

A peculiarly British institution

**An analysis of the contribution made by the Financial
Reporting Review Panel to accounting compliance in
the UK**

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**Sponsored by the Centre for Business Performance of the Institute of Chartered
Accountants in England and Wales**

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Acknowledgements

We wish to thank our interviewees for their openness and co-operation with us and for their comments on earlier versions of this research report. We also thank our two anonymous referees for their helpful and constructive comments.

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Chapter 1: Introduction and Motivation for this Study

Introduction to the Financial Reporting Review Panel

The Financial Reporting Review Panel (FRRP) was set up in 1991 and has been operating for almost 10 years. The overall objectives of this research study are to evaluate the contribution that the FRRP has made to the effectiveness of the regulatory framework for financial reporting in the United Kingdom (UK); to consider how well placed it is to adapt to future challenges; and to provide for academics and practitioners a comprehensive review of the FRRP's activities since its inception.

The FRRP is a subsidiary body of the Financial Reporting Council (FRC). The FRC was established in recognition of the need to strengthen the regulatory framework for financial reporting in the UK and to improve the overall quality of accounting information. Funding for the FRC is provided by the Department of Trade and Industry (DTI), the accountancy bodies and City institutions.

The FRRP is an innovation in the UK regulatory framework as it is authorised by the Secretary of State to examine departures from the accounting requirements of the Companies Act 1985 (including the true and fair view) and accounting standards. It has the power to appeal to the court to require directors to re-issue accounts that do not comply with these (Companies Act 1985, s245b; The Companies (Revision of Defective Accounts and Report) Regulations 1990; The Companies (Defective Accounts) (Authorised Person) Order 1991 and FRC, 1994). To date no such order has been sought as directors have voluntarily agreed to remedy the defects identified by the FRRP. When voluntary agreement has been reached the FRRP issues a press notice giving the name of the company, details of the defect and the remedial action agreed.

The jurisdiction of the FRRP covers the accounts of plcs and large private companies (FRC, 1991 p. 49). It is a reactive body and responds to defects in accounts drawn to its attention. It is authorised to inquire into the contents of audited financial statements i.e. profit and loss account, cash flow, balance sheet and notes. It has no jurisdiction over other material in an annual report. To December 1999, the date of the latest FRRP Annual Review, 346 company accounts have been the subject of FRRP inquiries (FRC, 1991 to 1999).

Inquiries may arise from complaints made by individuals or companies, press comment and, up to 1997, qualified audit reports or other disclosed non-compliance passed to the FRRP from the Stock Exchange in respect of listed companies. As a matter of policy the FRRP provides no information about the source of an investigation nor does it disclose information about cases inquired into which do not result in a press notice. In investigating a case, the FRRP's inquiries may extend to other issues, but not necessarily to all aspects of the company accounts in question. The FRRP's role is to enforce existing rules, not to modify them (Treadgold, 1997) or to provide advice on them, although when it encounters an anomaly or uncertainty in an accounting standard it will refer the issue to the Accounting Standards Board (ASB).

If a case referred to the FRRP appears to have substance, after a preliminary review the FRRP engages in correspondence with the company chairman. The FRRP also suggests that auditors should be involved (Hines, McBride, Fearnley and Brandt, 2001; Fisher, 1993). A case is dropped if the FRRP is satisfied with the company response. Meetings

are requested if the FRRP chairman believes firmer action to be necessary. Once remedial action is agreed with the directors, the press notice is issued.

Remedial action agreed by the companies has taken the form of restatement of comparatives in subsequent years' accounts, re-issuing of accounts, or the publication of a corrective supplementary statement, but there have been no court proceedings. More details of this process and the outcomes may be found in the FRRP's own operating procedures (last revised in July 2000) and in Hines et al (2001).

Where the auditors' report has not been qualified in respect of an identified defect the FRRP reports the case to the audit firm's regulatory body. Disciplinary action has been taken by the professional bodies only in some recent cases with no apparent consistency of action (Fearnley, Hines, McBride and Brandt, 2000).

Robust claims have been made about the effectiveness of the FRRP as an enforcement body since the issue of its first press notices in 1992. Plaistowe (1992) President of the Institute of Chartered Accountants in England and Wales (ICAEW), claims:

'It would not be too much of an exaggeration to say that the face of financial reporting in this country has already been transformed...a cultural change is in progress...At last we have a structure with real teeth.'

Glasgow, chairman of the FRRP (Fisher, 1993) claims:

'But the overwhelming majority of the worst practices that undoubtedly took place ceased overnight when the Panel went into business.'

In the FRC's latest Annual Review (FRC, 1999, p.58) the Chairman of the FRRP believes the FRRP fulfils a crucial role and has contributed to an improvement in financial reporting.

Motivation for this study

The FRRP is a peculiarly British institution. It is not a tribunal and its powers are much more limited than, for example, those of the United States (US) Securities and Exchange Commission (SEC), which engages in pro-active review of registrants' accounts and also (in a separate division) has powers to take enforcement action, impose fines on auditors and directors and delist companies (Zeff, 1995). Despite its lack of legal powers, the FRRP claims to be influencing financial reporting compliance in the UK. With the current interest in global reporting issues and enforcement, interest is being shown in the FRRP by regulators from other jurisdictions (FRC, 1999, p.57). This, combined with the current process of company law reform in the UK makes it an appropriate time to review various aspects of the FRRP's activities and to consider how effective it has been since its inception.

The study comprises seven chapters. Chapter one is the introduction. In chapter two we provide a brief overview of the relevant literature on regulation, and financial reporting and the historical context of the FRRP. In chapter three we analyse the FRRP's activities. In chapter four we consider the FRRP's activities in the light of some judgmental areas of financial reporting: trivia, judgment, materiality and the true and fair view. In chapter five we review the evidence of the FRRP's impact beyond the cases it actually pursues. In chapter six we consider the future role of the FRRP and chapter seven contains our conclusions and recommendations.

Research methods

Our research has been carried out using three main sources of information: that which is publicly available; interviews with interested parties; and a questionnaire study of partners in audit firms whose clients fall within the FRRP's remit.

The publicly available information we have analysed includes the press notices issued by the FRRP, information in company accounts relevant to the press notices and newspaper reports about the FRRP.

Separate interviews were conducted with five audit technical partners in larger firms, two finance directors of companies whose accounts had been criticised, one US regulator, one UK regulator and a group interview with three UK regulators. A semi-structured format was used as an initial guide. This was adapted to each interviewee as appropriate and interviewees were encouraged to expand on issues which emerged (Lincoln and Guba, 1985). All interviews were recorded, fully transcribed (Jones, 1985) and subsequently analysed. A coding scheme was developed from the data based on themes which we identified from reading and re-reading the transcripts. Each respondent's interview was summarised and coded into these themes. These coded themes were then used to search for cross-case patterns. This approach is based on the work of Glaser and Strauss, (1967), who expounded a theory building method which is known as grounded theory. The ideas of grounded theory (Glaser, 1978) were employed to analyse the interviews as this provides a means of handling complex unstructured qualitative data (Henwood and Pigeon, 1995).

Our questionnaire was addressed to compliance partners in audit firms¹ identified from Crawfords' Directory of City Connections (1999) as having clients with turnovers of more than £15m which therefore fall within the FRRP's remit. In all 154 questionnaires were sent out and 64 useable replies were obtained, a response rate of 41.6%. The questions were closed form and were designed with reference to the literature on questionnaire design (Converse and Presser, 1986). It was a four part questionnaire. Section A sought background information on the addressee and the firm. Section B asked how the firm dealt with FRRP press notices. Section C asked how the FRRP had influenced the audit firm's attitude to compliance and Section D asked for detailed views on specific FRRP cases. In this study we have used information from Sections A and C. Data from the other sections will be the subject of a separate paper.

We have integrated relevant data from each data source in each chapter to add breadth and richness to our study and to triangulate our findings (Robson, 1993).

¹Audit regulation 3.15 (ICAEW, 1995) requires each registered audit firm to appoint a Compliance Principal who is responsible for ensuring that the firm complies with the audit regulations and responds to inquiries from its regulatory body. As all partners in registered auditor firms are not necessarily auditors, e.g. tax partners, each firm was telephoned to establish the identity of the compliance partner, who would *de facto* be an auditor and be knowledgeable in respect of the firm's larger clients. In the larger firms (Big Five and Group A) the partner responsible for FRRP issues was specifically identified and the questionnaire was sent to this individual.

Chapter 2: Theoretical and historical background

Introduction

In this chapter we provide the theoretical and historic perspective which underpins our research into the FRRP's activities. We do this by providing a brief resume of issues relevant to our research from academic literature in the areas of regulatory theory and the regulation of financial reporting. We also provide the historical context which led to the establishment of the FRRP.

Relevant theories of regulation

A need for regulation arises where there is a lack of equilibrium in a market which can lead to market failure. In the case of financial reporting there is information asymmetry between providers and users of information. The key issue in establishing regulatory procedures lies in deciding what form the regulation should take, as the benefits, burdens and the effects on allocation of resources resulting from regulatory processes are extremely difficult to measure (Stigler, 1971). In some cases the economic damage from market failure may be less costly than regulation or limited arrangements may be more appropriate (Watts and Zimmerman, 1986).

Historically the UK has favoured private sector regulation for financial reporting. The advantage of private sector regulation is that it can be quick, cheap and flexible. (Veljanowski, 1991). The alternative of state-managed agencies (such as the US SEC) are more likely to be cumbersome to operate and governed by rules (Benston, 1976).

Regulatory processes do not necessarily match the market failures they are supposed to remedy (Breyer, 1982). Organisations may be formed and operate in such a way as to

appear to accommodate social expectations without necessarily dealing rigorously with the problems (Fogarty, Zucca, Meonske, and Kirch, 1997). A failure to meet these expectations may threaten their survival (Fogarty, 1996). A public organisation for example, needs to make efforts to maintain and manage its legitimacy if it is to retain the support of external groups.

Diver (1980) suggests that any theory of regulation must have a theory of enforcement. Efficient enforcement should be made up of due process and economic efficiency, the essential performance measure being to deter harmful violations. The legitimacy of regulatory intervention is also defended by this. The harm being prevented needs to be compared with the costs of enforcement, especially where there is pro-active monitoring. An enforcement agency may attempt to justify its existence by behaving in a risk averse way and dealing only with easily detectable violations rather than seeking out less visible offences. In this way an agency which reacts to complaints would achieve a much higher rate of violation detection than one which sought out offenders. However, regulatory enforcement may only reach part of the regulated community and breaches go undetected. Economic theory would suggest that deterrence from violating regulations will only be achieved if the costs (e.g. fines, legal costs, and loss of earnings from bad publicity) of those violations, multiplied by the detection risk, are equal to or greater than the benefits to be gained from violations (Becker, 1968). Alternatively, voluntary compliance may be sought through moral and intellectual commitment, fear of detection, peer group pressure and a belief in fairness. For a regulatory body, evidence of enforcement actions may serve to legitimate its existence (Bealing, 1994).

Hines et al (2001) argue that the FRRP is an organisation operating in an environment where institutional theory provides insights. It is an enforcement body dependent upon external funding. This funding from government, the accountancy profession and City institutions is contingent upon maintaining the confidence of these bodies. There is no final measurable output that summarises the FRRP's organisational performance, although there may be some important intermediate measures. The body also operates in secret and maintains a level of discretion over actions taken in specific cases. Institutional theory predicts that organisations like this may engage in 'myth making', providing an account (not necessarily a falsity) of their origin, function and efficacy (Ritti and Silver, 1986). Strong public claims have been made by both the FRC and the FRRP itself about its operations and its effect on the quality of UK financial reporting (e.g. Financial Reporting Council, 1991, 1997). These claims are very difficult to prove or refute given the lack of measurable outcomes, but may be explained in the context of institutional theory as the FRRP attempting to ensure its legitimacy and continuing survival (Hines et al, 2001).

A particular problem for regulators in financial reporting is the tension between accountancy and law. It is suggested that there are fundamental differences in analytical styles due to different historical, cultural and educational patterns of development of these two professions and this leads to a lack of comprehension (Freedman and Power, 1992). In the UK, accountants recognise that the preparation of accounts requires considerable judgment underpinned by a comprehensive regulatory framework for financial reporting. The legal profession perceive the law as a way of ensuring certainty and objectivity where the issues are too important to be left to subjective judgment (Freedman and Power, 1992). Regulatory bodies in financial reporting need to address

the tensions between legal compliance and the judgmental approach often based on economic substance adopted by accountants (Napier and Noke, 1992). Within the regulatory body of the FRRP, the tensions have been addressed by appointing chairmen who are lawyers with accountants as deputy chairmen. While such measures may promote understanding, they are unlikely to resolve the problem (Hines et al, 2001).

Why the FRRP was established in the UK

In the UK, following a number of problems of inconsistency in financial reporting practices,² the Accounting Standards Steering Committee was set up in 1969 by the accountancy profession and became the Accounting Standards Committee (ASC) in 1976. However, it was predicted that structure of the ASC would not be durable in a major accounting crisis (Bromwich, 1985). It was controlled by the profession, accountants formed the entire membership and it was accused of acting in the profession's self-interest. Claims were also made that auditors could not be relied on as the sole means of enforcement because of this self-interest and because of a poor awareness of users' needs (Lafferty, 1981).

In 1978, the regulatory processes were reviewed (ASC, 1978). The principal issue identified was the lack of enforcement. Soon after this Stamp (1981) predicted that inadequately enforced standards would receive little respect, leading the profession and the public interest to suffer. The enforcement of standards and the accounting standard setting process faced further criticism in the mid-eighties. There was increasing evidence of the management of earnings, or use of 'creative accounting' to improve reported

²The two celebrated cases which generated public criticism were GEC-AEI (1967) take-over bid where a reported profit of £10m was re-interpreted as a loss of £4.5m and Pergamon Press (1968) where the valuation of stock was reduced by 75%.

financial performance (Briloff, 1972, Griffiths, 1986, Smith, 1992). The following recession brought some highly publicised failures of companies and criticism of the auditing profession leading to increased pressure for change. Accounting standards were criticised as being too flexible (thus enabling wide interpretation) and of not being adequately enforced.

A review committee was set up in 1987, chaired by Dearing. This published *The Making of Accounting Standards* (CCAB, 1988) which proposed the reform of the UK regulatory framework for financial reporting. Some of the changes proposed were introduced by the Companies Act 1989. The standard setting process is now controlled by the FRC which is a legally mandated body independent of the accountancy bodies. The FRC oversees three other bodies: the Accounting Standards Board (ASB) which undertakes the setting of accounting standards; the Urgent Issues Task Force (UITF) which tackles emerging issues and the FRRP which regulates compliance with accounting standards.

Suggestions of legal backing for accounting standards were not accepted and therefore the FRRP has less legal support than Dearing originally envisaged. The UK did not want to establish a SEC-type organisation.³ Warnings had previously been given against the irreversible step of a British SEC (Benston, 1981, Stamp, 1981) with the risk of an

³The SEC is a government body unlike the FRRP in the UK. Its role is to ensure that investors have information necessary for informed decisions. Its Corporate Finance Division has monitored the form and content of financial statements since the 1960s (Zeff, 1995). It has far reaching powers and has the power to prevent a company obtaining a stock exchange listing or exclude a company already listed, thus imposing significant damage, both to the finances and the reputation of the company (Zeff, 1995). Some observers doubt that this process has improved compliance with the regulatory framework (Beaver, 1989). Schuetze (1992), former chief accountant of the SEC, asserts that auditors rely on the SEC to achieve compliance from their clients.

excessive and incompetent bureaucracy (Kripke, 1979) which would undermine the authority of the accounting profession.

As confidence in capital markets is important (Borrie, 1991), the profession recognised that the new structure was needed to restore confidence in financial reporting and in the profession (Fisher, 1993), and if it did not, then political intervention in the form of an SEC-type body was a real possibility. Thus it was in the accountancy profession's interests that the new structure, including the FRRP which was an entirely new concept for the UK, should work and be seen to work, as the alternatives were far less attractive.

Chapter 3: Analysis of the FRRP's activities

Introduction

This chapter reviews publicly available information on and published comment about the FRRP's activities with the objective of providing a richer understanding of its processes and achievements. Sources for this review are the FRC's annual reports, the press notices issued by the FRRP, the annual reports of companies featured in the FRRP's press notices and press comment. The chapter also draws on our analysis of 12 recently conducted interviews with interested parties.⁴

In this chapter we consider:

- a broad overview of the FRRP's activities;
- the attributes of companies that have been subject to press notices;
- the nature of the issues covered by the press notices and the impact of any required remedial action;
- the use of different forms of remedial action;
- the timeliness of the FRRP's activities.

Some of the key conceptual issues arising out of this review are considered further in chapter 4, while the FRRP's wider impact on company directors and auditors is considered in chapter 5.

⁴We interviewed four regulators, five audit firm technical partners and two FDs of companies which had been the subject of FRRP press notices. These are designated respectively: R1, R2, R3, R4; TP1, TP2, TP3, TP4, TP5; FD1, FD2. Whilst the regulators and the technical partners were all willing to discuss the FRRP, the request for an interview was declined by a number of finance directors whose accounts had been criticised. This is a different group of interviewees than reported in Hines et al (2001).

The FRRP's activities and operating costs

The FRRP has been empowered to make applications to the courts since 1 February 1991. To 31 December 1999 (the date of the FRC's last annual report (FRC, 1999)), 346 cases had been considered by the FRRP (see table 3.1). A clear downward trend in the number of new referrals over time is evident from table 3.1. This is interpreted by the FRC as due to improvements in compliance levels (FRC, 1997). Over the life of the FRRP 15.4% of inquiries have resulted in a press notice, 44.1% were resolved without the publication of a press notice and 40.5% were not pursued beyond initial examination. Although in recent years there has been a decline in the number of referrals, this has not affected the proportion of inquiries resulting in the publication of a press notice. Three further press notices have been issued since the last annual report and the cut off date for this study (30 June 2000).

Table 3.1 – FRRP activity analysis

Year	Cases brought forward	New referrals	Cases under review during the year	Not pursued beyond initial examination	Resolved without press notice	Press notices Issued	Cases carried forward
		Total		Total	Total	Total	
1991/2 ¹	0	78	78	28	21	10	19
1993	19	45	64	11	33	9	11
1994 ²	11	46	57	14	23	6	14 ³
1995	10 ³	43	53	19	15	4	15
1996	15	49	64	24	19	8	13
1997	13	24	37	11	16	5	5
1998	5	32	37	15	7	7	7
1999	7	29	36	12	12	2	10

Source: FRC Annual Reports 1991-9

Note 1 – The Second Annual Review covers a period from mid 1991 until November 1992.

