social Entrepreneurship at the Said Business School at Oxford.

Clause 26 - Appeal Officer; and Schedule 4 - Appeal Officer for Community Interest Companies

This clause creates the office of Appeal Officer. The Appeal Officer's role is to hear appeals against decisions of the Regulator. Only those decisions against which a right of appeal is provided in the Bill, including regulations made under the Bill, or in other legislation, may be the subject of an appeal to the Appeal Officer. It is intended that additional rights of appeal to the Appeal Officer will be included in regulations relating to the distribution of assets on winding-up (*clause 29*) and approvals of changes of objects (*clause 30(6)*). The Appeal Officer will be able to consider appeals on matters of law and of fact. The Appeal Officer will be able to report his findings on the facts and his rulings on the law to the Regulator, who will then be obliged to review the decision in the light of those findings and rulings. The decisions of the Regulator will, of course, also be subject to judicial review.

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93 ibid c334GC

94 ibid c333GC

Debate

Criticism of the clause in Committee focussed mainly on the fact that the Appeal Officer could challenge the Regulator only on issues of fact. Their Lordships noted that both the Charity Law Association and the Law Society made this criticism. The Law Society noted:

> "Clause 25(4) restricts the grounds on which an appeal to the Appeal Officer against a decision or order of the Regulator to a material error on the part of the Regulator as to the facts: we query whether such a restriction is justified given the likely circumstances of any appeal by (for example) a subscriber under clause 33(10) or the CIC under clause 35(10), when matters of law (such as the interpretation of the Bill or regulations made under it) may be highly relevant".

The Government considered the representations made by the opposition and subsequently tabled amendments on Report which had the effect of allowing the Appeal Officer to consider appeals on matters of law as well as on matters of fact.[95]

Clause 27 - Official Property Holder; and Schedule 5 - Official Property Holder for Community Interest Companies

This clause creates the office of Official Property Holder (OPH), which is to be filled by one of the Regulator's staff. Provisions relating to this office are set out in *Schedule 5*. The OPH's functions are to hold property where the Regulator has made an order under *clause 46(1)* vesting that property in the OPH, so as to safeguard it for the community interest.

The OPH shall hold property as a trustee, vested in him on trust for its rightful owner. He may release or deal with property that he holds so as to give effect to the rights of third parties in that property, or to comply with the request of various office-holders appointed under insolvency legislation in respect of the CIC. Otherwise, the OPH may only release or deal with the property in accordance with the directions of the Regulator.

Debate

The issues raised concerned the role of the OPH in the case of the insolvency of a CIC. Under the Bill the assets of a CIC are locked in and can only be released to another CIC or charity, but this has implications for other creditors who might therefore not be paid in the circumstances of an insolvency. The Minister responded to this point in his speech, he commented that:

95 HL Deb 7 July 2004, c865

> At this point I need to say a few words about how the official property holder will interact with the company insolvency regime. This is a point which Amendment No. 111 addresses. One of the principles underlying this part of the Bill is that CICs should resemble other companies as far as possible in terms of the way in which company law applies to them. In the particular case of insolvency, the Government intend that company insolvency law should apply to CICs in exactly the same way as it does to other companies, except in the case of the treatment of residual assets, which is governed by Clause 28. This parity of treatment is important, because it is vital that third parties feel confident that they can trade with CICs with the full protection that company law provides to creditors in the event of insolvency.
>
> Amendment No. 111 seeks to ensure that the regulator's ability to transfer property to the official property holder and to give him instructions does not undermine the normal processes that take place on insolvency. I am grateful to the proposers of the amendment for identifying the possible need for a refinement to the drafting in this area, which has also been identified by others including the Charity Law Association.[96]

The Government introduced amendments addressing this issue on Report.[97]

Clause 28 - Cap on distributions and interest

This clause provides for limits to be placed on the ability of CICs to make distributions to members and interest payments on debentures and debts. It also provides for the role of the Regulator in setting these limits. It therefore forms an important part of the 'asset lock', which is one of the distinguishing features of the CIC.

