

# **REGULATORY ARCHITECTURE TO ENHANCE DEMOCRACY AND BUSINESS ACCOUNTABILITY**

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This review was commissioned by the Shadow Chancellor of the Exchequer, John McDonnell MP, and conducted independently by Professor Prem Sikka and others.

The contents of this document form a submission to Labour's policy making process; they do not constitute Labour Party policy nor should the inclusion of conclusions and recommendations be taken to signify Labour Party endorsement for them.

This report is promoted by John McDonnell MP, Shadow Chancellor of the Exchequer at House of Commons, Westminster, London SW1A 0AA.

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## LIST OF ACRONYMS

Accounting Standards Board (ASB)  
Association of Chartered Certified Accountants (ACCA)  
Association of International Accountants (AIA)  
Bank of Credit and Commerce International (BCCI)  
Bank of England (BoE)  
Business Bank of Italy Limited (BBIL)  
Central Intelligence Agency (CIA)  
Chartered Accountants Ireland (CAI)  
Chartered Institute of Management Accountants (CIMA)  
Chartered Institute of Public Finance and Accountancy (CIPFA)  
Consultative Committee of Accountancy Bodies (CCAB)  
Committee on the Financial Aspects of Corporate Governance (CFACG)  
Competition and Markets Authority (CMA)  
Department for Business, Energy & Industrial Strategy (BEIS)  
Department of Enterprise, Trade, and Investment Northern Ireland (DETNI)  
Department for Trade and Industry (DTI)  
Department for Work and Pensions (DWP)  
Financial Conduct Authority (FCA)  
Financial Reporting Council (FRC)  
Financial Service Authority (FSA)  
Generally accepted accounting principles (GAAP)  
Insolvency Practitioners Association (IPA)  
Institute of Chartered Accountants in England and Wales (ICAEW)  
Institute of Chartered Accountants of Scotland (ICAS)  
International Accounting Standards Board (IASB)  
International Auditing and Assurance Standards Board (IAASB)  
International Federation of Accountants (IFAC)  
International Financial Reporting Standards (IFRS)  
Limited Liability Partnerships (LLPs)  
London Stock Exchange (LSE)  
National Audit Office (NAO)  
Office for Professional Body Anti-Money Laundering Supervision (OPBAS)  
Payment Systems Regulator (PSR)  
Pension Protection Fund (PPF)  
Prudential Regulation authority (PRA)  
The Pensions Regulator (TPR)  
Recognised Professional Bodies (RPBs)  
Recognised Qualifying Bodies (RQBs)  
Recognised Supervisory Bodies (RSBs)  
Republic of Ireland (ROI)  
Scottish Limited Partnerships (SLPs)  
Serious Fraud Office (SFO)  
Serious Organised Crime Agency (SOCA)  
Statement of Recommended Practice (SORP)  
Transparency International (TI)  
Trust and Companies Service Providers (TCSPs)

## EXECUTIVE SUMMARY

Numerous scandals have shown that the UK has an ineffective regulatory architecture populated by overlapping, uncoordinated and unaccountable bodies. This has resulted in duplication, waste and obfuscation as matters get shunted around from regulator to another. The UK has 41 regulators for the financial sector alone and at least 14 dealing with accounting, auditing, insolvency and some aspects of corporate governance. Even then there is no central enforcer of company law. There is little coordination to deal with corporate scandals, auditing failures, looting of pension schemes, insolvency abuses, tax avoidance, money laundering and general abuse of consumers and citizens.

After major scandals, regulatory deckchairs are often rearranged, but corporate grandees and their worldviews remain in dominant positions. All regulators are prone to capture by the very interests that they are supposed to be regulating. The public has little control over the regulatory apparatus and is not permitted to supervise the executives running the regulator bodies.

The central role of the regulatory bodies should be to protect consumers and citizens and society as a whole from predatory practices, but too often they have become direct promoters and defenders of corporate interests. Uncomfortable events are ignored or swept under dusty-carpets. Too many trade associations act as statutory regulators and have no independence from the very interests that they regulate. There is no urgency in investigating failures and too often it takes years for regulators to take any action. Timely reports are not published. Consequently, remedial legislation is delayed or postponed and predatory practices continue unchecked.

Concerns about corporate power span the distortions it produces in competition and also across issues about consumer protection, tax avoidance, economic crime, politics, employment, executive pay, civil rights, environmental degradation and broad social welfare. These issues are also linked, for example tax avoidance by large transnational corporations which reinforces their oligopolistic dominance over smaller national firms. Instead of the current compartmentalised approach to regulation, a more joined-up approach is necessary, and the regulatory system needs to be revised to tame the power of large corporations, level the playing field for genuine entrepreneurship, and rebalance the relationship between corporations and society. Incompetent and corrupt corporate practices have already resulted in the 2007-08 banking crash, the biggest economic crisis for nearly a century. Despite a plethora of regulators, the misalignment between big business and societal interests seems to have intensified and threatens to overwhelm society. Some of the political institutions on which a sustainable market economy rests are also compromised. Politicians and vested interests can intervene at high levels to stymie investigations, protect wrongdoers and prevent publication of crucial reports. Corporate malpractices and illegitimate power can only be dealt with by introducing greater accountability and transparency into the regulatory architecture and reforming the objectives of regulation. Failure to do so will continue to undermine faith in institutions of democracy and rule of law.

This report puts forward a stakeholder model of regulation that is independent of government departments and puts citizens in a position to oversee regulatory effectiveness. It focuses on key areas of corporate and financial regulation, but the general principles it proposes can and should be extended to many other areas in which regulation has become central to business, the economy, and society as a whole. It does not aim to increase the amount of regulation, but indeed to reduce it. Regulation has too often produced bloated bureaucracies that are both unaccountable and ineffective. The reforms would reduce duplication and waste and increase effectiveness of the regulatory system and its accountability to the public.

The key proposals are:

1. The regulatory system must be independent of all government departments so that ministers cannot sabotage investigations or prevent publication of critical reports.
2. Regulators must be independent of those who are to be regulated.
3. Regulatory bodies must have clear objectives as well as their scope and powers defined by law.
4. The central role of the regulatory bodies must be to protect consumers, taxpayers and the public in general from harmful practices. They must not directly or indirectly promote or protect the interests of those they regulate.
5. A Business Commission to oversee compliance with and enforcement of all aspects of business law must be created to replace existing regulators.
6. The Business Commission will act as an umbrella body, overseeing and coordinating sub-Commissions (such as a Companies Commission, Finance Commission) dealing with more specific aspects, such as corporate governance, accounting, auditing and insolvency, and sectors such as financial services
7. Each Commission shall have a plurality of interests represented on it to ensure that all matters are explored from diverse perspectives.
8. The heads of Commissions (Commissioners) shall be responsible for the day-to-day operations within a framework laid down by legislation and the Business Commissioner. The Business Commission and each of its sub-Commissions would have a Supervisory Board consisting of citizens and societal stakeholders. The Supervisory Board shall exercise strategic oversight and act as a bulwark against capture
9. Members of all Commissions and Boards can be nominated by ministers but shall be appointed by parliament.
10. The Supervisory Board meetings shall be held in the open and their working and background papers shall be publicly available.

11. A separate Enforcement Commission for investigation, enforcement and compliance. It shall be independent of all Commissions with powers to fine and prosecute individuals and corporations. Where necessary legislation should be revised to give the Commission powers to bring criminal proceedings.
12. An Ombudsman service to adjudicate on disputes between regulators and stakeholders would form an integral part of the architecture.
13. The businesses, trade bodies and individuals that are the subjects of regulation should pay the full cost of the system through levies on a fair and overall size of operations basis.
14. Sanctions, fines and other penalties should be allocated in priority to compensate victims and/or to contribute to the costs of regulation as appropriate.
15. The entire apparatus would be accountable to parliament and shall be subject to regular parliamentary reports and public hearings

## **CHAPTER 1 INTRODUCTION**

### **REGULATION MATTERS**

Regulation matters. Indeed, it has become central to what some have described as “regulatory capitalism”. It includes both hard law (legislation passed by parliament) and various kinds of soft regulation (e.g. codes of conduct). It establishes norms and standards governing the conduct of all types and areas of business. It plays a major role in the development of any cohesive and stable society. It is often equated with rules, practices and interventions to empower, restrict or change behaviour to secure desired outcomes. However, “smart” regulation also needs to enlist the cooperation and support of employees in regulated corporations and their customers and other stakeholders, as well as maintain the confidence of the public. Too often regulation is captured by the large corporations which are its target, and especially by the interests of their large shareholders and financiers. When effectively designed and applied, regulation can be more effective and promote long-term social interests, by involving and empowering employees, stakeholders and citizens.

Regulation has played a key role in democratisation of the workplace, protection of workers, health and safety, consumer rights and much more. It can give people a decent wage, healthcare, education and so on. Governments have also introduced rules, procedures and policies to address market failures such as in the areas of biotechnology, telecommunication, computing and aerospace, especially when private interest were not willing to invest and take long-term risks.

Regulation has been used to prohibit damaging practices. The tobacco and alcohol industries did not voluntarily restrict the sale and advertising of their products, even though they can cause premature death. A company manufacturing automobiles produces profits for shareholders but those activities pollute the environment and have a negative effect on air quality resulting in respiratory problems for citizens who are not a direct party to the transaction. In such cases, regulation serves to reduce the externalities and/or impose taxes or other measures to remedy the situation.

The 2007-2008 banking crash showed how poor regulation and enforcement in the financial system can have serious consequences for the stability of the economy. In the absence of adequate regulation and enforcement, banks are unlikely to maintain minimal capital and may engage in excessive leverage, and pay little attention to the knock-on effects of their recklessness. After bailing-out distressed banks, the state has imposed minimum capital requirements for banks. Previously, it introduced a depositor protection scheme in addition to acting as a lender of the last resort.

### **REGULATORY DECKCHAIRS**

To secure public confidence in markets and social stability, regulatory arrangements require reinforcement by independent and robust institutions. However, all is not well with UK corporate regulation. In response to failure and scandal, the response has been to increase the number of regulators and rearrange the regulatory deckchairs. Too often these bodies are under the control of the industry grandees who are wedded to voluntarism, self-regulation and unaccountable forms of regulation.



A key area in which regulation has proliferated, while becoming ever more dysfunctional, is the financial sector. Prior to the 1970s, there was little formal regulation: the City was said to be governed by “the raised eyebrow of the Governor of the Bank of England”. After the mid-1970s secondary banking crash, the Bank of England (BoE) became the formal regulator of banks. It also had responsibility for promoting the financial sector. By the mid-1980s, the government sought to reinvigorate the financial sector and a plethora of new regulators were set up.<sup>1</sup> In July 1991, the closure of the fraud-infested Bank of Credit and Commerce International<sup>2</sup> (BCCI) drew attention to the shortcomings of the BoE supervision. Anxieties were further fuelled by the 1995 collapse of Barings bank<sup>3</sup>. In 1997, the BoE was replaced by the Financial Service Authority (FSA). The 2007 banking crash raised questions about the regulatory ethos of the FSA, as well as the coordination between the FSA, the BoE and the Treasury. In 2013, the FSA was replaced by the supposedly independent Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) under the umbrella of the BoE. Despite the scandals, grandees from the financial sector have remained in control. They dominate key decisions, ranging from whether to prosecute and who should be charged, to the formulation of key industry standards. Despite regulatory gyrations, little has changed: “senior people somehow manage to keep their fingerprints off relevant documents sometimes”.<sup>4</sup> Notably, judges have criticised the FCA for failure to bring cases against more senior bankers.

Despite repeated regulatory overhauls, vital areas still lack a regulator, and coordination between them is patchy. Remarkably, there is no central enforcer of the UK company law. In the financial sector, accounting, auditing and insolvency continue to have overlapping and poorly co-ordinated regulators. The unsurprising outcome is waste, duplication, buck-passing, inefficiencies and a tendency to sweep things under dusty carpets. Under the cloak of voluntarism and soft regulation, professional bodies which operate as trade associations, continue to act as regulators even though they have no independence from those –members and firms - that they regulate. Conflicts of interests abound. Too many regulators are indecently close to those whom they are supposed to regulate. Regulators then act, often quite brazenly since they are fearless of any penalty, as promoters and defenders of the industry they are supposed to regulate, rather than as guardians of the public interest. They do so with impunity as politicians as well as the regulators themselves often stymie investigations. As a result, little is learnt from unsavoury

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<sup>1</sup> These included the Securities Investment Board (SIB), the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA), the Investment Management Regulatory Organisation (IMRO), the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO), the Personal Investment Authority (PIA) and a host of professional bodies

<sup>2</sup> United States Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, December 1992. Washington: USGPO

<sup>3</sup> Bank of England, Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, London: HMSO, 1995.

<sup>4</sup> Hussein v The Financial Conduct Authority (Financial Services - influence LIBOR) [2018] UKUT 186 (TCC) (20 June 2018)

episodes, and legislative deficiencies remain unaddressed.<sup>5</sup> In sum, the regulatory apparatus has not been able to provide durable protection to consumers, taxpayers, employees, suppliers and societal stakeholders. Little attention is paid to regulatory capture, control, or the tendency of the system to pass the buck.

## THE NEED FOR REFORM

There have been many calls for reform of the regulatory system. For example, the Investment Association has argued that

“It is essential that Directors of companies are held accountable and appropriately sanctioned when they negligently fail to meet their duties. Recent high profile examples have clearly demonstrated that the current framework for sanctioning needs re-thinking. The current system of sanctions is fragmented between many different authorities, and often Directors are only sanctioned as a result of investigations after a company goes into insolvency. By uniting the powers and responsibilities, we would be giving real teeth to a single body who could then hold any Directors to account for being negligent of their duties”.<sup>6</sup>

Pensions are primarily the domain of the Pensions Regulator (TPR) and a parliamentary inquiry into the collapse of Carillion concluded that

“The Pensions Regulator failed in all its objectives regarding the Carillion pension scheme ...where a tentative and apologetic approach is ingrained. We are far from convinced that TPR's current leadership is equipped to effect that change<sup>7</sup>”.

The chairman of the House of Commons Work and Pensions Committee has criticised the FCA, the main regulator for the financial sector, as “grossly inadequate”<sup>8</sup>. The 2007-08 banking crash caused considerable economic turbulence but the regulatory woes have continued. Some eight years after the bailout of HBOS, the House of Commons Treasury Committee said that:

"The regulators failed, both before and after the HBOS crisis. Seven years after the bank's collapse, we now know just how badly. And not because the regulators showed a spirit to learn the lessons of the past. It took persistent

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<sup>5</sup> For example, see Prem Sikka and Glen Lehman, Supply-side corruption and Limits to Preventing Corruption within Government Procurement and Constructing Ethical Subjects, *Critical Perspectives on Accounting*, Vol. 28, May 2015, pp 62-70.

<sup>6</sup> The Investment Association press release, The Investment Association calls for a new body to hold directors to account, 13 June 2018, <https://www.theinvestmentassociation.org/media-centre/press-releases/2018/the-investment-association-calls-for-a-new-body-to-hold-directors-to-account.html>.

<sup>7</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, May 2018, pp. 59 and 76; <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

<sup>8</sup> BBC News, Port Talbot steelworkers' pension help 'grossly inadequate', 18 December 2017; <https://www.bbc.co.uk/news/uk-wales-south-west-wales-42385085>,

pressure from the Treasury Committee to ensure these failures weren't swept under the carpet"<sup>9</sup>.

Regulators rarely undertake comprehensive analysis of failures and frauds as their investigations are too often narrowly confined to what they consider to be their jurisdiction. Matters get handed on to other regulators who may or may not work to the same standards or interpretation of the rules, or may dismiss even the need for an investigation. This pussy-footing procrastination is exemplified by the HBOS case where the Financial Reporting Council (FRC) was invited to examine the accounting/auditing aspects. The Treasury Committee said:

"The Financial Reporting Council's decision not to investigate the auditing of HBOS prior to the completion of the PRA/FCA report was a serious mistake. The process by which it reached its decision suggests a lack of curiosity and diligence on the part of the FRC. Having seen the final PRA/FCA report, the FRC's belated decision to launch an investigation into the auditing of HBOS is welcome. Better late than never".

All too often, a regulatory body writes the rules and standards then acts as judge, jury and prosecutor of corporate failures, abuses and frauds. The bodies rarely admit that their own rules may have contributed to the failures. In response to the weakness and failure, the Treasury Committee recommended that the enforcement function should be carried out by a separate body and that

"A separate body would bolster the perception of the enforcement function's independence, and provide the regulators with greater clarity over their objectives. The case for separation merits serious re-examination"<sup>10</sup>.

In relation to a fragmented regulatory structure, the House of Lords Economic Affairs Committee stated that

"The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator—medicine for example under the General Medical Council<sup>11</sup>" (p. 31).

The preceding paragraphs offer a brief glimpse the depth and scope of regulatory problems. The challenge is to redesign a regulatory architecture that is better coordinated, more effective, responsive and publicly accountable, and so is less prone to capture by elites.

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<sup>9</sup> House of Commons Treasury Committee, HBOS failure: lessons for the regulators, 26 July 2016; <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/hbos-report-published-16-17/>

<sup>10</sup> House of Commons Treasury Committee, HBOS failure: lessons for the regulators, 26 July 2016; <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/hbos-report-published-16-17/>

<sup>11</sup> House of Lords Economic Affairs Committee, Auditors: Market concentration and their role: Volume 1, London: House of Lords, 2011; <https://publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf>.

A comprehensive review of every regulatory arena is beyond the scope of the present report. Instead, its focus is on the financial sector broadly defined. It is shown how regulatory failure is in substantial part attributable to the multiplicity of overlapping regulators. They are seen to be poorly co-ordinated, marred by conflict of interests, and lacking adequate public accountability. The remainder of this report is structured as follows.

Chapter 2 provides an overview of the regulatory maze comprising 14 regulatory bodies responsible for corporate governance, accounting standards, audit and auditors. It notes that trade associations exercise statutory regulatory powers without any public accountability.

Chapter 3 zooms in on the 41 regulators for the financial sector. Once again, many trade associations act as regulators. There is little co-ordination amongst the regulatory bodies.

Chapter 4 provides some evidence of how the regulatory maze is responsible for avoidable neglect, obfuscation, waste and failure, which damages public confidence in the institutions of democracy and rule of law.

Chapter 5 shows that the UK has a corrosive political and regulatory culture that appeases business interests by sweeping its shortcomings under the carpet in a way that impedes the development and enforcement of rules and laws necessary for protection of citizens. It provides three case studies to show how ministers and regulators have stymied inquiries into corporate abuses.

Chapter 6 specifies the principles necessary for the development of more effective regulatory structures.

The details of the proposed alternative architecture are presented in Chapter 7.

Chapter 8 concludes the report with a brief summary.

## CHAPTER 2

### THE REGULATORY MAZE IN THE FINANCE SECTOR: CORPORATE GOVERNANCE, ACCOUNTING, AUDITING AND INSOLVENCY

#### HOW MANY REGULATORS?

Ascertaining the number of UK regulators affecting the finance sector alone is not easy. That is because numerous organisations perform formal regulatory roles and some may even be considered to be private bodies but have a public role in some sense. The usual first source of information, when seeking to identify organisations formally functioning as regulatory bodies, is government lists and websites.

At the time of preparing this report, the UK has twenty-five government departments, twenty non-governmental departments and three devolved administrations relating to Northern Ireland, Scotland and Wales listed on the official government website<sup>12</sup>. These are accompanied by 391 agencies and public bodies, and 79 high profile groups and 12 public corporations. This is not the sum total of formal regulatory bodies, however, as the published list does not include bodies which the government does not regard as public in status. For example, the government list excludes accountancy trade associations even though they are designated as statutory regulators for external auditors and insolvency practitioners under the Companies Act 2006 and Insolvency Act 1986. Other omissions include the Panel on Takeovers and Mergers, despite being a statutory and independent body.

According to the Hampton Review, in 2005, the UK had more than 674 national regulatory bodies. Since then a few have lapsed or have been amalgamated<sup>13</sup>, but additional bodies have also been added. For example, in April 2013 the FSA was replaced by the FCA *and* the PRA. In April 2015, the FCA created a separate body, the Payment Systems Regulator (PSR), in accordance with section 40 of the Financial Services (Banking Reform) Act 2013. The PSR is a subsidiary of the FCA, with its own board of directors, and its role is to “promote competition and innovation in payment systems<sup>14</sup>”. In January 2018, a new body, housed within the FCA, known as the Office for Professional Body Anti-Money Laundering Supervision (OPBAS) was created<sup>15</sup> to ensure that accountancy and law bodies with anti-money laundering responsibilities provide high standards of supervision. In short, there is no publicly available comprehensive list of all regulators.