Note 2 – The date of the annual review changed from November to 31 December from this year.

Note 3 – The brought forward figure in the 1995 Annual review did not agree with that carried forward in the 1994 edition.

Significantly, the FRRP has yet to exercise its legal power of seeking a court order requiring a company to revise its accounts. The FRRP chairman regularly emphasises in the FRC's annual report that voluntary compliance is the preferred route to resolving an

issue, although if necessary the FRRP will not hesitate from initiating legal action (see for example FRC, 1998).

Table 3.2 shows the FRRP's operating costs as disclosed in the annual report. The modest level of these costs has been previously noted (Brandt, Fearnley, Hines and Beattie, 1997) and the trend has continued into recent years. However, the year ended 31 March 1997 stands out as a comparatively expensive one. Sydney Lipworth, chairman of the FRC noted that:

'the past financial year has seen significant expenditure preparatory to litigation. The fact that this expenditure was incurred signals the Panel's determination not to be deflected or delayed from pursuing an action in court if it believes that to be necessary.' (FRC, 1997, p. 14-15)

Peter Goldsmith (chairman of FRRP at the time) stated that *'two cases came close to court before voluntary resolution could be achieved'* (FRC, 1997, p.72). This illustrates that the FRRP's continuing cost effectiveness is dependent upon obtaining an early agreement from company directors. Although the legal costs fund was reduced by these cases, by the end of 31 March 1998 it had been replenished to its normal level of £1.95 million as a consequence of a more generous contribution from the FRRP's sponsors. It is normal practice for the sponsors to top up the legal cost fund each year.

Table 3.2 – FRRP annual costs

Year ended	FRRP Total operating costs (£000's)	FRRP Investigation costs (£000's)	Legal costs fund year end balance (£000's)
31 March 1995	227	9	1,993
31 March 1996	226	19	1,980
31 March 1997	481	259	1,741
31 March 1998	292	41	1,950
31 March 1999	290	14	1,996

Source: FRC Annual Reports 1995-9

The companies subject to press notices to 30 June 2000

Table 3.3 lists in chronological order to 30 June 2000 the 54 cases which were concluded with an FRRP press notice. The press notices relate to 50 different companies, as four have now been the subject of two separate press notices.⁵ One of the weaknesses of a reactive body is that some companies may suffer from a higher level of scrutiny than others because of the activities of potential complainants with a specific grievance. A recent public example of this was Photobition,⁶ referred to the FRRP by Wace, a company for which it was bidding (Blackwell and Kelly, 1999). Furthermore the investigation did not enjoy the usual confidentiality, since the complaint was made public by the complainant in January 1999 and a press notice was finally issued in the following October.

Although the remit of the FRRP extends to large private companies, only one, M & W Mack,⁷ has been the subject of a press notice. While all the remaining companies have been Plc's, not all are listed. Some have been listed on a second tier market (e.g. Eurocity Properties, Associated Nursing Services), four were unlisted (e.g. Penrith Farmers' & Kidd's). The largest companies to be affected were British Gas and RMC group (in terms of turnover); Royal Bank of Scotland and Guardian Royal Exchange (in terms of gross assets), but 50% of the cases have concerned much smaller companies with an annual turnover of less than £100 million.

⁵The most recent, Strategem, had aspects of its annual report criticised for two successive years.

⁶Table 3.3, case number 51.

⁷Table 3.3, case number 40; appendix 1, case 1.

Table 3.3 – Issues raised by FRRP to 30 June 2000 and the impact of remedial action on accounts

Company	Press notice date	Size Turnover (£M)	Gross assets (£M)	Sector	Item	Category	Effect on Numbers			
							Earnings per Share Net change pence	%	Shareholders' funds Net change £m	%
1	Williams Holdings 28.1.92	834	612	Support services	Exceptional items stated net of tax EPS calculated before exceptional items Inadequate disclosure of acquisitions and disposals	Classification Classification Disclosure	(1.10)	(4.93)	-	-
2	Ultramar 28.1.92	1,761	2,315	Oil & gas (taken over by Lasmo)	Unrelieved ACT included in cost of dividends	Classification	(3.30)	(10.25)	-	-
3	Shield Group 31.1.92	7	17	Real estate	Revaluation treated as prior year item	Measurement	(36.56)	(82.27)	-	-
4	Forte 4.2.92	2,641	3,979	Leisure	Accounting policies for: Capitalisation of interest Expenses on information technology projects Non-depreciation of freehold and long leasehold properties Date varies between signing balance sheet and auditors' report	Disclosure Disclosure Disclosure Disclosure	-	-	-	-
5	Williamson Tea Holdings 10.8.92	38	79	Food	Adequacy of disclosure re overseas assets	Disclosure	-	-	-	-
6	Associated Nursing Services 10.8.92	19	40	Health (Second tier market)	Accounting treatment of start-up costs Explanation of change in accounting policy	Recognition – element Disclosure	(6.10)	(16.09)	(2.453)	(18.95)
7	GPG 7.10.92	5	45	Speciality & other finance	Non-compliance with SSAPs 6 and 3 by applying FRED 1	Classification	(1.80)	(53.25)	-	-
8	Trafalgar House 15.10.92	3,357	2,084	Diversified	Re-classification from current to fixed assets Amount of ACT carried forward in balance sheet Disclosure re investment Compliance with statutory format of profit and loss account	Measurement Measurement Disclosure Disclosure	(24.33)	(279.66)	(20.00)	(2.84)
9	British Gas 26.10.92	10,485	15,972	Gas distribution	Reporting 12 months instead of 9 months results following change of year end Omission of 9 months EPS calculation	Disclosure Omission	(17.10)	(62.64)	-	-
10	S.E.P. Industrial Holdings 26.10.92	50	24	Distributors	Stock provision treated as prior year item Non-depreciation of freehold properties	Measurement Measurement	(0.21)	(43.75)	(0.038)	(0.53)
11	Eurotherm 22.2.93	158	101	Electronics	Excess extraordinary provision written back as exceptional	Classification	-	-	-	-
12	Foreign & Colonial Investment Trust 17.3.93	47	1,190	Investment company	Disclosure of directors remuneration Non-consolidation of subsidiary undertaking	Disclosure Recognition – group	0.09	2.66	1.07	1.11
13	Warnford Investments 1.4.93	13	115	Real estate	Investment properties in parent not shown at current valuation	Measurement	-	-	-	-

Table 3.3 (Continued)

Company Press notice date	Size Turnover (£M)	Gross assets (£M)	Sector	Item	Category	Effect on Numbers			
						Earnings per Share Net change pence	%	Shareholders' funds Net change £m	%
14 Penrith Farmers' & Kidd's 5.4.93	1	4	Auctioneer (Unlisted)	Reasons for restatements not provided	Disclosure	-	-	-	-
15 Breverleigh Investments 27.7.93	0	2	Property investment (Unlisted)	Non-consolidation of subsidiary Cash flow statement omitted Statement of compliance with applicable accounting standards omitted	Recognition – group Omission Disclosure	0.33	45.83	-	-
16 Royal Bank of Scotland Group 11.8.93	N/A	34,497	Bank	Effect of change of accounting policy treated as exceptional current profit and not prior year adjustment	Measurement	(0.70)	(50.00)	-	-
17 Control Techniques 24.9.93	88	72	Electronics	Mis-classification in cash flow statement	Classification	-	-	-	-
18 B M Group 19.10.93	519	540	Engineering	Cash equivalents in cash flow statement incorrect Mis-description of placing of shares in subsidiary	Classification Disclosure	-	-	-	-
19 Parmigan Holdings (Graystone) 25.10.93	3	4	Engineering	Change in accounting policy not adequately explained	Disclosure	-	-	-	-
20 Chrysalis Group 29.11.93	66	85	Media & photography	Accounting for associated company	Measurement	-	-	-	-
21 Intercare Group 28.1.94	29	17	Health (Second tier market)	Cash flow statement: Included non-cash items Omitted negative balances of cash and cash equivalents Included interest not on cash basis	Classification Omission Classification	-	-	-	-
22 Pentos 11.2.94	236	205	General retailers	Inadequate explanation of treatment of reverse premiums	Disclosure	-	-	-	-
23 BET 24.4.94	2,176	1,147	Support services	Treatment of exceptional items	Classification	-	-	-	-
24 Butte Mining 2.11.94	0	6	Mining	Mis-classification of bank overdraft Investment proceeds of sale and repayment of loan omitted from cash flow statement	Classification Omission	-	-	-	-
25 Clyde Blowers 23.11.94	7	11	Engineering	Treatment and explanation of disposal to directors	Disclosure	-	-	-	-
26 Alliance Trust 20.3.95	34	1,104	Investment company	Non-consolidation of subsidiary	Recognition – group	3.51	7.42	(0.001)	(0.11)
27 Courts 21.6.95	259	88	General retailers	Accounting for instalment and hire purchase transactions	Measurement	(note 1)	(note 1)	(note 1)	(note 1)
28 Caradon 8.11.95	961	1,195	Construction & building materials	Analysis of shareholders' funds between equity and non-equity interests Disclosure of rights of each class of shareholder incomplete	Classification Disclosure	-	-	-	-

Table 3.3 (Continued)

Company Press notice date	Size Turnover (£M)	Gross assets (£M)	Sector	Item	Category	Effect on Numbers			
						Earnings per Share Net change pence	%	Shareholders' funds Net change £m	%
29 Ferguson International Holdings 13.12.95	175	111	Support services	Goodwill and merger relief shown net	Classification	-	-	-	-
30 Securicor Group 15.2.96	733	509	Support services	Analysis of shareholders' funds between equity and non-equity interests	Classification	-	-	-	-
31 Newarthill 8.3.96	264	195	Construction	Non recognition of financial cost of preference shares issued by subsidiary No statement of material departure from accounting standards	Recognition – element/ measurement Disclosure	89.50	371.37	-	-
32 Brammer 28.3.96	152	110	Distributors	Classification of assets held for rental as stock rather than fixed assets	Classification	-	-	-	-
33 Foreign & Colonial Investment Trust 9.4.96	39	1,693	Investment company	Disclosure of reasons for departure from SSAP1 re accounting for associate company	Disclosure	-	-	-	-
34 Alexon Group 1.3.96	95	43	General retailers	Analysis of shareholders funds between equity and non-equity interests Disclosure of rights of share categories incomplete	Classification Disclosure	-	-	0.423	2.51
35. Ransomes 30.5.96	180	162	Engineering	Analysis of shareholders' funds between equity and non-equity interests Disclosure of rights of share categories incomplete	Classification Disclosure	-	-	-	-
36 Sutton Harbour Holdings 24.7.96	1	17	Transport facilities (Unlisted)	Disclosure of reasons for true and fair override re depreciation of government grants and investment properties	Disclosure	-	-	-	-
37 Butte Mining 2.10.96	1	7	Mining	Treatment of profit on a transaction in which consideration given in the form of shares subject to trading restrictions Disclosure of position of non-equity shareholders	Measurement Disclosure	(40.00)	(285.71)	-	-
38 Associated Nursing Services 17.2.97	34	89	Health (Second tier market)	Quasi-subsidiary treated as an associated company. Accounting treatment of sale and leaseback transactions	Recognition – group Recognition – element	(5.80) (0.60)	(44.27) (5.22)	(1.288) (1.410)	(3.83) (4.52)
39 Reckitt & Colman 15.4.97	2,353	2,736	Personal care	Adequacy of disclosure of fair value adjustment in year following an acquisition	Disclosure	-	-	-	-
40 M & W Mack 29.8.97	190	38	Food (Unlisted)	Accounts excluded income, expenses and assets of employee share option scheme	Recognition – element	2.39	10.97	3.013	19.39
41 Burn Stewart Distillers 2.10.97	54	81	Beverages	Insufficient disclosure of sale not reflected in results	Disclosure	-	-	-	-
42 Stratagem Group 10.11.97	131	73	Diversified	Disclosure of fair value adjustments incomplete	Disclosure	-	-	-	-

Table 3.3 (Continued)

Company Press notice date	Size Turnover (£M)	Gross assets (£M)	Sector	Item	Category	Effect on Numbers			
						Earnings per Share Net change pence	%	Shareholders' funds Net change £m	%
43 Guardian Royal Exchange 25.2.98	4,090	18,764	Insurance	Equalisation reserves legally required for some subsidiaries excluded from consolidation	Recognition – element	(2.80)	(5.75)	(75)	(3.25)
44 Stratagem Group 27.4.98	159	67	Diversified	Insufficient disclosure that exceptional costs were related to fundamental restructuring Exceptional items shown after deduction of interest	Disclosure Classification	-	-	-	-
45 RMC Group 12.5.98	4,614	3,578	Construction & building materials	Non disclosure of fines incurred by subsidiaries	Disclosure	-	-	-	-
46 Reuter Holdings 22.7.98	2,882	2,836	Media & photography	Amortisation of goodwill excluded from operating profit	Classification	-	-	-	-
47 H & C Furnishings 7.8.98	152	71	General retailers	Valuation of consideration paid for acquisition Non compliance with disclosure requirements (FRS 1, FRS 3, FRS 8, SSAP 15, CA 1985)	Measurement Disclosure	-	-	-	-
48 Photo-Me International 2.9.98	159	66	Media & photography	Intra-group sales/ cost of sales not eliminated on consolidation	Measurement	-	-	-	-
49 Concentric 20.10.98	150	94	Engineering	Inadequate disclosures on acquisition, particularly with respect to fair value table & cash flow statement	Disclosure	-	-	-	-
50 Aim Group 24.2.99	64	47	Engineering	Reorganisation costs treated as a liability on acquisition Inadequate disclosures re acquisition and policy change	Recognition – element Disclosure	(6.2)	(24.60)	(904)	(5.86)
51 Photobition Group 28.10.99	38	43	Media & photography	Inadequate disclosure of results of acquisition Non-disclosure of geographical analysis	Disclosure Disclosure	-	-	-	-
52 PWS Holdings 10.1.00	11	167	Insurance	Depreciation of goodwill treated as exceptional	Classification	-	-	-	-
53 Eurocity Properties 18.2.00	0	4	Property (Second tier market)	Non-disclosure of executive directors incentive scheme	Disclosure				
54 Sinclair Montrose Healthcare 24.2.00	79	43	Health	Marketing costs capitalised as development expenditure Disclosure of exceptional item and amortisation of goodwill	Recognition – element Classification	(13.54)	(330.24)	(3.44)	(37.57)

Note 1 – Not quantifiable, other changes made in same year.

Peasnell, Pope and Young (2000) have analysed data with the aim of identifying the characteristics of companies cited in FRRP press notices. The only aspect of corporate governance that distinguished such companies was that they are less likely than similar companies which have not been criticised by the FRRP to employ a Big Five auditor. However they are apparently also characterised by declining financial performance, circumstances which, the authors argue, increase the pressure for 'earnings management'.

Eleven cases (20.4%) have a qualified audit report and one has an 'emphasis of matter'. However four of the qualifications are on different grounds from the issues included in the FRRP press notices. Since 1996 only two out of 25 cases (8%) have received a qualified audit report. Originally the London Stock Exchange passed listed company annual reports with qualified audit reports to the FRRP, but this practice later ceased. The FRRP is now reliant on other sources of information to identify annual reports with qualified audit reports.

Classification of issues subject to FRRP criticism

The 54 press notices have raised a total of 83 issues. These are listed as part of table 3.3. In order to provide an appreciation of their nature, these issues have been sub-divided into six categories (Brandt et al, 1997):

1. *Recognition – group* concerns the boundaries of the group entity and the nature of items to be included in group accounts (e.g. does a company qualify for inclusion in the group accounts because it is either a subsidiary or quasi-subsidiary?).
2. *Recognition – element* concerns the recognition of an element (e.g. asset or liability) in the accounts and the allocation of transactions to those elements

according to their substance (e.g. should marketing costs be capitalised or written off as an expense?).

3. *Measurement* concerns the value to be attached to an element in the accounts (e.g. has the value of consideration paid for an acquisition been appropriately calculated in accordance with accounting standards?).
4. *Omission* refers to a failure to include information in primary statements (e.g. failure to include a cash flow statement).
5. *Classification* refers to the classification of items within a particular element in a primary statement (e.g. are assets held for rental to be classified as fixed or current assets?).
6. *Disclosure* refers to a deficiency in the information content of the financial statements not directly affecting the primary statements.

The first three categories cover the fundamental accounting issues (Tweedie and Whittington, 1990) which are most likely to impact on key accounting measures.

Table 3.3 also shows how the remedial action required by the FRRP affected two significant accounting numbers – earnings per share and shareholders' funds. Reported earnings per share were altered in 19 cases (35.2%) and in 14 (73.7 %) of these, the required remedial action produced a decrease in the revised earnings per share. Twelve of these cases came from the first 27 press notices. The three biggest percentage changes affected Sinclair Montrose Healthcare (-330.24%), Butte Mining (-285.71%) and Trafalgar House (-279.66%) and in all three cases a reported profit was transformed into a loss. Shareholders' funds were altered in 11 cases (20.3%), with only three (27.3%) of these showing an increase. The largest increase of 19.39% was M & W Mack, where the FRRP ruled that the income, expenses and assets of the employee share option scheme

needed to be incorporated into the company financial statements. The largest decrease of 37.57% affected Sinclair Montrose Healthcare.⁸ Given the relatively small number of cases where the required remedial action has produced substantial changes based on the criteria of earnings or shareholders' funds, it is understandable why accusations of immateriality are made.

In order to make its interpretation clearer the FRRP has increased the level of explanation provided in its press notices. This change can be illustrated by the fact that the first 10 press notices issued in 1992 had a mean length of 512.4 words, while the nine press notices issued in 1998 and 1999 had a mean length of 828.7 words. Despite these efforts to improve the information content of press notices, four of our five technical partner interviewees remain critical. They consider that the problem which has been remedied is not as clearly described as it could be:

'Very frequently you cannot really tell what the problem was from the press notice. Or at least, you can't understand how they managed to reach their decision.'
(TP3)

There is also a feeling that the lack of explicit information was the result of negotiation with the FRRP, which could reflect a damage limitation exercise on the company's part (Hines et al, 2001).

'One of the difficulties...is that what you get is perhaps a page of explanation of what was agreed between the Panel and the company, so to some extent they both have an interest in it being relatively bland and not too explicit. So sometimes you are guessing...what actually is behind it all. Obviously there is enough truth in the press release for it to be released, but there is no guarantee you have got the whole truth in there.' (TP1)

⁸Table 3.3, case number 54; appendix 1, case 2.