Debate

Also raised in the debate on this clause was the issue of the remuneration of the directors of CICs. The Government rejected the proposal that there should be prescriptive requirements in the regulations. Instead the general power of the Regulator to ensure that CICs were acting in an appropriate manner was considered sufficient.

Clause 29 - Distribution of assets on winding up

This clause provides for regulations to impose restrictions on the distribution of a CIC's assets on winding up, so that the Regulator can ensure that such assets are preserved for community benefit. The restrictions will only apply to any assets which remain after the company's liabilities to creditors have been satisfied. It is intended that regulations will provide that any such assets may only be transferred to other CICs or charities, as these

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96 HL Deb 25 March 2004, c354GC
97 HL Deb 7 July 2004 c867

organisations have an asset lock. Regulations may in due course allow the transfer of such assets to an industrial and provident society ("IPS") with an asset lock, once regulations establishing such an asset lock for IPSs have been made under the *Co-operatives and Community Benefit Societies Act 2003.*

Debate

Debate on the clause began with a Government amendment reflecting in part the concerns expressed in the debate on the insolvency procedures of CICs.

Under *clause 29* when a CIC is wound up, any assets remaining after its creditors are satisfied will continue to be used for the benefit of the community. The only difference is a change in the way in which residual assets are treated in a winding-up. The creditors of a CIC that is being wound up should continue to have the same rights as the creditors of any other company. Lord Sainsbury made the policy point that:

> Any suggestion that the rights of the creditors on the winding-up of CICs could be undermined might reduce the willingness of people to invest in, and trade with, community interest companies. We had no intention of using the power in this way. The amendment is therefore intended to cut back the power provided by Clause 28, so that it can be used only to affect what happens to those assets remaining after all the creditors of the company have been paid. I beg to move.[98]

Clauses 30 to 38

These clauses deal with the internal organisation of a CIC, its administration, names etc and the way in which a CIC can be set up and how different companies can convert into CICs. Most of these clauses were dealt with with a minimum of debate. Conversely, **clauses 50 to 54** deal with the reverse procedure, how CICs convert into charites or industrial provident societies.

Clause 39 - Supervision by Regulator Conditions for exercise of supervisory powers

This clause restricts the circumstances in which the Regulator is able to exercise the supervisory powers conferred by *clauses 40* to *49*. It constrains the Regulator in three respects. First, *subsection (1)* imposes a general requirement on the Regulator, to make use of these powers in such a way that his supervisory activity is not greater than is needed to maintain confidence in CICs. Second, *subsection (2)* prevents the Regulator from exercising the powers listed in that subsection unless the company default condition is satisfied. The purpose of this provision is to ensure that the Regulator can only use these relatively intrusive powers where it is necessary to do so and there are particular grounds for doing so. The grounds are set out in *subsection (3).*

98 HL Deb 29 March 2004, c373GC

One of the four triggers of the company default condition relates to community interest objects (*subsection (3)(d)*). These are defined in *clause 33(3).* If they wish, CICs will be able to state wide objects in their memorandum, such as commercial trading objects. Alternatively, they may choose to limit themselves to 'community interest objects' that only include specific activities for the benefit of the community. A CIC may wish to do this, for instance, to demonstrate to potential investors, grant-givers or other stakeholders that it is restricted to particular activities. If a CIC chooses to limit its objects in this way, then a failure to carry on activities in pursuit of those objects will be sufficient grounds to trigger the company default condition.

The third constraint is applied by *subsection (4).* This prevents the Regulator from exercising the power to order a transfer of shares or other membership interests in a CIC under *clause 47* unless the CIC in question is an excluded company within the meaning of *clause 33(6).* It is intended that regulations will provide that companies subject to the control of a political party will be excluded companies (see also the note on *clause 33(6)* above).