This list used in this chapter has been compiled from government websites, answers to parliamentary questions provided by ministers, and scrutiny of reports issued by various regulatory bodies. In response to a request for a list of the (1) public, (2) private, (3) self-regulatory, and (4) other bodies which have regulatory responsibility

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<sup>12</sup> As per <https://www.gov.uk/government/organisations>

<sup>13</sup> HM Treasury, *Implementing Hampton: from enforcement to compliance*, London: HM Treasury, 2006; [http://webarchive.nationalarchives.gov.uk/20120709025634/http://www.hm-treasury.gov.uk/d/hampton\\_compliance281106.pdf](http://webarchive.nationalarchives.gov.uk/20120709025634/http://www.hm-treasury.gov.uk/d/hampton_compliance281106.pdf)

<sup>14</sup> Financial Conduct Authority, *Market review into the supply of indirect access to payment systems*, March 2016; <https://www.psr.org.uk/sites/default/files/media/PDF/MR1512-indirect-access-market-review-interim-report.pdf>

<sup>15</sup> Financial Conduct Authority, *Office for Professional Body Anti-Money Laundering Supervision (OPBAS)*; <https://www.fca.org.uk/opbas>

for companies, company law, corporate governance, accounting standards, audit and auditors, the government provided the list provided in Table 2.1 .

**Table 2.1**

**UK bodies with regulatory responsibility for companies, company law, corporate governance, accounting standards, audit and auditors:**

**Public Bodies (under the Government Resources and Accounts Act 2000):**

Bank of England (including the Prudential Regulation Authority)

Companies House

Financial Conduct Authority

Financial Reporting Council

Insolvency Service

**Other:**

Association of Chartered Certified Accountants

Association of International Accountants

Chartered Accountants Ireland

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Takeover Appeal Board

Takeover Panel

**Source:** Hansard. House of Lords, Written question - HL8591, 13 June 2018;

<https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-06-13/HL8591/>;

However, this list is incomplete<sup>16</sup>. It excludes *inter alia* the Consultative Committee of Accountancy Bodies (CCAB), which is permitted to formulate accounting rules/standards for limited liability partnerships (LLPs) - see below for further information. The above list mentions the Insolvency Service and accountancy bodies responsible for regulating insolvency practitioners, but omits the Insolvency Practitioners Association (IPA). Accordingly, the above list has been reconstituted and is shown in Table 2.2 below.

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<sup>16</sup> In another parliamentary statement, the Business Secretary listed the following bodies: Companies House, Financial Reporting Council, Insolvency Service, Association of Chartered Certified Accountants, Chartered Accountants Ireland, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland, Takeover Appeal Board and Takeover Panel; Hansard, House of Commons, Written question – 157600, 2 July 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-26/157600/>

| <b>Table 2.2</b>   |  |
|--|--|
| <b>ORGANISATIONS RESPONSIBLE FOR COMPANY LAW, CORPORATE GOVERNANCE, ACCOUNTING STANDARDS, AUDIT AND AUDITORS</b> |  |
| <b>REGULATORY BODY</b>   | <b>JURISDICTION</b>  |
| <b>Public Bodies</b>   |  |
| 1. Bank of England (including the Prudential Regulation Authority) (PRA)   | Financial sector   |
| 2. Companies House   | Company registration and filing  |
| 3. Financial Conduct Authority (FCA)   | Financial Sector   |
| 4. Financial Reporting Council (FRC)   | Accounting, auditing, actuaries, corporate governance, Anti-Money Laundering         |
| 5. Insolvency Service  | Insolvency   |
| <b>Other Bodies</b>  |  |
| 6. Association of Chartered Certified Accountants (ACCA)   | Auditors, Accountants, Insolvency, Tax, Anti-Money Laundering                        |
| 7. Association of International Accountants (AIA)  | Auditors, Accountants, Insolvency and Anti-Money Laundering                          |
| 8. Chartered Accountants Ireland (CAI)   | Auditors, Accountants, Insolvency, Tax and Anti-Money Laundering                     |
| 9. Consultative Committee of Accountancy Bodies (CCAB)   | Common interests of the accountancy bodies, Limited liability partnership accounting |
| 10. Insolvency Practitioners Association (IPA)   | Insolvency Practitioners   |
| 11. Institute of Chartered Accountants in England and Wales (ICAEW)  | Auditors, Accountants, Insolvency and Tax Practitioners, Anti-Money Laundering       |
| 12. Institute of Chartered Accountants of Scotland (ICAS)  | Auditors, Accountants, Insolvency and Tax Practitioners, Anti-Money Laundering       |
| 13. Takeover Appeal Board  | Takeovers  |
| 14. Takeover Panel   | Takeovers  |

The most critical concern to note is the absence of a central enforcer of UK company law who protects the interests of diverse stakeholders. Companies House deals with formation of companies and filing of annual accounts and returns. Some parts of corporate law enforcement fall to the financial sector regulators such as the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Their jurisdiction is restricted to the financial sector. The Insolvency Service can investigate insolvent companies and disqualify directors. The businesses in the financial sector, and elsewhere, that are required to have external audits and regulators rely on external auditors<sup>17</sup> for a variety of purposes ranging from effectiveness of internal controls, solvency, liquidity, probity and separation of client assets. However, accounting and auditing is the domain of the Financial Reporting Council (or its successor body), and accountancy trade associations, such as ACCA, AIA, CAI, ICAEW and ICAS, functioning as Recognised Supervisory Bodies (RSBs) under the Companies Act 1989 and 2006. The FRC checks compliance with accounting and auditing aspects of company law, with particular focus on listed companies. The RSBs licence their members as auditors and check compliance with accounting and auditing aspects of the law and standards issued by the FRC. They monitor compliance with the rules by individuals and firms conducting audits of organisations others than listed companies.

## ACCOUNTING AND AUDITING REGULATORS

### Accountancy Bodies

At 31 December 2017, the six main bodies operating in the UK and Republic of Ireland (ROI) had 360,124 professionally qualified accountants out of an estimated global total of around 3 million<sup>18</sup>. This is nearly 12% of the global total even though the UK and ROI economies accounts of around 3-3.5% of the global gross domestic product (GDP). It is the highest number of professionally qualified accountants per capita in the world and more than the rest of the EU put together. The UK-based membership of each of the major professional accountancy bodies is shown in Figure 2.1<sup>19</sup>.

**Figure 2.1**  
**UK Membership of Major Accountancy Bodies**

| Growth of Members in the UK & ROI  | ACCA   | CIMA   | CIPFA  | ICAEW   | CAI    | ICAS   | AIA   | TOTAL   |
|------------------------------------|--------|--------|--------|---------|--------|--------|-------|---------|
| Total numbers for 2017             | 94,622 | 82,587 | 12,630 | 126,560 | 23,905 | 18,528 | 1,292 | 360,124 |
| % growth (16 - 17)                 | 4.3    | 3.2    | -2.4   | 1.2     | 5.3    | 2.3    | -6.2  | 2.6     |
| % growth (13 - 17)                 | 17.6   | 10.2   | -2.3   | 5.0     | 18.5   | 7.6    | -14.4 | 9.9     |
| % compound annual growth (13 - 17) | 4.1    | 2.5    | -0.6   | 1.2     | 4.3    | 1.9    | -3.8  | 2.4     |

<sup>17</sup> For example see, Prudential Regulation Authority, Supervisory Statement SS1/16: Written reports by external auditors to the PRA, January 2016; <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2016/ss116>

<sup>18</sup> <https://www.ifac.org/about-ifac>

<sup>19</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018, p. 4; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>



At 31 December 2017, the professional bodies also had 163,809 UK-based registered students which in due course will swell their ranks. The skewed enrolment of graduates in the accounting industry deprives other sectors of educated labour and affects the economic performance of the nation. Accountants are in demand because ‘accounting think’ has colonised UK business, governmental and institutional practices. Almost all businesses are required to publish audited accounts. The statutory market of auditing and insolvency provides comparative job security, high financial rewards and is attractive to graduates.

In the surveillance society, one set of accountants prepares accounts. Then another set, often labelled "internal auditors", arrives to say that organisational procedures are appropriate and followed. Subsequently, another set labelled "external auditors" arrive to tell the first two that all was well. When businesses go belly-up, another set of accountants, this time acting as insolvency practitioners, arrives to downsize or liquidate the business. Accountants collect vast fees and salaries at every stage of the life cycle of a business and serious questions need to be asked about the social contribution of this bloated sector.

The UK incurs enormous social cost to produce accountants, but it has neither resulted in superior economic performance nor stability. The unprecedented investment in accounting has not resulted in good financial reporting, better audits, and freedom from frauds and fiddles, safe pension schemes, absence of tax dodging and money laundering, or abundance of good corporate governance. Financial engineering is rife as companies develop ruses to inflate profits and assets. Too many companies are mired in scandals and produce opaque accounts, which are routinely described by auditors as ‘true and fair’.

The state guaranteed market of external auditing is reserved for accountants belonging to select few professional bodies. In order to be eligible to conduct external audits an individual must hold a qualification from one of the Recognised Qualifying Bodies<sup>20</sup> (RQBs), as designated under the Companies Act 2006. The Financial Reporting Council (FRC) decides the eligibility of a body as a RQB. The following bodies are currently designated as RQBs (Table 2.3).

| <b>Table 2.3</b>                    |   |
|-------------------------------------|---|
| <b>RECOGNISED QUALIFYING BODIES</b> |   |
| 1.                                  | Association of Chartered Certified Accountants (ACCA)           |
| 2.                                  | Association of International Accountants (AIA)                  |
| 3.                                  | Chartered Accountants Ireland (CAI)                             |
| 4.                                  | Institute of Chartered Accountants in England and Wales (ICAEW) |
| 5.                                  | Institute of Chartered Accountants of Scotland (ICAS)           |

The body licensing an individual to act as an auditor must be recognised as a Recognised Supervisory Body (RSB) by the Financial Reporting Council (FRC). The RSBs licence individuals and firms to act as auditors. The employees of such firms and individuals do not need to be licensed auditors. The licensed firms must purchase professional liability insurance, submit to practice inspection by the RSB

<sup>20</sup> In recent past CIPFA was recognised as a RQB. As its education scheme puts less emphasis on audits, its RQB status was revoked in December 2017.

and comply with various rules. The following bodies are currently designated as RSBs (Table 2.4).

| <b>Table 2.4</b>   |
|--|
| <b>RECOGNISED SUPERVISORY BODIES</b>                               |
| 1. Association of Chartered Certified Accountants (ACCA)           |
| 2. Chartered Accountants Ireland (CAI)                             |
| 3. Institute of Chartered Accountants in England and Wales (ICAEW) |
| 4. Institute of Chartered Accountants of Scotland (ICAS)           |

If members of Association of International Accountants (AIA), a RQB, engage in delivering statutory audits they must be licensed and supervised by one of RSBs. It should be noted that the accountancy bodies also licence their members to sell consultancy services, including tax advice, so that they can use their professional soubriquet to distinguish themselves from other suppliers. The professional bodies may discipline all members for failure to comply with the rules and codes.

In May 2018, the UK had 23,473 registered statutory auditors<sup>21</sup>, operating as sole traders, partnerships and limited liability companies of various sizes. Figure 2.2<sup>22</sup> shows that at 31 December 2017, 5,660 firms were registered with RSBs and authorised to conduct statutory external audits in the UK and Republic of Ireland (ROI).

**Figure 2.2**  
**Accounting Firms Registered with RSBs**

| Number of Principals per Firm | ACCA         | ICAEW        | CAI        | ICAS       | TOTAL        |
|-------------------------------|--------------|--------------|------------|------------|--------------|
| 1                             | 1,137        | 1,136        | 404        | 56         | 2,733        |
| 2 - 6                         | 566          | 1,562        | 382        | 108        | 2,618        |
| 7 - 10                        | 11           | 142          | 12         | 9          | 174          |
| 11 -50                        | 5            | 92           | 10         | 8          | 115          |
| 50+                           | 0            | 16           | 2          | 2          | 20           |
| <b>Total as at 31.12.17</b>   | <b>1,719</b> | <b>2,948</b> | <b>810</b> | <b>183</b> | <b>5,660</b> |
| <b>Total as at 31.12.16</b>   | <b>1,856</b> | <b>3,121</b> | <b>844</b> | <b>189</b> | <b>6,010</b> |
| <b>Total as at 31.12.15</b>   | <b>1,982</b> | <b>3,256</b> | <b>894</b> | <b>199</b> | <b>6,331</b> |

<sup>21</sup> Financial Reporting Council, Developments In Audit 2018, October 2018; <https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

<sup>22</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018, p. 25; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>

Despite a series of scandals, the big four firms' share of the FTSE 350 market increased from 95% to 98%. In Germany, big four firms have 94% of the 130 largest listed company audits and almost 100% of audit fee income. In the USA they have 79% of the 3,000 largest public company audits and collect 96% of audit fees<sup>23</sup>. For the period 2014 to 2017, the big four firms controlled around 78% of the audit of UK listed companies. In France, the big four firms audit 100% of the listed companies but because of a system of compulsory joint audits their share is effectively reduced to 50% of the audit market for listed companies<sup>24</sup>. The FRC data shows that for 2017, the number of Public Interest Entities<sup>25</sup> (PIEs) audited by PwC, Deloitte, Ernst & Young and KPMG were 533, 337,287 and 464 respectively. The next biggest are BDO and Grant Thornton with 100 and 69 clients respectively<sup>26</sup>.

The domination of the big four firms has been aided by a close business relationship with financial institutions. The big firms handle most of the major insolvencies, many of which are instigated by financial institutions in their capacity as secured lenders. Before 2014 it was common practice for banks and other major lenders to insert clauses in leveraged facility agreements to restrict borrower's choice of auditors to one of the big four firms. This was outlawed by the European Union Directive 2014/56/EU (the "Directive") and implemented in the UK by the Statutory Auditors and Third Country Auditors Regulations 2016, but the legacies remain.

The alumni effect is also a factor in the market power of the big four accounting firms as companies often appoint auditors from the firms familiar to their directors and officers. Nearly a fifth of FTSE 100 chief executives are accountants<sup>27</sup>. Some 64% of FTSE100 finance directors are linked to the big four accounting firms and 61 out of the 100 audit committee chair positions at the highest level of UK companies are held individuals who previously worked for at least one of the big four firms or one of their predecessor firm<sup>28</sup>. The alumni group also provides political support. It is common for the 100 Group, essentially finance directors of FTSE100 companies, to support the interests of the big four firms. For example as a possible split of the big four firms and a 'cap' on the number of FTSE 350 clients is being considered, the

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<sup>23</sup> Financial Reporting Council, Developments in Audit 2018, October 2018; <https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

<sup>24</sup> Trends in Auditor Market Concentration in Select European Countries, 6 November 2018; <https://www.auditanalytics.com/blog/trends-in-auditor-market-concentration-in-select-european-countries/>

<sup>25</sup> PIEs are defined by the European Union (EU) Directives 2013/34/EU on accounting (the Accounting Directive) and 2014/56/EU on statutory audits (the Audit Directive). The definition is governed by the law of a member state whose secure transferable securities (equity and debt) are admitted to trading on a regulated market in the EEA; and credit institutions and insurance undertakings i.e. mostly listed companies plus banks and insurance companies, whether listed or not.

<sup>26</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>

<sup>27</sup> Economia, Fifth of FTSE 100 CEOs are accountants, 19 February 2018; <https://economia.icaew.com/en/news/february-2018/fifth-of-ftse-100-ceos-are-accountants>

<sup>28</sup> Accountancy Daily, Two thirds of FTSE 100 CFOs are ex-Big Four, 4 December 2017; <https://www.accountancydaily.co/two-thirds-ftse-100-cfos-are-ex-big-four>

chair of the 100 Group said that such a move would be “detrimental”<sup>29</sup>. The alumni effect is a huge money spinner but also has implications for audit quality. A branch of research shows that the corporate executives’ background as partners or managers in audit firms equips them with “extensive knowledge of audit procedures and negotiation tactics. As a result, executives could use their higher-order ability to hide misstatements or to avoid current-period adjustments when the external auditor finds misstatements<sup>30</sup>”.

## **FINANCIAL REPORTING COUNCIL (FRC)**

### **FRC Authority**

The FRC has been the key player in the regulation of professionally qualified accountants and external auditors. It was incorporated in March 1990 and became a public body in its current form in 2004<sup>31</sup>. It was originally formed in the aftermath of scandals to address concerns about the quality of financial reporting and audits. It sets accounting, auditing and actuarial standards as well as the corporate governance Code. The FRC issues a code of ethics which has a bearing on the non-auditing services that auditors may be able to sell to audit clients. Following the 2016 implementation of the 2014 EU Audit Regulation and Directive, the government has designated the FRC as the UK Competent Authority for audit with responsibility for the regulation of statutory audit; including setting auditing and ethical standards, monitoring and enforcement. The FRC monitors, investigates and enforces the statutory audit of public interest entities, which are mainly listed companies and Lloyd’s syndicates. As most of these are carried out by big accounting firms, the monitoring of the quality of their audit work falls to the FRC.

The RSBs carry out their regulatory functions under legally binding delegation agreements with the FRC. The conditions for performance of these Regulatory Tasks are agreed with each of the bodies in respect of their members in the following areas:

- the application of the FRC’s criteria for the purpose of determining whether persons are eligible for appointment as statutory auditors, the registration of such persons, keeping the register and making it available for inspection (Registration);
- procedures for maintaining the competence of such persons (Continuing Professional Development);
- monitoring of statutory auditors and audit work except where retained by the FRC (Audit Monitoring); and

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<sup>29</sup> SKY News, Finance chiefs warn against capping big four's audit share, 2 November 2018; <https://news.sky.com/story/finance-chiefs-warn-against-capping-big-fours-audit-share-11543056>

<sup>30</sup> Anne Albrecht, Elaine Mauldin, and Nathan J. Newton (2018) Do Auditors Recognize the Potential Dark Side of Executives' Accounting Competence?. *The Accounting Review*, In-Press.

<sup>31</sup> Hansard, House of Lords Written Question HL8896, 25 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-06-25/HL8896/>

- investigations and imposing and enforcing sanctions in relation to breaches of relevant requirements by statutory auditors except where retained by the FRC (Enforcement).

The FRC has delegated the majority of investigation and sanctioning of non-public interest cases to the RSBs.

## Financial Reporting

Historically, the contents and purpose of company accounts has been specified by parliament in the Companies Acts. Companies Act 2006 states that company directors are responsible for preparation and public filing of “true and fair” accounts, In the case of individual companies, the accounts must comprise a balance sheet as at the last day of the financial year, and a profit and loss account. Where a company has subsidiary undertakings there is an obligation to prepare “true and fair) group accounts in the form of consolidated accounts. The Companies Act requires that directors of a company must not approve accounts, unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, in the case of individual accounts, and of the undertakings included in the consolidation, in the case of the company's group accounts. The Companies Act 2006 does not provide a detailed specification of the accounting rules to be used in the preparation of company accounts, but it recognises the standards issued by the FRC.

Since 2005, UK companies have been able to prepare their accounts in accordance with the International Financial Reporting Standards (IFRS) formulated by the International Accounting Standards Board (IASB) and adopted by the European Union. The FRC has adopted the framework pushed by the IASB. It is not irrelevant to note that the parent company of IASB, now known as the International Financial Reporting Standards Foundation (IFRSF), is based in Delaware so that it can avoid taxes on its income<sup>32</sup>. The IFRSF is funded by the big four accountancy firms and about 200 corporations, many of whom have a history of accounting abuses and auditing failures. The FRC claims that IFRS represents a global system of accounting. But that is simply not true. After the banking crash, the US has refused align its accounting standards with the IFRSs and Japan does not fully use it either. Besides, accounting standards, like other social arrangements, are the outcome of social negotiations and bargaining, but the FRC has handed the entire arena to giant corporations and accounting firms.

What is the purpose of requiring companies to publish audited financial statements? Parliamentary debates can provide some answers. During the passage of the Companies Act 1929, audited accounts were described as more than just for the “protection of shareholders and investors, wholly or even mainly<sup>33</sup>”. During the passage of the Companies Act 1948, audited accounts were considered to be “in the

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<sup>32</sup> Kees Camfferman and Stephen A Zeff, *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee, 1973-2000*, Oxford: Oxford University Press, 2007.

<sup>33</sup> Hansard, House of Commons Debates, 21 February 1928, col. 1523

interests and protection of the public<sup>34</sup>”. During the passage of the Companies Act 1967, the then President of the Board of Trade said, “It is right, both from the point of view of efficiency and of fair distribution of rewards, that full information should be available to shareholders, employees, creditors, potential investors, financial writers and the public as a whole<sup>35</sup>”. Another supporter of the Bill added: “modern company laws should be concerned not just with the interests of the shareholders but with the contribution of the company to the economic efficiency of the whole community<sup>36</sup>”. The Opposition benches supported the Bill and added that “We need a number of figures to be able to make that comparison, and it is this inquiry by those interested in the company, whether as an onlooker or as a shareholder in a number of companies, which is so important to improve the performance of companies in any particular industry<sup>37</sup>”. A 1975 report<sup>38</sup> issued by the accountancy bodies did not consider financial reporting to be a private matter between the company and its shareholders. It recognised that there were diverse needs of various stakeholder groups, including employees, suppliers, the government and the general public. Yet the FRC has neglected the interests of stakeholders.