One of the regulators believes the problem is largely generated by legal problems:

‘When they draft the press release the FRRP has to be mindful of its legal implications and that can make it difficult to put the point across simply.’ (R4)

It is acknowledged that in the absence of a public pronouncement, a wider audience may not benefit from the Panel’s rulings, although the FRC claims the work of the Panel is discussed in general terms with leading practitioners (FRC, 1999).

Remedial action required

When the FRRP publishes a press notice, the remedial action agreed as a result of the investigation is disclosed. Seven different forms of remedial action have been used and their frequency is set out in table 3.4. The form of remedial action most likely to have the greatest impact on directors or shareholders is for companies to revise their existing accounts. This is done by re-issuing the accounts in their entirety or by issuing a supplementary note, both of which are distributed to all members. This is outside of the usual communication channels between directors and shareholders and imposes costs on the company. Of lesser impact is an announcement, either in isolation or as part of the normal interim or preliminary results announcement, followed by an adjustment in the subsequent annual report. This does not involve much additional cost, but ensures that users receive timely information on the nature of the problem and its remedy (although other information may be given greater prominence in the announcement thus reducing its impact). Table 3.4 indicates that the remedy with the lowest impact, changing the comparatives in the following years’ annual report, is the one most commonly used (in 48.1% of cases). This is the most satisfactory outcome for the company since it combines low cost and low impact. The information is dated and of little significance

compared with the current year information. Another outcome is for no remedial action to be required. This occurred in three early cases.⁹

Table 3.4 – Use of different forms of remedial action for different categories of FRRP case

Remedial action required by press notice	All press notices		Press notices including at least one recognition or measurement issue	
	No.	%	No.	%
Issue revised accounts	3	5.6	3	15.0
Issue a supplementary note	8	14.8	3	15.0
Revise interim announcement & subsequent annual report	7	13.0	1	5.0
Revise preliminary announcement & subsequent annual report	5	9.3	3	15.0
Announcement & revise subsequent annual report	2	3.7	0	0.0
Revise subsequent annual report	26	48.0	10	50.0
None	3	5.6	0	0.0
Total	54	100.0	20 ¹	100.0

Note 1 Some press notices covered more than one recognition / measurement issue.

It is not clear why a particular form of remedial action has been adopted for a particular case. Logically, higher impact remedies should be used to correct more serious defects, particularly issues of recognition and measurement which may affect earnings or shareholders' funds. Table 3.4 identifies the remedial action taken for cases involving at least one recognition or measurement issue. All three cases in which companies have been required to reissue their accounts have involved recognition or measurement issues, with the second case on Associated Nursing Services¹⁰ requiring two years accounts to be reissued. However, there are 10 other recognition and measurement cases where an amendment of a comparative in the subsequent annual report has been considered

⁹Ultramar did not produce a subsequent set of accounts as it had been taken over by Lasmo by the time the press notice had been published. Forte's press notice was unusual in that it is the only occasion when the FRRP has publicly cleared a company it has investigated. It stated that it welcomed increased disclosure in the subsequent year's annual report, but this was not classed as remedial action. GPG adopted an exposure draft before it was finalised thereby failing to comply with the existing accounting standard. Remedial action in the following year's accounts would have been unnecessary as by then the new accounting standard was in force.

¹⁰Table 3.3, case number 38; appendix 1, case 3.

sufficient, and seven cases involving disclosure or classification issues which have been considered sufficiently serious to justify the publication of a supplementary note or other announcement.

As previously noted, the FRRP has never needed to file for a court order, although according to press reports it has come close in a few cases (notably Trafalgar House¹¹ and Associated Nursing Services, *second case*). In the face of a display of persistence from the FRRP, the company directors have given way, apparently seeing little to gain and much to lose from a court appearance. This is very costly for the FRRP, for although it has a fighting fund of £2 million, this would soon disappear in lengthy court proceedings.

‘The danger too is, and I think it’s happened a couple of times, you’ve got a situation where the Panel is just about to go to court and then suddenly the company says okay. That’s probably cost a quarter of a million...they can’t claim it off anybody...’ (R1)

This regulator was of the view that further support from the sponsors would be forthcoming in the event of the FRRP running out of funds over court proceedings:

‘But they’ve always said, you know, you have a backing but don’t let that be a problem if you start running out.’ (R1)

The same regulator thought that a court battle with the FRRP, apart from being expensive, would be very damaging for a company:

‘But the interesting thing is one of the barristers has said to companies, “You should never get into that situation because the press will love it...and regardless of what the law says, the fact is you’re in court because your accounts are rotten. You win on a technicality and the press will rubbish you...so you may win the battle but lose the war really. So don’t get in there, concede at an early stage”.’ (R1)

¹¹Table 3.3, case number 8; appendix 1, case 4.

It was possible that the FRRP could lose a case on a technicality, but in such an eventuality a change of law would be requested:

'I think they prefer to settle to avoid the risk of going to court and losing by accident...a legal technicality. Chances are it probably would be, in that case we expect they'd ask the DTI to change the law unless it was some European thing.' (R1)

One finance director interviewee simply ruled out court proceedings:

'Because of the cost of it...the way we looked at it in the end is it's all history, so let's just get on and cut our losses and reissue the accounts.' (FD2)

Our other finance director interviewee was urged by his auditors to fight the case, but neither he nor the company chairman was interested:

'The chairman is very experienced. He took the view he didn't want to get into a fight and I tended to agree with him. I wasn't going to get personally involved.' (FD1)

This finance director could see no value for his shareholders in a fight with the FRRP.

'Various things have been said... but in the end what was in it for the company?...You stand in front of the shareholders and say we are delighted by the way we have spent £200,000 of your money and we've beaten the Financial Reporting Review Panel. I'm not doing my job as a director really.' (FD1)

This director did speculate as to what the outcome would have been if they had fought it:

'I think in the end if we had held our position, I wonder if they really would have wanted to take us to court on it. My own view is that they could have looked very silly, and other members of the accounting profession would have rallied round us.' (FD1)

But the bluff was never called.

Timeliness of FRRP press notices

The time taken by the FRRP to complete its investigations can only be estimated as the FRRP does not disclose when a complaint is received (although the recent press notice

involving Sinclair Montrose Healthcare provided the date when the enquiry was initiated). This is now normal practice. Our regulator and company interviewees provide more information on timing issues. Complaints are not necessarily received when company accounts are issued:

‘There’s a general assumption that when accounts are issued hawk-eyed shareholders sit down and read them and then think, “Oh I think I’ll write to the Panel on this.” In general that tends not to happen as quickly as you might like to have it. Very often a complaint might only be made, perhaps, after the publication of the interim report when the shareholder, or whoever, is actually looking at the last year’s accounts with the interim, or with a trading statement or something else.’ (R4)

Sometimes the complaint arrives very close to the next year-end:

‘In a fair number of cases I would say the Panel only has a matter brought to its attention really not that long before...the issue of the next year’s accounts. In any event that’s a significant delay from the last year-end.’ (R4)

Obviously a complaint cannot be made until the accounts have been issued and the only public indication of this is the date the directors signed the accounts (although there may be a considerable time lag between the two events). This represents the maximum time the FRRP investigation could have taken. The number of days varies greatly between cases from 746 days (RMC) to 121 days (Eurocity Properties). The mean is 306.1 days and the median 322 days. Nine cases (16.7%) may have taken longer than a year to complete. There is no evidence that the investigation time has changed over the life of the FRRP despite claims that the process has been made ‘*speedier*’ (FRC, 1999, p. 17). The FRRP are fully aware of criticism that their procedures are slow (e.g. Peel, 2000) and that it is in the public interest that defective accounts are remedied as soon as possible:

‘The Panel needs to be able to opine before the information it is dealing with becomes completely out of date so that, if appropriate, corrections can be made to the market’s view of performance sooner rather than later.’ (FRC, 1999, p. 51)

One regulator also thought time was of the essence:

'I would like to see it faster, because I think it would actually send a better signal, you know, a bad set of accounts, they're replaced in three months.' (R1)

However they argue that this principle must be balanced against the requirements of natural justice where *'the company under enquiry must be given every opportunity to answer the points that the Panel has put to it'* (FRC, 1997, p. 71). Also:

'You need to ensure that you've really bottomed the thing out and given the company a chance...I think you also have to recognise that we are dealing with contentious issues. The company and its auditors have probably signed off on a basis that they believe to be right and we are challenging them on that grey area, I mean its very seldom that we ever get a sort of straightforward sin presented to us and the companies say: "Ye gods, you're right and we're wrong".' (R3)

Besides which, the FRRP can have its own logistical problems:

'Its pretty difficult to do much in the way of speeding up and I mean, we mustn't ignore the fact that our Panel members are volunteers, so its often quite a strenuous job to get a group meeting together and even with the best will in the world, it can take time to get a group together with the Panel and the company.' (R3)

It is recognised that a company may deliberately delay proceedings, and there is little the FRRP can do about it:

'Anecdotal evidence, you maybe find something, maybe a couple of months after the accounts have come out they then write to the company. There's a long delay and a reply comes back asking a load of questions and the correspondence goes backwards and forwards for several weeks. Then they ask them for a meeting but unfortunately the chairman is overseas and he wants to be there, so its delayed for another month, and it's all this sort of delay, things going backwards and forwards. So then they come along and they say, "Well we're at a new set of accounts in six weeks, there's no point in changing our accounts now. We'll just change the comparatives." So the impact in a way is lessened. Companies can slow it down deliberately, and their lawyers.' (R1)

While directors may have an incentive to prolong an investigation to avoid costly, higher impact forms of remedial action, as the date for delivery of the year end accounts approaches they feel the need to get the matter settled:

‘We were just about to prepare our 199X accounts. We took the view that we would like the matter solved very quickly. We weren’t going to spend any time on it. They came back with a very intransigent position. ...I suspect that if we hadn’t been under pressure to put our accounts out we would have stood our ground for rather longer.’ (FD1)

Production of interim figures can also be a reason to reach a settlement:

‘This was going on in [month X] and our interims normally come out at the end of [month X], but we didn’t particularly want to put the interims out with an incorrect balance sheet...So we delayed the interims so we could get on and change the previous year’s figures.’ (FD2)

Table 3.5 shows the time taken for a press notice to be published in relation to the form of remedial action prescribed by the FRRP. It shows that the investigation time for cases where supplementary notes are issued is shorter than the time taken in cases where comparatives are amended in the subsequent annual report, suggesting that the timing of an investigation may affect the chosen remedy.

Table 3.5 – Time taken for press notice to be published for different remedies used by the FRRP

Remedial action required by press notice	Number of press notices	Mean days elapsed between date accounts signed and press notice issued.
Issue revised accounts	3	311.7
Issue a supplementary note	8	283.8
Revise interim announcement & subsequent annual report	7	194.1
Revise preliminary announcement & subsequent annual report	5	358.0
Announcement & revise subsequent annual report	2	368.0
Revise subsequent annual report	26	343.4
None	3	285.3
Total	54	

Table 3.6 shows the mean number of days elapsing between the accounts being signed and the press notice being issued, ranked according to the most serious defect covered by the press notice. The ranking adopted is the same as the order in the table, so for example, if a press notice deals with a measurement issue and a disclosure issue, the

measurement issue will be assumed to be the more serious. It might be expected that the investigation period for recognition and measurement issues might be rather longer than for the others. These are the issues that are more likely to cause amendments to the primary statements and the companies may consider that there is more at stake and be inclined to resist the FRRP's view for rather longer. As table 3.6 demonstrates, there is no evidence to support this view, in fact it appears to be disclosure issues that take the longest to resolve, although it must be borne in mind that this is a very crude measure of the FRRP's investigation period.

Table 3.6 – Time taken for press notice to be published for different categories of FRRP case

Category of most serious issue covered by a press notice	Number of press notices	Mean days elapsed between date accounts signed and press notice issued
Recognition – group	5	326.2
Recognition – element	5	290.8
Measurement	10	298.0
Omission	3	302.7
Classification	17	289.5
Disclosure	14	355.9
Total	54	

Summary

The overall level of complaints to the FRRP is lower than in its early years and this is reflected in the number of press notices issued. One explanation could be that the quality of financial reporting in the UK is improving as a result of the FRC's activities in standard setting and enforcement. Almost regardless of its achievements, it would be difficult to argue that the FRRP was excessively costly.

There is no particular pattern to the companies subject to press notices, although it is notable that in addition to larger companies of wider public interest, some smaller unlisted companies (covered by the FRRP's terms of reference) are included. It is

surprising that four companies have been subject to two press notices. This raises the possibility of persistent or vexatious complainants using the FRRP for their own purposes. It could also indicate continuing deficient accounting practices. A high proportion of the issues covered by the FRRP's press notices fall into disclosure and classification categories which are less likely to affect key accounting numbers in the financial statements. The press notices have also been criticised for lacking information content, although attempts have been made to rectify this.

A range of remedial actions has been required by the FRRP in resolving cases. Despite a certain amount of posturing over the possibility of a case going to court it does not appear to be in anyone's interest to resolve a case by this route. The time taken to complete investigations remains a source of criticism of the FRRP. By the time the remedial action is required a great deal more information about the company will have reached the market and the impact of the FRRP's press notice on users may be negligible. The type of remedial action chosen by the FRRP appears to be more closely related to the timing of the investigation than to the nature of the case, as directors seek to manage the outcome to minimise costs and external impact.

Chapter 4: Trivia, judgment, materiality and the true and fair view

Introduction

In this chapter we consider issues how the FRRP's activities relate to key issues in accounting and its overall role in interpretation of the regulatory framework. For this we again draw on publicly available information and our analysis of 12 recently conducted interviews with interested parties (see chapter 3). We summarise the issues raised by the FRRP and review comments made on them in the light of current accounting practices.

The four issues addressed are:

- dealing with trivia;
- areas of judgment;
- interpretations of materiality;
- the true and fair view.

Dealing with trivia

Table 4.1 provides a summary of the 83 issues raised by the FRRP classified according to the categories of recognition, measurement, omission, classification and disclosure set out in chapter three. Disclosure is the most frequently cited. Recognition and measurement issues (which are most likely to affect key financial indicators) form 28% of the total.

The FRRP has been functioning now for nine years. We have separated the issues raised in the first 29 press notices (up to December 1995, approximately half way through its operational life) from the 25 press notices issued to February 2000. Recognition and measurement issues i.e. those which directly affect the primary statements are a similar

proportion of the total issues in both periods, being 27.0% in the first period and 28.6% in the second period.

Table 4.1 – Summary of issues raised by FRRP by classification

Category	Category of issues included in all press notices		Issues in press notices 1992/5		Issues in press notices since 1996	
	No.	%	No.	%	No.	%
Recognition – group	4	4.82	3	6.25	1	2.86
Recognition – element	6	7.23	1	2.09	5	14.28
Recognition – element / measurement (note 1)	1	1.20	0	0.00	1	2.86
Measurement	12	14.46	9	18.75	3	8.57
Omission	4	4.82	4	8.33	0	0.00
Classification	21	25.30	13	27.08	8	22.86
Disclosure	35	42.17	18	37.50	17	48.57
Total	83	100.00	48	100.00	35	100.00

Note 1 – This category relates to a case which involved both element definition and measurement.

Note 2 – A press notice may cover more than one issue.

However issues relating to disclosure, which Tweedie and Whittington (1990) do not include in their analysis of fundamental accounting problems, have increased from the first to the second period from 37.5% to 48.6% of the total issues. Although disclosure issues can be important they are not necessarily the most important. This has led to criticism that that the FRRP has been dealing with trivia (Peel, 1999). One of our technical partner interviewees makes the same point:

‘Not many Panel decisions are anything to do with accounting policies. The majority are to do with fairly bitty items of disclosure. ...They find it most easy to deal with questions which are obvious breaches of specific rules, as they would put it, in either the Companies Act or accounting standards, and that isn’t always the most important thing about a set of accounts...and I mean the number of occasions the Panel has really got to something that I would have regarded as important – probably count on the fingers of one hand.’ (TP3)

The Penrith Farmers case¹² is viewed as an example of dealing with trivia and one which the FRRP should not have got involved with:

¹²Table 3.3, case number 14; appendix 1, case 5.

'Penrith Farmers, it's a bit heavy to impose that, I am not sure the public interest requires it. So I think there might be a case for putting the level up a bit, but on the other hand there aren't many cases which aren't listed companies, so I doubt if there's a real problem there now.' (TP4)

However, one regulator gives a different perspective on this case:

*'I always remember [Regulator XX] because he had these big firms saying, "This is outrageous, and you shouldn't be doing these sorts of things", and he said "It might be trivial to see in London, but it's a b***** big thing in Penrith".'* (R1)

There is a feeling that the FRRP would have more impact if it concerned itself with fewer issues of greater substance:

'I would much rather they had fewer press releases on bigger deals. ...That way the Panel will be taken more seriously because...at the moment, the threat of a Panel case is not that big a threat because the column inches which they get at the end of the day are not very many. I think it would be a more effective operation if there were fewer cases but each of them was a "Gosh, there is a Panel announcement out today. We had better cover it in the press". Everyone ought to get worried about it and so on.' (TP2)

In the FRC's 1998 Annual Report (p. 61) the FRRP robustly defends itself against accusations of trivia:

'I know that some consider that the Panel should not address so-called "minor" matters such as failure to comply fully with the detailed disclosure requirements of applicable reporting standards where the accounting treatments themselves are satisfactory and their correction would not materially affect the financial statements. The Panel's procedures allow it the discretion of not inquiring into all instances of this type of non-compliance. On the other hand, the Panel must be seen to respect the status of the provisions both of the Act and reporting standards it has been empowered to maintain, particularly where a number of clear requirements have been breached.'

A further defence based on the reactive nature of the FRRP was provided by Goldsmith (Peel, 1999, p. 26.):

'To people...who say, why aren't you picking up the important issues? I have always said, why aren't you bringing us the important issues?'

Critics have also commented that the FRRP chooses easy targets, and disclosure issues are easier to find (Kelly, 1997b).