Debate

This clause was described as ‘an extraordinary piece of psychology’[99] by the opposition who had general concerns over the extent of the ‘light touch’ regulation promised by the Government and the fact that a lot of the CICs would be run by ‘lay activists’.[100] By contrast Lord Sainsbury for the Government, described the clause as:

> We do not believe that the provision is unnecessary, nor that it is an "extraordinary bit of psychology". It is an important over-arching provision that is intended to stop the regulator using his powers to a greater degree than is necessary. It is the single most important means of ensuring a proportionate approach to the use of the regulator's supervisory powers. In fact, it is a light-touch regulation. The Government attach great importance to ensuring that the regulation of CICs is done in a proportionate way. That is not just because it is the right approach in principle. It is also vital in practice because, if the regulatory regime is seen as being too onerous, that will be bound to deter the use of this new type of company.
>
> Without subsection (1), the regulator would be able to use his powers wherever the rest of Clause 38 permitted him to do so, even if it was not necessary to do so in order to maintain confidence in CICs. For instance, a relatively modest breach of the company default condition set out in subsection (3) might not be sufficiently material to affect confidence in the CIC form, but could be enough to justify the use of a wide range of supervisory powers if subsection (1) were deleted.[101]

[99] ibid c406GC
[100] ibid c406GC
[101] ibid c409GC

Clauses 40 to 49

These clauses deal with the various specific powers that the Regulator has at his disposal and when they can be used. He may investigate the affairs of a CIC (clause 40), require an audit of the accounts (clause 41), initiate civil proceedings (clause 42), appoint and remove directors (clauses 43 and 44). There was very little debate on these clauses.

Clause 55 - Fees

This clause provides for regulations to set the fees that may be charged by the Regulator (*subsection (1)*). They may provide for the registrar of companies to collect fees on behalf of the Regulator, so that only a single payment would need to be made in respect of matters that involve both the Regulator and the registrar (*subsection (2)*). An example would be the formation of a company as a CIC, where the Regulator applies the community interest test and the registrar of companies registers the company. In addition, the clause enables the Regulator to charge fees (without the need for regulations) for providing services which he is not legally required to provide (*subsection (3)*). However, the Regulator cannot use the power under *subsection (3)* to charge fees for the provision of guidance of general interest.

Debate

With the debate on fees it is helpful to have in mind the estimated costs of the Regulator's office. These are also set out in the explanatory notes:

> PUBLIC SECTOR FINANCIAL COST AND PUBLIC SECTOR MANPOWER EFFECTS
> The Bill will involve some new expenditure from public funds. One element of expenditure will be the costs of establishing and running the Regulator of Community Interest Companies. This is intended to be a small organisation, probably co-located with Companies House in Cardiff. We estimate the Regulator's annual running costs at approximately £400,000, plus exposure to legal liability estimated at £50,000 per year. Estimated non-recurring set-up costs include:
> i) recruitment costs and salaries for a 'shadow' regulator and skeleton staff in the period before the Regulator begins operations (estimate £125,000);
> ii)accommodation fit-out, new IT systems, IT and other office equipment, website development, publication design and production costs, and provision for contracting out production of some initial guidance to experts from the social enterprise sector (estimate £225,000);
> iii) establishing information systems and changing existing (including Companies House) systems (estimate circa £150,000).
>
> This gives a total estimate of set-up costs in the region of £500,000.

The Regulator's income will come in the first instance from the registration fees, of provisionally £20, for CICs and for filing of accounts (£15).[102] It is expected that there will be public sector subsidy until the number of applications builds up. The clause allows the Regulator to charge for other services, although these services, nor the fees are not specified in either the regulations or the Bill. Fee receipts will be paid to the public purse. The opposition amendment was generally aimed at limiting the circumstances in which fees could be levied in case they inhibited the uptake of CIC membership – 'killing their (the government's) own goose' as Lord Philips of Sudbury put it.[103] The Minister, Lord Evans, made it clear that allowing the Regulator to charge for services was helpful both as a way to provide a service to CICs and to offset the extent of the public sector subsidy.