In a landmark House of Lords judgment in *Caparo Industries Plc v Dickman* [1990] UKHL 2 (08 February 1990) the law lords had an opportunity to consider the purpose of company accounts and stated that

“one purpose of providing the statutory information might be to enable the recipient to exercise whatever rights he has in relation to his proprietary interest by virtue of which he receives it, by way, for instance, of disposing of that interest. I can, however, see no ground for supposing that the legislature was intending to foster a market for the existing holders of shares or debentures by providing information for the purpose of enabling them to acquire such securities from other holders who might be minded to sell.”

“... I therefore conclude that the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts. “

The FRC set out its stall in 1990 and in complete contrast to the House of Lords decision and parliamentary sentiments; its “Statement of Principles” stated that

- “The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions.

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<sup>34</sup> Hansard, House of Lords Debates, 18 February 1947, col. 745

<sup>35</sup> Hansard, House of Commons Debates, 14 February 1967, col. 360

<sup>36</sup> Hansard, House of Commons Debates, 14 February 1967, col. 403.

<sup>37</sup> Hansard, House of Commons Debates, 14 February 1967, col. 444

<sup>38</sup> Accounting Standards Steering Committee, *The Corporate Report*, London: ASSC, 1975.

- That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user.
- Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability<sup>39</sup>.

The above is notable for “*focusing exclusively on the information needs of present and potential investors*” and the assertion that whatever is good for investors is somehow also good for other stakeholders, including employees, suppliers, pension scheme members, the state, local communities and anyone else affected by corporate practices. None of this is borne out by the collapse of BHS, Carillion, banks and numerous other scandals. In any case little is known about how investors process information.

The FRC framework is based on a schema advanced by the International Accounting Standards Board (IASB) which has long asserted that

“the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions depend on the returns that those investors, lenders and other creditors expect from investing in the entity's debt and equity instruments or from providing credit to the entity. Their expectations about returns depend on their assessment of the prospects for future net cash inflows to the entity<sup>40</sup>”.

Again, the emphasis is on “*future*” cash flows. The IASB/FRC conceptual framework is informed by Chicago economics and based on a set of arguments initially developed by the US-based accounting standard setter, the Financial Accounting Standards Board (FASB) in the 1970s. The framework has been in limbo for many years as it could not easily address many of contemporary accounting issues. In the FRC and IASB framework “mark-to-market” or fair value have become the key drivers of financial reports even though markets are volatile, uncertain, driven by bubbles, manipulations and poor assessment of risks by credit rating agencies. A number of IFRS's enforce the application of fair value reporting, that is, capitalizing expected future earnings of a firm's assets into their on-going revaluations and IFRS 13 on Fair Value Measurement<sup>41</sup> sets out a general ‘fair value hierarchy’ to inform accountants how to value assets.

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<sup>39</sup> Accounting Standards Board, Statement of Principles, London: ASB, 1999. The ASB started issuing accounting standards in 1990 and was part of the FRC. In 2012, it was replaced by the Accounting Standards Council but the framework established by the ASB, with some modification, has remained central to the promulgation of accounting standards.

<sup>40</sup> International Accounting Standards Board, Staff Paper: Conceptual Framework – October 2017; <https://www.ifrs.org/-/media/feature/meetings/2017/october/iasb/conceptual-framework/ap10b-sweep-issue-flowchart-chapter1.pdf>.

<sup>41</sup> <https://www.iasplus.com/en/standards/ifrs/ifrs13>

- Asset value can be based on quoted prices in active markets for identical assets or liabilities,
- Quoted prices for similar assets or liabilities in active markets, or
- A reporting entity can develop and model, using unobservable inputs, to generate a valuation (using the best information available in the circumstances).

Traditionally, financial statements have been based on invoices, contract notes, costing records and even market values of tangible assets. However, tangible assets are increasingly replaced by intellectual property (patents, logos, software, trademarks, copyrights, etc.) and complex financial instruments. Companies are keen to improve their reported performance by including such items in their financial statements, but in the absence of active markets consisting of numerous buyers/sellers and where everyone is a price-taker rather than a price-maker, it is almost impossible to verify the valuation of company specific intellectual property. Nevertheless, the FRC permits companies to generate their own numbers through what has become known as ‘mark-to-model’ or ‘mark-to-myth’ as some critics have called it. Traditionally the numbers assigned to assets, liabilities, income and expenses in corporate financial statements were verifiable and could be corroborated from actual transactions, but that is not necessarily the case now.

The FRC, under the influence of the IASB, has diluted “reliability” as criteria in financial reporting and has replaced it with “faithful representation”, which permits plenty of scope for inserting educated guesses in company accounts, albeit the ones based on fancy models, algorithms and formulas. The FRC approach to financial reporting has diluted the traditional transactions and realisation based model of financial reporting in favour of one aligned with markets and valuation models. One consequence of the market based approaches is that companies can report gains/profits because market prices have gone up even though assets/liabilities have not been realised i.e. not turned into cash or near-cash.

For a long time ‘prudence’ was considered to be a fundamental accounting concept and required that companies should not anticipate profits and must make provision for foreseeable losses at the earliest possible opportunity. The FRCs adoption of IFRSs has resulted in abandonment or at least severe dilution of the concept of prudence and companies have been required to make provisions for losses only when they were incurred. The shortcomings of the accounting standards and FRC’s oversight of financial reporting were exposed 2007-08 banking crash as many banks had continued to postpone the write-off of toxic assets and bad loans in their balance sheets. This was known, and led to a collapse of trust in the valuation of assets on bank balance sheets, which in turn triggered the crisis in August, 2007, by freezing inter-bank lending. The FRC and the use of IFRSs was heavily criticised by the parliamentary Banking Standards Commission<sup>42</sup>.

Later chapters of this report will show that the accounting standards approved by the FRC significantly obscured the transparency at banks, Carillion, BHS and elsewhere.

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<sup>42</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.



## Auditing Standards

The auditors' duties, rights and powers are specified in the Companies Act 2006. In general, auditors are required to state whether in their opinion the annual accounts give a true and fair view of the state of affairs and the balance sheet and profit or loss of the company or group at the end of the financial year. Unlike the directors' duties, the legislation does not fully spell the auditors' duties though there are some exceptions. For example, the Building Societies Act 1986, Financial Services Act 1986, Banking Act 1987 and their subsequent revisions impose duties on auditors to report irregularities to financial sector regulators even without client knowledge. The same duties are not imposed in other segments of the economy even though there are considerable concerns about auditor duty to detect/report fraud and actively reporting on whether at the date of the balance sheet, a business is a going concern. The statutory vacuum has enabled the FRC to specify auditor duties through auditing standards.

The FRC promulgates auditing standards which cover auditor duties and working practices. These are drafted by working parties and committees dominated by the auditing industry, and big firms in particular. The auditing standards are often based on the lowest common denominator and have been a mechanism for limiting audit work, auditor responsibility and liability.<sup>43</sup> The FRC has adopted auditing standards set by the International Auditing and Assurance Standards Board (IAASB) which is part of the International Federation of Accountants (IFAC). The IFAC is a trade association that represents accountancy bodies in most countries. It is funded by the accountancy bodies from the UK and elsewhere. While there are many auditing standards, there are no standards on auditor accountability to the public, or even a requirement for auditors to publish meaningful information about their affairs or giving access to societal stakeholders to their files.

## FRC Colonisation

The Chairman and Deputy Chairman of the FRC are appointed by the Secretary of State for Business, Energy & Industrial Strategy (BEIS). The composition of its current board<sup>44</sup> is shown in Table 2.5.

**Table 2.5**  
**FRC Board Members**

| <b>Name</b>   | <b>Business Links</b>  |
|---|--|
| Sir Winfried Bischoff (Chairman);<br>appointed 1 April 2014 | Chairman of Lloyds Banking Group plc (2009-2014); CEO and then Chairman of Schroders plc (1984-2000); Chairman of Citigroup Europe (2000-2009) and interim CEO and then Chairman of Citigroup Inc (2007-2009); Since 1983 he has served on the boards of 10 major public |

<sup>43</sup> Prem Sikka, "Audit Policy-making in the UK: The Case of "The auditor's considerations in respect of going concern", *European Accounting Review*, Vol. 1, No. 2, 1992, pp. 349-392.

<sup>44</sup> As per <https://www.frc.org.uk/about-the-frc/structure-of-the-frc/frc-board/frc-board-members>

|  |  |
|--|--|
|  | companies (5 in the UK, 3 in the US, 2 in Europe)  |
| Gay Huey Evans (Deputy Chairman); Appointed 1 April 2012                           | Formerly vice chairman, Investment Banking & Investment Management at Barclays. Prior to that President of Tribeca LLC and Head of Governance at Citi Alternative Investments (EMEA) and Director of the Markets Division at the Financial Services Authority (1998-2005); various senior management positions with Bankers Trust Company in New York and London between 1984 - 1998   |
| Stephen Haddrill (Chief Executive Officer); Appointed 16 November 2009             | Previously Director General, Fair Markets Group at the Department of Trade and Industry (DTI); previously Director of Employment Relations, and Consumer Affairs at DTI; Also held a number of other positions at DTI  |
| David Childs (Chair of the Conduct Committee); Appointed 1 May 2014                | Managing Partner of Clifford Chance from 2006 until 30th April 2014  |
| Paul Druckman (Chair of the Corporate Reporting Council); Appointed 1 January 2017 | Past President of the ICAEW; Takeover Panel member   |
| Nick Land (Chair of the Codes and Standards Committee); Appointed 1 April 2011     | Former chairman of Ernst & Young; non-executive director of Thames Water Utilities Ltd and Astro Lighting Ltd; previously been a non-executive director of Vodafone Group plc, Ashmore Group plc, BBA Aviation plc, Alliance Boots GmbH and Royal Dutch Shell plc; advisor to the board of Dentons UK and Middle East LLP and chairs the Private Equity Reporting Group of the British Venture Capital Association; chairman of the board of trustees of the Vodafone Group Foundation                       |
| Olivia Dickson (Non- Executive Director); Appointed 2 July 2012                    | Non-executive Director of the Royal London Group, and a non-executive adviser to the Senior Partner and Managing Partner of Travers Smith LLP; previously a non-executive Director and Chair of the Risk Committee of Canada Life, a non-executive Director and Chair of the Remuneration Committee of Virgin Money plc, a non-executive Director of Investec plc, a Trustee Director and Chair of the Risk Committee of the Mineworkers' Pension Scheme, a non-executive Director and Chair of the Risk and |

|   |   |
|---|---|
|   | Compliance Committee of Aon Limited and as a member of the Financial Services Authority's Regulatory Decisions Committee and the Pensions Regulator's Determinations Panel; Senior Adviser to the Financial Services Authority, a Managing Director and Head of European Exchange Traded Derivatives Brokerage at JP Morgan and a non-executive Director and Chair of the Audit Committee of the London International Financial Futures Exchange. |
| Mark Zinkula (Non-Executive Director); Appointed 1 April 2017         | Chief Executive Officer of Legal & General Investment Management; previously at Aegon Asset Management where he was Global Head of Fixed Income   |
| Mark Armour (Non-executive Director); Appointed 2 July 2012           | Non-Executive Director and member of the Audit Committee of Tesco PLC, a Member of the Takeover Panel; previously Non-Executive Director, Chairman of the Audit Committee and a member of the Remuneration Committee of SABMiller PLC.  |
| Sir Brian Bender KCB (Non-executive Director); Appointed 1 March 2014 | Retired British civil servant, who served as the Permanent Secretary of the Ministry of Agriculture, Fisheries and Food (later the Department for Environment, Food and Rural Affairs) and the Department of Trade and Industry (later the Department for Business, Enterprise and Regulatory Reform).  |
| John Coomber (Non-executive Director); Appointed 23 July 2015         | Joined the Board of Pension Insurance Corporation as a Non Exec Director in 2006, was appointed Chief Executive Officer in 2009 until June 2015 and continued as a Director until May 2017; also Chairman of MH (GB) Limited; previously director of Swiss Re, Euler Hermes, Chairman of The Climate Group, Chairman of Climatewise and a member of the Deutsche Bank Climate Advisory Board  |
| Roger Marshall (Non-executive Director); Appointed 1 November 2010    | Former PwC partner; now on a number of Boards and committees including Old Mutual plc and Pensions Insurance Corporation, where he Chairs the Audit Committees  |
| Keith Skeoch (Non-executive Director); Appointed 1 March 2012         | Co-Chief Executive of Standard Life Aberdeen plc; previously Head of Global Equities with James Capel (HSBC   |

|   |   |
|---|---|
|   | Securities from 1996)   |
| Julia Unwin CBE (Non-Executive Director); Appointed 1 April 2018  | Former Chief Executive of the Joseph Rowntree Foundation, a Charity Commissioner, Chair of the Refugee Council and Deputy Chair of the Food Standards Agency. |
| Jenny Watson CBE (Non-Executive Director); Appointed 1 April 2018 | Chair of the House of St Barnabas, and of the Independent Complaints Panel at the Portman Group; non-executive director at the Financial Ombudsman Service.   |

The FRC board and operations are dominated by those with links to the big accountancy firms. Of the 15-member current main board, five are Big Four alumni, three of which came from one firm, PwC.

In November 2017, amidst intense public scrutiny, the FRC decided to publish a Register of Interests<sup>45</sup> and it lists details of board and committee members' appointments, offices and directorships currently and for the past ten years, their membership of professional bodies and trade unions, membership of an audit firm pension schemes, and 'relevant declarations in respect of family and close personal relationships. The FRC Register shows that out of the 10 members of the FRC's codes and standards committee, four come from the Big Four, while five members of the 13-strong conduct committee have a Big Four background. Of the 44 names appearing on the Register, 18 are ICAEW members, one is a CIMA member, and two are ICAS members. The evidence shows that partners from firms implicated in accounting, auditing and tax avoidance scandals are welcome at the FRC and sit on its committees. It is to be expected that they are selected for their expertise; and that the need to be independent, objective and serve the broader public interest is impressed upon them. However, what 'independence', 'objectivity' and 'public interest' means is inevitably conditioned by their education, income, wealth and business interests.

The FRC sponsored accounting standards affect calculations of solvency, liquidity, leverage, profit/loss and assets and liability. Accounting standards have distributional effects as they influence the distribution of income, wealth, risks, pension rights, supplier security and employee pension rights. Therefore, it is vital that such effects are considered in making rules, but they rarely are. The entrenchment of 'corporate think' could be challenged and the debate on the purpose and effectiveness of the FRC could be enriched by a plurality of stakeholder perspectives. However, there is virtually no representation of employees, suppliers, trade unions, or pension scheme members even though such stakeholders are routinely affected by accounting and auditing practices. There are also concerns about oversight by the state when it is noted that the senior civil servant at the Department of Business, Energy and Industrial Strategy (BEIS), responsible for managing the department's relationship with the UK audit regulator, is married to FRC chief executive Stephen Haddrill<sup>46</sup>.

<sup>45</sup> [https://www.frc.org.uk/getattachment/0739443f-82e5-44e5-9d86-33c73de4fb63/Section-A-Final-RoI-data\\_for-publication-11-October-2018.pdf](https://www.frc.org.uk/getattachment/0739443f-82e5-44e5-9d86-33c73de4fb63/Section-A-Final-RoI-data_for-publication-11-October-2018.pdf)

<sup>46</sup> *Economia*, BEIS denies conflict of interest over FRC relationship, 1 November 2017, <https://economia.icaew.com/news/november-2017/beis-messes-up-over-frc-relationship>

## **FRC Resources and Public Accountability**

Until 2009, the FRC was partly funded by the government. Since then, the Government has progressively withdrawn its financial contribution to the FRC and it ceased to provide direct funding from 2016 onwards. Whereas from 2009-2016, the FRC received £2.7 million from the government, it is presently funded<sup>47</sup> by the UK accountancy bodies boosted by annual Preparers Levy raised from listed companies, i.e. large companies with a turnover of £500m, various government departments, local authorities and public sector organisations, insurance companies and pension schemes. In 2016/17, the FRC raised nearly £32 million.

FRC board meetings are not held in the open and minutes are not publicly available. The FRC's mode of public accountability is annual reports, press releases and a short annual open public meeting where the public can ask some questions<sup>48</sup>, but may not necessarily receive answers.

## **FRC Disciplinary Action**

Disciplinary action against auditors for audit failures is overseen by the FRC's Conduct Committee. The Case Management Committee advises on the handling of disciplinary cases. Each case is assigned a group of at least 3 Case Management Committee members. The present membership of the Committees, somewhat sanitised after the Carillion and BHS failures, includes individuals currently or previously connected with PwC, Ernst & Young, KPMG, GlaxoSmithKline, Standard Chartered, Conoco and a number of law firms<sup>49</sup>. Previous memberships are heavily colonised by individuals connected with firms and businesses implicated in audit failures, tax avoidance and related anti-social practices<sup>50</sup>. No doubt the FRC would argue that individuals declare their conflict of interests and are then excluded from selected proceedings, but the point remains that their worldviews are embedded in the institution and inform notions of good/bad audits and related practices. Their worldviews determine whether any case is worthy of investigation. The Committees lack presence of stakeholders injured by accounting, auditing and corporate governance failures

The FRC criterion for making disciplinary judgments is that an individual's conduct "fell significantly short of the standards reasonably to be expected of them". This is a dilution of the previous benchmark which was that "the conduct or quality of work of

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<sup>47</sup> Financial Reporting Council, Strategy 2018/21 Budget and Levies 2018/19, London: FRC, March 2018; [https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-\(March-2018\).pdf](https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-(March-2018).pdf)

<sup>48</sup> The minutes of the 2017 meeting provide a flavour of the tone of the meeting.

<sup>49</sup> As per <https://www.frc.org.uk/about-the-frc/structure-of-the-frc/conduct-committee/conduct-committee-members>

<sup>50</sup> For some evidence, see Appendix 5, Financial Reporting Council, The FRC's enquiries and investigation

of KPMG's 2007 and 2008 audits of HBOS, November 2017; <https://www.frc.org.uk/getattachment/646bb35a-f39f-4d75-a12e-6d2480e0b2a7/HBOS-Report-Nov-2017-FINAL.pdf>

the firm fell below that which was to be expected<sup>51</sup>". The "significantly short" criterion is problematical as this makes many matters acceptable even though they are short of what may be acceptable to public at large. In addition, the FRC uses accounting/auditing standards and code of ethics as benchmarks, which have been crafted by itself. Therefore, it does not use any independent benchmarks in making assessments of accounting and auditing failures.

The whole process is fundamentally flawed in that the same body sets the rules, investigates failures and then acts a judge and jury

If the accountants under scrutiny satisfy the benchmarks, their conduct is considered to be satisfactory even though the benchmarks themselves may be deficient. For example, for a long time the FRC has permitted auditors to sell non-auditing services, albeit subject to restrictions in the aftermath of scandals. When considering the lack of independence in a disciplinary case its starting point is whether accountants complied with the code of ethics and if so that is not considered to lead to unacceptable conduct even though the provision of non-audit services results in erosion of independence. The FRC accounting standards did not require BHS, a wholly-owned subsidiary, to publish cash flow statements<sup>52</sup>. Its cash flows could not be untangled from the accounts of its parent company (Taveta Investments) as it had a number of additional subsidiaries. The net result is that the FRC's accounting standards ensured that BHS published opaque financial statements and failed to inform stakeholders of solvency and liquidity of the company. Compliance with such standards in FRC's universe is considered to be good.

The FRC has handed out disqualification and suspensions from professional body membership to individuals, as well as fines for the individuals and firms. The disciplinary hearings are not open to the public and how the evidence available to the FRC is weighted or filtered is not known. Before announcing disciplinary penalties the FRC negotiates them with accountancy firms and the relevant RSB, but the same privilege is not available to any complainant or those affected by the audit failures. In its quasi-judicial capacity, the FRC permits firms and the individual auditors to appeal against the FRC's initial conclusions, but stakeholders have no such rights.

## **FRC and Codes of corporate governance**

A key moment in the recent history of corporate governance was the publication, in 1992, of the Report of the Committee on the Financial Aspects of Corporate Governance<sup>53</sup>. Widely known as the Cadbury Committee and the Cadbury Report<sup>54</sup>,

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<sup>51</sup> For example, see the Joint Disciplinary Scheme report on Barings auditors - Coopers & Lybrand, Gareth Maldwyn Davies and Andrew Charles Turner, October 1998.