Issues involving judgment

The criticism of dealing with trivia is tempered by the recognition that substantive issues are much harder to find, and judgments are harder to challenge:

‘At the moment the Panel seems to be concerned with fair value table disclosures, not the actual values that go into them. ...Revenue recognition topics are pretty hard because they are highly judgmental and...no-one can write the rules for provisions for bad debts or whatever it happens to be.’ (TP3)

‘I think, ideally, it should be more focused on measurement than it is at the moment, but it is harder for them to find. It is not as though disclosure is not important. I mean if something pretty important is missing then it is right that it gets chased.’ (TP2)

The consensus among the interviewees, including our client service partner, is that it is the auditor who should ensure that accounting decisions in areas of judgment comply with the regulatory framework, particularly when the decision taken is not obvious from the face of the accounts:

‘Assuming FRS 12 on provisions is in, if...that company has provided more than it is now permitted to provide, that is actually rather hard to spot unless you have the inside information. Now the auditors ought to spot that and hopefully generally do. But, even if they haven’t done then it is actually quite hard for the Panel to spot it. Because, if you see a number there, how do you know if it is more or less than it should be under some measurement rule?’ (TP2)

‘The knowledge, which relates to a company is only held by the auditor. It doesn’t become available to others unless it’s referred to us. And neither the company nor the auditor wishes us to, nor would we want to take it on, because we’d only be able to take it on after they had made their decision.’ (R3)

‘I think they are the front line to be honest, you know. The Review Panel is the mop up troops. The auditor may not necessarily have failed, he may have qualified.’ (R1)

However, one finance director believes some of the firms do not really want the FRRP to involve itself in judgment issues because this could lead to many more challenges in the future:

‘I think that what was concerning the professional firms was that almost anything, any one off item, potentially could leave them open to the fact that they hadn’t exercised their judgment properly because it wasn’t disclosed in the accounts. I think that was the road that they were really nervous about trailing down.’ (FD1)

Interpretations of materiality

The issue of materiality emerges particularly in respect of the RMC case¹³ and its possible wider implications. The 1994 group accounts disclosed a potential fine from the restrictive practices court as a contingent liability. The actual fines and legal costs of £4.97 million were disclosed in the accounts of the subsidiary to which they related in 1995, but not in the group accounts. This was not considered material to a pre-tax profit of £340 million by the company or its auditors. In the FRRP’s view, the fine was material not because of its size but because of its nature and circumstances. This case has caused much angst among technical partners, because they saw the potential precedent for disclosure of many other fines:

‘Oh yes, well there was some considerable discussion after the RMC case about disclosure of fines and whether it was going to be material and so on. Especially when there was a bunch of pensions mis-selling fines around at the time. There were hopes to get some guidance out to supplement the materiality guide that was currently in use...but it proved to be rather difficult to get words that would be agreeable.’ (TP1)

One finance director interviewee believes this case was to do with the interpretation of materiality as a qualitative as well as a quantitative issue:

‘I think this was an area where judgment was called for. The actual standards say that materiality is a judgment issue. I think that they were trying to clarify that materiality wasn’t necessarily a size-related issue.’ (FD1)

¹³Table 3.3, case number 45; appendix 1, case 6.

This is the view taken by the regulators:

‘All we were doing was interpreting materiality in a qualitative sense and relying on a document issued by the English Institute which explained it in those terms.’ (R2)

A technical release (TECH 32/96) issued by the Institute of Chartered Accountants in England and Wales states that the main determinants of materiality are ‘its size, nature and circumstances’ and that both quantitative and qualitative aspects need to be considered.¹⁴

Interestingly, one technical partner thinks that the interpretation made by the FRRP on this issue was wrong:

‘Having disclosed the contingent liability for four years, I would help the shareholders by telling them where it had gone. The Review Panel specifically said that was not the issue. That was the one thing that seemed to me to be really relevant. It wasn’t because there had been a contingency there in the past. It was purely because the fine had been levied this year.’ (TP5)

This technical partner also has concerns about disclosure of a fine purely on qualitative grounds without considering the monetary value:

‘But I am saying that if that fine had been big enough you would have hit into disclosure. So what I am saying is that the existence of a fine seems to me to say not enough. I don’t accept the fact that purely because it is a fine it is disclosable. It is the fine and the monetary amount together.’ (TP5)

Two technical partners describe in detail the action their firms took after the RMC case:

‘Most sizeable financial services groups will probably have had some fines this year... So they were very interested to know what the RMC case meant for them. And we spent quite a lot of time on that. Developing guidance to try to draw out

¹⁴The technical release also refers to the ASB’s draft statement of principles: ‘Council recognises that the guidance in the statement is based on the ASB’s latest published thinking as set out in the draft Statement of Principles, and may need to be amended if the final version of the Statement of Principles incorporates changes that have an impact on the interpretation of materiality.’ ICAEW (1996)

some criteria as to what factor it is that makes a fine disclosable. Is it the size, is it how recent or how archaic it is, or what? Is it a question of civil breach, or criminal breach, or what? There is a whole load of possible ways of cutting it, if you believe as we do that not all fines are disclosable.’ (TP2)

‘We did subsequently give formal advice to the effect that really one would have to disclose pretty well all these things and if you were making a billion profit then perhaps a £10,000 fine isn’t material but a million is. You know it’s nearly one thousandth of the profit.’ (TP3)

Thus the RMC case is seen by interviewees as a precedent setter, both in terms of interpretation of materiality in what is perceived as a purely qualitative sense and in terms of specific disclosures in relation to certain types of fine.

One technical partner believes that the FRRP’s position on materiality more generally arises because it would be difficult to win a court case on materiality decisions:

‘I think that in every set of accounts you come to some judgment on materiality. It may be that people disagree with those judgments. I always think that the Panel doesn’t end up disagreeing with the judgments, it ends up saying you should not have made the judgments, which I must fundamentally disagree with... Unless they are honest and say, “we disagree with your judgment” “We would have judged materiality at a different point”. But in each of those cases they seem to say that materiality is not the issue... The Review Panel realises that they can’t go to court and say they made a judgment. It’s their accounts and we think the judgment’s wrong.’ (TP5)

Technical partners do not consider that the FRRP’s position on materiality is compatible with the view that they take on issues which would lead to them qualifying an audit report:

‘Yes it might be for example, it might be a missing disclosure, or it may be a matter of format, layout, of a primary statement, where it isn’t quite right or something is missing, but the extent of the error or the omission is not that great. If you look at the sort of things on which you would qualify your audit opinion, it may be half way to the starting point.’ (TP2)

This technical partner refers to one FRRP inquiry he dealt with which, in his view, illustrates the difference between matters on which an auditor would qualify a clients’

accounts and minor issues arising from an audit which would be reported to an audit committee, but not necessarily acted on because they are not considered important.

‘There is one case I can think of where something was identified, I think it was mentioned in the reports to the audit committee of this company, along with quite a number of other things. It was not thought to be a particularly big deal. It was listed. We didn’t for a minute think about qualifying...but it was reported to the audit committee, and there is again that class of things which one reports to the audit committee which are not anywhere near being qualifying matters. But the Panel picked it up. Now, you are actually spending...far more time looking into it, considering the pros and cons, and in due course defending it, than you ever did at the time, because you thought it was a non point.’ (TP2)

Another technical partner believes that materiality is not a primary concern for the FRRP:

‘But it seems to me that the principle they adopt which is that there is an absolute rule and materiality isn’t relevant to it, cannot be right.’ (TP5)

There are clearly wide differences in perceptions of materiality between the FRRP and technical partners.

The true and fair view

Singleton-Green sees the RMC case as an extension of the true and fair view (1998, p.3) but this view is not reflected in the comments made above by the technical partners who see it more simply as a different interpretation of materiality.

In two of the early cases, Pentos and Trafalgar House, the FRRP appeared to rely on the true and the fair view. The issues arising in both cases were subsequently the subject of new UITF abstracts.¹⁵ However, since the Pentos case in 1994, there have been no cases

¹⁵ The Pentos case (table 3.3, case number 22; appendix 1, case 7) dealt with the treatment of reverse lease premiums and was followed by UITF abstract 12. The major issue in the Trafalgar House case (table 3.3, case number 8, appendix 1, case 4) referred to the re-classification of property from current to fixed assets and the treatment of the diminution in value. UITF abstract 5 was issued shortly afterwards.

which relied on the FRRP's interpretation of the true and fair view,¹⁶ and subsequent claims by companies that they used the true and fair override have been over-ruled by the FRRP.¹⁷

One of our finance director interviewees claims that his company used the true and fair override in its accounts and this was not accepted by the FRRP. He believes the way the item was originally treated reflects the reality of the situation:

'We noted in the accounts that's what we'd done...and everyone was relatively relaxed with it. ...Commercially, that's what had happened...we'd been through it with the auditors and they'd helped us to draft all the notes because...that was the commercial reality of the situation.' (FD2)

He still believes that what they had done was right:

'We always try to comply with the standards and we still do, it was just this one. We thought by complying with the standards the accounts were incorrect. We were using the true and fair override...I had to sign them off again, but I didn't like doing it, It's not right, no, no.' (FD2)

The technical partners strongly believe in the concept of true and fair, but are concerned that the FRRP may be moving the UK framework away from the true and fair override towards a more legalistic American-type approach:

'It comes back to this wonderful phrase we have and I have always thought a marvellous piece of legislation "true and fair"...The reason we have got true and fair is because if you look at the structure of the law you know why we have a set of rules and then it says it must be true and it must be fair – it is an additional thing. It is much weightier and much more difficult to achieve than following a set of rules. If we pull everything back to a set of rules you end up with the directors' report.' (TP5)

'At the moment the Panel looks at the accounts, raises a number of questions, which are apparent from the face of the accounts but doesn't go much beyond that. ...If you make compliance with accounting standards the only thing you

¹⁶It has also been suggested to us that the Guardian Royal Exchange case (table 3.3 case 43) also involved a true and fair interpretation.

¹⁷After Butte Mining's second case where the company re-issued its accounts, the auditors, Cooper Lancaster Brewers qualified the re-issued accounts claiming that they no longer showed a true and fair view.

look at that will relegate the true and fair view and common sense...and basically you will have an American system where you present fairly in accordance with GAAP rather than present fairly and comply with GAAP. There's a subtle, and I think rather important distinction in that which hasn't necessarily been realised.' (TP3)

Technical partners consider that the defects identified by the FRRP have little to do with the true and fair view:

'They are undoubtedly necessary but they are not usually things of such earth shattering importance that...they affected the true and fair view.' (TP3)

The FRRP and Accounting Standards

The FRRP plays an important role in supporting the ASB's new accounting standards, although as a reactive body it claims not to target particular issues (FRC, 1998). Table 4.2 lists the accounting standards issued by the ASB since it assumed responsibility for standard setting and FRRP cases which involve a breach of these standards.

Table 4.2 – FRRP cases arising from accounting standards issued by the ASB

Accounting standard	Effective from	Related FRRP cases	Date of problem accounts	Press notice date
FRS 1 – Cash flow statements	23.3.92	Breverleigh Control Techniques BM Group Intercare group Butte Mining (1) Clyde Blowers H&C Furnishings Concentric Photobition	30.6.92 30.9.92 30.6.92 31.10.92 30.6.93 31.8.93 26.4.97 30.9.97 30.6.98	27.7.93 24.9.93 19.10.93 28.1.94 2.11.94 23.11.94 7.8.98 20.10.98 28.10.99
FRS 2 – Accounting for subsidiary undertakings	23.12.92	Alliance Trust	31.1.94	20.3.95
FRS 3 – Reporting Financial Performance	22.6.93	Eurotherm (e) BET (e) Clyde Blowers Strategem (2) Reuters Holdings H & C Furnishings Photobition PWS	31.10.91 27.3.93 31.8.93 31.8.97 31.12.97 26.4.97 30.6.98 30.9.98	22.2.93 24.5.94 23.11.94 10.1.97 22.7.98 7.8.98 28.10.99 10.1.00

Table 4.2 (Continued)

Accounting standard	Effective from	Related FRRP cases	Date of problem accounts	Press notice date
FRS 4 – Capital instruments	22.6.94	Caradon Securicor Newarthill Alexon Ransomes Butte Mining (2)	31.12.94 30.9.94 31.10.94 28.1.95 30.9.95 30.6.95	8.11.95 15.2.96 8.3.96 1.3.96 30.5.96 2.10.96
FRS 5 – Reporting the substance of transactions	22.9.94	Assoc. Nursing (2) Burn Stewart	31.3.95 30.6.96	17.2.97 2.10.97
FRS 6 – Acquisitions and mergers	23.12.94	Reckitt & Colman Strategem (1) Concentric Aim Group Photobition	30.12.95 31.8.96 30.9.97 30.4.98 30.6.98	15.4.97 27.4.98 20.10.98 24.2.99 28.10.99
FRS 7 – Fair values in acquisition accounting	23.12.94	Reckitt & Colman H & C Furnishings Concentric Aim Group	30.12.95 26.4.97 30.9.97 30.4.98	15.4.97 7.8.98 20.10.98 24.2.99
FRS 8 – Related party disclosures	23.12.95	H & C Furnishings	26.4.97	7.8.98
FRS 9 – Associates and joint ventures	23.6.98	None		
FRS 10 – Goodwill and intangible assets	23.12.98	Reuters Holdings (e) PWS (e) Sinclair Montrose	31.12.97 30.9.98 31.12.98	22.7.98 10.1.00 24.2.00
FRS 11 – Impairment of fixed assets and goodwill	23.12.98	None		
FRS 12 – Provisions, contingent liabilities and contingent assets	23.3.98	None		
FRS 13 – Derivatives and other financial instruments: Disclosures	23.3.99	None		
FRS 14 – Earnings per share	23.12.98	None		
FRS 15 – Tangible fixed assets	23.3.00	None		
FRS 16 – Current tax	23.3.00	None		

(1) / (2) Refers to first or second case where a company has been subject to more than one press notice.

(e) Company adopting an accounting standard earlier than required.

Some cases involve a breach of more than one standard. For example, H & C Furnishing¹⁸ is primarily a breach of FRS 7 *Fair values in acquisition accounting* in that the directors did not use the market share price ruling on the date of acquisition as the basis for establishing fair value (believing it to be ‘unreliable’) but instead used one which applied four months earlier. However, the accounts also breach the disclosure requirements for a number of other recent standards. Except for most recent standards which have yet to work through the system, there is a clear pattern of cases following the

¹⁸ Table 3.3, case number 47; appendix 1, case 9.

introduction of each new accounting standard (see especially FRS's 1, 3, 4, 5, 6 and 7). The press notices have provided some early general authoritative clarification on FRSs, although the FRRP disputes any suggestion that they go beyond the content of the relevant FRS in requiring remedial action (FRC, 1997). Given that 15 out of the last 20 press notices have involved (in part at least) the most recent accounting standards issued by the ASB, the activities of the FRRP may be evolving, by accident or design, into a role which concentrates particularly on the interpretation and enforcement of new standards. Other cases have been based on newly issued UITF pronouncements. For example, M & W Mack¹⁹ were criticised for not complying with UITF Abstract 13 *Accounting for ESOP Trusts* which sought to provide more specific guidance in this area than FRS 5.

One technical partner sees value in some of the relatively minor issues being put right by the FRRP:

'I think to some extent this has been useful because from the audit point of view, we are trying to enforce the standards. We don't always believe in everything the standards say, and if you particularly take a standard like FRS 3, which is so much about classification, it is amazing how much time can be wasted and you do sometimes wonder, "What am I doing here? I have just spent an hour discussing a trivial point about whether an item is up here or down there in the profit or loss account". Now I think to that extent the Panel, although it has dealt with some small looking issues, has done quite a useful service, because it has said, "Well, you may think this is not that important, but we think you haven't complied with a standard and that the end of the matter". I think it has brought home to people that we are actually in a different environment now where, unfortunately, some more attention is required to the standards than otherwise.' (TP4)

One finance director took a different view:

'It is quite ridiculous that grown men want to spend their time doing this.' (FD1)

¹⁹Table 3.3, case number 40, appendix 2, case 1.

Summary

Concerns emerge from our interviewees about the lack of substance in some of the cases that the FRRP deals with. It is accepted that many decisions which affect the accounting numbers are not visible from the accounts and the FRRP can only deal with what it can see. There are some suggestions that it should deal with fewer issues but make sure they are of substance, but it is not at all clear how these issues can be found. There are also very few cases where the FRRP has taken a true and fair override position and none are recent. It may be there are none, or that the FRRP is avoiding confrontation on the true and fair view, but as there is no information available on cases that are dropped this cannot be proved either way. There is some evidence to suggest that the FRRP is inclining towards requiring the rectification of compliance breaches which in some cases may be relatively minor, and the interpretation and enforcement of new accounting standards and other technical pronouncements such as the ICAEW technical release on materiality. These issues are much easier to deal with than matters of judgment. Practitioners do see the FRRP as a precedent setter and interpreter of standards, although this is denied by the FRRP (Treadgold, 1997). What is also clear, however, is that the FRRP is taking a different approach to materiality and the true and fair view from that which is currently understood and applied by practitioners.

Chapter 5: The FRRP's Wider Impact on UK Financial Reporting

Introduction

The FRRP obviously has an impact on the financial reporting of the companies referred to it. However as Goldsmith points out:

'When considering the extent to which the Panel achieves its objectives, the Panel needs to be judged not simply by its performance on a case by case basis, but on whether it is effective in helping to reinforce the will and commitment of those involved in preparing financial statements.' (FRC, 1999, p. 50)

This chapter reviews the evidence to support the FRRP's claim that its activities do have a wider impact on the quality of financial reporting in the UK beyond the specific cases referred to it (FRRP, 1997). This comprises:

- evidence of the impact on companies cited in press notices:
 - ◆ adverse market reaction;
 - ◆ adverse publicity;
 - ◆ costs to the company.
- the impact of FRRP press notices on the accounting policies of other companies;
- the impact of the FRRP on auditors:
 - ◆ the effect on audit firms;
 - ◆ how auditors influence clients;
 - ◆ views on the FRRP's impact on the interpretation of accounting regulations.

Evidence of the impact on companies cited in press notices

Adverse market reaction

Early anecdotal evidence shows a belief that the stock market was reacting to FRRP press notices dealing with significant issues (Singleton-Green, 1992). The company subject to the first press notice, Williams Holdings, suffered a share price fall of 3.4%

(10 pence) on the day of announcement, although it soon became apparent that such a reaction was not the norm.

A systematic share price study was undertaken by Hines, McBride and Page (1999) on the first 33 press notices issued by the FRRP which had cited a listed company (up to 31 December 1996). Efficient markets of the semi-strong form (Fama, 1970) will react to any new information in the public domain about a company which is believed to influence rational estimates of future security returns. However, the results of the study showed no evidence of a systematic price reaction by the market. This implies that the market does not consider that the press notices published by the FRRP contain new information. This is not surprising as the issue would have been evident from the relevant corporate annual report.