[102] Lord Evans of Temple Guiting, ibid c421GC
[103] ibid 420GC

IV Annex:

A. Review of the Regulatory Regime of the Accountancy Profession

Introduction and executive summary

1.1 The consultation document "Review of the Regulatory Regime of the Accountancy Profession" was published on 9 October 2002. The review was announced by Patricia Hewitt, Secretary of State for Trade and Industry in her oral statement on the interim report of the Co-ordinating Group on Accounting and Auditing issues (CGAA), which was set up in response to the corporate failures of WorldCom and Enron in the United States.

1.2 This review was an opportunity to review, strengthen and simplify the UK framework against the background of changing national and international expectations. Its main purpose has been to look at the way the accountancy and audit professions are currently regulated, and to consider whether any improvements should be made to make the system more effective. The full terms of reference are at Annex A.

1.3 The review team is very grateful for the constructive and unstinting help it has received during the course of its work from the Accountancy Foundation bodies, from the Financial Reporting Council, from the professional self-regulatory bodies and from a wide range of other stakeholders and UK and overseas regulatory organisations. This input, and the views expressed in the 45 written responses to the consultation document, has greatly informed the team's thinking on the issues.

1.4 In summary, our task was to consider:

- what regulatory functions are needed, who should carry them out, and how they are funded, including the scope for simplifying the current arrangements;
- whether the existing balance between professional self regulation and independent regulation is the right one, and whether there should be a statutory basis for regulation;
- the case for taking a different approach to the regulation of the accountancy profession in general and to the regulation of auditors in particular.

1.5 This task was undertaken as one strand of a wider workstream looking at the consequences of US corporate failures to ensure that the UK regime provided appropriate protections against anything similar happening here. Other strands have included the work of the Co-ordinating Group on Accounting and Audit (CGAA) which has considered a range of issues around the regulation of the profession and the role of the auditor, including auditor independence, transparency and the enforcement of accounting standards. The CGAA is reporting at the same time as this review. Independent reviews have also been carried out into non-executive directors (under Derek Higgs) and into audit committees (under Sir Robert Smith) and have reported recently.

1.6 Our proposals also take into account the international context. Other jurisdictions have been reviewing arrangements for regulatory oversight. The United States has introduced tough external regulation under the Sarbanes-Oxley Act. Canada is introducing a regulator with extensive powers, including a national inspections unit as independent monitor of major audits. Irish and Australian solutions are based mainly on oversight rather than on full regulatory control, but all these jurisdictions share an underlying purpose of protecting the credibility of financial information in order to maintain investor confidence in capital markets.

1.7 On the international regulatory front, the International Organisation of Securities Commissions (IOSCO) has published a statement of principles for auditor oversight. The International Audit and Assurance Board is committed to moving towards common audit standards by 2005; the European Commission is discussing how to ensure that members states apply international standards on auditing, and is also due to issue a statement on audit supervision in the near future. The Government strongly supports the European move towards International Accounting Standards; and the DTI is currently considering the response to its consultation on the Regulation on the adoption of such standards. All these developments have implications for the current purpose and structure of the Accountancy Foundation (and of the Financial Reporting Council whose responsibilities are not the subject of our remit).

1.8 The UK's existing regulatory system is widely acknowledged to be among the best in the world. During the course of our work, we found no evidence that the system was seriously flawed. However, there were concerns about the perceived independence of key aspects of the current arrangements, and about the complexity of the current Accountancy Foundation structure. We think there is scope further to strengthen the independence of the system for the regulation of audit and to achieve a clearer, more authoritative and more transparent regulatory structure. In particular, we recommend that:

- the Financial Reporting Council (FRC) should take on the functions of the Accountancy Foundation to create a unified and authoritative structure ("the independent regulator") with three clear areas of responsibility; the setting of accounting and audit standards; their enforcement or monitoring; and the oversight of the major professional accountancy bodies;
- the independent regulation and review of audit should be significantly strengthened. Specifically, that responsibility for setting independence standards for auditors and for monitoring the audit of listed companies and other significant entities should be transferred from the professional accountancy bodies to the independent regulator.