<sup>52</sup> Financial Reporting Council, Accounting and Reporting Policy FRS 102 - Staff Education Note 1 Cash flow statements; <https://www.frc.org.uk/getattachment/ed90f95c-4180-426c-b543-c688d127f7a9/SEN-01-Cash-flow-statements-FINAL-FINAL-FINAL.pdf>

<sup>53</sup> For further information see Jeroen Veldman and Hugh Willmott, The cultural grammar of governance: The UK Code of Corporate Governance, reflexivity, and the limits of 'soft' regulation, *Human Relations*, 69(3): 581-603, 2016.

after the name of its Chairman, its work provided what became the UK Combined Code of Corporate Governance. The basis for the institutionalization of the Code was the establishment of a form of private interest government that headed off the risk of 'hard', statutory regulation. Since 1992, the Code has been revised a number of times.

Historically, the UK has relied upon company, insolvency and related laws to regulate governance of companies and accountability of directors. The 1980s/90s scandals relating to Bank of Credit and Commerce International (BCCI), Barlow Clowes, Dunsdale, Guinness, Levitt, Lloyd's, Maxwell Communications Corporation and Mirror Group Newspaper, Polly Peck and others highlighted failures of directors, auditors and City institutions. These scandals prompted a clamour for stronger and effective laws. The outcome was that elites were permitted to develop their own voluntary solutions.

The FRC and the London Stock Exchange (LSE), together with the ICAEW, established the 'Committee on the Financial Aspects of Corporate Governance' (CFACG). CFACG's prescription for minimizing future failures of corporate governance was the establishment of a privately operated Code in which company boards would be required to reflect on 'best practice'. The 1992 Code and its subsequent revised editions remain voluntary and apply to listed companies only. The Code lacks a statutory basis, but compliance with it became a formal part of the listing requirements for the Stock exchange, thereby creating a strong presumption in favour of compliance in the operation of the Code.

The Code has advanced a shareholder-centric model of corporate governance and has accommodated and promulgated the myth that shareholders are owners of companies. It sought to regularise the relationship between directors and shareholders and it endorsed the idea that alignment of shareholder and director interests would improve corporate governance. It stated that directors should address shareholder concerns and the annual general meeting was considered to be an effective way of maintaining contact with shareholders. It called for regular board meetings and distinct and separate roles for the chairman and chief executive. It urged non-executive directors to exercise their independence and scepticism in challenging and scrutinising management.

To discharge effective accountability, executive directors were urged to present a fair, balanced and understandable assessment of the company's position and prospects in annual reports. In particular, directors were asked to state in annual and half-yearly financial statements whether they consider it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements. Directors were urged to explain remuneration practices and payments to shareholders and also disclose the same in the annual accounts.

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<sup>54</sup> Committee on the Financial Aspects of Corporate Governance (Cadbury Report), 1992. To obtain the Reports and access the Cadbury Archive, visit <http://www.cadbury.jbs.cam.ac.uk/index.html>.

The Code is based on a 'comply or explain' approach. The Code requires companies to report on a set of issues by indicating not only their degree of compliance with what is assumed to be 'best practices' but also by providing an explanation of any deviation from them. The declared purpose of the explanations is to point to examples of 'better' practice(s) as well as to disclose where companies have fallen short of what the Code identifies as 'best practice(s)'. It is important to appreciate that the Code does not require compliance *per se*. Instead, it seeks recognition and explanation of practices that exceed, or fall short of, its specification of 'best practice(s)': 'The Code is to be followed by directors and companies in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form'.

Since 1992, the code has gone through a number of revisions<sup>55</sup>, but shareholder interests remain central to it. Other stakeholders are marginalized. The 1992 Code did not mention of any other stakeholder to whom directors might, or should, be held accountable. Its subsequent revisions have failed to give any recognition to the distinct interests of other stakeholders. The Code does not, for example, require listed companies to pay a living wage, curtail tax avoidance or reduce environmental degradation. It remains based on the idea of governance by selected disclosures on financial matters; and it fuels the view that accountability and transparency are confined to the evaluation of financial performance in relation to the sentiments, calculations and speculations of traders in financial markets. Everything else is neglected, or is of relevance only insofar as it is seen to contribute to, or advance, shareholder interests. The Code promotes passive forms of accountability and does not give any enforceable rights to any stakeholder, even shareholders. For example, there are no binding shareholder votes on executive pay.

The shortcomings of the Code and its voluntary approaches are repeatedly demonstrated by recurrent scandals.

## **CONSULTATIVE COMMITTEE OF ACCOUNTANCY BODIES (CCAB)**

The Consultative Committee of Accountancy Bodies (CCAB) is a vehicle for promoting the joint interests of the UK professional accountancy bodies. Since 1984, it has operated as a limited liability company (CCAB Limited) with total issued share capital of £1,000. The ICAEW is its majority shareholder. Other shareholders are the ACCA, ICAS, ICAI and CIPFA. In 2011, CIMA withdrew from CCAB over wrangling about the benefits from its financial contributions to the FRC<sup>56</sup>. CCAB claims to have four strategic objectives (Table 2.6).

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<sup>55</sup> For example, Study Group on Directors' Remuneration: Final Report (Greenbury Report), 1995; Committee on Corporate Governance; Final report (Hampel Report), 1998; Internal Control: Guidance for Directors on the Combined Code (Turnbull Report), 1999; Review of the Role and Effectiveness of Non-Executive Directors (Higgs Report), 2003; The Combined Code: Principles of Good Governance and Code of Best Practice, 1998, 2003, 2005, 2008; Financial Reporting Council, The UK Corporate Governance Code 2014; Financial Reporting Council, The UK Corporate Governance Code, London: FRC, 2018

<sup>56</sup> <https://www.cimaglobal.com/Press/Press-releases/2011/CIMA-withdraws-from-the-CCAB/>



**TABLE 2.6**  
**CCAB Strategic Objectives**

**Current and Emerging Issues**

Providing a forum for considering current and emerging issues and agreeing joint approaches to the Financial Reporting Council (FRC), government and other authorities, both national and international, on behalf of the UK profession and, in particular, where significant public interest issues are at stake.

**Maintaining Identity**

Maintaining and developing CCAB's identity as the collective voice of the UK profession.

**Representing Views to International Standard Setters, Regulators and Other Bodies**

Providing a mechanism for influencing the global profession by representing the views of the UK profession to international standard setters, regulators and other bodies; including the making of nominations to international organisations.

**Joint Approaches**

Facilitating joint project based thought leadership, technical work and research on behalf of the UK profession, where this enhances the 'collective voice' and adds value for the bodies.

**Turf Wars**

CCAB has long conducted campaigns to secure 'social closure' around the term "accountant", and to argue that only members of the CCAB bodies should be entitled to call themselves 'accountants' and deliver book-keeping, accounting, tax and related services. External auditing and insolvency markets have long been reserved exclusively for members of ICAEW, ICAS, ACCA and CAI. Only 'registered auditors', authorised by one of the RSBs can carry out statutory audits. Members of the ICAEW, ICAS, ACCA, CAI, CIPFA and CIMA (still collectively described as CCAB bodies) are already able to distinguish themselves from others through the exclusive use of the word 'chartered' and designatory letters, but the word 'accountant' is not exclusively reserved for members of these bodies. As the ACCA chief executive put it "ACCA and the other CCAB bodies in the UK have for many years called for the term 'accountant' to be legally defined and protected"<sup>57</sup>.

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<sup>57</sup> Accountingweb, ACCA response on protecting the term Accountant, 24 September 2010, <https://www.accountingweb.co.uk/any-answers/acca-response-on-protecting-the-term-accountant>; also see The Irish Times, Professional titles are not always a guarantee, 2 June 2014; <https://www.irishtimes.com/news/consumer/professional-titles-are-not-always-a-guarantee-1.1815540>; Irish Auditing & Accounting Supervisory Authority, Consultation Paper CP 1/06: Invitation to Comment on the Matter of Legal Protection of the Term 'Accountant', 2 March 2006, [https://www.iaasa.ie/getmedia/87a5a3a0-2658-4047-8b57-872da641e47b/Consultation\\_Paper\\_No\\_1\\_of\\_2006.pdf?ext=.pdf](https://www.iaasa.ie/getmedia/87a5a3a0-2658-4047-8b57-872da641e47b/Consultation_Paper_No_1_of_2006.pdf?ext=.pdf); Accountancy Age, ICAEW CEO Izza challenges government on tax regulation, 1 April 2015, <https://www.accountancyage.com/aa/news/2402538/icaew-ceo-izza-challenges-government-on-tax-regulation>

The campaign is built around the claim that the so-called unqualified accountants (i.e. not members of the CCAB bodies) are responsible for money laundering, tax avoidance/evasion, poor accounting, tax and other business advice and their elimination would somehow lead to higher standards of practice. No reference is made to the role of professionally qualified accountants in scandals. The aim of the joint campaign, if successful, is to control the supply of professionally qualified accountants, secure monopolies and niches for them, and push up their financial rewards. This makes it impossible for thousands of graduates with BA/BSc, MA/MSc, PhD, accounting and others with technician level qualifications to secure work that is effectively reserved for members of the major bodies.

### **Accounting Standards for Limited Liability Partnerships**

In response to demands from the accounting industry, the Companies Act 1989, permitted accountancy firms to trade as limited liability companies and secure liability protection for their members/partners. Limited liability status is usually accompanied by disclosure requirements i.e. publish audited financial statements and related information. As legal persons, companies are also taxed on their profits. However, big accountancy firms did not welcome disclosures or the possible loss of lucrative tax arrangements available to partnerships. They therefore campaigned to form limited liability partnerships (LLPs) which enabled them to secure liability protection for their partners and retain the tax advantages available to partnerships.

Initially, the UK government resisted the pressure to allow LLPs. Price Warehouse (now part of PricewaterhouseCoopers) and Ernst & Young spent over £1 million to privately draft a LLP Bill and in 1996 persuaded the government of Jersey to enact the legislation<sup>58</sup>. The threat was that the big accounting firms (accompanied by law, surveying, architects and other firms) would shift their business operations to Jersey, and thereby unleash economic turmoil on mainland UK<sup>59</sup>. The campaign was supported by the ICAEW and other CCAB bodies. The government capitulated and the Limited Liability Partnership Act 2000 conceded the firms' demands. LLPs are required to publish audited financial statements. Almost all accounting firms operate as LLPs which gives them considerable liability protection so that partners have limited "skin in the game".

As a new form of business vehicle, matters relating to LLPs financial reporting and disclosures needed to be addressed. The Limited Liability Partnership Act 2000 and regulations made thereunder specified the broad financial reporting framework (for example see Limited Liability Partnerships Regulations 2001 (SI 2001/1090) which came into force on 6th April 2001<sup>60</sup>). But the details were left to the Accounting Standards Board (ASB). At that time, the ASB was a subsidiary of the FRC and was tasked with developing accounting standards<sup>61</sup>. On 2 March 2000, the ASB invited

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<sup>58</sup> Prem Sikka, Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey, *Accounting, Auditing and Accountability Journal*. 21(3): 398-426, 2008.

<sup>59</sup> Such a threat had no real substance but the bait was taken by the media.

<sup>60</sup> [http://www.legislation.gov.uk/uksi/2001/1090/pdfs/uksi\\_20011090\\_en.pdf](http://www.legislation.gov.uk/uksi/2001/1090/pdfs/uksi_20011090_en.pdf)

<sup>61</sup> On 2 July 2012, however, the FRC Board assumed responsibility for setting accounting standards

CCAB to formulate what eventually became known as the Statement of Recommended Practice (SORP). From the very beginning, the control of LLP SORP was predominantly in the hands of big law/accounting firms and professional bodies (Table 2.7<sup>62</sup>)

**TABLE 2.7**  
**Control of LLP Accounting SORP**

| <b>Steering Committee</b>  |   |
|----------------------------|---|
| <b>Name</b>                | <b>Links</b>  |
| Graham Ward (Chairman)     | The Institute of Chartered Accountants in England and Wales; PricewaterhouseCoopers partner                             |
| Michael Foulds             | The Association of Chartered Certified Accountants (former President)   |
| James Gemmell              | The Institute of Chartered Accountants of Scotland; chairman of Horwath Clark Whitehill, previously partner at Deloitte |
| Peter Graham               | The Law Society   |
| Nigel Llewellyn            | Association of Partnership Practitioners  |
| Andrew Nairn               | Construction Industry Council   |
| Frances Paterson           | Construction Industry Council   |
| Richard Turnor             | Association of Partnership Practitioners Observer   |
| David Dean                 | Department of Trade and Industry  |
| <b>Working Party</b>       |   |
| Nigel Llewellyn (Chairman) | Deloitte & Touche   |
| Jeremy Boadle              | Smith & Williamson  |
| James Carty                | RSM Robson Rhodes   |
| Kathryn Cearns             | Herbert Smith   |
| Fiona Crozier              |   |
| Ian Dinwiddie              | Allen & Overy   |
| John Oliver                | Bacon & Woodrow   |
| John Robinson              | Barclays Bank plc   |
| Michael Roden              | KPMG  |
| Peter Saunders             | Deloitte & Touche   |
| Desmond Wright             | CCAB  |

The domination by big accountancy firms has continued in all subsequent revisions of the SORPs. The 2014 working party consisted solely of partners from Deloitte, PwC, KPMG and Clark Whitehill<sup>63</sup>. The 2017 working party consisted solely of partners from Deloitte, PwC, KPMG, Clark Whitehill and BDO<sup>64</sup>. It should be noted that there are a number of sector specific SORPs e.g. for insurance industry.

<sup>62</sup> Adapted from CCAB, Statement of Recommended Practice – Accounting by Limited Liability Partnerships, May 2002.

<sup>63</sup> CCAB, Statement of Recommended Practice - Accounting by Limited Liability Partnerships, 15 July 2014; <http://www.ccab.org.uk/documents/LLPSORPFinal.pdf>

<sup>64</sup> CCAB, Statement of Recommended Practice - Accounting by Limited Liability Partnerships, 26 January 2017; <http://www.ccab.org.uk/documents/FinalSORP26012017.pdf>

However, LLPs are not sector specific: they are found in numerous businesses, such as law, accounting, surveying, architects, engineering and numerous other lines of business. The case for handing over the formulation of accounting rules to the accountants and lawyers is correspondingly weak. Accounting firms also audit LLPs. For example PwC's 2017 financial statements are audited by Crowe Clark Whitehill<sup>65</sup>, a firm that sat with PwC to write the accounting rules. The auditor cannot be considered to be independent.

The financial reports published by the auditing firms are described as 'true and fair' which in its broadest is taken to mean that all material information for appreciation of financial statements is provided. However, that is rarely the case. The firms, or their network, have links with numerous offshore entities<sup>66</sup> through which they market tax avoidance schemes. Those links have been highlighted by parliamentary committees<sup>67</sup> and whistleblowers (for example, see Panama Papers<sup>68</sup>, Luxembourg leaks<sup>69</sup>, Swiss leaks<sup>70</sup> and the Paradise Papers<sup>71</sup>). Yet the firms do not provide any list of their offshore links though equivalent limited liability companies are required to provide information about group structure, subsidiaries and affiliates. The firms do not provide information about lawsuits i.e. contingent liabilities, fines or regulatory action, all of which are of interest to a wide variety of stakeholders interested in making assessments of the quality of services or even viability of the firms. There is no mention of how much of the fines have been paid through insurance or by partners themselves or deferred onto to future entrants to the partnerships. Auditing firms have insurance arrangements with captive insurance companies i.e. the companies controlled by the firms and/or their partners, but no information is available<sup>72</sup>.

Some firms separately disclose fees from major business segments, such as accounting and auditing, but many do not, and that deficiency makes it difficult to know the marginalisation of audits within the firms. The LLP accounts show the total profits attributable to partners but the amounts received by each partner (equivalent to executive pay in companies) are not shown, though as part of a beauty parade some firms identify the highest paid partner. Some partners receive incentives and bonuses and these are not identified. No data is provided about profits from tax

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<sup>65</sup> As per <https://www.pwc.co.uk/annualreport/assets/2017/pdf/annual-report-2017-financial-statements.pdf>

<sup>66</sup> Moran Harari, Markus Meinzer and Richard Murphy, Financial Secrecy, Banks and the Big 4 Firms of Accountants, Tax Justice Network, 2012, [https://www.taxjustice.net/cms/upload/pdf/FSI2012\\_BanksBig4.pdf](https://www.taxjustice.net/cms/upload/pdf/FSI2012_BanksBig4.pdf); Chris Jones, Yama Temouri and Alex Cobham, Tax haven networks and the role of the Big 4 accountancy firms, Journal of World Business, Vol 53, Issue 2, February 2018, pages 177-193.

<sup>67</sup> House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms (follow-up), 28 January 2015; <https://publications.parliament.uk/pa/cm201415/cmselect/cmpublicacc/1057/1057.pdf>

<sup>68</sup> <https://www.icij.org/investigations/panama-papers/>

<sup>69</sup> <https://www.icij.org/investigations/luxembourg-leaks/>

<sup>70</sup> <https://www.icij.org/investigations/swiss-leaks/>

<sup>71</sup> <https://www.icij.org/investigations/paradise-papers/>

<sup>72</sup> Arthur Andersen (now defunct) had professional liability cover with a captive insurance company. When faced with claims, it was found that the insurance company was insolvent - <https://www.insurancejournal.com/magazines/mag-features/2002/05/13/21740.htm>

avoidance schemes, the number of court cases won/lost or pending, or action by regulators.

## THE INSOLVENCY INDUSTRY

The Insolvency Service is the key regulator for the insolvency industry. It is an executive agency of the Department for Business, Energy and Industrial Strategy. In 2017-18 it had a budget of £76 million (£84 million for 2016-17) and staff of 1,488 (1426 for 2016-17)<sup>73</sup>. It examines the affairs of companies in liquidation, investigates misconduct by directors and oversees the operations of the Recognised Professional Bodies (RPBs) responsible for regulating licenced insolvency practitioners (IPs).

Until the early 1970s, most of the powers for dealing with insolvent businesses lay with the Official Receivers and the Insolvency Service housed within the Department for Trade and Industry (DTI). These officials could investigate frauds, dispose of company assets and enforce compulsory liquidations of companies though private sector practitioners handled voluntary liquidations. However, with the mid-1970s quadrupling of the oil prices and the secondary banking and property crash, the number of bankruptcies and liquidations began to increase. The government was busy bailing out troubled businesses and concern grew about the loss of jobs and the means of rescuing businesses.

In 1977, the Labour government appointed a committee to review the insolvency legislation. The committee was chaired by Sir Kenneth Cork, a partner in Cork Gully (subsequently part of PricewaterhouseCoopers)<sup>74</sup>. Whilst the Cork Committee was deliberating, the Conservative Government came to office with a commitment to prioritise private sector solutions. The Cork Committee's report recommended that the state should reserve the insolvency market for accountants and lawyers that belonged to a handful of elite trade associations. Instead of an independent regulator, the Cork Committee recommended that insolvency practitioners should be regulated by accountancy and law trade associations.

The Conservative government accepted most of Cork's proposals and the Insolvency Act 1986 was introduced. In promoting the legislation, the Ministers argued that the Act would "result in a reduction of 40 staff [at the DTI] and a corresponding decrease in staff costs of £280,000 per year. There will be some reduction in the fee income in the Insolvency Service<sup>75</sup>". Whereas the Cork Report anticipated that the government would develop legislation which would require the insolvency practitioners to consider society's broad interests and employment considerations in discharging their tasks, the 1986 Insolvency Act did no such thing. Almost all of the insolvency practitioners were required to belong to one of the accountancy and law trade associations (subsequently known as the Recognised

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<sup>73</sup> The Insolvency Service Annual Report and Accounts 2017-18; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/729616/annual\\_report\\_2017-2018\\_for\\_web\\_v2.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/729616/annual_report_2017-2018_for_web_v2.pdf)

<sup>74</sup> For further information see Jim Cousins, Austin Mitchell, Prem Sikka, Christine Cooper and Patricia Arnold, *Insolvent Abuse: Regulating The Insolvency Industry*, Basildon: Association for Accountancy & Business Affairs, 2000.

<sup>75</sup> Hansard, House of Commons Debates, 30 April 1985, col. 197.

Professional Bodies, or the RPBs) whose mission is to secure economic advantages for their members. The legislation was not accompanied by an independent system of regulation or an independent ombudsman to investigate and adjudicate on complaints. The RPBs are expected to act simultaneously as defenders, promoters, prosecutors, judges, juries and reformers of the industry. The Insolvency Service subsequently established a Complaints Gateway to record complaints against IPs, but the investigation is primarily left to the RPBs.