Adverse publicity

The FRRP cites two reasons for publishing press notices. First, to increase the knowledge base available to users and preparers of accounts. Second:

‘Publicity should deter others from adopting similar accounting treatments that do not meet the legal requirements of the Act.’ (FRC, 1998, p.60)

This view was shared by one interviewee:

‘I think in the British context, naming and shaming is a pretty draconian power because companies hate it, they absolutely loathe it. So it is effective in the sense of... you know, the raised eyebrow in the City is quite a powerful weapon and we find they hate that most.’ (R1)

Such assertions about the importance of publicity have been reiterated elsewhere (e.g. Zeff, 1995; Jack, 1994). Some directors with direct experience of FRRP investigations have expressed the opinion that case publicity is unnecessary, or alternatively, that even

if the details of a case were made public, the name of the relevant company should be withheld (Hines et al, 2001). This suggests that publicity does have a deterrent effect.

Table 5.1 summaries the press coverage referring to each FRRP case. Those appearing in the *Financial Times* and those which also mention the company's auditor are included in the overall total.²⁰ The Trafalgar House²¹ case is still the one to have received the greatest press attention. This is partly because of the high profile nature of the issue and the impact of the required remedial action (reducing reported earnings by 279.7%), but also because the company was regularly in the news for a variety of reasons (take-overs and indifferent results) and reference was frequently made to the FRRP investigation. Williams Holdings, next in terms of publicity, was the FRRP's first case and therefore this press notice provided insights into its approach to regulatory enforcement. Associated Nursing Services *second case*²² was a fiercely contested case based on FRS 5 'Reporting the Substance of Transactions', which was considered to have implications for other companies in the health care sector.

Table 5.1 – Press coverage of companies subject to FRRP press notices and their auditors

Company	FT no. of articles	Total no. of articles	Auditors	Total no. of articles
1 Williams Holdings	8	26	Pannell Kerr Forster	7
2 Ultramar	6	12	Ernst & Young	5
3 Shield Group	4	6	Stoy Hayward	2
4 Forte	7	9	Price Waterhouse	0
5 Williamson Tea Holdings	1	1	Drury Thurgood	0
6 Associated Nursing Services	3	8	Clark Whitehill	1

²⁰The data has been extracted from the McCarthy database, which covers the main national newspapers. Any article naming the company and the FRRP has been included regardless of the main focus of the article.

²¹Table 3.3, case number 8; appendix 1, case 4.

²²Table 3.3, case number 38; appendix 1, case 3.

Table 5.1 (Continued)

Company	FT no. of articles	Total no. of articles	Auditors	Total no. of articles
7 GPG	2	5	Coopers & Lybrand	1
8 Trafalgar House	28	94	Touche Ross	22
9 British Gas	3	8	Price Waterhouse	0
10 S.E.P. Industrial Holdings	2	3	Bloomer Heaven	2
11 Eurotherm	1	4	Arthur Andersen	3
12 Foreign & Colonial Investment Trust	1	3	Price Waterhouse	0
13 Warnford Investments	1	2	Blakemores	0
14 Penrith Farmers' & Kidd's	1	1	N.T.O'Reilly	1
15 Breverleigh Investments	2	2	Copeland	2
16 Royal Bank of Scotland	1	7	Coopers & Lybrand	2
17 Control Techniques	2	3	Coopers & Lybrand	3
18 B M Group	3	5	Kingston Smith	2
19 Ptarmigan Holdings	1	2	Ernst & Young	1
20 Chrysalis Group	1	2	KPMG	1
21 Intercare Group	2	3	Price Waterhouse	2
22 Pentos	3	8	Coopers & Lybrand	0
23 BET	2	4	Coopers & Lybrand	1
24 Butte Mining	2	4	Cooper Lancaster Brewers	1
25 Clyde Blowers	1	4	Downie Wilson	0
26 Alliance Trust	0	2	KPMG	0
27 Courts	1	4	Coopers & Lybrand	0
28 Caradon	1	2	Price Waterhouse	1
29 Ferguson International Holdings	2	6	Price Waterhouse	1
30 Securicor Group	0	1	Baker Tilly	0
31 Newarthill	0	1	Touche Ross	1
32 Brammer	0	0	KPMG	0
33 Foreign & Colonial Investment Trust	1	1	Price Waterhouse	0
34 Alexon Group	1	2	Price Waterhouse	2
35 Ransomes	0	0	Price Waterhouse	0
36 Sutton Harbour Holdings	1	1	Nevill Hovey	0
37 Butte Mining	3	7	Cooper Lancaster Brewers	0

Table 5.1 (Continued)

Company	FT no. of articles	Total no. of articles	Auditors	Total no. of articles
38 Associated Nursing Services	5	14	Clark Whitehill	2
39 Reckitt & Colman	1	3	Price Waterhouse	0
40 M & W Mack	0	0	Ernst & Young	0
41 Burn Stewart Distillers	4	2	Price Waterhouse	2
42 Stratagem Group	1	1	Coopers & Lybrand	0
43 Guardian Royal Exchange	3	7	Price Waterhouse	0
44 Stratagem Group	1	1	Coopers & Lybrand	1
45 RMC Group	1	1	Coopers & Lybrand / Kidsons Impey	0
46 Reuters Holdings	2	3	Price Waterhouse	0
47 H & C Furnishings	1	2	Coopers & Lybrand	1
48 Photo-Me International	1	4	Menzies	0
49 Concentric	1	2	Wenham Major	0
50 Aim Group	0	0	Rothman Pantall	0
51 Photobition Group	0	0	Deloitte & Touche	0
52 PWS Holdings	1	1	Mazars Neville Russell	0
53 Eurocity Properties	0	0	Baker Tilly	0
54 Sinclair Montrose Healthcare	0	0	BDO Stoy Hayward	0

Source: McCarthy Database.

Overall the level of publicity and public interest in a case depends on the nature of the issue and the size and profile of the company involved. However, there is a distinct long term trend of decline in the level of press reporting with most cases arising in 1999 and 2000 not being reported at all. Even the RMC case which was considered sufficiently significant to form the basis of an editorial in *Accountancy* (Singleton–Green, 1998) was not widely reported in the national press. One regulator interviewee believes that declining press interest in the FRRP’s activities is because it has been in existence for some time:

'I think by definition as an institution goes on it gets less press worthy. You know you want blood all over the table and a bit of sex for it to be of any interest now.'
(R3)

The FRRP has other means of reporting details of cases (for example, direct circularisation of press notices, the stock exchange news system and its web site) which may enhance the knowledge base available to users and preparers, but for publicity to work as a deterrent, a reasonable level of press interest is essential. The declining level of press coverage may undermine the impact of an FRRP intervention with those minded to commit regulatory breaches.

Costs to the company

An FRRP investigation has a nuisance value and incurs costs:

'It is not the existence of the Panel, full stop, like the existence of an ombudsman. But equally it isn't the detail of what they have said, it is merely the fact that they are there, they do see things, that which they see they can act on, and the other thing is a significant fear factor that there is a lot of hassle, lost management time, frustration, etc. etc. involved in visiting the Panel. Therefore people say "Well, I don't mind debating something with somebody", because that's what they do with their auditors, "but this sounds like a bad news experience".' (TP1)

'We had to do a lot of checking internally...We had a bill from [name of auditors] They bore most of the cost themselves, I don't know what they absorbed but we paid about £15,000. We had a bill from [name of solicitors] for another £5,000. In term of management time...there were all sorts of people. I obviously got involved, the financial controller got involved. We had to check the people who were here at the time...probably I think it cost in time about £100,000, and a lot of time at board meetings discussing it. I think totally out of proportion to the point.' (FD1)

There is therefore a deterrent effect in the costs and aggravation that accompany an FRRP investigation, but only if the extent of it is known.

Impact of FRRP press notices on the accounting policies of other companies

One indicator of the wider impact of the FRRP's activities would be that, following the issue of a press notice, other companies for whom the point raised was relevant (e.g. in the same industry sector) changed their accounting policy in the relevant area. Having reviewed the Press Notices (PNs) we carried out a limited test to investigate whether three particular PNs (which were relevant to accounting policies in specific industry sectors) had led other companies to change their accounting policies. These are:

- a) FRRP PN 33 issued on 21 June 1995 on the accounts of Courts Plc for the year ended 31 March 1994;²³
- b) FRRP PN 38 issued on 28 March 1996 on the accounts of Brammer Plc for the year ended 31 December 1994;²⁴
- c) FRRP PN 44 issued on 17 February 1997 on the accounts of Associated Nursing Services Plc for the years ended 31 March 1995 and 31 March 1996.²⁵

In all we looked at 21 companies' accounts in relation to PN 33, 9 with respect to PN 38 and 9 for PN 44.

For each company included in the test, the last annual report signed off before the publication of the relevant press notice and at least two following its publication were reviewed for any evidence of change in accounting practice. The sample comprised other listed companies in the same industrial sectors (as defined by the London Stock

²³Table 3.3, case number 27; appendix 2, case 10.

²⁴Table 3.3, case number 32; appendix 2, case 11.

²⁵Table 3.3, case number 38; appendix 2, case 3. Kelly (1997) suggested that the press notice would have implications for a number of other companies within the health care sector and we therefore reviewed these.

Exchange) who were likely to be engaged in similar activities (according to SIC classifications on Extel).²⁶

Table 5.2 (wider effect of Courts press notice) shows that out of 21 companies, only two appeared to have changed their accounting policy for instalment and hire purchase debtors to comply with SSAP 21 during the relevant time period. In the case of GUS, the change had occurred in accounts signed within a month of the Courts press notice, while for Harveys, almost a year had elapsed. However, there was no evidence that other companies were not complying with SSAP 21.

Table 5.2 – Investigation of wider effects of Courts (21.6.95) press notice

Company	Annual reports reviewed (year end)	Evidence of relevant accounting policy change
Allders	30.9.94 30.9.95 30.9.96	None
Allied Carpets Group	29.6.96 28.6.97 27.6.98	None
Beale	2.11.96 1.11.97 31.10.98	None
Beattie J	31.1.94 31.1.95 31.1.96	None
Bentalls	29.1.94 27.1.96	None
Brown N	25.2.95 2.3.96	None
Carpetright	30.4.94 29.4.95 27.4.96	None
DFS Furnishings	29.7.95 27.7.96	None
Dixons Group	30.4.94 29.4.95 27.4.96 3.5.97	None

²⁶Although Brammer is a distributor, discussions with senior members of the accountancy profession prompted a review of the transport sector because the case was considered to be widely applicable to companies in this sector .

Table 5.2 (Continued)

Company	Annual reports reviewed (year end)	Evidence of relevant accounting policy change
GUS	31.3.94 31.3.95	In the 1994 accounts the accounting policy for instalment and hire purchase debtors was 'the gross profit and finance charges on goods sold under hire purchase and certain instalment agreements are brought into profit as and when instalments are received' (p.18). In the 1995 accounts (dated 12 July 1995) this had changed to 'the gross margin from sales on extended credit terms is recognised at the time of sale' (p.17).
Hampden	28.12.96 3.1.98	None
Harveys (Previously Cantors and H & C Furnishing)	22.4.95 27.4.96	The 1996 accounts (dated 4 July 1996) included a restatement of the previous year's figure for turnover, administration expenses, provisions and hire purchase debtors. The accounting policy note (p.20) explains 'hire purchase and credit account debtors are now stated net of provision for future charges, collection costs and bad debts. The provision for future finance charges and collection costs had previously been included within provisions for liability and charges. Movement on the provision for future finance charges and collection costs is now included as turnover rather than deducted from administrative expenses.'
House of Fraser	28.1.95 27.1.96	None
Kingfisher	28.1.95 3.2.96	None
Liberty	28.1.95 27.1.96	None
Limelight	31.12.96 31.12.97	None
MFI Furniture	27.4.96 26.4.97	None
Marks & Spencer	31.3.95 31.3.96	None
Next	28.1.95 28.1.96	None
Roseby's	30.12.95 28.12.96 3.1.98	None
Upton & Southern	31.7.94 27.7.96 26.7.97	None

Table 5.3 shows that of the nine companies we identified in the transport sector engaging in contract hire, one company, Goode-Durrant, did change its accounting policy with respect to the hire of commercial vehicles and equipment. In the accounting policy note the directors state that following the disposal of non-core businesses they considered it

appropriate to reclassify hire fleet as fixed assets. This annual report was signed off on 10 July 1996, just over three months after the Brammer press notice.

Table 5.3 – Investigation of wider effects of Brammer (28.2.96) press notice

Company	Annual reports reviewed (year end)	Treatment of assets for contract hire
Avis Europe (New to market 1.97)	20.2.98	Tangible fixed assets
Arriva	31.12.94 31.12.95 31.12.96 31.12.97	Tangible fixed assets
Dawson Group	31.12.95 31.12.96 31.12.97 31.12.98	Tangible fixed assets
Goode-Durrant	30.4.95 30.4.96 30.4.97 30.4.98	Year ended 30.4.96 accounting policy changed so vehicle hire fleet reclassified from current to fixed asset
Hill Hire	31.3.95 31.3.96 31.3.97 31.3.98	Tangible fixed assets
NFC	30.4.95 30.4.96 30.4.97	Tangible fixed assets
Railtrack	31.3.95 31.3.96 31.3.97 31.3.98	Tangible fixed assets
Stagecoach (Porterbrook Leasing company acquired during 1997)	30.4.97 30.4.98	Tangible fixed assets
Transport Development Group (Hire business sold during y.e. 31.12.97)	31.12.94 31.12.95 31.12.96 31.12.97	Tangible fixed assets

Table 5.4 shows the impact of the Associated Nursing Services press notice on nine other companies in the healthcare sector. Tamaris made specific reference to the ‘FRC review panel findings on Associated Nursing Services’ in their 1997 annual report. They had reviewed their accounting treatment of operating leases, but did not consider any policy change to be justified. Another company, Kunick had changed accounting

treatment in 1994 from a sale to a financing transaction. However, this preceded the publication of the relevant press notice.

Table 5.4 – Investigation of wider effects of ANS (17.2.97) press notice

Company	Annual reports reviewed (year end)	Evidence of relevant accounting policy change
Community Hospitals Group	30.6.94 30.6.95 30.6.96 30.6.97 30.6.98	No – Sale and leaseback transaction treated as a sale
Crestacare	31.12.94 31.12.95 31.12.97 31.12.98	No evidence of sale and lease back
Kunick	30.9.94 30.9.95 30.9.96 30.9.97 30.9.98	The 1994 accounts stated that a sale and leaseback transaction previously accounted for as a sale was now treated as a financing transaction as a consequence of FRS 5's implementation
Matrix Healthcare	30.9.96 30.9.97 30.9.98	No evidence of sale and lease back
Nestor Healthcare Group	31.12.96 31.12.97 31.12.98	No evidence of sale and lease back
Tamaris	31.3.95 31.3.96 31.3.97 31.3.98	No – Sale and leaseback transactions treated as a sale. 1997 accounts included a reference to the FRRP's actions which 'led to a review of operating leases' (p.20)
Trinity Care	31.3.96 31.3.97 31.3.98 31.3.99	No – Sale and leaseback transaction treated as a sale
Univent	30.9.95 30.9.96 30.9.97 30.9.98	No evidence of sale and lease back
Westminster Healthcare	31.3.94 31.3.96 31.3.97 31.3.98	No evidence of sale and lease back

The above results show three companies changed their accounting policies within a year of a relevant FRRP press notice. Clearly a company would only need to change if it was out of compliance. Although, it is not possible to identify a causal link between the two events, it does provide weak evidence of FRRP influence.

An alternative perspective is provided by Jupe and Rutherford (1997) who surveyed the cash flow statement in 225 large company accounts and identified many additions and omissions from the standard FRS 1 format, none of which had attracted comment from the auditors or the FRRP. Not all their findings can be classified as ‘material departures’, but they identify two companies who did not use the FRS 1 definition of cash and cash equivalents, an issue which was the basis of the BM Group case.²⁷ This case did not prevent other breaches of FRS 1.

The impact of the FRRP on auditors

The effect on audit firms

Although the FRRP has no direct authority over auditors, companies are encouraged to involve their auditors when an inquiry takes place. The companies cited in the 54 press notices to 30 June 2000 were audited by 24 different firms, although 32.5²⁸ (60.2%) involved a Big Five (formerly Six) auditor. Eleven (20.4%) of the accounts criticised received a qualified audit report, although not necessarily on the issues criticised by the FRRP. In eleven cases (20.4%) the auditors were changed within two years. Only five (45.5%) of the changes were companies moving from a Big Five firm, while eight of the changes were movements to a Big Five firm. Although there is no causal link, this is a high rate of auditor change. One technical partner explicitly states that FRRP cases are bad news for client relationships:

‘The effect on the audit relationship of an adverse, or indeed any Panel reference, is not very good, it certainly does happen in that way, to an extent that management can shrug off an adverse Panel finding. It is much more difficult for the auditors to shrug it off.’ (TP3)

²⁷Table 3.3, case number 18; appendix 2, case 2.

²⁸One case had joint auditors.

One finance director found his auditors more enthusiastic to fight than he was:

‘The auditors really wanted to fight it but we said “are you prepared to pay the costs?” They wanted to go the whole way and the other big firms rallied round to a degree of course. It was a political issue. I think the firms would all like to put a marker across the Panel at some stage.’ (FD1)

Where a press notice is issued in respect of defective accounts and the auditors have not qualified the audit report in respect of the defect, the FRRP draws the matter to the attention of the body responsible for regulating the auditors.²⁹ Therefore the prospect of an investigation and possible disciplinary action by a professional accountancy body is a further incentive for auditors to avoid the FRRP:

‘The Panel...have heard some of the arguments, they could know whether there was any merit in it, whether it appears that the auditors have been on side or whether there’s been a big dispute and they caved in. I don’t think its quite fair just to refer them all to the Institute and that’s no doubt one reason the Institute did nothing. I mean these things are not normally the result of people saying you can do what you like, we don’t care, there’s often been considerable debate about some of the issues, or just sometimes, the point was not considered contentious.’ (TP4)

No disciplinary action was taken in any case until 1999, when the ICAEW began to discipline the auditors involved in FRRP cases (Fearnley et al, 2000). The disciplinary investigations also include any individual directors of companies criticised by the FRRP who are members of the professional body responsible for regulating their auditors. This provides an additional disincentive to directors who are ICAEW members:

‘One of the things we always have to remind them is that the Panel is one thing, but the institute investigating its members, that’s you FD as well as me the auditor, is a stage yet to come. Some will not care much about that really. Some will get tremendously worried about it. Couldn’t possibly have an Institute having a fine on me, goodness me. And others will say, oh well that was a long time ago.’ (TP2)

²⁹ In all but one case to date this has been the Institute of Chartered Accountants in England and Wales.

