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Gatekeeper or Concierge?
The Regulation of Corporate Governance and Auditing

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Corporate Governance Codes

- UK: 25 years of Corporate Governance Codes
- 1992 The Cadbury report:

> "It is…the continuing concern about standards of financial reporting and accountability…which has kept corporate governance in the public eye."

- The board should have a balance of power "such that no one individual has unfettered powers of decision".
- Role of non-executive directors; independence
- Audit committees (NYSE 1978), importance of audit
- Directors' pay: focus of Greenbury report 1995
- Reporting: accountability to shareholders – 'balanced and understandable', in addition to 'true and fair'.

Combined Code

- Hampel 1998: combining CG and remuneration; dialogue with shareholders; code for shareholders
- Higgs 2003: review of effectiveness of NEDs – senior independent director; chair’s independence
- Internal control: Turner guidance 1999, updated 2005
- Going concern and viability: Sharman 2012;
- Combined code updates: latest 2016
- 2017-18: government calls for reform; stewardship code reform

Comply or explain is a constant through all this

Comply or Explain

Companies state compliance

- Identify where they do not comply; explain why not
- Most common failures: >50% independent NEDs; audit committee membership; independent chair
- Allows variation in company behaviour eg younger and smaller companies
- Relies on disclosure to allow shareholders to assess the risks created by the breach
- Complaints that explanations are not good enough
- One size does not fit all e.g., US companies often still have a combined chairman and CEO

Principles-based rules rather than detailed prescription

Self-regulation or Statute

The end of self-regulation

- Companies have long paid governments for the right to trade, and they are not above the law
- Milton Friedman, who said companies' prime responsibility was to increase profit added:

  "While conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom"

- Self-regulation e.g., of a profession continues for training and qualification purposes; discipline of individuals (minor offences)

The advantage of self-regulation is industry knowledge and peer review, the disadvantage is protectionism and…peer review

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Statutory authority: Rule of Law

Government oversees activity in the public interest

- Standard-setting and enforcement has moved to authorities that are accountable to governments
- The Financial Reporting Council oversees corporate governance, accounting, auditing and actuarial practice
- Companies Acts have set limits eg UK Factory Acts in 1800s limited employment of children and working hours
- More recently: crime of corporate manslaughter e.g., Hong Kong; international anti-bribery and corruption laws
- UK Government 2017 – a voice, or even a board seat, for workers representatives; as on German supervisory boards

Companies need a social / political 'licence to operate'

UK Companies Act 2006, section 172

A director…must act in the way…most likely to promote the success of the company for the benefit of its members…and in doing so have regard to:

a) the likely consequences of any decision in the long term,

b) the interests of the company's employees,

c) the need to foster the company's business relationships with suppliers, customers and others,

d) the impact of the company's operations on the community and the environment,

e) the desirability of the company maintaining a reputation for high standards of business conduct, and

f) the need to act fairly as between members of the company.

Proposal: directors should report on how they do this

Financial reporting standards

- Originally set by accountants' professional bodies
- Moved to arm's length standard-setters with other stakeholders represented e.g., investors
- IFRS produced by International Accounting Standards Board, implemented via EU or national law
- Policed by EU/national market regulators
- Accountants remain involved: 'regulatory capture'?
- Improving balance of interests: preparers of accounts, auditors, users of accounts; public interest?

Principles based = different interpretations; 'through the eyes of management' versus consistency and comparability

Reform of audit regulation

- **Auditors work for investors but are paid by the company. How to ensure their independence?**
- Audit committee of independent directors chooses auditor
- Rotation to avoid over-familiarity – tender every 10 years, maximum service 20 years (24 for joint audits)
- Non-audit services: blacklist and 70% cap on fees
- Extended auditor's report to shareholders: risks of material mis-statement (eg Tesco AR P79)
- Audit firm governance code: independent non-execs
- Enforcement: fines ratcheted up to £5m+
- FRC audit inspections: public reports

High quality audit

Provides investors and other stakeholders with a high level of assurance that:

- the financial statements give a true and fair view, reliable basis for decision-making
- auditors act with integrity and objectivity and are demonstrably independent
- the audit complies with both the spirit and letter of regulation and is supported by rigorous due process
- it meets users' needs, is driven by robust risk assessment and informed by thorough understanding of the entity
- auditors provide challenge, transparency and insight
- the audit provides a strong deterrent to actions against the public interest

Regulatory Innovation by Regulators

- Financial Conduct Authority: ‘Innovate’ project

➢ Tackling barriers to innovation, helping entrepreneurs navigate the regulatory process

➢ ‘Sandbox’, or innovation hub: development and trial of financial products in a safe place

- Co-operation with Singapore, Hong Kong, Japan, Australia
- “RegTech” – technologies to improve regulatory reporting and data sharing
- Bank of England’s FinTech Accelerator: explore how FinTech innovations could be used in central banking; improve understanding of FinTech trends

Regulatory Innovation by the Regulated

- Auditors: big data analysis e.g., 100% sample, analyse patterns and depict graphically, spot outliers
- Software companies that help with regulatory returns and compliance e.g., MiFID II payments for research
- Use of blockchain in contracts e.g., IBM, one immutable version of the chain of events in a transaction reduces level of disputes
- Some of the regulated e.g., Uber, Airbnb are innovative in a way that looks like regulatory arbitrage

Regulatory Innovation by all parties

Deregulation of payments in Europe

- Encouraging new payment services providers
- Breaking the incumbent banks monopoly
- Decentralized payments – threat to central bank control
- Open banking: access to customer data for third parties – if the customer allows it
- Counter trend: data protection (EU General Data Protection Regulation 2018)

< who owns data about you?

< concerns about privacy

Regulators struggle to keep up!

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Q&A Session