The current regulators of the insolvency industry<sup>76</sup>, known as the RPBs, are shown in Table 2.8.

| <b>TABLE 2.8</b>   |
|--|
| <b>RECOGNISED PROFESSIONAL BODIES (RPBs)</b>                       |
| 1. Association of Chartered Certified Accountants (ACCA)           |
| 2. Chartered Accountants Ireland (CAI)                             |
| 3. Insolvency Practitioners Association (IPA)                      |
| 4. Institute of Chartered Accountants in England and Wales (ICAEW) |
| 5. Institute of Chartered Accountants of Scotland (ICAS)           |

Due to a decline in the member of solicitors acting as insolvency practitioners, both the Law Society of Scotland and the Law Society of England and Wales have withdrawn from regulatory roles. They were replaced by the Solicitors Regulatory Authority (SRA), that initially acted on behalf of the Law Societies. In March 2016, the SRA also withdrew from insolvency regulation. The SRA regulated 129 solicitors operating as insolvency practitioners and most of them are now regulated by the ICAEW. Since January 2017 ACCA has delivered the majority of its insolvency regulatory functions through the collaboration agreement with the IPA, which consolidated the complaints-handling and monitoring arrangements of the two bodies. During 2017, ACCA retained responsibility for the initial licensing of insolvency practitioners.

The number of Insolvency Practitioners (IPs) registered with each of the RPBs is shown in Table 2.9

| <b>TABLE 2.9</b>   |              |            |             |             |            |              |
|--|--------------|------------|-------------|-------------|------------|--------------|
| <b>NUMBER OF INSOLVENCY PRACTITIONER AUTHORISATIONS (2017- 2018)</b> |              |            |             |             |            |              |
|  | <b>ICAEW</b> | <b>IPA</b> | <b>ACCA</b> | <b>ICAS</b> | <b>CAI</b> | <b>Total</b> |
| <b>IPs at 1 January 2017</b>   | 788          | 567        | 108         | 98          | 44         | 1,605        |
| <b>Appointment takers</b>  | 610          | 472        | 102         | 77          | 41         | 1,302        |
| <b>IPs at 1 January 2018</b>   | 783          | 557        | 94          | 93          | 42         | 1,570        |
| <b>Appointment takers</b>  | 599          | 460        | 89          | 75          | 41         | 1,264        |

The key point to note is that five professional bodies are directly responsible for regulating 1,264 IPs, creating enormous scope for duplication, waste and obfuscation. All UK personal and corporate bankruptcies are handled by the IPs. In

<sup>76</sup> As per The Insolvency Service, Annual review of insolvency practitioner regulation 2017; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/706354/Annual\\_Review\\_of\\_IP\\_Regulation\\_2017.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/706354/Annual_Review_of_IP_Regulation_2017.pdf)

2017, the Insolvency Service's Complaints Gateway recorded a total of 757 complaints (847 in 2016) against IPs. Of the 757 complaints, 41% were referred, 48% were rejected and 11% were put on hold.

## **COMPANIES HOUSE**

Companies House is an Executive Agency of the Department for Business, Energy & Industrial Strategy (BEIS) and accountable to the Business Secretary. It has a budget of £69 million and 900 staff<sup>77</sup>. Companies House deals with the regulation and incorporation of limited liability partnerships (LLPs) and limited companies in the UK. It is the first port-of-call for the formation of LLPs and companies. Its main responsibilities are to incorporate and dissolve limited companies, examine and store company information and make information available to the public. The information displayed on the register of companies can be accessed online by the general public. All electronic data is available free-of-charge.

## **TAKEOVER PANEL**

The Takeover Panel is a statutory body (see sections 942 to 965 of the Companies Act 2006) which was originally established in 1968. Its statutory functions are set out in Chapter 1 of Part 28 of the Companies Act 2006. Its major function<sup>78</sup> is to issue and administer the City Code on Takeovers and Mergers and to supervise and regulate takeovers and other matters to which the Code applies. It has been designated as the supervisory authority to carry out certain regulatory functions in relation to takeovers pursuant to the EU Directive on Takeover Bids (2004/25/EC). The rules set out in the Code also have a statutory basis in relation to the Isle of Man, Jersey and Guernsey. The Code is not concerned with the financial or commercial advantages or disadvantages of a takeover. These are considered to be matters for the company and its shareholders. Wider questions of public interest, such as competition policy, are the responsibility of government and other bodies, such as the Competition and Markets Authority.

The Panel regulates takeover bids and other merger transactions for companies which have their registered offices in the United Kingdom, the Channel Islands or the Isle of Man if any of their securities are admitted to trading on a regulated market or multilateral trading facility in the United Kingdom or on any stock exchange in the Channel Islands or the Isle of Man. Its remit also extends to other public companies and certain private companies which are resident in the United Kingdom, the Channel Islands or the Isle of Man.

The Takeover Panel comprises up to 36 members, representing a spread of expertise in takeovers, securities markets, industry and commerce. The Chairman, Deputy Chairmen and up to 20 other Panel members are appointed by the Panel on the recommendation of the Nomination Committee. In addition, 12 Panel members are appointed by the following financial and business institutions (Table 2.10).

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<sup>77</sup> Companies House Annual Report and Accounts 2017/18

<sup>78</sup> Information as per its website <http://www.thetakeoverpanel.org.uk/>

**TABLE 2.10**  
**Organisations Permitted to Appoint Takeover Panel Members**

- The Association for Financial Markets in Europe (with separate appointees also for its Corporate Finance Committee and Securities Trading Committee)
- The Association of British Insurers
- The Association of Investment Companies
- The Confederation of British Industry
- The Institute of Chartered Accountants in England and Wales
- The Investment Association
- The Pensions and Lifetime Savings Association
- The Personal Investment Management and Financial Advice Association
- The Quoted Companies Alliance
- UK Finance

The Chairman and at least one Deputy Chairman are designated as members of the Hearings Committee. Of the other members appointed by the Panel, up to 12 Panel members are designated upon appointment as members of the Code Committee; and up to eight Panel members are designated upon appointment as members of the Hearings Committee. The Panel members appointed by the bodies listed above become members of the Hearings Committee without further designation.

It should be noted that trade unions, employee, shareholder, consumer, supplier and other stakeholder organisations do not have any appointment rights, although the designated organisation(s) may nominate a person from such constituencies.

The funding of the Panel is derived from three main sources:

1. Document charges (scale charges are payable on offer documents);
2. Panel on Takeover and Mergers Levy or PTM (100p on contracts over £10,000 on most trades in securities of companies incorporated in the UK, the Channel Islands and the Isle of Man); and
3. Exempt/recognised intermediary status charges (entities benefitting from recognised intermediary status are required to pay a charge of £6,000 for each group entity, payable at the time of the annual review).

## **FINANCIAL SECTOR REGULATORS**

The FCA and PRA are concerned with regulation of the financial sector. They were established in their current form in April 2013 by the Financial Services Act 2012. Within their prescribed role they are concerned with governance of the regulated businesses. Neither the FCA nor the PRA specifically formulate any accounting and auditing standards for the financial sector though they work closely with the FRC. They do not directly appoint auditors but can intervene to influence choice. For example, the PRA rules require auditors of a British bank to have the "required skill, resources and experience to perform its function under the regulatory system". Almost all UK banks are audited by a big four firm, but in 2018 Goldman Sachs held discussions with Grant Thornton about the possibility of becoming the bank's next auditor. This prompted the PRA to intervene and query the possible appointment of



the firm<sup>79</sup>. The PRA action elicited a joint letter<sup>80</sup> from chairs of the House of Commons Work and Pensions and Business, Energy and Industrial Strategy Committees on 12 July 2018, and said:

“we would question whether any of the Big Four have sufficiently demonstrated “the required skill, resources and skills to undertake these [bank] audits ... It would be most unfortunate if auditors like Grant Thornton now find that not only is the market working against them, but so too is the financial services regulator ...If the PRA were to block Goldman Sachs from appointing Grant Thornton then you are introducing your own form of Big Four-only clauses”.

The PRA reply of 20 July 2018 seems to suggest that it acts as quasi audit regulator:

“we have a significant interest in the quality of the audits of the firms we regulate, not least because our supervisory approach relies in some areas on high quality audit, and we gain value from productive dialogue between each audit team and the relevant supervisor. Given this, we: liaise closely with the FRC; discuss aspects of the audit in a range of bilateral, trilateral and roundtable discussions with regulated firms, audit firms and other regulators; and carry out various activities designed to encourage the delivery of improvements in audit quality ... When we think it necessary we will discuss aspects of the process with the regulated firm or with one or more of the audit firms that are or might be tendering for the work<sup>81</sup>”

The PRA has an interest in auditing and accounting matters, but the compartmentalisation of accounting regulation in FRC adds layers of unnecessary bureaucracy and creates co-ordination and oversight problems.

## **SUMMARY AND DISCUSSION**

This chapter noted the difficulty of ascertaining the number of regulators. It relied upon parliamentary questions, government websites/lists and other information to compile a list of 14 overlapping public and private bodies responsible for regulating some aspects of corporate, all authorised by various statutes. It provided brief details of the bodies responsible for regulating corporate governance, accounting, auditing and insolvency.

There is no central body responsible for enforcement of the UK company law. Accountancy bodies, effectively trade associations, act as statutory regulators for auditing and insolvency and have no independence from the individuals and firms

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<sup>79</sup> The Times, Bank queries appointment of Grant Thornton as Goldman auditor, 10 July 2018; <https://www.thetimes.co.uk/article/bank-of-england-queries-goldman-auditor-grant-thornton-0rqxwx7dw>

<sup>80</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180712-PRA-to-Chairs-audit-Goldman-Sachs.pdf>

<sup>81</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180716-Sam-Woods-to-chair-audit-of-goldman-sachs.pdf>; and <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/pral-letter-audit-of-goldman-sachs-17-19/>

that they regulate. The resources for the public regulatory bodies are derived from public and private sources. The RSBs and RPBs are funded by their members. Their officers are elected by their members and there is no public presence on their ruling bodies. Until recently, the FRC received some public funding but it is now almost exclusively funded by the private sector. The heads of the FCA and PRA are appointed by the Secretary of State. None of the regulatory bodies hold their meetings in the open and many are dominated by private interests.

The financial sector regulators use accounting data to make assessment of bank liquidity, solvency and risks, but they do not directly formulate accounting and auditing rules. To make sense of the shortcomings and risks in the financial sector, they rely upon accounting information produced in accordance with the accounting standards and designed to inform shareholders about corporate profits, assets and liabilities. Such reliance is problematical because financial reports are not designed to provide information about systemic risks or disclose the health and stability of the financial system. A bank can take reckless risks and strike it lucky and make considerable profits. This may appease shareholders and markets but could also destabilise the financial system. There was some recognition of this in the Banking Standards Commission report and it said that

“flaws in IFRS mean that the current system is not fit for regulators’ purposes. The Commission recommends that non-EU mandated regulatory returns be combined, with any other accounting requirements needed, to create a separate set of accounts for regulators according to specified, prudent principles set by the regulator. This second set of accounts should be externally audited and the Commission recommends that a statutory duty to regulators be placed upon auditors in respect of these accounts. Where there is a public interest for these accounts to be published, the regulator should have a legal power to direct that they (or where appropriate, abbreviated accounts) are included in the financial statements, alongside a reconciliation to the IFRS accounts<sup>82</sup>”.

The government expected the FRC to respond<sup>83</sup>, but nothing happened. Almost a year later, the House of Lords Select Committee on Economic Affairs revisited the issue and its chair said,

“since we cannot get IFRS to change in the way that we would like it to and because there has to be European Union agreement, which means that it is difficult to get any change, the way of cutting the Gordian knot was to say that banks should have two sets of accounts: one according to the IFRS rules and another according to rules set down by the regulator to fit regulatory needs—that is the PRA/Bank of England<sup>84</sup>”.

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<sup>82</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.

<sup>83</sup> The Government’s response to the Parliamentary Commission on Banking Standards, July 2013;

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211047/gov\\_response\\_to\\_the\\_parliamentary\\_commission\\_on\\_banking\\_standards.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/211047/gov_response_to_the_parliamentary_commission_on_banking_standards.pdf)

<sup>84</sup> Unrevised transcript of evidence taken before The Select Committee on Economic Affairs Inquiry into

The replies from FRC officials showed that they were not on the same wavelength as the legislators. For example, the FRC chief executive said:

“We are a bit nervous about creating two sets of accounts for lots of sectors, because that undermines the principle that there should be comparability between companies of different kinds and investors should be able to make a decision about where to put their money based on that comparability”.

The Committee chair interjected and said:

“No, I am just talking about banks. Banks are different ... for banks which are regulated there should be a set of accounts that best meets the needs of the regulator”.

Eventually nothing happened. Regardless of the merits of the “separate set of accounts” for the regulator, the above episode shows the lack of urgency and co-ordination across regulators who have different concerns and priorities. As a result some policies fall through the cracks and receive little or no attention.

## **CHAPTER 3**

### **REGULATORY MAZE: FINANCIAL SECTOR REGULATORS**

#### **INTRODUCTION**

This chapter examines the regulatory maze in relation to the UK financial services sector. The financial sector includes the commercial activities of a wide range of firms, including banks, insurance firms, asset managers, broker-dealers, financial advisors, building societies, hedge funds and pension funds to name a few. The sector is wider than the activities of the businesses located in the City of London and Canary Wharf. In 2016/17, the financial services sector employed 408,000 in banking, 323,000 in insurance, 52,000 in fund management and 290,000<sup>85</sup> in other financial services across London and the regions. It claims to have generated a trading surplus of £68.2 billion.

Since the 1970s, the finance sector has been mired in a steady stream of scandals. The mid-1970s secondary banking crash, debacles at Lloyd's of London, Vehicle and General, Grays Building Society, Johnson Matthey Bank, Guinness plc, Barlow Clowes, Dunsdale, Levitt, Bank of Credit and Commerce International, Barings, Equitable Life and the 2007-08 financial crash are reminders of the problematical practices of the financial sector. The state (effectively taxpayers) rescued banks not only in the 2007-08 crash but also on previous occasions.

The financial sector has been a serial offender, and it has continued to mis-sell a variety of financial products. It has rigged interest rates, exchange rates, engaged in tax avoidance/evasion, money laundering and sanctions busting. Despite the hype of self-promotion, there is an opportunity cost to the UK economy. Resources secured by the finance sector are denied to others, and could be used to generate greater economic welfare in the form of good jobs and opportunities. One report estimates that between 1995 and 2015, the UK finance sector cost the UK economy around £4,500 billion<sup>86</sup> in lost economic output. Of the £4,500 billion loss in economic output, £2,700 billion is accounted for by the misallocation of resources when diverted away from more productive, non-financial activities into the finance sector. The other £1,800 billion arises from the 2008 banking crisis and its aftermath. Despite the huge social cost, successive governments have indulged the sector with light-touch regulation.

#### **FINANCIAL SECTOR REGULATORS**

Despite the periodic attempts to consolidate the number of regulators, the sector has at least 41 overlapping regulators (see Table 3.1) performing a variety of tasks.

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<sup>85</sup> As per TheCityUK, Key Facts About UK-Based Financial And Related Professional Services, April 2018; <https://www.thecityuk.com/assets/2018/Reports-PDF/38f60d8b7d/UK-key-facts-about-UK-based-financial-services.pdf>. This report also attributes 514,000 consultancy, 366,000 and 342,000 legal services jobs to the City and the finance sector. Of course, accountants, consultants and lawyers work across all sectors

<sup>86</sup> Andrew Baker, Gerald Epstein and Juan Montecino, The UK's Finance Curse? Costs and Processes, Sheffield Political Economy Research Institute, October 2018; <http://speri.dept.shef.ac.uk/wp-content/uploads/2018/10/SPERI-The-UKs-Finance-Curse-Costs-and-Processes.pdf>

**TABLE 3.1  
FINANCIAL SECTOR REGULATORS**

| <b>REGULATOR</b>   | <b>RESPONSIBILITY</b>   |
|--|---|
| 1. Association of Accounting Technicians (AAT) Accountants                   | Accountants   |
| 2. Association of Chartered Certified Accountants (ACCA)                     | Accountants   |
| 3. Association of International Accountants (AIA)                            | Accountants   |
| 4. Association of Taxation Technicians (ATT)                                 | Tax Advisers  |
| 5. Chartered Institute of Management Accountants (CIMA)                      | Accountants   |
| 6. Chartered Institute of Legal Executives (CILEX)                           | Legal executives  |
| 7. Chartered Institute of Taxation (CIOT)                                    | Tax Advisers  |
| 8. Claims Management Regulator (CMR)   | Regulates Claim Management Companies  |
| 9. Council for Licensed Conveyancers (CLC)                                   | Licensed Conveyancers   |
| 10. Department of Enterprise, Trade, and Investment Northern Ireland (DETNI) | Insolvency Practitioners in Northern Ireland  |
| 11. Faculty of Advocates (Scottish bar association) (FoA)                    | Barristers in Scotland  |
| 12. Faculty Office of the Archbishop of Canterbury (AoC)                     | Notarial profession in England & Wales  |
| 13. Financial Conduct Authority (FCA)  | Credit and financial institutions   |
| 14. Financial Ombudsman Service (FOS)  | Adjudicates disputes between consumers and financial businesses.  |
| 15. Financial Reporting Council (FRC)  | Large Accountancy firms and Professional Accountancy Bodies   |
| 16. The Financial Services Compensation Scheme (FSCS)                        |   |
| 17. Gambling Commission (GC)   | Non-remote and remote casinos   |
| 18. General Council of the Bar (England and Wales) (GCBEW)                   | Barristers in England and Wales   |
| 19. General Council of the Bar of Northern Ireland (GCBNI)                   | Barristers in Northern Ireland  |
| 20. HM Revenue & Customs (HMRC)  | <ul style="list-style-type: none"> <li>• Tax Avoidance/Evasion in the UK</li> <li>• Money Service Businesses</li> <li>• Bill Payment Service Providers</li> <li>• Telecommunication, digital and IT Payment Service Providers</li> <li>• Trust and Company Service Providers</li> <li>• Estate Agency Businesses</li> </ul> |

|  |   |
|--|---|
|  | <ul style="list-style-type: none"> <li>• High Value Dealers</li> <li>• Accountancy Service Providers (for those not registered with a professional body)</li> </ul> |
| 21. Insolvency Practitioners Association (IPA)   | Insolvency Practitioners  |
| 22. Insolvency Service   | Insolvency Practitioners  |
| 23. Institute of Certified Bookkeepers (ICB)   | Bookkeepers   |
| 24. Institute of Chartered Accountants in England and Wales (ICAEW)                                      | Accountants   |
| 25. Institute of Chartered Accountants in Ireland (ICAI)   | Accountants   |
| 26. Institute of Chartered Accountants of Scotland (ICAS)  | Accountants   |
| 27. Institute of Financial Accountants (IFA)   | Accountants   |
| 28. International Association of Bookkeepers (IAB)   | Bookkeepers   |
| 29. Law Society of England and Wales (LSEW) regulating through the Solicitors Regulation Authority (SRA) | Solicitors and Solicitor firms  |
| 30. Law Society of Northern Ireland (LSNI)   | Solicitors and Solicitor firms  |
| 31. Law Society of Scotland (LSS)  | Solicitors and Solicitor firms  |
| 32. Money Advice Service (MAS)   | Consumer Advice on money and debt   |
| 33. National Crime Agency (NCA)  | Serious and Organised Crime; subject to scrutiny by the Home Affairs Committee and the Public Accounts  |
| 34. National Economic Crime Centre (NECC)  | To improve cooperation between the UK's economic crime-fighting agencies  |
| 35. Office for Professional Body Anti-Money Laundering Supervision (OPBAS)                               | Oversight of professional bodies exercising anti-money laundering supervision   |
| 36. Payment Systems Regulator (PSR)  | Payment systems industry  |
| 37. The Pensions Advisory Service (TPAS)   | Advice on pension schemes   |
| 38. The Pensions Ombudsman (TPO)   | Resolve disputes of fact or law and to investigate claims of maladministration.   |
| 39. The Pensions Regulator (TPR)   |   |
| 40. Pension Wise (PW)  | Advice on pension freedoms  |
| 41. Prudential Regulation Authority (PRA)  | Financial firms   |

The above table shows that the regulatory responsibility is spread across a number of government departments. The FCA and PRA are independent bodies but closely connected to HM Treasury. HMRC is a non-governmental department, but subject to ministerial oversight by HM Treasury. The law, accountancy and insolvency professional bodies mainly come under the jurisdiction of the Department for

Business, Energy and Industrial Strategy (BEIS). The Gambling Commission is an executive non-departmental public body, but is subject to oversight by the Department for Digital, Culture, Media & Sport. Not all of the bodies listed above can take prosecutorial decisions which may involve the Ministry of Justice, the Crown Prosecution Service, Serious Fraud Office, HMRC, the Attorney General and others. Thus the lines of communications and co-ordination are absent, unclear or stretched. As a consequence, misunderstandings, neglect, duplications, waste and obfuscation are rife.