Our finance director interviewees were disgruntled about the time and expense involved in being investigated:

‘Then people started getting letters. We had to start digging out the records at the time. People had gone. We had to get the board to agree to meet the costs of the former directors. It was quite a lot of work and the...chairman was scathing about it, all this work.’ (FD1)

The inequity of only disciplining some members of the Board was criticised:

‘You see the Institute should be there to help its members not to accuse them of things all the time. You know, at the end of it the accounts, it’s a board decision, we are two members of an [X] man board. All right they rely on us but at the end of the day if the Board say that’s it what do we do?’ (FD2)

How auditors influence clients

In order to gain an understanding of the FRRP’s influence on auditors’ interactions with clients, a questionnaire was sent out to audit firms with clients which fall within the FRRP’s remit. A total of 154 questionnaires were sent out in June 1999 and 64 usable replies were obtained, a response rate of 41.6%. A few partners in smaller firms declined to complete the questionnaire on the grounds of (arguably mistaken) irrelevance, for example:

‘It does not relate to us. Our total turnover is in the £5 million to £10 million range and we have no quoted Plcs nor does the Financial Reporting Review Panel have any practical impact on us.’

Table 5.5 shows how partners refer to the FRRP in their dealings with clients, broken down by different firm size. The results for the total population shows little interest in the FRRP, with few partners claiming to refer to them more frequently than ‘seldom’ in their dealings with clients (39.4% was the highest response to any of the questions), with most (varying between 60.6% and 71.9%) claiming ‘never’ to refer to them.

Table 5.5 – Questionnaire responses: situations where audit firm partners refer to FRRP in dealing with clients

Question		Total		Big 5		Group A		National Audit		Regional Audit		Local	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
To assist clients with best practice Respondent	Regularly	7	11.5	2	50.0	1	16.7	1	25.0	1	6.7	2	6.3
	Seldom	12	19.7	1	25.0	1	16.7	1	25.0	3	20.0	6	18.7
	Never	42	68.8	1	25.0	4	66.6	2	50.0	11	73.3	24	75.0
	Total	61	100.0	4	100.0	6	100.0	4	100.0	15	100.0	32	100.0
To assist clients with best practice Respondent's partners	Regularly	3	5.0	1	25.0	0	0.0	1	25.0	0	0.0	1	3.3
	Seldom	13	21.7	2	50.0	1	14.3	1	25.0	3	20.0	6	20.0
	Never	31	51.6	1	25.0	4	57.1	2	50.0	6	40.0	18	60.0
	Don't Know	13	21.7	0	0.0	2	28.6	0	0.0	6	40.0	5	16.7
	Total	60	100.0	4	100.0	7	100.0	4	100.0	15	100.0	30	100.0
To discourage clients from regulatory breaches Respondent	Regularly	9	14.8	3	75.0	2	33.3	1	25.0	1	6.7	2	6.3
	Seldom	15	24.6	1	25.0	0	0.0	1	25.0	4	26.6	9	28.1
	Never	37	60.6	0	0.0	4	66.7	2	50.0	10	66.7	21	65.6
	Total	61	100.0	4	100.0	0	100.0	4	100.0	15	100.0	32	100.0
To discourage clients from regulatory breaches Respondent's partners	Regularly	5	8.3	3	75.0	0	0.0	1	25.0	0	0.0	1	3.3
	Seldom	16	26.7	1	25.0	2	28.6	2	50.0	4	26.7	7	23.3
	Never	28	46.7	0	0.0	3	42.8	1	25.0	7	46.6	17	56.7
	Don't Know	11	18.3	0	0.0	2	28.6	0	0.0	4	26.7	5	16.7
	Total	60	100.0	4	100.0	7	100.0	4	100.0	15	100.0	30	100.0
To discourage creative accounting Respondent	Regularly	9	14.7	3	75.0	2	33.3	1	25.0	1	6.7	2	6.3
	Seldom	14	23.0	1	25.0	0	0.0	1	25.0	5	33.3	7	21.9
	Never	38	62.3	0	0.0	4	6.7	2	50.0	9	60.0	23	71.8
	Total	61	100.0	4	100.0	6	100.0	4	100.0	15	100.0	32	100.0

Table 5.5 (Continued)

Question		Total		Big 5		Group A		National Audit		Regional Audit		Local	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
To discourage creative accounting Respondent's partners	Regularly	6	10.0	3	75.0	1	14.3	1	25.0	0	0.0	1	3.3
	Seldom	16	26.7	1	25.0	2	28.6	2	50.0	5	33.3	6	20.0
	Never	28	46.6	0	0.0	3	42.8	1	25.0	6	40.0	18	60.0
	Don't Know	10	16.7	0	0.0	1	14.3	0	0.0	4	26.7	5	16.7
	Total	60	100.0	4	100.0	7	100.0	4	100.0	15	100.0	30	100.0
In support of your request for specific changes to the Financial statements of clients Respondent	Regularly	8	13.1	2	50.0	2	50.0	2	33.3	0	50.0	2	0.0
	Seldom	15	24.6	2	50.0	0	50.0	0	0.0	5	0.0	8	33.3
	Never	38	62.3	0	0.0	4	0.0	2	66.7	10	50.0	22	66.7
	Total	61	100.0	4	100.0	6	100.0	4	100.0	15	100.0	32	100.0
In support of your request for specific changes to the Financial statements of clients Respondent's partners	Regularly	4	6.7	1	25.0	0	0.0	1	25.0	0	0.0	2	6.7
	Seldom	18	30.0	3	75.0	2	28.6	2	50.0	4	26.7	7	23.3
	Never	27	45.0	0	0.0	3	42.8	1	25.0	7	46.6	16	53.3
	Don't Know	11	18.3	0	0.0	2	28.6	0	0.0	4	26.7	5	16.7
	Total	60	100.0	4	100.0	7	100.0	4	100.0	15	100.0	30	100.0
In other ways Respondent	Regularly	2	3.5	0	0.0	0	0.0	1	33.3	0	0.0	1	3.3
	Seldom	10	17.6	1	33.3	1	16.7	0	0.0	3	20.0	5	16.7
	Never	41	71.9	1	33.3	4	66.6	2	66.7	11	73.3	23	76.7
	Don't Know	4	7.0	1	33.4	1	16.7	0	0.0	1	6.7	1	3.3
	Total	57	100.0	3	100.0	6	100.0	3	100.0	15	100.0	30	100.0
In other ways Respondent's partners	Regularly	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
	Seldom	10	18.2	1	33.3	1	16.7	1	33.3	3	20.0	4	14.3
	Never	29	52.7	0	0.0	3	50.0	2	66.7	7	46.7	17	60.7
	Don't Know	16	29.1	2	66.7	2	33.3	0	0.0	5	33.3	7	25.0
	Total	55	100.0	3	100.0	6	100.0	3	100.0	15	100.0	28	100.0

Slightly more respondents are inclined to refer to the FRRP as a means of discouraging bad practice rather than assisting with good practice (for example, 31.2% of respondent partners making some reference to the FRRP ‘to assist clients with best practice’ compared with 39.4% ‘to discourage clients from regulatory breaches’). In responding to the same questions on behalf of their partners, the respondents believed that a reference to the FRRP was even less likely (for example, although 14.8% of respondents referred to the FRRP regularly to ‘discourage clients from regulatory breaches’ only 8.3% thought their partners did the same).

However striking variations arise in responses from different firms. Big Five firm partners cite the FRRP much more frequently, with very few (the maximum was 33.3%) instances of ‘never’ referring to it. The partners from the smallest audit firms (regional audit and local categories) are the ones most likely ‘never’ to refer to the FRRP in client negotiations. The lowest response for these partners was 60.0% for regional audit firms and 65.6% for local firms. Partners from Group A and national audit firms are more likely to refer to the FRRP than those from smaller firms, but much less likely than Big Five partners.

Table 5.6 shows the perceptions of the impact of the FRRP on compliance. While only 17.7% of total respondents thought that the FRRP had changed their clients’ attitudes to compliance, all the Big Five respondents believed it had, compared with 6.7% of regional audit firm partners and 12.5% of local firm partners.

Table 5.6 – Questionnaire responses: the impact of the existence of the FRRP on audit partners’ and clients’ attitudes to compliance

Question		Total		Big 5		Group A		National Audit		Regional Audit		Local	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Has the existence of the Review Panel changed your clients’ attitudes to compliance?	Yes	11	17.7	4	100.0	1	14.3	1	25.0	1	6.7	4	12.5
	No	36	58.1	0	0.0	4	57.1	1	25.0	11	73.3	20	62.5
	Don’t Know	15	24.2	0	0.0	2	28.6	2	50.0	3	20.0	8	25.0
	Total	62	100.0	4	100.0	7	100.0	4	100.0	15	100.0	32	100.0
Has the existence of the Review Panel changed attitudes to compliance with your firm? Respondent	Yes	14	22.6	2	50.0	1	14.3	1	25.0	3	20.0	7	21.8
	No	45	72.6	2	50.0	6	85.7	3	75.0	12	80.0	22	68.8
	Don’t Know	3	4.8	0	0.0	0	0.0	4	0.0	0	0.0	3	9.4
	Total	62	100.0	4	100.0	7	100.0	4	100.0	15	100.0	32	100.0
Has the existence of the Review Panel changed attitudes to compliance with your firm? Respondent’s partners	Yes	9	5.0	2	50.0	2	28.6	1	25.0	2	13.3	3	6.7
	No	38	63.3	2	50.0	4	57.1	3	75.0	10	66.7	19	63.3
	Don’t Know	13	21.7	0	0.0	1	14.3	0	0.0	3	20.0	9	30.0
	Total	60	100.0	4	100.0	7	100.0	4	100.0	15	100.0	30	100.0

Many of the questionnaire respondents in smaller firms added comments such as, *'Probably 99% (of clients) were unaware of the FRRP's existence'*. 22.6% of respondents thought attitudes to compliance had changed, although only 5% thought that the attitudes of their partners had. The compliance partners who responded may have considered themselves better acquainted with the FRRP's activities than their fellow partners.

These results provide a mixed picture of the FRRP's impact on auditors who have a major influence on companies' compliance with financial reporting. Apart from the respondents from Big Five firms, the FRRP appears to have had little impact on behaviour of auditors. All the Big Five firms have direct experience of an FRRP investigation, but this does not apply to respondents in the other categories. Although the FRRP's remit includes large private limited companies, 87.5% of press notices have cited listed companies, a group where Big Five auditors dominate. In other words the activities of the FRRP may seem relatively remote and irrelevant to the smaller audit firms.

Interviewees' comments on FRRP's impact on interpretation of accounting regulations

Our technical partner interviewees (who are from larger firms) believe that the auditors' position has been strengthened in client negotiations by the FRRP's existence:

'The impression I get is that whereas before the client would be inclined to say, "Well I am going to do this, what are you going to do about it". To which the answer is, "Well I don't like it very much, I am very unhappy with it and it does not seem to be quite right. I am very nervous about whether I find this acceptable". There is now another strand, which says, "Well the Review Panel are likely to be picking this sort of thing up".' (TP1)

Although one technical partner thinks that this has an undesirable side:

‘There has been much, rather too much I think, emphasis on, “Well you may not accept my opinion but I am sure that the Panel will get you if you don’t”, which rather takes away from the authority of the audit partner and that is definitely a bad thing.’ (TP3)

There is also a view from technical partners and finance directors that the FRRP had changed the way in which the regulatory framework is interpreted:

‘Rightly or wrongly...the UK accounting rules have become far more prescriptive...my attitude now is that whereas before I might have had a healthy debate with the auditors about whether something should be disclosed this way or that. They tell me something must be disclosed, I just disclose.’ (FD1)

There is a belief that contentious issues are more likely to be better concealed in the accounts:

‘I think in the early nineties I think it was probably easier for the Panel to find them, you know. The auditors’ defence in a problem was to put a note in, that’s what I used to call “leaving a foot sticking out of the grave”, you know and now he’s six feet down and you don’t see him.’ (R1)

‘You don’t make notes in accounts if you think they’re, that the regulator is going to pick them up, you know, you hide things away. We all know we can hide things away from the auditors fairly easily if we want to.’ (FD2)

Summary

The effectiveness of the FRRP depends on companies being deterred from breaching the regulatory framework because of the risk of a referral. There is no evidence of companies cited in the press notices suffering economic damage as a result of an adverse market reaction. Although an FRRP investigation will involve a company incurring some additional costs, this may not be an effective deterrent to others if the extent of this is not fully appreciated. Press interest in the FRRP is declining which may reduce the deterrent effect of adverse publicity.

There is weak evidence that a press notice issued on one company may affect the accounts of other companies with related issues. It is not possible to identify a causal relationship and so the results are inconclusive.

Auditors have good reasons to avoid an FRRP case. They too may incur additional costs and be subject to unwanted publicity. The relationship with the client may be adversely affected and they may become involved in an investigation from their regulatory body. However, while it is clear that the Big Five firms take this threat seriously, actively promoting the FRRP with their clients, it is less obvious that audit partners from smaller firms are equally concerned.

Chapter 6: The future role of the FRRP

Introduction

In this chapter we consider how the role of the FRRP could develop in the medium term in the UK, and we briefly consider other developments which have long-term implications for the regulation of financial reporting.

In July 2000, the FRRP introduced some relatively minor changes to its working practices (FRRP, 2000). These are expected to improve a number of procedural matters but do not change the scope of what FRRP does. A number of suggestions for changes to its role have been made, which arise from our interviewees' comments, our questionnaire responses and the UK Company Law Review (DTI, March 2000, p.162, pp.179-80). We also provide our interviewees' preliminary views on the longer-term issues. The matters identified are set out below and discussed in turn:

- changes in the FRRP's remit in respect of the companies with which it deals;
- a more pro-active role in the pre-clearance of documents and accounting treatments and better disclosure of matters considered and found acceptable;
- extension of the FRRP's remit, in respect of listed companies, to other published financial information;
- pro-active monitoring of listed company financial statements;
- the FRRP to operate as a tribunal and be able to impose remedies or penalties itself without reference to the courts;
- views about the effectiveness of the FRRP and the long-term future.

Changes in the FRRP's remit in respect of the companies with which it deals

The FRRP's remit covers all Plcs and large private companies. 50 of the 54 FRRP press notices analysed in table 3.3 (92.5%) concern listed companies. As these companies have a higher public interest profile, it has been suggested that the FRRP should concern itself only with listed companies (as the SEC does in the US). If it were to do so, responsibility for dealing with non-compliance in the others would revert to the DTI.

One technical partner believes there is a case for the FRRP to restrict itself to listed companies. The Penrith Farmers case,³⁰ which concerned disclosure issues in a non-listed Plc in Cumbria, is cited in support of his argument:

'I would maybe confine it to listed companies and public interest companies, because there were, especially in the early days...those poor people up in Cumbria. ...So there might be a case for putting the level up a bit.' (TP4)

However, two regulators believe that the FRRP is a valuable resource to shareholders of the non-listed companies within its current remit:

'I really do think we could be useful to... the individual shareholder in the large private company and I don't think we should lose that responsibility.' (R2)

The alternative to the FRRP for these shareholders, under current company law, would be for DTI to pursue action through the courts. This would be a more complex and lengthy process, with an uncertain outcome:

'In the case of a large private company [the shareholder] would have to try to persuade the prosecution authorities to mount a prosecution.' (R3)

Table 6.1 shows our questionnaire respondents' views on whether the FRRP's remit could be extended to deal with a wider range of companies.

³⁰Table 3.3, case number 14; appendix 1, case 5. The FRRP's involvement in this case is also criticised by TP4 in chapter 4.

Table 6.1 – Questionnaire responses: audit partners’ views of terms of reference of FRRP

Question		Total		Big 5		Group A		National Audit		Regional Audit		Local	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Do you think the Review Panel’s remit could be extended to deal with a wider range of companies?	Yes	9	15.0	0	0.0	1	14.3	0	0.0	4	28.6	4	12.9
	No	43	71.7	4	100.0	6	85.7	3	75.0	8	57.1	22	71.0
	Don’t Know	8	13.3	0	0.0	0	0.0	1	25.0	2	14.3	5	16.1
	Total	60	100.0	4	100.0	7	100.0	4	100.0	14	100.0	31	100.0
Do you think the Review Panel’s remit could be extended to deal with the entire contents of the annual report?	Yes	22	37.3	0	0.0	4	57.1	2	50.0	5	35.7	11	36.7
	No	31	52.5	4	100.0	3	42.9	1	25.0	7	50.0	16	53.3
	Don’t Know	6	10.2	0	0.0	0	0.0	1	25.0	2	14.3	3	10.0
	Total	59	100.0	4	100.0	7	100.0	4	100.0	14	100.0	30	100.0
Do you think the Review Panel’s remit could be extended to deal with information (e.g. Preliminary announcements)?	Yes	23	41.1	2	50.0	4	57.1	2	50.0	8	57.1	7	25.9
	No	26	46.4	2	50.0	3	42.9	1	25.0	4	28.6	16	59.3
	Don’t Know	7	12.5	0	0.0	0	0.0	1	25.0	2	14.3	4	14.8
	Total	56	100.0	4	100.0	7	100.0	4	100.0	14	100.0	27	100.0
Do you think the Review Panel is an effective regulator under its current terms of reference?	Yes	29	46.8	4	100.0	4	57.1	2	50.0	7	46.7	12	37.5
	No	6	9.7	0	0.0	1	14.3	0	0.0	1	6.6	4	12.5
	Don’t Know	27	43.5	0	0.0	2	28.6	2	50.0	7	46.7	16	50.0
	Total	62	100.0	4	100.0	7	100.0	4	100.0	15	100.0	32	100.0
In your opinion is the Review Panel a ‘good thing’?	Yes	45	72.6	4	100.0	6	85.7	4	100.0	10	66.6	21	65.6
	No	3	4.8	0	0.0	1	14.3	0	0.0	1	6.7	1	3.1
	Don’t Know	14	22.6	0	0.0	0	0.0	0	0.0	4	26.7	10	31.3
	Total	62	100.0	4	100.0	7	100.0	4	100.0	15	100.0	32	100.0

72% of respondents including all Big Five respondents and all but one of the Group A respondents are against widening the remit. There is very limited support for this proposal from the smaller firms but the great majority are opposed. Even limited support from smaller firms is surprising given that they show very little interest overall in the activities of the FRRP, and an extension of the FRRP's remit would bring more of their clients under surveillance.