There would be consequential changes to the responsibilities of the boards of the Accountancy Foundation.

1.9 We recognise that this would represent a further change early in the life of the Accountancy Foundation. However, we think that our proposals would promote public confidence in the regulation of accountancy in the UK and would maintain the UK system's leading international reputation in the light of wider reforms. If our proposals were to command support, it will clearly be crucial that the resulting framework is left in place for the foreseeable future, without further significant change.

1.10 Our proposals will carry costs, but the Review Team thinks that they would provide a net benefit in terms of increasing the independence, authority and efficiency of the regulatory process in the public interest.

Summary of recommendations

1.11 In summary, our full recommendations are:

(i) that the FRC should take on the functions of the Accountancy Foundation, creating a new body, referred to in this report as "the independent regulator". This option was widely supported in responses to the consultation. We consider that this would result in a simpler and clearer regulatory structure and would maximise co-ordination of related regulatory functions – in particular between the setting of accounting and audit standards. (Chapter 3, paragraph 3.7) *a.* **(ii)** that the independent regulator should have clear arrangements for accountability and transparency and should be outward facing in its role**. (Chapter 3)**

(iii) that the Auditing Practices Board should take over the professional bodies' responsibility for setting standards for independence, objectivity and integrity for auditors. Responsibility for setting all other ethical standards should remain with the professional bodies and should be overseen by an appropriate board within the independent regulator. (Chapter 4, paragraph 4.21)

(iv) that a new audit inspection unit should report to a board within the independent regulator. It would take over from the professional bodies responsibility for monitoring the audit of those entities whose activities have the greatest potential to impact on financial and economic stability – specifically listed companies and major charities and pensions funds. It would report to the successor board to the Review Board which, for the purposes of this report, we call the *Professional Oversight Board*. (Chapter 5, paragraph 5.17)

(v) that the Professional Oversight Board, as the successor to the Review Board, should retain its wider accountancy remit within a reformed structure, but that its primary focus should be oversight of audit, and this should be enshrined in the body's key objectives. (Chapter 7, paragraph 7.5)

(vi) that the Secretary of State should delegate her recognition role to the independent regulator and that this role should be assumed by the Professional Oversight Board. That is, recognition of professional supervisory bodies and qualifications for the purposes of the framework set out in the Companies Act 1989 for the supervision of the statutory auditor. (Chapter 7, paragraph 7.12)

(vii) that the long planned Investigation and Discipline Board should be brought into being without further delay to provide, as intended, a demonstrably independent forum for hearing significant public interest disciplinary cases. We consider it should become a subsidiary of the independent regulator and should be able to impose appropriate sanctions including removal of eligibility to audit. (Chapter 6, paragraph 6.22)

(viii) that Ministers should consider putting certain parts of the independent regulator on a statutory basis, and should seek to bring forward any appropriate provisions at the earliest opportunity. (Chapter 9, paragraph 9.5) *(ix)* ***that the annual running costs of the independent regulator should be broadly shared by Government, business and the professional bodies****, with the exception of the costs of cases coming before the Investigation and Discipline which we consider should continue to fall to the professional bodies, as the draft arrangements currently envisage, and the costs of an independent audit inspection unit which should be borne by audit firms. (Chapter 8, paragraph 8.10)*

1.12 We do not envisage that our proposals would have implications for the professional bodies' responsibilities for registration. For example, a power for the Investigation and Discipline Board to remove eligibility to audit may be possible through a modification of the eligibility criteria in Section 25 of the Companies Act 1989 (chapter 6, paragraph 6.26).

Implementation

1.13 On the basis of our recommendations, the independent regulator would look something like the organisation illustrated at Fig 1. In chapters 3 to 7, we discuss governance and functional changes in terms of that organisation. The following chapter 2 describes the current regulatory structure.

1.14 The creation of a new independent regulator out of the Accountancy Foundation and the Financial Reporting Council would require the commitment of all the key regulatory bodies concerned. We envisage that the DTI would work closely and constructively with the parties to help drive forward any implementation programme.