## **MAIN FINANCIAL REGULATORS**

In the financial sector, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) are the leading regulators. They operate under the umbrella of the Bank of England. The FCA is the conduct regulator for 58,000 financial services firms and financial markets in the UK, and the prudential regulator for over 18,000 of those firms. The PRA is the prudential regulator of around 1,500 banks, building societies, credit unions, insurers and major investment firms. As a prudential regulator, its general objective is to promote the safety and soundness of the firms it regulates.

The Payment Systems Regulator (PSR) was launched in 2015. It is the economic regulator for the £81 trillion payment systems industry in the UK. It is a subsidiary of the FCA, but has an independent board and managing director. It handles competition and innovation amongst payment system operators (cards and interbank), payment service providers, including banks and building societies; and infrastructure providers.

The integrity of the financial system also depends on its ability to combat illicit financial flows routed through banks, financial systems and a variety of financial intermediaries. Here the regulatory field is highly fragmented with public and private organisation of various sizes acting as regulators.

HMRC<sup>87</sup> is a non-governmental department. It is best known as the tax nation's tax authority, but it also has anti-money laundering (AML) responsibilities. It supervises over 27,000 businesses across seven different sectors, comprising money service businesses, accountancy service providers, trust or company service providers, high value dealers, estate agency businesses, bill payment service provider and IT and digital payment service providers.

## **ECONOMIC CRIME**

Successive governments have struggled to develop suitable regulatory structures to combat economic crime. The most recent development is the creation of the National Crime Agency (NCA). Its remit is to combat organised crime, economic crime, weapons and drug trafficking, strengthen borders, fight fraud and cybercrime, and

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<sup>87</sup> HMRC, Report on Tackling Financial Crime in the Supervised Sectors 2015-2017; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/704163/Report\\_on\\_Tackling\\_Financial\\_Crime\\_in\\_the\\_supervised\\_sectors\\_2015\\_to\\_2017.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/704163/Report_on_Tackling_Financial_Crime_in_the_supervised_sectors_2015_to_2017.pdf).

protect children and young people from sexual abuse and exploitation. It has the authority to investigate any economic crime and also has anti-money laundering (AML) responsibilities.

The NCA was established in 2013 as a non-ministerial government department, and replaced the Serious Organised Crime Agency (SOCA) and a number of other agencies. It has around 4,200 officers are based across the UK and in strategic locations around the world. The NCA estimates that about £90 billion of dirty money is laundered through the UK each year<sup>88</sup>. Reports frequently highlight the involvement of accountants, lawyers, banks and financial reports in economic crimes<sup>89</sup>, especially money laundering, but the NCA does not licence, monitor or discipline any of these occupations and does not have the authority to withdraw the powers of the accountancy and law professional bodies for their failures (also see the next section)

On 11 December 2017, the government announced the formation of the National Economic Crime Centre (NECC), which is to be housed within the NCA<sup>90</sup>. It is expected to become operational on October 31 with a staff of 55 and an initial budget of £6 million. The main rationale for the formation of the NECC is to improve cooperation between the UK's economic crime-fighting agencies. The NECC will include representatives from the Serious Fraud Office (SFO), HM Revenue & Customs (HMRC), the City of London Police and the Financial Conduct Authority (FCA), as well as officers from police forces around the country. The £6 million budget is not necessarily new money as it will come from the existing agencies i.e. the NCA, the SFO and the FCA.

### **Anti-Money Laundering (AML) Supervision**

There are 25 Anti-Money Laundering (AML) supervisors in the UK. These include the Financial Conduct Authority (FCA), HM Revenue and Customs, the Gambling Commission and the 22 accountancy and legal professional bodies. A number of these have been covered in earlier parts of this report.

The Faculty Office of the Archbishop of Canterbury (AoC) is responsible for regulating 763 notaries across England and Wales and has AML responsibilities for the same. Its website states that "A Notary Public is a legal officer of ancient standing. The functions of Notaries include the preparation and execution of legal documents for use abroad, attesting the authenticity of deeds and writings, and

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<sup>88</sup> The Guardian, UK lawyers failing to report suspected money laundering, says watchdog, 14 September 2018; <https://www.theguardian.com/uk-news/2018/sep/14/uk-lawyers-failing-report-suspected-money-laundering-national-crime-agency>

<sup>89</sup> UK Home Office and HM Treasury, National risk assessment of money laundering and terrorist financing 2017, October 2017; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/655198/National\\_risk\\_assessment\\_of\\_money\\_laundering\\_and\\_terrorist\\_financing\\_2017\\_pdf\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/655198/National_risk_assessment_of_money_laundering_and_terrorist_financing_2017_pdf_web.pdf)

<sup>90</sup> UK government press release, Home Secretary announces new national economic crime centre to tackle high level fraud and money laundering, 11 December 2017; <https://www.gov.uk/government/news/home-secretary-announces-new-national-economic-crime-centre-to-tackle-high-level-fraud-and-money-laundering>



protesting bills of exchange. Notaries in England and Wales may also provide any non-contentious legal service, including Conveyancing and Probate activities. The admission and regulation of Notaries Public in England & Wales is one of the functions of the Faculty Office. The Master of the Faculties (the judge who presides over the Faculty Office) is the approved regulator of the profession. This jurisdiction regarding the Notarial Profession was confirmed and enhanced by the Courts and Legal Services Act of 1990 and the Legal Services Act 2007. Both confirmed the Master's statutory powers to make Rules for the regulation of the profession".

In 2007, the Solicitors Regulation Authority (SRA) replaced the Law Society Board. It regulates 186,000 solicitors and 10,400 law firms in England and Wales. Its key task is to protect consumers, setting and enforcing professional standards, and supporting access to affordable legal services, the rule of law and the administration of justice. It also has anti-money laundering duties, especially as many legal professionals form companies, handle cash and act as nominee shareholders and directors. In addition to the SRA, the Chartered Institute of Legal Executives (CILEx), the Council for Licensed Conveyancers (CLC), the Faculty Office of the Archbishop of Canterbury (FOAC), the General Council of the Bar (England and Wales) (GCBEW), the Faculty of Advocates (Scottish bar association) (FoA), the General Council of the Bar of Northern Ireland (GCBNI), the Law Society of Northern Ireland (LSNI) and the Law Society of Scotland (LSS) also have anti- money laundering supervisory powers for the legal sector

There are 15 bodies charged with anti-money laundering (AML) supervision of accountants, insolvency practitioners and their professional bodies. These are the Association of Accounting Technicians (AAT); Association of Chartered Certified Accountants (ACCA); Association of International Accountants (AIA); Association of Taxation Technicians (ATT); Chartered Institute of Management Accountants (CIMA); Chartered Institute of Taxation (CIOT); Institute of Certified Bookkeepers (ICB); Institute of Chartered Accountants in England and Wales (ICAEW); Institute of Chartered Accountants in Ireland (ICAI); Institute of Chartered Accountants of Scotland (ICAS); Institute of Financial Accountants (IFA); International Association of Bookkeepers (IAB); Insolvency Practitioners Association (IPA). In addition, accountants who are not members of the above bodies are supervised by HMRC.

In January 2018, the Office for Professional Body Anti-Money Laundering Supervision (OPBAS) was created to supervise the anti-money laundering (AML) supervisory regime operated by accountancy, law and insolvency professional bodies. It is housed within the FCA and will facilitate collaboration and information sharing between the professional body AML supervisors, statutory supervisors, and law enforcement agencies. It should be noted that OPBAS does not supervise members of professional bodies, such as firms, accountants and solicitors, or any other type of business subject to the requirements of the Money Laundering Regulations 2017, or the adequacy of any functions performed by professional body supervisors unrelated to AML supervision.

## **PENSIONS**

The Pensions Regulator (TPR) is a non-departmental public body and is the regulator of workplace pension schemes. It was created by the Pension Act 2004

and its remit includes the regulation of defined contribution (DC) schemes, the authorisation and supervision of DC master trusts, ensuring public service schemes are well run, fighting scams, and delivering automatic enrolment (AE) by making sure employers put their staff into a pension and pay the right contributions<sup>91</sup>. Its senior officers, including chairman and non-executive directors are appointed by the Secretary of State for the Department of Work and Pensions (DWP).

In 2017/18 TPR had 609 employees and a payroll cost of £42.3m TPR funding of regulation is derived from two main sources: a grant-in-aid from the DWP which is recoverable from a levy on pension schemes and covers activities relating to the Pensions Act 2004 and the Pensions Act 2008, and a separate grant-in-aid from general taxation which funds AE. In the year ended 31 March 2018, TPR had net expenditure of £83.5m, of which £43.3m related to levy-funded activities and £40.2m was attributable to AE. The net expenditure is offset by contributions from the DWP of £44m for levy activities and £40.1m from the DWP for AE activities.

The regulation of pensions is supplemented by the Pension Protection Fund (PPF). It was created under the Pensions Act 2004 and is sponsored by the DWP. Its main function is to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. PPF protects members of insolvent pension schemes in two ways: a) Members over their normal retirement age or those who retired early due to ill health will receive 100% of the pension they are currently receiving; b) Others will receive the 90% level of compensation capped at a certain level. Where dependents are eligible to receive pension, the payment is half the member's entitlement. The PPF is funded by levies on all eligible defined benefit schemes. In 2017/18, the PPF had staff of 418, income from levies and grants of £564 million and net assets of £6.8 billion<sup>92</sup>. As at February 2018, some 235,835 members were transferred to PPF after the employer standing behind their pension scheme became insolvent, and 132,385 were receiving compensation which averaged £4,480 and totalled £3.6 billion<sup>93</sup>.

## **GAMBLING COMMISSION**

The Gambling Commission is an independent non-departmental public body sponsored by the Department for Digital, Culture, Media and Sport. It was established the Gambling Act 2005 to regulate commercial gambling in Great Britain in partnership with licensing authorities. It regulates 152 casinos, 8532 betting shops, 1810 licensed arcades, 640 bingo premises, 183,928 gaming machines and a number of sweepstakes lotteries. It is also responsible for AML oversight of these

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<sup>91</sup> As per the 2017/18 annual report; <http://www.thepensionsregulator.gov.uk/docs/annual-report-and-account-2017-2018.pdf>

<sup>92</sup> As per 2017/19 annual report;

<https://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Annual%20Report%202017-2018.pdf>

<sup>93</sup> As per <https://www.pensionprotectionfund.org.uk/TransferredSchemes/pages/Transferred-Schemes.aspx>

businesses. However, spread betting is regulated by the FCA. It also regulates the National Lottery under the National Lottery etc. Act 1993.

The Commission has around 300 employees, mostly based at its offices in Birmingham, including around 40 home-based employees working across England, Scotland and Wales<sup>94</sup>. It is funded by application and licence fees set by the Secretary of State, approved by Parliament and paid by the gambling industry. These fees fund all gambling regulation except that for the National Lottery. In respect of National Lottery functions, it is funded by grant-in-aid from the National Lottery Distribution Fund. For the year to 31 March 2018, the Commission had budget/income of £19.9 million.

The Commission's statutory duties include preventing gambling from being a source of crime or disorder, being associated with crime or disorder, or being used to support crime, ensure that gambling is conducted in a fair and open way and to protect children and other vulnerable persons from being harmed or exploited by gambling. Despite the objectives, 430,000 people in the UK are considered to be problem gamblers and up to two million are at risk of having a gambling problem.

## **DISPUTE RESOLUTION**

The regulatory architecture includes a number of organisations with powers to settle disputes. These include the Financial Ombudsman Service (FOS) and the Pensions Ombudsman (TPO). The FOS was established in 2001 following the implementation of the Financial Services and Markets Act 2000. Members of the FOS board are appointed under Schedule 17 of the Financial Services and Markets Act 2000 – which provides that “the chairman and other members of the board must be persons appointed, and liable to removal from office” by the FCA. In the case of the chairman, the appointment must also be approved by HM Treasury. At March 2017, the FOS board consisted of six non-executive directors, all industry grandees. The FOS is funded by a combination of compulsory levies on the financial service sector and case fees. Its March 2017 report<sup>95</sup> states that it resolved 336,381 complaints during the year and received 321,283 new ones. The FOS Board appoints an independent assessor who can consider complaints from consumers and businesses about the level of customer service provided by FOS and its handling of complaints. The FOS publishes an annual report.

According to its website the TPO is an independent organisation set up by law to investigate complaints about pension administration. It can consider complaints about the actions and decisions of the Pension Protection Fund and about some decisions made by the Financial Assistance Scheme. It is funded by grants from the Department for Work and Pensions (DWP). The grant is largely recovered from the general levy on pension schemes administered by the Pensions Regulator. The Ombudsman and Deputy Ombudsman are appointed by the Secretary of State for Work and Pensions.

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<sup>94</sup> As per its 2017/18 report - <https://www.gamblingcommission.gov.uk/PDF/Annual-report-and-accounts-2017-2018.pdf>

<sup>95</sup> <http://www.financial-ombudsman.org.uk/publications/directors-report-2017.pdf>

The regulatory architecture also includes a number of consumer advisory services. The three major ones are the Money Advice Service (MAS), the Pensions Advisory Service (TPAS) and Pension Wise. The MAS was set up in 2010 under the Financial Services Act 2010. Its objectives are to enhance the understanding and knowledge of members of the public of financial matters (including the UK financial system); and enhance the ability of members of the public to manage their own financial affairs. Its statutory duties in relation to debt advice are set out in the Financial Services Act 2012. The MAS has a 12-member board, which is appointed by the FCA. The FCA's appointments of the Chair and Chief Executive are subject to the approval of HM Treasury. The MAS is funded by levies collected by the FCA. The MAS is required by statute to consult on its business plan and budget with the Department for Business, Innovation and Skills, and additionally with the Financial Services Consumer Panel and the FCA's Practitioner and Smaller Business Practitioner panels, and devolved governments in Scotland, Wales and Northern Ireland.

The Pensions Advisory Service (TPAS) is a non-departmental arms-length body of the Department for Work and Pensions (DWP). In 2016/17 it received £2,158,243 (2015/16: £2,887,814). TPAS gives information and guidance to members of the public on state, company and personal pensions. It helps any member of the public who has a problem with their occupational or private pension arrangement. Its board is appointed by the DWP.

Pension Wise (PW) was launched on 6 April 2015 to help people understand the new pension reforms, which gave over 55s unfettered access to their pension pots. The pension freedoms are peppered with new and complicated rules. This government backed service helps people understand the pension options available to them. It offers guidance, not regulated financial advice.

The Claims Management Companies have been regulated by the Claims Management Regulator, which is part of the Ministry of Justice. The Financial Guidance and Claims Act 2018 will transfer their regulation to the FCA. The Act will also merge the Money Advice Service, the Pensions Advisory Service and Pension Wise into a new single body. The new publicly-funded debt advice, pensions and money guidance body is expected to come into operation in late 2018

## **SUMMARY AND DISCUSSION**

This chapter provided an overview of the financial sector regulatory maze. There are 41 overlapping regulators, all working to different rhythms and priorities. The government has continuously created additional bodies to exercise oversight, as shown by the creation of OPBAS and NECC, thereby adding to duplication, waste and obfuscation. In any regulatory system there is a concern that regulators will be captured by the regulated. In the case of professional bodies that is the starting point. Accountancy and law bodies were formed to protect and advance the interests of their members in the name of the public interest, rather than a commitment to enable social justice. Yet, they act as statutory regulators whose meetings are not held in open, and the minutes of their board meetings are not publicly available. The public has no presence on, or oversight of, the boards of such bodies.

## **CHAPTER 4 CONSEQUENCES OF THE REGULATORY MAZE**

### **Introduction**

Chapters 2 and 3 noted that the UK has a complex and overlapping structure of regulatory bodies. The bodies have poor public accountability. Each operates at its own rhythm and often to different standards. There are few, if any, mechanisms for developing common benchmarks or standards of best practice. There are few forums for sharing their experiences even within a sector (e.g. insolvency, auditing, money laundering), far less across the regulatory landscape. The failures highlighted below cut across various regulatory agencies and show that their operations are not aligned with broader societal interests. The myth is that citizens and consumers are sovereign, yet the examples in this chapter show that abuses and failures are institutionalised. In an ideal world, citizens' concerns would jolt the system, but too many regulators are aligned with corporate interests. Regulators should be protecting people from irresponsible practices, but that is not always the case. Their failures inevitably erode confidence in the regulatory system. This chapter provides some examples of the effects of the regulatory maze.

### **COMPANIES HOUSE OF FOLLIES**

Companies House is the first port-of-call for information about company accounts, directors and shareholders. This information is essential in combating economic crime, but all is not well with Companies House, company law or its oversight by government departments. That is unsurprising given the finding by Transparency International that in 2017 just six staff at Companies House were directly responsible for examining documents and policing 4 million companies<sup>96</sup>. Since then, their number has increased but they merely accept the documents submitted. They lack the resources to perform substantial checks on the quality or authenticity of information. In short, Companies House acts more as a filing box. Companies House scans documents and but makes no checks on the legibility of the documents. Consequently, some of the information cannot even be read<sup>97</sup>.

Secrecy is a key ingredient in economic crime and is facilitated by company law and the timid role of Companies House. UK company law permits nominee shareholdings. The owner of shares can ask a nominee (usually banks, accountants and lawyers) to hold shares on his/her behalf. The share register shows the name of the nominee and not the real owner. When asked to prohibit nominee shareholdings the Business Secretary said:

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<sup>96</sup> Transparency International, *Hiding in Plain Sight: How UK companies are used to launder the proceeds of corruption*. London, TI, 2017.

<sup>97</sup> Hansard, House of Commons, Written question – 157603, 26 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-26/157603/>

“The Government has no plans to introduce legislative proposals to prohibit nominee shareholdings<sup>98</sup>”.

The government’s refusal to prohibit nominee shareholdings means that those with criminal intent can continue to enjoy the benefit of UK-registered companies and conceal their identity. UK company law permits the appointment of nominee directors, which enables the real controllers of a company to remain anonymous. There are plenty of company formation agents offering this service, for a fee. UK company law requires public limited companies (PLCs) to have at least two directors, but only one of these needs to be natural person. The other can be an anonymous company registered anywhere in the world and beyond the reach of UK law enforcement agencies.

Since 2016, the UK requires companies to file information about people with significant control (PSCs). This is anyone holding more than 25% of the shares or voting rights in the company, or who has the right to appoint or remove the majority of the board of directors. So not all shareholders need to be publicly identified and it is not difficult for anyone to manipulate the 25% criteria, use nominee shareholders and directors to retain anonymity. In May 2018, it was reported that 57,227 companies had failed to comply with the PSC requirements<sup>99</sup>. A 2018 report by Global Witness<sup>100</sup> found that more than 335,000 companies declared they have no beneficial owner, i.e. no individual holds more than 25% of the shares of the company. More than 208,000 companies are registered at a company factory i.e. a physical address that is the registered address of more than 1,000 companies. The BBC’s File on Four radio programme<sup>101</sup> reported that 4 thousand beneficial owners are listed as under the age of 2; Over 40% of the beneficial owners of Scottish Limited Partnerships (SLPs) are either a national of a former-Soviet country, or a company incorporated there; and 5 beneficial owners control more than 6,000 companies. This raises the question of whether some of these individuals are simply stooges put in place by the real owners. Weaknesses at Companies House pose enormous challenges for law enforcement authorities in identifying the perpetrators and beneficiaries of economic crime.

A joint report<sup>102</sup> by HM Treasury and Home Office noted that “Company formation continues to be exploited by criminals to mask the ownership of assets or transfer

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<sup>98</sup> Hansard, House of Commons, Written question 105220, 14 September 2017 (<https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105220/>)

<sup>99</sup> *Economia*, Thousands of companies avoid disclosing ultimate ownership. 16 May 2018; <https://www.accountancydaily.co/thousands-companies-avoid-disclosing-ultimate-ownership>

<sup>100</sup> Global Witness, *The Companies We Keep*. August 2018; <https://www.globalwitness.org/en/campaigns/corruption-and-money-laundering/anonymous-company-owners/companies-we-keep/#chapter-0/section-0>

<sup>101</sup> Global Witness Blog, *IN PURSUIT OF HIDDEN OWNERS BEHIND UK COMPANIES*, 6 February 2018; <https://www.globalwitness.org/en/blog/pursuit-hidden-owners-behind-uk-companies/>

<sup>102</sup> HM Treasury and Home Office, *National risk assessment of money laundering and terrorist financing 2017*, October 2017 ([https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/655198/National\\_risk\\_assessment\\_of\\_money\\_laundering\\_and\\_terrorist\\_financing\\_2017\\_pdf\\_web.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/655198/National_risk_assessment_of_money_laundering_and_terrorist_financing_2017_pdf_web.pdf)).

these assets between persons”. This suggests the need for effective checks on company formation, to ensure that the privilege of incorporation is used only by bona fide individuals who can be called to account by both the authorities and members of the public having dealings with companies. At present that is not the case. The UK permits anyone from anywhere in the world to form a company and become a company director. More than 175,000 UK-registered companies<sup>103</sup> have used directors giving addresses in secretive offshore jurisdictions. Such companies provide a respectable front for financial crime but their directors remain beyond the reach of law enforcement agencies. There are no checks on the authenticity of what is provided. The Business Secretary informed parliament that

“Companies House does not have powers to verify the authenticity of company directors, secretaries and registered office addresses<sup>104</sup>”.