Overall, therefore, there is little evidence to suggest that the FRRP's remit in respect of the companies it deals with should be extended.

A more pro-active role in the pre-clearance of accounting treatments and better disclosure of matters considered and found acceptable

Our interviewees comment on two issues: pre-clearance of accounting treatments prior to inclusion in financial statements and disclosure of cases which the FRRP has investigated and found the accounting treatment acceptable.

One regulator feels that either the FRRP or the Financial Services Authority (FSA)³¹ could get involved with pre-clearance of accounting issues for annual reports:

'And accounts sometimes, you know. I've got this issue. I now have to go and clear it with [Mr XX at the FSA] before we publish, or the Panel, whatever.'
(R1)

However, if the FRRP were to take this on, much more resource would be required:

'It would certainly have to be beefed up enormously if it was going to start looking at all these.' (R1)

³¹ Until 1999 the UK Stock Exchange was responsible for regulation of prospectuses and new issues. This responsibility has now been transferred to the Financial Services Authority (FSA).

Another vehicle for pre-clearance of accounting issues could be the UITF. One regulator expresses some doubts about the UITF involving itself with individual cases and about pre-clearance more generally. There is scope for misinterpretation and specific issues being taken out of context:

'The UITF won't pronounce if an individual company went...it needs several companies to get into this box before the UITF will move. ...My strong view is that if there is to be a pre-clearance system it's not us. I mean if you're the enforcer it doesn't seem to me to be appropriate that you should also do the pre-clearance, no. ...It seems to me thoroughly inappropriate to say, "Yes, this is the appropriate thing", and then when you see the treatment in the context of the accounts as a whole to say, "Well, we didn't like that".' (R3)

Apart from the pre-clearance issue, there is a belief among technical partners that that it would be helpful for the FRRP to release information about accounting treatments that had been cleared in inquiries, so that acceptable precedents could be recognised:

'I think the fact that they have looked at something and cleared it would be helpful to people and perhaps to say why they've cleared it...as the existence of a precedent out in the field may not have been looked at by the Panel, or may have been looked at and cleared. You don't know whether they are precedents you can rely on or not. That's ...something I would like the Panel to change its stance on. I think that would be more helpful.' (TP4)

Although the FRRP does not believe itself to be a setter of precedents, it is nevertheless seen as such:

'It is certainly a precedent setter and in some respects it is a standard setter, even though it is not meant to be.' (TP2)

There is also a belief that it would be a positive move for the FRRP to deal with more 'general' issues (based on accounting principles) as well as specifics, but the secrecy about cases clouds this possibility:

'I would like to see them doing less of the straight, "This doesn't comply with the rules" approach and deal with more general issues. But...it's a bit difficult to be certain they wouldn't tackle a broad general issue because you don't know...what has been referred to them and what they have looked at and said,

“Oh well, I am sorry we can’t deal with that because there is no rule that covers that area”.’ (TP4)

Another technical partner is uncomfortable about the FRRP’s secrecy:

‘The Review Panel by its nature works with a degree of secrecy...you do not want to have to make rules in secret.’ (TP5)

A tension emerges from this evidence. Technical partners believe the FRRP is a precedent setter and would like this to be recognised so that issues which have been addressed can be known about, and precedents established on a coherent basis. There is also a lack of clarity about the issue of pre-clearance of accounting treatments. Understandably the FRRP, as an enforcer does not see pre-clearance as compatible with its role, and the demand is currently not being met, as the UITF appears only to address issues raised by a number of parties.

Extension of the FRRP’s remit, in respect of listed companies, to other published financial information

The Company Law Review (DTI, March 2000) recognises the importance of the preliminary announcement and suggests that this should be the main statutory document which shareholders receive, rather than the current annual report which is lengthy and contains information other than that which is required by statute. It is also suggested that companies should produce a statutory Operating and Financial Review (OFR), as an alternative to the directors’ report and the ASB should develop standards for both. It is also proposed that these documents will be subject to review by the auditors for consistency with information in the financial statements. Enforcement would be the responsibility of the FRRP. All accounting standards would have the force of law as this

‘should strengthen the position of the Panel in persuading companies to prepare revised accounts’. (p. 179)

There is generally little opposition from interviewees for the FRRP to extend its remit to preliminary announcements and interim statements. One regulator expresses surprise that interim statements particularly have not been subject to greater scrutiny in the past:

‘I’ve always been staggered that that we’ve never insisted that these be at least reviewed. I know most companies do something like that, but I find it amazing that the market moves on accounts which technically the auditors don’t have to look at.’ (R1)

However, a clear view emerges from the technical partners that the FRRP can only regulate information for which pre-set standards exist:

‘The idea of extending their coverage to things like prelims is very seductive because prelims are in many ways more important than the annual accounts these days. Whoever saw the share price move from their issue? But the constitution of the Review Panel is that it enforces rules set by other people. They don’t make the rules and they have no due process for making rules...you apply, you don’t set the rules.’ (TP5)

Although not disagreeing with the principle, this technical partner foresees some difficulty in setting out too many rules for preliminary announcements, as timeliness is of the essence:

‘The whole purpose of prelims is that it takes some time to produce and finalise the accounts...to iron out the detail. The market should not have to wait and there is a danger of leaks of price sensitive information. So you forego a degree of absolute certainty that you get with the annual accounts for a degree of getting out quickly information with less certainty, and you can’t have it both ways. ...But if they are going to apply rigour to it and have the Review Panel enforce it in the same way that they do with the accounts, we might just as well wait until we get the accounts. Then that defeats what the market wants.’ (TP5)

There is a balance to be achieved between communication and regulation, as heavy handed regulation can inhibit the flow of information:

‘You actually communicate better if you don’t heavily regulate the communication. That involves the danger that people will abuse the process, but it is only by putting that danger in, allowing that danger to happen that they communicate properly. If you are absolutely tied to a set of rules they will apply that set of rules and you won’t communicate.’ (TP5)

The existing statutory directors’ report is cited as an example of poor information:

‘We have rules already in the directors’ report. It says you give a full and fair review of the period. What you get is boiler plate...To get something meaningful you have got to allow flexibility for the company to present in a flexible way.’ (TP5)

The market already plays a key role in monitoring the accuracy of statements made in the preliminary announcement:

‘Companies quite firmly get the message back if they start giving misleading statements – you don’t do it twice.’ (TP5)

The regulators also recognise that they need something to measure performance against:

‘The essential starting point has to be requirements, whether they are in statute or whether they are from a standards board...because a Panel can’t enforce unless there’s some requirement against which to judge what the company has produced.’ (R3)

‘In the best of all possible worlds...we might be looking after a lot more things than we are currently looking after. ...It seems to me that we have fairly clearly defined areas of responsibility and we’re equipped to look after that area and probably only to look after that area.’ (R2)

Our questionnaire respondents (table 6.1) are divided fairly evenly on whether they feel the FRRP should look at other financial information, such as preliminary announcements. Overall 41% are in favour and 46% are against. The Big Five respondents are equally divided and there is a small majority of group A and national audit firms respondents in favour. What is surprising is that whereas regional firm respondents support the suggestion by two to one, the local firms are against in

approximately the same proportions. Neither type of firm would be much affected by these proposals and we would have expected the views to be consistent.

The responses to the question whether the FRRP remit should be extended to the whole contents of the annual report are broadly similar except that all the Big Five respondents are opposed to it and there is less support from the smaller firms. The opposition from the Big Five could be explained because the annual report contains qualitative information which is more difficult to regulate.

The problem of regulating qualitative information is recognised also in our interviewees' comments on the suggestion in the Company Law Review (DTI, 2000) that the FRRP could have regulatory oversight of the OFR. They are generally not comfortable with the FRRP being involved in regulating what they describe as softer information because of the recognised problem of regulating judgment:

'The stuff outside the primary statements is inevitably pretty soft and there is no book of rules that this is how to do it and you will get it right if you follow the book, at least not on this sort of thing. ...I think until you have sorted out the judgment type...approaches you are not really going to be in a position to really contribute positively to the information outside. In any case I query whether it is actually necessary, because I don't think that great mischiefs are done, particularly if you have a set of accounts which are pretty reliable. Someone is going to cross check.' (TP5)

Another technical partner believes that the market can be the only effective regulator of qualitative information in the long term:

'I think you have to accept that, apart from those blatant examples, the market is the only policeman, and that if people consistently make extravagant claims about what is going on eventually it will be found out.' (TP3)

This technical partner believes that the FRRP would have great difficulty in regulating an OFR:

'I think that it would have great difficulty in doing it and I would prefer they stuck to the accounting side until that was working better...It's soft information and they're not used to applying judgment...you have the general law of misrepresentation and that's very rarely invoked in these sorts of cases...I suspect they have quite a lot of difficulty applying it. I just think you have to leave it to the market.' (TP3)

One technical partner believes that control over the contents of an OFR has to remain with the auditors:

'I suppose this is the problem...tell me what's misleading...the auditors have to decide whether it's misleading. The audit standards require them to read the OFR and so on and if it's misleading to raise the matter. ...I know the question always arises, "Well, what can the auditor do?" and when you look at the auditing standard it says seek legal advice or something.' (TP4)

The regulators are more up-beat about the OFR but recognise the difficulty of dealing with non-financial information:

'If an OFR became a standard then we'd have one more standard against which we judge companies' statements...If it was a totally deceptive statement it's a non-financial matter. Broadly our remit I think would extend to financial matters contained in the OFR.' (R2)

What emerges from these issues is a recognition that where information needs to be brought out quickly and where it is of a more judgmental nature, a different approach to regulation needs to be considered as an entirely rule-based process may not be appropriate. Some technical partners who see the FRRP as a rule-based operation doubt whether, as it is currently constituted, the FRRP would be able to regulate soft information.

A further issue raised by one regulator is whether there is a role for the FRRP in looking at company prospectuses. Frustration is expressed about a poor prospectus which was drawn to the FRRP's attention after the event:

‘That was sent to us and we looked at this thing...and you know it set all the alarm bells off but we were told we couldn’t touch it...it was a prospectus. It wasn’t a set of accounts...there was nothing the Panel could do and the question has been “What should it look at?”.’ (R1)

This regulator feels that effective pre-clearance of accounting treatments in prospectuses is a must:

‘The Panel’s cheap and cost benefit to us is pretty effective. If you want to get into tighter regulation then I think obviously the things that do move markets have got to be looked at. ...Some of those things like prospectuses should be pre-cleared...The others maybe you do a post clearance on a regular basis.’ (R1)

The clearance of prospectuses would be a very different role for the FRRP to take on because a prospectus does not form part of a company’s routine financial reporting activity and is subject to a different form of regulatory control.

Should the FRRP be more pro-active in seeking out regulatory breaches?

The FRRP does not pro-actively monitor company accounts and seek out breaches of the regulatory framework. It relies on cases being brought to its attention. This has led to some criticism that non-compliance is being missed (Jupe and Rutherford, 1997). The FRRP’s approach in this differs from the SEC which has a policy of systematically reviewing all registrants’ filings over time.

One regulator believes that the FRRP is not quite as passive as it might first seem:

‘The word reactive and pro-active are a bit simplistic because in effect we have a whole group of people out there doing our proactive research for us, in the form of the press commentators... ‘Company Reporting’, ‘Accountancy’ and indeed other firms. They pick up oddities and very often it comes back to us. It might be in a written, formal sense. It might be chit chat, “I’m a bit surprised that this company...”, and so on, and we will have a look at it.’ (R3)

One technical partner agrees that the FRRP is not entirely reactive but recognises that one weakness in the current process is that complainants can have their own reasons for raising issues with the FRRP:

'It isn't entirely reactive in the sense it doesn't depend solely on complaints. It does take up matters which are drawn to its attention. ...It is not always the case that journalistic comment is accurate and it does rely very heavily on that which is slightly tiresome. ... But on the other hand...there aren't that many complainers in this world and often people who write in to complain have another agenda and it's just part of a general attack on an entity.' (TP4)

Another technical partner favours more resourcing for the FRRP if it means that some of the more difficult judgmental issues are addressed:

'One punishment warns a hundred people....It's yet to have an impact on some of the more difficult issues.' (TP3)

This technical partner also believes that despite its faults, the SEC with its pro-active monitoring on the whole produces reasonable outcomes:

'You have a very large SEC which creates a lot of hassle and costs an enormous amount but the product on the whole is not actually that bad. You lose something in the process which is an ability to think independently and you'd have to form a judgment as to which was the most appropriate system.' (TP3)

Our US interviewee believes their systematic review process is positive and helpful and that registrants are generally comfortable with it:³²

'I think people respond...the accounting profession and the registrants do realise that we play a very important role and I think most people are for the most part fairly honest and want to do what's right. I think the professions and the markets all recognise the critical role we do play. We don't ever try to intimidate people.' (R5)

³²A key difference between the UK and the US system is that unless the SEC takes an enforcement action (through a separate division) against a company, remedial action taken as a result of a cold review of a filing is not made the subject of a press notice.

However the SEC experience of cyclical reviewing of every filing does require specialist knowledge, although our interviewee recognises that the SEC may lag behind some of the firms in technical expertise:

‘Most of the professional staff are either attorneys or accountants. We have a few engineers and we also have some financial analysts. ...Some will focus on financial institutions...insurance companies...oil and gas companies etc. ...The accountants become familiar with the issues that confront that industry...What does happen though is that the staff accountant could have, let’s say four or five years experience. They are dealing generally with some of the top technical people in the various firms...people that have been practising for you know twenty-five or thirty years...We’re always at a disadvantage to a certain extent in that way.’ (R5)

However there are very few occasions where a file review finds nothing wrong:

‘That does happen but that’s rare, very rare.’ (R5)

One regulator interviewee receives information, sometimes informally, from audit firm partners. Our questionnaire respondents were asked whether they referred accounts to the FRRP, routinely, seldom or never. It would be surprising if an audit firms sent its own accounts to the FRRP but we would have expected them to refer non-compliant accounts which came to their attention. However, 56 out of 58 respondents (96.8%) never send cases to the FRRP and two (one Group A partner and one national firm partner) seldom do. No-one sends cases as a matter of routine. We find this regrettable as auditors are well placed to spot regulatory breaches but are not in the habit of informing the FRRP.

The FRRP to operate as a tribunal and be able to impose remedies or penalties itself without reference to the Courts

Under its present remit the FRRP has no powers to impose fines or penalties itself. Our regulator interviewees on the whole do not think this would make much difference, although a predecessor regulator believed it would:

'I know that Mr XX always believed that they should change...into a sort of tribunal that just says, "There's your ruling, bang".' (R1)

Another believes the key to not becoming a tribunal is the retention of respect from the regulated constituency, but a tribunal would take longer to reach decisions:

'It seems as though our present structure, which is obviously faster than if we were a tribunal...works OK. ...If we lost respect...then we might have to be changed so that we made the decisions...I don't think I am bothered about the High Court judges making decisions on the basis of the expert evidence...so I don't see the necessity of taking it away from the courts...and I don't see that it's necessary that we should make the judgments provided that we're held in respect.' (R3)

But even if the FRRP became a tribunal similar procedures would have to be followed:

'If we were to change to a tribunal there would still have to be...an agreement mechanism...because the prosecuting arm here must have the ability to agree with the defendant some compromise which might then be put to the tribunal for validation but would really replicate the same process we have at the moment...so that process would take place anyway.' (R2)

One regulator rather likes things as they are:

'I quite like the old British sort of muddle through way and I think we've got to be careful that we don't become an over-regulated society.' (R1)

Views about the effectiveness of the FRRP and the long-term future

Despite criticisms of the FRRP and no general endorsement of extension of the FRRP's role, one issue our questionnaire respondents overwhelmingly agree on (72.6%) is a belief that the FRRP is a 'good thing'. There are 14 'don't knows' (22.6%) from the

regional and local firms but only three dissenters. 46.8% of respondents also believe that the FRRP is an effective regulator under its current terms of reference. In this case however there are many more 'don't knows' (43.5%) but only six (9.7%) who disagree. It is interesting to observe that a number of respondents who do not know whether the FRRP is an effective regulator still believe it to be a 'good thing'.

There are two key regulatory issues for the future in which the FRRP could play a part. These are the moves towards the adoption of a common set of financial reporting standards worldwide and the accompanying enforcement issues, and second, the regulatory implications of the use of the internet for financial reporting. At this stage nothing has been agreed but there are some emerging views.

The overwhelming view of our interviewees is that for global accounting standards to work, there must be an accompanying enforcement mechanism. The audit firms are seen to be key to this and the International Federation of Accountants (IFAC) has already set up initiatives to raise the standards of financial reporting and auditing worldwide (IFAC, 2000). However it is believed that any statutory enforcement must be linked to a jurisdiction:

'There are two additional bits to the standards setting which are necessary if the thing is going to work. One is enforcement and the other is interpretation. The effectiveness of unified standards will be seriously eroded if they are not interpreted in a consistent way and they are not enforced. To an extent the only way it will work in the current world scene is for national bodies to do these roles.' (TP3)

One regulator believes the UK, with its FRRP, is well placed to maintain standards in the UK:

'It's all right for [Regulator XX] to say we want common standards in Europe.... Well, we want common standards of enforcement as well otherwise the

whole thing's going to collapse in a heap. It'll look the same but it won't be the same. It'll be pretty good here because [Regulator XX] and his mates will just make it good here.' (R1)

How this will be resolved is yet to be decided.

Our interviewees also have mixed views about the extent to which companies will put financial information on the Internet, but the existence of a potential problem is recognised. There is agreement that the development of enforcement mechanisms either from audit oversight or another from of regulatory control is some way off:

'Nobody's been here before. This is virgin snow. As far as auditors are concerned, tramp there at your own risk. ...What sort of information should be on there? It always amuses me because people say, "Oh, you don't need accounting standards because after all we will have the internet. Well, what do you do then? Just tip in the numbers and let them sort it out. Of course we are going to have to structure it somehow...and having structured it...what's the auditing part of it?' (R1)

'It's a hornet's nest...but you scratch the surface and it raises some quite fundamental issues. ...Do the auditors have to check information going on the internet?...Does it make a difference if the internet is the means of statutory delivery or not?...It goes to all and sundry and you don't know where it's come from, but whether in practice it changes the role of the regulator or the way in which regulators have to respond, I don't know. ... I know things are moving very fast in the internet area, I am really a bit sceptical whether companies are going to want to open themselves up.... I think they will still want to control pretty closely the information that people are being given.' (TP4)

These are key issues for regulators to address, but the optimal solutions are still to be identified.