### **ANYONE CAN FORM A COMPANY OR A BANK**

It is possible to form fake companies with the address “10 Downing Street<sup>105</sup>” and name Cabinet members<sup>106</sup> as directors. Individuals with dubious records and links with Italian mafia have easily been able to form companies in the UK<sup>107</sup>. In one case, a company with the name Magnolia Fundaction UK was registered; and one of its officers supplied his name in Italian which when translated into English read “the Chicken Thief” and listed his occupation as “fraudster” and another officer gave his address as “Street of the 40 Thieves” in the town of Ali Babba”. The filings were accepted by Companies House. When pressed to take action on Magnolia Fundaction UK, the Business Secretary admitted that no action has been taken against the officers of the company for “filing inappropriate information<sup>108</sup>”.

Individuals with a known criminal record can also form companies with sensitive words such as “bank” and invite the public to invest. Neither Companies House nor the FCA, NCA or any other agency seems to have any mechanism for monitoring

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<sup>103</sup> The Guardian, Offshore secrets: how many UK companies are run from overseas havens?, 3 April 2013 (<https://www.theguardian.com/uk/datablog/2013/apr/03/uk-companies-controlled-offshore>).

<sup>104</sup> Hansard, House of Commons, Written question 105222, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105222/>

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<sup>105</sup> The Independent, Italian journalists say they could register company at 10 Downing Street in name of mafia boss, 16 November 2017; <https://www.independent.co.uk/news/uk/politics/paradise-papers-italian-journalists-register-company-a8058201.html>

<sup>106</sup> The Independent, Companies House lambasted for trumpeting conviction of fraud whistleblower Kevin Brewer 16 April 2018; <https://www.independent.co.uk/news/uk/home-news/companies-house-fraud-whistleblower-prosecuting-kevin-brewer-vince-cable-a8307246.html>

<sup>107</sup> Organized Crime and Corruption Reporting Project (OCCRP), How the Camorra Went Global, 21 July 2017; <https://www.occrp.org/en/investigations/6750-how-the-camorra-went-global>

<sup>108</sup> <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105290/>

this conduct. An example is the Business Bank of Italy Limited (BBIL)<sup>109</sup>. BBIL was registered at Companies House in 2008, giving a central London street as its initial address. Since then, the bank's registered address has changed several times, and eventually located in Birmingham. By mid-2018, it had a total of 26 director appointments and 24 resignations. The shareholders and directors are mostly from Italy, Hungary, San Marino and Spain, and they are resident outside the UK. Its website offered venture capital, wealth management and prepaid Mastercard services to the general public. BBIL is a dormant company and therefore files rudimentary accounts that barely cover one page. Its accounts say that in 2009 the company had share capital of £10m. The 2014 accounts stated that the company had a cash balance of £10m. The 2016 and 2017 filings reported share capital of £15m but said that it was "called up share capital not paid". (In other words, there was no cash).

Several BBIL directors have had run-ins with the Italian police. Alessandro Della Chiesa was BBIL's first director, a position he held until 2009, and was also company secretary between 2010 and 2015. He had been on the radar of Italian police for some time, and he was sentenced to six years in jail for fraud and embezzlement in 2009. Another former director, Antonio Righi (aka Tonino the Blond) had alleged links to the mafia. Righi was convicted of trafficking drugs and handling stolen goods in 2004. The *Carabinieri* – an Italian military force charged with police duties – has been investigating Righi's activities since 2008, and in 2016 Italian police seized the business empire of the Righi brothers.

The case of BBIL was raised in the House of Commons by the Shadow Treasury Secretary on 6 March 2018<sup>110</sup>, and this was followed by a written question to the Chancellor asking him to explain when BBIL was authorised to conduct business. Eventually the FCA chief executive responded on behalf of the Chancellor and said that BBIL is "not authorised by the FCA. It has never applied for authorisation with us. It is not clear if the company is carrying on any regulated activities ... that would require FCA authorisation". Despite the public revelations, BBIL has so far been allowed to retain the word "bank" in its name. The FCA chief executive confirmed that the FCA is aware of the reports about BBIL, but would not say whether it has taken any action, conveniently sheltering behind the cloak of "confidentiality" to avoid public accountability. Following questions in Parliament, the website of BBIL has now vanished but the company is still registered at Companies House. In 2017/18, only 71 companies were wound up in the public interest by the Insolvency Service<sup>111</sup>.

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<sup>109</sup> For further information see "Tax-haven transparency won't stop money laundering in Britain", The Guardian (Comment is Free), 8 May 2018; <https://www.theguardian.com/commentisfree/2018/may/08/tax-haven-transparency-money-laundering-britain>.

<sup>110</sup> Hansard, House of Commons, 6 March 2018; [https://hansard.parliament.uk/Commons/2018-03-06/debates/57c3bd4b-0291-4c56-881a-a8ba128c6739/SanctionsAndAnti-MoneyLaunderingBill\(Lords\)\(SixthSitting\)#](https://hansard.parliament.uk/Commons/2018-03-06/debates/57c3bd4b-0291-4c56-881a-a8ba128c6739/SanctionsAndAnti-MoneyLaunderingBill(Lords)(SixthSitting)#)

<sup>111</sup> The Insolvency Service, Insolvency Service Enforcement Outcomes (Experimental Statistics) – 2017/18, 20 April 2018; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/701026/Insolvency\\_Service\\_Enforcement\\_Outcomes\\_-\\_2017-18\\_-\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/701026/Insolvency_Service_Enforcement_Outcomes_-_2017-18_-_web.pdf)



## INSOLVENCY GAMES

The insolvency industry has a long history of abuses<sup>112</sup> and remains poorly regulated. Little action is taken against miscreants. Insolvency practitioners work with banks (secured creditors) and law firms and pass business to each other. The industry is marred with conflict of interests. Yet regulators have done little to check predatory practices. Insolvency practitioners collect vast fees from prolonged liquidations and regulators show little concern

A 2013 report by Lawrence Tomlinson on lending practices by banks noted that

“The bank artificially distresses an otherwise viable business and through their actions puts them on a journey towards administration, receivership and liquidation ... “some of the banks, RBS in particular, are harming their customers through their decisions and causing their financial downfall<sup>113</sup>”.

Such practices require the active co-operation of insolvency practitioners. Yet the Tomlinson Report has not been followed-up by any insolvency regulator.

A report based upon an investigation by the FCA, the banking regulator, into the lending practices of the Global Restructuring Group (GRG) located within Royal Bank of Scotland (RBS) was withheld in 2014, though a summary of the findings was published. In February 2018, the House of Commons Treasury Committee exercised its parliamentary privilege to release the report<sup>114</sup>. The Treasury Committee noted that

“The findings in the report are disgraceful. The overarching priority at all levels of GRG was not the health and strength of customers, but the generation of income for RBS, through made-up fees, high interest rates, and the acquisition of equity and property<sup>115</sup>”.

Subsequently, the House of Commons Treasury Committee concluded that

“The treatment of vast numbers of SME customers placed in RBS’s Global Restructuring Group was nothing short of scandalous. The actions of GRG staff heaped untold misery on hard working business owners, recklessly destroying livelihoods in pursuit of profit. The “Just Hit Budget!” memo typified

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<sup>112</sup> For evidence, see Jim Cousins, Austin Mitchell, Prem Sikka, Christine Cooper and Patricia Arnold, *Insolvent Abuse; Regulating the Insolvency Industry*, Basildon, Association for Accountancy & Business Affairs, 2000.

<sup>113</sup> Lawrence Tomlinson, *Banks’ Lending Practices: Treatment of Businesses in distress*, London: Department for Business, Innovation and Skills, November 2013

<sup>114</sup> Financial Conduct Authority, *RBS Group’s treatment of SME customers referred to the Global Restructuring Group*. London: FCA, 2014;  
<https://www.parliament.uk/documents/commons-committees/treasury/s166-rbs-grg.pdf>

<sup>115</sup> Treasury Committee publishes RBS-GRG report, London: House of Commons;  
<https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2017/rbs-global-restructuring-group-s166-report-17-19/>.

the toxic and unscrupulous culture entrenched within the organisation; a culture that has been rightly highlighted as a key driver of events at GRG<sup>116</sup>”

In 2017, a bank manager and a number of his associates at HBOS (subsequently part of Lloyds Banking Group) were convicted of loan fraud going back more than a decade. The fraud funded lavish trips, yachts and sex parties. The scam – which pulled money from small and medium businesses – put many individuals and companies into needless bankruptcy<sup>117</sup>. The Judge described the bank manager as “utterly corrupt”, driven by “rapacious greed”, “got his tentacles into the businesses of ordinary and honest people and ripped them apart without a thought for those affected”. Anthony Stansfeld, Police and Crime Commissioner for Thames Valley<sup>118</sup>, estimated that £1bn could have been involved and said that:

“The fraud was denied by Lloyds Bank for 10 years, in spite of it being apparent that senior members of the bank were aware of it at least as far back as 2008. It resulted in a great number of companies being ruined, and the lives and livelihoods of their owners and those that worked with them being destroyed. ... They were pursued for their personal guarantees, and lost their houses and possessions as the bank and its lawyers pursued them for all they owned. Families were split up, marriages ruined, and suicides resulted.”

The FCA had been aware of the frauds for a number of years. A report codenamed as “Project Lord Turnbull” detailing some of the frauds was prepared in 2013, but the FCA considered it to be confidential and chose not to release it. Amidst much public concern, the All Party Parliament Group (APPG) on Fair Business Banking released the report in June 2018<sup>119</sup>. The APPG urged

“the Serious Fraud Office (SFO) and the National Crime Agency (NCA) to investigate the alleged criminality of individuals named in the report....This exercise must recognise the loss to business and livelihoods for many people as a result of the mistreatment documented in the report and the potential loss to investors who participated in the HBoS and Lloyds rights issues and the subsequent takeover. Any resolution that does not recognise these wider issues will severely undermine confidence in our regulatory and enforcement agencies”.

In the absence of a central enforcer of UK company law, the government was asked to intervene and investigate the frauds revealed by the Tomlinson, RBS and

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<sup>116</sup> House of Commons Treasury Committee, SME Finance, October 2018; <https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/805/805.pdf>

<sup>117</sup> The Guardian, HBOS manager and other City financiers jailed over £245m loans scam, 2 February 2017; <https://www.theguardian.com/business/2017/feb/02/hbos-manager-and-other-city-financiers-jailed-over-245m-loans-scam>

<sup>118</sup> <https://www.thamesvalley-pcc.gov.uk/news-and-events/thamesvalley-pcc-news/2018/01/statement-from-the-police-and-crime-commissioner-fraud/>

<sup>119</sup> All Party Parliament Group (APPG) on Fair Business Banking, Statement on release of draft Project Lord Turnbull Report - 21 June 2018; <http://www.appgbanking.org.uk/statements/statement-on-release-of-draft-project-lord-turnbull-report/>

Turnbull<sup>120</sup> reports. The Chancellor said that “This is a matter for the operationally independent Financial Conduct Authority (FCA). The FCA continues to conduct an ongoing investigation into Royal Bank of Scotland’s Global Restructuring Group, focusing on whether there is any basis for enforcement action<sup>121</sup>”. He refused to say when HM Treasury became aware of the Turnbull Report on frauds at HBOS and repeated the mantra that it is a matter for the FCA.

Shortly afterwards, the FCA told a parliamentary committee that its powers to discipline anyone for misconduct do not apply in the case of RBS’s Global Restructuring Group. Its chief executive said: “I appreciate that many GRG customers will be frustrated by this decision, but we have explored all the options available to us before arriving at this conclusion<sup>122</sup>”. Such a statement sits uneasily with the scope of the Fraud Act 2006 and the FCA’s own actions. For example, fraud is a criminal offence under the Fraud Act 2006 and subject to a maximum prison sentence of ten years. Under the Act, fraud can be committed by making false representations, by failing to disclose information, and by abuse of position. This provides plenty of scope for the police, the Serious Fraud Office (SFO), the Financial Conduct Authority (FCA), HM Treasury and others for dealing with abuse of individuals and SMEs. In December 2014, the FCA banned a former Managing Director at Blackrock Asset Management Investor Services Limited for life from performing any function in relation to any regulated activities because “he deliberately and knowingly failed to purchase a valid ticket to cover his entire journey whilst travelling on the Southeastern train service<sup>123</sup>”. Yet the same regulator claims to be powerless in dealing with misconduct at giant banks.

The Tomlinson, RBS and Turnbull report has not been followed-up by any known regulatory action by the FCA or the NCA. HM Treasury and BEIS have shown no concern about such failures. The alleged frauds could not have been carried out without the involvement of insolvency practitioners but none of the RPBs or the Insolvency Service has taken any action.

Insolvency practitioners have a licence to print money. All personal and corporate bankruptcies are handled by them. The process generates vast amount of guaranteed fees. Under the Enterprise Act 2002, secured creditors (usually banks) have the first claim on the amounts raised by the sale of bankrupts’ assets. This is followed by the expenses and fees of IPs, and then unsecured creditors. The size of IPs’ fees erodes amounts that may be left for unsecured creditors, which includes suppliers, employees, HMRC and pension scheme members. In 2017, unsecured creditors suffered losses of £4.2bn. IPs can charge exorbitant fees and that drains

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<sup>120</sup> Hansard, House of Commons - Written question – 155661, 20 June 108; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-20/155661/>

<sup>121</sup> Hansard, House of Commons - Written question – 155654, 20 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-20/155654/>

<sup>122</sup> The Guardian, No FCA action against RBS after mistreatment of small businesses, 31 July 2018; <https://www.theguardian.com/business/2018/jul/31/fca-to-take-no-action-against-rbs-after-mistreatment-of-small-businesses>

<sup>123</sup> Financial Conduct Authority, Final Notice - Jonathan Paul BURROWS, 15 December 2014; <https://www.fca.org.uk/publication/final-notices/jonathan-paul-burrows.pdf>

the amounts, if any, left for unsecured creditors. PwC, Carillion's liquidator, charged out partners at up to the rate of £1,156 per hour<sup>124</sup>. Such charges are not isolated<sup>125</sup> and could be iniquitous for other stakeholders. RPBs have shown no concern.

People suffering from the excesses of insolvency practitioners can complain (now through the Insolvency Service portal) but investigations are carried out by the RPBs. They can fob-off people and there is no way of knowing how they filter or weigh any of the evidence that is submitted to them. The RPBs claim to have their own independent compliant assessors/reviewers, but these are hired and paid by them. Concerned citizens are passed from pillar-to-post and some eventually persuade the Insolvency Service to act. In its 2017/18 report, it said

“One complaint against ACCA was upheld as it failed to consider some new and relevant evidence. In addition, it was found that not all of the complaint had been seen by the independent assessor ... One complaint has been partially upheld, due to our concerns over the complainant's ability to challenge the ICAEW decision on his complaint<sup>126</sup>”.

Many fobbed-off individuals probably are overwhelmed by the regulatory maze and may well not pursue matters with the Insolvency Service. In relation to ACCA, previously (in 2015), the Insolvency Service stated that:

“We remain concerned that there is not a sufficiently independent process for considering the outcome of unsatisfactory monitoring visits to insolvency practitioners ... we also remain concerned about the lack of transparency for complainants who are not provided with details of the independent assessor who reviews their case<sup>127</sup>”.

On even earlier occasions, the Insolvency Service had made recommendations to ACCA to improve its procedures and then noted “We are disappointed to note that the ACCA has rejected two of the recommendations made - one concerning the monitoring of insolvency practitioners and the other on the handling of complaints<sup>128</sup>”. Yet there have been no sanctions against ACCA. Interestingly, when

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<sup>124</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Carillion/180329-Letter-from-Marissa-Thomas-Head-of-Deals-PwC-re-role-as-Special-Managers-Carillion.pdf>

<sup>125</sup> Prem Sikka, “Carillion collapse: here's how much corporate undertakers could make from the liquidation”, Left Foot Forward, 20 March 2018; <https://leftfootforward.org/2018/03/carillion-collapse-corporate-undertakers-are-now-preparing-to-feast-on-the-carcass/>.

<sup>126</sup> The Insolvency Service, 2017 Annual Review of Insolvency Practitioner Regulation, May 2018; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/706354/Annual\\_Review\\_of\\_IP\\_Regulation\\_2017.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/706354/Annual_Review_of_IP_Regulation_2017.pdf)

<sup>127</sup> The Insolvency Service, 2015 Annual Review of Insolvency Practitioner Regulation, March 2016; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/511324/IP\\_Annual\\_Review\\_2015.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/511324/IP_Annual_Review_2015.pdf)

<sup>128</sup> The Insolvency Service, ACCA Monitoring Report, February 2015; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/435734/ACCA\\_Monitoring\\_Report\\_-\\_ACCA\\_comments\\_-\\_Feb\\_15.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/435734/ACCA_Monitoring_Report_-_ACCA_comments_-_Feb_15.pdf)

faced with legal action from its own students and members, ACCA informed a court that because of its royal charter the “Court does not have any jurisdiction to hear the case<sup>129</sup>”, though after intervention by the Lord Chancellor it had to issue a grovelling apology.

The Small Business, Enterprise and Employment Act 2015 authorises the government to end the insolvency regulatory maze. Sections 144-146 give the Secretary of State a power to establish a single regulator of IPs. This is a reserve power which will lapse after 7 years if not used.

## **DUMPING LIABILITIES THROUGH STRATEGIC INSOLVENCIES**

Strategic insolvencies provide opportunities for off-loading liabilities, such as those attached to pension schemes. In the case of poultry farmer Bernard Mathews Limited<sup>130</sup>, the investigation revealed practices bordering on abuses and a deliberate strategy to dump pension scheme liabilities and enrich shareholders/directors. In 2017, the House of Commons Work and Pensions Committee published a mini report<sup>131</sup> based on the written evidence collected from various parties. The background is that Bernard Matthews Limited was an ailing business. In 2013, Rutland Partners, a private equity company, acquired control in return for a £25 million loan carrying 20% interest. Prior to that, the pension scheme was a secured creditor. But Rutland placed its security, with pension trustees’ approval, above that of the pension scheme.

Three years later, in September 2016, Rutland Partners sold Bernard Matthews to Boparan Private Office (BPO) via a pre-pack administration process overseen by Deloitte. Bernard Matthews defined-benefit company pension scheme – with a deficit estimated at up to £75m – was jettisoned into a Pension Protection Fund (PPF) assessment. The letters seen by the Work and Pensions Committee show that BPO had previously offered to buy Bernard Matthews outright, and to assume ongoing responsibility for the full liabilities of the pension scheme. This offer was rejected by Rutland Partners as it would have involved a write-off of some of their outstanding loans to the company. The directors chose to maximise the return to private equity (i.e. themselves) and had no hesitation in walking away from the pension scheme. They knew that the deficit (at least 90% of it) would be picked up by the PPF. Unsecured creditors of £39m are unlikely to receive more than 1p in the £. The Administrators have extracted fees of £790,000 at an hourly rate of between £390 and £872. Another £668,000 in legal and related fees is also expected. More fees will follow as the remainder of what used to be Bernard Matthews was placed into liquidation in November 2017. Despite the media coverage, no regulator has examined the Bernard Matthews pre-pack administration.

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<sup>129</sup> Austin Mitchell and Prem Sikka, “Accountability of the Accountancy Bodies: The Peculiarities of a British Accountancy Body”, *British Accounting Review*, Vol. 36, No. 4, 2004, pp. 395-414.