Summary

There is little demand for change to the companies within the FRRP's remit. However, in terms of its activities, there is some demand for pre-clearance of accounting issues although it is not clear as to whether responsibility for this should reside with the FRRP.

Although the FRRP insists that it is not a precedent setter, others believe that it is and would like to be provided with information about cases where accounting treatments have been accepted by the FRRP.

Questionnaire respondents are divided as to whether the FRRP's remit should be extended to other financial information but it must be borne in mind that these responses were received before the March 2000 Company Law Review proposals. Interviewees have little opposition to these proposals, but there is a clear view that the FRRP can only regulate where standards exist against which performance can be measured. There is also a view that over-regulation can inhibit the quality of information and the speed at which it is delivered. Another dimension which emerges is whether the FRRP should be involved in the accounting issues included in prospectuses.

There is concern about the FRRP regulating the OFR. This arises from doubts about its ability to handle soft information. There is no support for its remit to extend beyond financial information. It is seen by some interviewees as a rule-based operation, but the regulators, whilst recognising they need standards against which to measure, do not see themselves in this light.

Some support exists for the FRRP to take a pro-active role in reviewing the financial statements of all listed companies, as the SEC does. Although regulators believe that practitioners do draw cases to their attention, 96.5% of our questionnaire respondents say they do not. If the FRRP's remit were to be extended in this respect, specialist expertise would be required for review of complex industry sectors. There is little support for the FRRP to become a tribunal. It is believed that this would delay proceedings.

Despite the inevitable criticisms, the FRRP can be encouraged by the overwhelming view of our audit firm partner questionnaire respondents that it is a 'good thing' and a belief that it is an effective regulator.

The move towards acceptance of common accounting standards world-wide inevitably raises the need for effective enforcement, if the outputs are to be respected. A recognition is emerging that effective enforcement is best done at a country rather than international level and the FRRP is well placed to contribute to this in the UK.

The potential regulatory implications of financial information being communicated via the internet are still in their infancy. Whilst developments must be carefully observed, it is premature to envisage how a regulator would operate in this area.

Chapter 7: Conclusions and recommendations

Introduction

In our final chapter we draw conclusions from our research and make recommendations for the future for regulators and practitioners to consider.

This study is a comprehensive appraisal of the FRRP's activities and its effectiveness as a regulator. When the FRRP was established there was no doubt that the regulatory framework for financial reporting in the UK needed strengthening following the creative accounting scandals in the 1980s (Griffiths, 1986). The FRRP's supporters (e.g. Plaistowe, 1992) had great hopes for its effectiveness. Assessing regulatory effectiveness is a complex issue as there are a number of measures against which performance can be judged. A regulator's enforcement actions need to be visible and relevant to its constituency for it to be respected and for its activities to be supported by external groups (Bealing, 1994). Efficient risk averse behaviour for a regulator is to concentrate on easily detectable violations (Rollins and Bremser, 1997). This is a valuable strategy for a reactive agency to demonstrate activity, but there is a risk that violations which are more difficult to detect will be missed. A key issue for an enforcement agency is the extent to which knowledge of its existence and its activities acts as a deterrent to those who would otherwise be minded to breach the regulations, but the cost of its actions must not outweigh the benefits of its existence (Diver, 1980). A regulator must also be prepared to adapt to a changing environment. A particular difficulty in enforcement of the regulatory framework for accounting is the tension between the rule of law, where a regulatory breach can be readily identified, and the exercise of judgment, where the true and fair view prevails. The latter is much more difficult to regulate as economic substance can override legal compliance (Napier and Noke, 1993).

In this study we analyse the FRRP's activities and their relevance to the regulatory framework. We assess available evidence about its impact beyond the cases it has acted upon and discuss ways in which its role could change in the light of current developments. A number of research methods are used, including analysis of publicly available information, interviews with interested parties and a questionnaire study.

Conclusions

The FRRP overall is believed to be a 'good thing', and it certainly provides value for money, with its average running costs being less than £300,000 per year. Over time there have been fewer cases, and the cases are now attracting far less press coverage than they did when the FRRP was first established. We have only weak evidence that companies have changed accounting policies as a result of an FRRP case. These phenomena could be explained either because the FRRP has little impact on its constituency and may risk losing respect, or because its existence and activities have led to an overall improvement in compliance. There is evidence from our audit firm questionnaire respondents (particularly the Big Five who audit the overwhelming majority of UK listed companies) that its existence has changed some attitudes to compliance, and that they use the FRRP's existence as a negotiating tool to discourage clients from regulatory breaches. This may be influenced by the fact that FRRP cases are bad news for auditors. An FRRP case can undermine an auditor-client relationship and the firm may subsequently be disciplined by their regulatory body for signing audit reports on accounts which do not comply with the regulatory framework. Therefore, although the FRRP is receiving less press interest, our research suggests that its influence is being upheld through the activities of the Big Five. Smaller firms generally have little interest in the FRRP and

some may not even be aware that some of their clients fall within its remit. However, there is a general view that the FRRP's remit to deal with all Plcs and larger listed companies is about right.

There is one overriding criticism of the FRRP, which emerges in various ways from our research and is linked to the tensions between the detail of the law and the judgments of accounting. The criticism is two-pronged. The FRRP is too concerned with relatively minor issues of non-compliance and is missing issues of substance.

Our analysis of cases shows that there is some justification for the criticism that some cases represent relatively minor matters of non-compliance. (This could be explained by the FRRP's need to demonstrate to its constituency that it is active.) The majority of cases overall involve classification and disclosure and only 20 out of the 54 restatements (37%) change earnings. But these are the cases of non-compliance which have been drawn to the FRRP's attention. However, readily identifiable non-compliance is much easier to address than complex areas of judgment. The nature of the cases taken up by the FRRP highlights wide differences in beliefs between auditors and the FRRP as to what is material in relation to a particular set of accounts. The FRRP appears to give compliance primacy over materiality (a perfectly respectable position for a regulator to take), whereas practitioners take a more pragmatic view, where materiality and the overall true and fair view prevail over details of compliance. Another indicator of the FRRP's emphasis on compliance is the noticeable pattern of cases which cluster around the implementation of new accounting standards.

There appears to be a fundamental difference between interpretations of materiality applied by the FRRP and those applied by auditors.

The criticism from practitioners that the FRRP is not dealing with major issues has received a response from the chairman requesting, not unreasonably, that major issues be brought to the FRRP's attention (FRC, 1999, p.52). Audit firms generally are not doing this. Furthermore the FRRP can only address what is visible on the face of company accounts. It cannot second guess the judgments of auditors and company boards on issues which are not visible. There have been suggestions that there is less disclosure in some areas because of the possibility of FRRP intervention. This issue can only be resolved if practitioners choose to bring issues of concern forward or if the FRRP's remit is changed so that accounts are pro-actively monitored.

There is some demand from practitioners for a regulatory mechanism for pre-clearance of accounting issues (a service provided by the SEC) one reason for which, we presume, is to pre-empt a subsequent adverse finding. We find the regulators' arguments that this is not a role for the FRRP convincing (as advice could be given out of context), and the UITF does not opine on specific cases. Under the present regime it is possible for the FRRP to take up a case where the company and the auditors genuinely believe they have adopted the right interpretation, and the FRRP disagree. (One of our finance director interviewees makes this claim.) In this respect there is a gap in the regulatory framework in that there is no mechanism for regulatory approval of accounting treatments where more than one interpretation may exist.

There is a difference of opinion as to whether or not the FRRP is a precedent setter. The FRRP does not believe that it is but the practitioners disagree. The practitioners do not like the FRRP's secrecy about cases which have been investigated and the accounting treatment has been cleared. They believe it would be helpful for more information to be provided.

There have been suggestions that the FRRP should act as a tribunal, rather than merely being empowered to apply to the courts for a restatement of accounts where voluntary restatement is not forthcoming from the company. We do not support tribunal powers being given to the FRRP. This would further delay the outcomes of proceedings which are already criticised for taking too long, and further reduce the timeliness of any revised information. Furthermore we do not believe it to be necessary, as the balance of power is already very much in the FRRP's favour. No board of directors has yet been prepared to defend a case in court, simply because it is not in their economic interests to do so. They have nothing to gain and a great deal to lose in management time, costs and reputation. However, although there is no case for the FRRP to act as a tribunal itself, an anomaly exists in that whilst auditors are subject to disciplinary action by their regulatory body for giving an unqualified report on accounts which are out of compliance, there is no adequate mechanism for equivalent action to be taken against the company board.³³

There are suggestions in the Company Law Review (DTI, 2000) for the remit of the FRRP to be extended to dealing with a proposed statutory preliminary announcement and interim statements. It is also suggested that a statutory OFR should be introduced

³³To date the only action against directors has been taken by the ICAEW against its own members who happen to be on the board of a company which has been criticised. Others, whether implicated or not, escape regulatory action because there is no mechanism to pursue them.

and the FRRP could regulate it. Our findings indicate clearly that the FRRP is considered capable of dealing with accounting information for which standards exist and which has been audited or subject to review by auditors. However it is viewed primarily as a rule-based body, i.e. it is inclining more towards legal compliance than judgmental interpretations. Serious doubts exist as to whether it can, in its present form, act as a regulator for qualitative or soft information for which clear cut rules cannot be drawn up, and which has not been audited or reviewed. Other mechanisms may be needed if such information is to be subject to any form of regulatory oversight. We also consider that the situation under the present regulatory framework, where the contents of a company's annual report are subject to different levels of regulatory oversight, may not be fully understood by all users.

The issue of different levels of regulatory oversight for financial information may come to the fore in respect of information which is placed on the internet and because of the search for consistency of regulatory enforcement on a global basis. The distinction between what has and has not been subject to oversight needs to be made clearer.

Our final point concerns prospectuses. One regulator expresses concern about accounting compliance in prospectuses and there may be a case for FRRP involvement, as it has developed expertise in regulating accounting compliance. However, where the raising of funds depends on a prospectus being issued, it would not be appropriate for delay to be built into this process. Now that responsibility for regulation of the New Issues has become the responsibility of the FSA, a closer relationship may develop between the two bodies and an appropriate role for the FRRP may emerge.

Recommendations

The criticism that the FRRP is not picking up significant non-compliance in company accounts is a serious one, and one which we believe needs to be addressed. If audit firms are not prepared to bring non-compliance to the attention of the FRRP themselves, then the alternative solution is for the FRRP to develop a programme of pro-active monitoring itself, on a cyclical basis, but only in respect of listed companies, which are subject to the highest level of public interest. A reactive approach should suffice for the others. But apart from picking up non-compliance, we believe the knowledge that pro-active monitoring was taking place would be a significant deterrent to those minded to commit regulatory breaches.

There is a gap in the regulatory framework in respect of pre-clearance of accounting treatments. It is not obvious where responsibility for this could reside but we believe that consideration should be given to setting up a process for pre-clearance. It would also be helpful if, on a no-names basis, the FRRP were prepared to issue information about accounting treatments which it has investigated and subsequently cleared. We find the arguments that it is not a precedent setter unconvincing and it would be helpful if the reality of this situation were recognised.

There is a regrettable anomaly in the regulatory follow up of FRRP cases. Whereas auditors are subject to action from their regulator, directors, unless they happen to be members of the ICAEW, appear not to be. We have previously suggested that a Companies Commission should be established which could impose fines on directors who prepare accounts which do not comply with the regulatory framework (Brandt,

Fearnley and McBride, 1998). There is no reason why the auditors should suffer worse penalties than the directors.

Provided appropriate standards are developed we consider it is appropriate for the FRRP to have regulatory oversight over preliminary announcements (if they become statutory) and interim statements.

We suggest that consideration should be given to the involvement of the FRRP in oversight of accounting compliance in prospectuses.

In its present form, the FRRP is not equipped to regulate soft information. A heavy-handed regulatory regime for some forms of qualitative information would inhibit the provision of helpful information to users. The existing directors' report stands as an example.

We cannot foresee a role for the FRRP to oversee information in an OFR or other qualitative statement beyond that which has been reviewed by auditors. In our view the FRRP's activities should follow those of the auditor, particularly as it does not have the right of access to company records.

Rather than trying to devise ways of regulating soft information, which is a very difficult matter, we suggest it would be better to develop a framework for public reporting which very clearly segregates and labels, in a user friendly way, the extent to which information has been subject to audit and regulatory oversight and the identity of the regulatory body involved. Information which has not been subject to any oversight should equally be

clearly labelled. The present situation even in relation to data in a company's annual report is confusing. The increasing use of the internet for the dissemination of financial information is likely to add to this confusion.

We are aware that some of our recommendations will increase the cost of the FRRP's activities. We believe they should all be considered by the regulators and the profession and the cost benefit assessed.

As it stands the FRRP plays a key role in the enforcement of accounting standards in the UK and is equally well placed to play a key role in the enforcement of global accounting standards. We believe our recommendations would further strengthen its position and improve compliance in the United Kingdom.

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Appendix: Further details of key cases referred to in the text

Company	Summary of FRRP Concerns
1. M & W Mack (case 40, table 3.3)	The requirements of Urgent Issues Task Force (UITF) Abstract 13 had not been followed. The accounts did not include the income, expenses and assets of the M & W Mack Ltd. Employee Share Ownership Plan. The auditors had qualified the audit report on this. The problem was rectified in the subsequent year's accounts.
2. Sinclair Montrose Healthcare (case 54, table 3.3)	Costs of £3,482,000 were capitalised as development expenditure. In the Panel's view capitalisation of these costs did not comply with the requirements of SSAP 13. Revised accounts wrote off these costs to the profit and loss account. In the revised accounts the directors also amended the disclosure of an exceptional item and amortisation of goodwill.
3. Associated Nursing Services – second case (case 38, table 3.3)	<p>The company failed to account for a complex sale and leaseback arrangement in accordance with FRS 5. The FRRP took the view that <i>'not all the significant rights or other access to benefits relating to the asset in question and not all the significant exposure to the risk inherent in those benefits had been transferred to the purchaser'</i> (FRC, 1997 p.2). The properties should, therefore, have remained on the consolidated balance sheet with the sale proceeds included in borrowings.</p> <p>The FRRP also took the view that the company were in breach of FRS 5 in their treatment of joint ventures as associated undertakings. Underlying agreements were such that the company had effective control over the joint venture net assets and the arrangements should therefore have been treated as quasi-subidiaries.</p> <p>Both issues were resolved by the publication of revised accounts.</p>
4. Trafalgar House (case 8, table 3.3)	The company reclassified certain properties, which were the subject of a write down, from current assets (stock) to fixed assets. Consequently the valuation deficit was debited to the revaluation reserve rather than the profit and loss account. Also, the Advanced Corporation Tax carried forward in the balance sheet was not considered fully recoverable. The disclosure of the company's investment in BREL and statutory Profit and loss account formats were not considered adequate. These issues were rectified in the subsequent year's accounts.
5. Penrith Farmers' & Kidd's (case 14, table 3.3)	Certain comparative figures had been properly restated to comply with the requirements of paragraph 4 (2) of Schedule 4 of the Companies Act 1985. However, the accounts did not give the particulars and reasons for the adjustments. Also there was a typographical error in the cash flow statement. A Supplementary Note was issued to rectify these matters.
6. RMC Group (case 45, table 3.3)	The point at issue was disclosure of fines of £4.97 million levied on certain of the group's subsidiaries arising from the breach of Orders made by the Restrictive Practices Court. The background to the issue had been disclosed in previous year's Group Accounts as a contingent liability and also when levied, the fine was disclosed in the accounts of the subsidiary. The Panel considered that disclosure was also required in the Group accounts as <i>'the payment of fines was an important matter that ought to be brought specifically to the attention of the users of the accounts because of the nature and circumstances of the fine'</i> . The Panel's view was that in such a case, materiality was determined primarily by its qualitative aspects. The disclosure was subsequently included in the Directors' Report of the 1997 Group accounts.

Appendix (Continued)

Company	Summary of FRRP Concerns
7. Pentos (case 22, table 3.3)	The FRRP were concerned that the company did not provide adequate information in the accounts about the company's accounting treatment of reverse premiums received in respect of property leases. The policy was explained more fully (including disclosure of the amounts received in respect of reverse premiums) in a statement issued by the company.
8. Butte Mining – second case (case 37, table 3.3)	The value of shares in Gem River Corporation received in consideration for services rendered by the company was taken to profit, but the FRRP considered the profit to be unrealised. The shares were subject to an Escrow agreement prohibiting them being traded on the Alberta Stock Exchange and in the FRRP's view the ultimate cash realisation of these shares could not be assessed with reasonable certainty. Revised accounts reduced profit by £967,000.
9. H & C Furnishings (case 47, table 3.3)	<p>The valuation of consideration paid for the acquisition of Harveys Furnishings plc was questioned by the FRRP. The consideration was satisfied by the issue of shares to Harvey's shareholders. The directors took the view that the share price of £1.65 at the date of acquisition was unreliable and valued the consideration based on a share price of £1 (the valuation four months earlier when the transaction had been negotiated). Given that the share price had continued to rise after the takeover, the FRRP did not accept the directors' view referring to FRS 7 paragraph 78 which states that 'the market price on the date of acquisition would normally provide the most reliable measure of fair value'. The accounts were revised to base the valuation of the consideration on a share price of £1.65.</p> <p>A Supplementary note was also issued amending the breaches of disclosure requirements of FRS 1 (revised); FRS 3; FRS 8; SSAP 15 and schedules 4 and 6 of the Companies Act 1985.</p>
10. Courts (case 27, table 3.3)	The company did not comply with SSAP 21 'Accounting for leases and hire purchase contracts' and Companies Act 1985 (paragraphs 12 and 13 of Schedule 4) in their treatment of instalment and hire purchase transactions. The total amount due under long-term credit arrangements was included in turnover and operating profit with transfers made to a deferred profit reserve. This was corrected in subsequent accounts.
11. Brammer (case 32, table 3.3)	Assets held for rental were classified as stock contrary to the requirements of SSAP 21 (paragraph 42) which states they should have been classified as fixed assets. The assets were reclassified in the subsequent year's accounts.
12. B M Group (case 18, table 3.3)	<p>The cash equivalent part of the cash flow statement included items not permitted by the definition of cash equivalents in FRS 1</p> <p>An exceptional profit and the related goodwill written back were incorrectly described as arising from the sale of companies by the parent company to one of its subsidiaries. The amounts arose from a share placing of some of the parents shares in the subsidiary after a temporary increase in the parent's shareholding.</p>