<sup>130</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Bernard-Matthews-administration-arrangement-Prem-Sikka-briefing-05-10-2016.pdf>

<sup>131</sup> <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/bernard-matthews-pension-scheme-correspondence-16-17/>

A 2017 investigation by Financial Times<sup>132</sup> into pre-pack administrations reported that companies had offloaded £3.8bn of pension liabilities, and that the assets or the business was often sold to existing directors or owners. The Insolvency Service reported that 68% of business or asset sales were to a connected party<sup>133</sup>. Pre-pack administrations result in a secretive sale of businesses before they are formally declared bankrupt. Unsecured creditors are informed after the sale has taken place. The off-loaded pension schemes are bailed out by the Pension Protection Fund (PPF), albeit with a maximum limit of 90%. This forces pension scheme members to accept lower pensions. The FT reported that approximately 17% of the 868 schemes managed by the PPF for the retirement plans of failed companies have been injected as a result of pre-pack administrations. Two in three pre-pack schemes entering the PPF involved sales to existing owners or directors. PPF is funded by a levy on other pension schemes. This means that some liabilities have effectively been visited on others or surviving pension schemes. The pensions schemes off-loaded by pre-packs and rescued by PPF include AEA Technology, at £478m, and printing company Polestar at £529m. Over the past 10 years, 148 pension schemes have been placed into the PPF through pre-pack administrations. A further 20 schemes, with liabilities of hundreds of millions of pounds are in the assessment period for PPF entry, following pre-packs. Yet no insolvency, pension or corporate governance regulator has documented such matters.

## **IS ANYONE IN-CHARGE?**

In January 2018, Carillion<sup>134</sup>, a major construction and outsourcing company, collapsed with £7 billion of liabilities, including a £2.6 billion pension liability. Its accounts had always received a clean bill of health from its auditors. The collapse of the company has been investigated by a number of parliamentary committees. The outcome of investigations by formal regulators, which includes the Insolvency Service, Financial Reporting Council (FRC), Financial Conduct Authority (FCA), the Pensions Regulator (TPR) and others, is still awaited.

BHS collapsed in into administration in April 2016, sparking an investigation by parliamentary committees. Their report was published in July 2016<sup>135</sup>. The Insolvency Service is responsible for investigating insolvent businesses and for taking action against directors. Some two and half years later, the Insolvency Service report is yet to appear. Yet such reports can stimulate required legislative change. When asked about the timescale for publication of the report on BHS, the Business Secretary told parliament that

“The Insolvency Service is currently bringing disqualification proceedings against a number of former directors of BHS and connected companies. As

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<sup>132</sup> Financial Times, Companies use ‘pre-packs’ to dump £3.8bn of pension liabilities, 9 April 2017; <https://www.ft.com/content/f3f574fa-0f2c-11e7-a88c-50ba212dce4d>

<sup>133</sup> The Insolvency Service, 2015 Annual Review of Insolvency Practitioner Regulation, March 2016; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/511324/IP\\_Annual\\_Review\\_2015.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/511324/IP_Annual_Review_2015.pdf)

<sup>134</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018.

<sup>135</sup> <https://publications.parliament.uk/pa/cm201617/cmselect/cmworpen/54/54.pdf>

these matters may now be tested in Court it would not be appropriate to comment or issue further information at this time. Once the disqualification proceedings are complete government will consider what detail it is appropriate to publish, having full regard to any legal restrictions on publication and also the legitimate public interest in the cause of the BHS failure”<sup>136</sup>.

There is little urgency in investigating corporate collapses and consequently resulting reforms are delayed. By default, parliamentary committees are attempting to fill the void produced by the regulators.

## **NO COORDINATION**

Another example is the practices at Tesco, a major UK grocery chain. In September 2014 a £250 million black hole was noticed in the company's accounts. It related to the way company booked income/discounts from its suppliers. A 2016, report by the Grocery Code Adjudicator<sup>137</sup> said that Tesco "knowingly delayed paying money to suppliers in order to improve its own financial position"<sup>138</sup>. Such practices enabled Tesco to report a favourable financial position even though it damaged the viability of its suppliers.

The FRC looked at the quality of Tesco audits and concluded that “there is not a realistic prospect that a Tribunal would make an Adverse Finding against PwC LLP”<sup>139</sup>. This bald announcement was not accompanied by any report to show how the FRC arrived at its conclusions. In sharp contrast, The FCA felt that there was some evidence of concern and levied a fine of £129 million for “market abuse”<sup>140</sup>. Market abuses are manufactured in company board rooms, but the Insolvency Service has not taken any action against the directors. Seemingly, each regulator is working to a different benchmark.

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<sup>136</sup> House of Commons Business, Hansard, Written Question 156315, 21 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-21/156315/>

<sup>137</sup> The Groceries Code Adjudicator was established by the Groceries Code Adjudicator Act 2013. It an independent entity within the Department for Business, Energy and Industrial Strategy. Its role is to enforce the Groceries Supply Code of Practice and to encourage and monitor compliance with it. The Code applies to all retailers with UK annual groceries turnover exceeding £1 billion

<sup>138</sup> Grocery Code Adjudicator, Investigation into Tesco plc, London: GCA, 9 January 2016; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/494840/GCA\\_Tesco\\_plc\\_final\\_report\\_26012016\\_-\\_version\\_for\\_download.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/494840/GCA_Tesco_plc_final_report_26012016_-_version_for_download.pdf).

<sup>139</sup> Financial Reporting Council, Closure of investigation into the conduct of members and a member firm as auditors of Tesco plc, 5 June 2017; <https://www.frc.org.uk/news/june-2017/closure-of-investigation-into-the-conduct-of-membe>.

<sup>140</sup> Financial Conduct Authority, Tesco to pay redress for market abuse, 28 March 2017; <https://www.fca.org.uk/news/press-releases/tesco-pay-redress-market-abuse>.

## REGULATORY SILENCE

A key purpose of financial statements is to report on the maintenance of capital i.e. the amounts which could be made available to creditors and other stakeholders in the event of bankruptcy. This is required by Part 23 of the Companies Act 2006 and forms the basis of any assessment of profit, solvency and the ability of a business to remain a going concern. The Companies Act 2006 also provides the rules for payment of dividends. In short, a company must have *sufficient* distributable reserves to enable it to pay dividends<sup>141</sup>. The payment of dividends must not deplete its capital which is seen as a kind of reserve fund for protection of its creditors.

The ‘sufficiency’ of distributable reserves and maintenance of capital depend on accounting standards and rules issued by the FRC. It is hard to discern any recognisable or measurable concept of capital maintenance in IFRSs advanced by the FRC. The Local Authority Pension Fund Forum (LAPFF) has argued that the FRC’s interpretation of company law is faulty and consequently companies may have paid illegal dividends<sup>142</sup>. Some companies, including Domino’s Pizza, Dunelm and stockbroker Hargreaves Lansdown<sup>143</sup>, have acknowledged making dividend payments in contravention of the requirements of the Companies Act.

In the absence of a designated regulator, the Business Secretary was asked to intervene. In response, he informed Parliament that his

“Department is not responsible for carrying out checks on dividends paid by companies to ensure that they do not exceed their distributable reserves<sup>144</sup>”.

The Business Secretary failed to say who else should be focusing on enforcement of company law.

## NO CHECK ON PREDATORY PRACTICES

The regulatory system should prioritise protection of consumers and the public but regulators are often too close to the industries that they regulate. There is a consistent pattern of regulatory neglect and obfuscation, even though the role of accountancy firms, banks and corporations in tax avoidance has been the subject of

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<sup>141</sup> For example, see The Institute of Chartered Accountants in England & Wales, Guidance on Realised and Distributable Profits under the Companies Act 2006, London: ICAEW, April 2007.

<sup>142</sup> Reuters, UK pension funds urge firms to disregard certain regulator guidance, 3 December 2015; <https://uk.reuters.com/article/uk-britain-accounting/uk-pension-funds-urge-firms-to-disregard-certain-regulator-guidance-idUKKBN0TM1N020151203>.

<sup>143</sup> Accountancy Daily, Two more PLCs pay out dividends breaking Companies Act rules, 16 February 2017, <https://www.accountancydaily.co/two-more-plcs-pay-out-dividends-breaking-companies-act-rules>; Financial Times, Hargreaves Lansdown breaks company law over dividend payments, 8 February 2017, <https://www.ft.com/content/44b97ab8-edda-11e6-ba01-119a44939bb6>.

<sup>144</sup> Hansard, House of Commons, 12 October 2018, <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105198/>



parliamentary hearings<sup>145</sup> and adverse court rulings<sup>146</sup>. In 2013, the Big Four accountancy firms became the subject of a hearing into their tax avoidance practices by the UK House of Commons Committee of Public Accounts. Just before the hearing the Committee received evidence from a former senior PwC employee stating that the firm's policy was that it would sell a tax avoidance scheme which had only a 25% chance of withstanding a legal challenge, or as the Committee chairperson put it

“you are offering schemes to your clients—knowingly marketing these schemes—where you have judged there is a 75% risk of it then being deemed unlawful. That is a shocking finding for me to be told by one of your tax officials<sup>147</sup>”

Representatives of the other three firms admitted to “selling schemes that they consider only have a 50% chance of being upheld in court”. This did not result in regulatory action by any of the regulators even though it raised issues about ethics, relationship with audit clients and the nation's tax revenues. In the absence of an independent regulator, the consultancy side of accountancy firms is regulated by the ICAEW, which simultaneously promotes and protects the firms. Despite strong court judgements, no firm has ever been disciplined. When pressed, the chief executive of the ICAEW said:

“You ask whether any of the major firms has been the subject of an adverse disciplinary finding in relation to advisory work on taxation. I can confirm that no such findings have been made either by the ICAEW or by the Financial Reporting Council<sup>148</sup>”.

Auditors sell tax avoidance schemes their audit clients and then report on the financial statements based upon those schemes. Ernst & Young did so, as shown by the case of *GDF Suez Teesside Limited v Revenue And Customs [2018] EWCA Civ 2075*. Another example is the case of *Iliffe News and Media Ltd & Ors v Revenue & Customs [2012] UKFTT 696 (TC) (01 November 2012)*. Ernst & Young devised a tax avoidance scheme for its audit client, a highly profitable media company which wanted to conceal its profits and defeat employees' claims for higher pay, amongst other things. The company owned a number of newspaper titles and was advised to

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<sup>145</sup> For example see, UK House of Commons Committee of Public Accounts, HM Revenue & Customs 2010–11 Accounts: tax disputes, London: The Stationery Office, 2011; UK House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms, London: The Stationery Office, 2013; UK House of Commons Committee of Public Accounts, Tax Avoidance–Google; London: The Stationery Office, 2013; UK House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms (follow-up), London: The Stationery Office, 2015; UK House of Commons Committee of Public Accounts, Collecting tax from high net worth individuals, London: The Stationery Office, 2017.

<sup>146</sup> Austin Mitchell and Prem Sikka, *The Pin-Stripe Mafia: How Accountancy Firms Destroy Societies*, Basildon: Association for Accountancy & Business Affairs, 2011.

<sup>147</sup> UK House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms, London: The Stationery Office, 2013

<sup>148</sup> Letter from the ICAEW chief executive to Austin Mitchell MP, dated 5 December 2012.

treat its mastheads as a new asset. These were all transferred to the parent company for a nominal sum, and then immediately leased back to the subsidiaries for annual royalties. Over a five year period, the subsidiaries paid royalties of £51.6 million and published lower profits. This intragroup transaction did not result in any transfer of cash to an external party, but the subsidiaries claimed tax relief on the royalty payments. The company's board minutes, as reproduced in the court papers, noted that

“[Ernst & Young] had confirmed that if the newspaper titles and/or mastheads were registered as trade marks in the ownership of [INML], it was possible for the latter [i.e. INML] to charge the newspaper companies a fee for the use of the former in a tax efficient manner that would significantly lessen the transparency of reported results. It was agreed to progress this matter in consultation with [E&Y]<sup>149</sup>”.

In view of the seriousness of the above revelations, a formal complaint was lodged with the FRC by Austin Mitchell MP on 5 December 2012. The tax transactions took place during years 2003 to 2005, but a complaint could only be lodged after the legal judgment as without that nothing would have been known about the unsavoury practices. On 13 February 2013, the FRC said it was a matter for the accountancy body licensing Ernst & Young. A complaint had already been lodged on 5 December 2012 with the ICAEW, the RSB responsible for licensing Ernst & Young and its partners. On 20 December 2012, the ICAEW chief executive promised to respond. As is usual in matters relating to big firms, a period of silence ensued and nothing further was heard. The matter was taken-up by The Independent newspaper in a story published on 18 January 2016. When prodded, the ICAEW said: “We will always look at any scheme if it is ruled unlawful but it does not follow that if a tax case is lost disciplinary action will automatically follow<sup>150</sup>” and the matter was still “live”. This face saving statement still did not result in any speedy response. Eventually, on 11 November 2016, some four years after the original complaint, the ICAEW responded and said that the firm had destroyed some of the earlier files, but it nevertheless concluded that everything was fine and in line with the extant rules i.e. the firms can continue to sell tax avoidance schemes which the courts say are unlawful and auditors can continue to provide assurances that their interventions “would significantly lessen the transparency of reported results”. Apparently, none of this impaired auditor independence and everything was ethical as per the rules devised by auditing industry itself. The ICAEW sought to limit damage by claiming that the revised code of ethics might make it difficult for the firms to engage in the above practices, but did not explain why the same had previously been permitted. It did not explain its own role in crafting the rules either. The Nelsonian practices of the regulators only embolden the firms.

Another Ernst & Young scheme for an audit client was declared to be unlawful. The scheme involved loans between companies in the same group and its ultimate aim

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<sup>149</sup> *Iliffe News and Media Ltd & Ors v Revenue & Customs* [2012] UKFTT 696 (TC) (01 November 2012).

<sup>150</sup> The Independent, ‘Big Four’ audit firms never examined over illegal tax plans, 18 January 2016; <https://www.independent.co.uk/news/uk/crime/emb-0000-big-four-audit-firms-never-examined-over-illegal-tax-plans-a6818126.html#r3z-addoor>

was to enable the company making the interest payment to claim tax relief on this expense, whilst enabling the company receiving the interest to avoid tax. This scheme was sold to Greene King, a leading pub retailer and brewer. Tax relief on payments of £21.3 million was at stake and the agreement, as the tax tribunal noted, required that Ernst & young would take a percentage of the tax avoided by adoption of its scheme. After a prolonged legal battle the scheme was declared to be unlawful by the court judgment in *Greene King Plc & Anor v Revenue and Customs [2016] EWCA Civ 782*.

The role of PwC in mass marketing tax avoidance schemes was exposed by what became known as Luxembourg Leaks (or Luxleaks). Since November 2014, some 28,000 pages of tax agreements, returns and other papers relating to over 1,000 businesses have been available on the website of the International Consortium of Investigative Journalists<sup>151</sup>. The papers provide details of tax avoidance schemes and relate to giant corporations, such as Accenture, Amazon, Deutsche Bank, Disney, Dyson, FedEx, Heinz, IKEA, JP Morgan, Pepsi, Procter & Gamble, Shire, and many more. The 28,000 pages did not contain even one instance where PwC made any mention of ethics, morality, or the possible social impact of lost tax revenues. A PwC crafted scheme in the case of *Vocalspruce Ltd v The Commissioners for HMRC [2014] EWCA Civ 1302* was described by the judge as “fiction” and declared to be unlawful

The UK Supreme Court heard the case of *Commissioners for Her Majesty’s Revenue and Customs v Pendragon plc and others; [2015] UKSC 37*. It related to a VAT avoidance scheme designed and marketed by KPMG. The scheme enabled car retailing companies to recover VAT input tax paid while avoiding the payment of output tax. The court declared the scheme to be unlawful and the judge said that:

“In my opinion the KPMG scheme was an abuse of law”.

The US case of *Salem Financial Inc. v United States, No. 10-192T (Ct. Fed. Cl. Sept. 20, 2013)* shows how the big auditing firms market avoidance schemes on a global scale, playing one country’s tax system against another’s. In this example, KPMG collaborated with Barclays PLC to mass market a tax avoidance scheme to several global corporations, including AIG, Microsoft, Prudential, Wachovia, Wells Fargo, Bank of New York Mellon, and Branch Banking & Trust (BB&T). The purpose of the scheme was to generate hundreds of millions of dollars of foreign tax credits through paper transactions and thus reduce the US tax liabilities of the clients. The scheme was declared to be unlawful and the judge said that the scheme was “driven solely by the sham circular cash flows of the Trust”. He described the scheme as “an economically meaningless tax shelter” and said that the conduct of those persons from BB&T, Barclays, KPMG ... who were involved in this and other transactions was nothing short of reprehensible”.

KPMG were both auditors and tax advisers to the P&O group and designed a scheme to enable P&O to artificially generate a tax credit of £14m. It was thrown out by the tax tribunal in the case of *Peninsular & Oriental Steam Navigation Company v Revenue & Customs [2013] UKFTT 322 (TC)*. The scheme involved a series of

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<sup>151</sup> <http://www.icij.org/project/luxembourg-leaks>

transactions between the UK and Australian subsidiaries to boost tax credits on dividend income. The judges said that the

“scheme was designed and implemented for no reason other than tax avoidance” and contrived transactions were “all part of an elaborate trick designed to exploit [tax legislation]. ... P&O and its subsidiaries played out a scripted game of charades (paragraph 69 of the judgment)”.

A Deloitte scheme enabled a number of companies to generate tax deductible losses through complex financial transactions. Amongst others, the scheme was sold to Ladbroke Group International (LGI), a betting company. The key idea was for two subsidiaries to deliberately transact with each other in order to generate a tax loss in one of them. The group suffered no real loss overall. Ladbrokes tax director told the court that he had “been approached by Deloitte with a proposal for a tax planning opportunity involving a total return swap... and a novation of loans to extract reserves” (*Travel Document Service & Anor v Revenue & Customs [2015] UKFTT 582 (TC)*). Ladbrokes admitted it sought to avoid tax, but argued that the special transactions fell outside the scope of anti-avoidance rules. The First-Tier Tribunal threw out the scheme and said that the evidence

“seems to us to provide unequivocal confirmation that at the very least one of LGI’s main purposes in becoming a party to the relevant loan relationships was to secure a tax advantage”.

Deloitte and Ladbrokes appealed and the £71 million scheme was once again thrown out by the Upper Tribunal (*Travel Document Service & Anor v Revenue & Customs [2017] UKUT 45 (TCC) (07 February 2017)*).

The global economy is yet to fully recover from the 2007-08 banking crash, but auditing firms have done their best to deplete the public purse. A mass marketed avoidance scheme designed by Deloitte was sold to Deutsche Bank and UBS, amongst others. The scheme centred on bankers receiving a specially created class of shares in companies specifically formed in Jersey and the Cayman Islands. The banks paid banker bonuses into the schemes without having to account to HMRC for income tax or national insurance contributions for the staff or their own liabilities on earnings. After 12 years of litigation and a series of court battles, the matter eventually went to the UK Supreme Court and its judgement in the case of *UBS AG v HMRC and DB Group Services v HMRC [2016] UKSC13* rejected the scheme because “It had no business or commercial rationale beyond tax avoidance”. The judges added:

“In our society, a great deal of intellectual effort is devoted to tax avoidance. The most sophisticated attempts of the Houdini taxpayer to escape from the manacles of tax ... structuring transactions in a form which will have the same or nearly the same economic effect as a taxable transaction but which it is hoped will fall outside the terms of the taxing statute. It is characteristic of these composite transactions that they will include elements which have been inserted without any business or commercial purpose but are intended to have the effect of removing the transaction from the scope of the charge.”

The above are just some examples of instances where despite court decisions no banking, accounting, auditing, or any professional body has bothered to take any action.

## FRAGMENTED STRUCTURES

The case of HBOS demonstrates the fragmented nature of UK regulatory system, resulting in the failure of regulators to work to common and consistent standards and deliver timely reports. HBOS was the biggest casualty of the 2007-08 banking crash<sup>152</sup> and became the subject of a £37 billion bailout. HBOS had always received unqualified audit reports from KPMG, its auditor. A number of reports examined the HBOS failure<sup>153</sup>. The reports put the blame on company directors, and also raised questions about the quality of external audits, but accounting regulator, the Financial Reporting Council (FRC) showed little curiosity. The banking regulator told the Treasury Committee that he was “surprised and shocked” by the “mutual distrust” that had built up between the FSA and the auditors prior to the crisis. The Committee noted that while some meetings between the FSA [at that time the Financial Services Authority was the regulator] and KPMG did take place, these were infrequent and there was only a single telephone call in the whole of 2006 to discuss HBOS” (p. 46). The 2016 Treasury Committee report noted that

“The auditing of HBOS is the one major element of the HBOS affair that has yet to be subject to adequate scrutiny. *The Committee will expect the FRC to undertake an extremely thorough analysis of the HBOS case.* Regardless of the outcome of the FRC’s investigation process, it is likely that the Committee will want to consider its work and regulatory approach in more detail. The investigation announced on 27 June 2016 is better late than never. But the very tardy response by the FRC appears to be as inexplicable as it is unacceptable” (p.48, emphasis added).

In September 2017, the FRC abandoned its investigation of the 2007 audit of HBOS with the statement that

“there is not a realistic prospect that a Tribunal would make an Adverse Finding against KPMG in respect of the matters within the scope of the investigation. The firm’s work did not fall significantly short of the standards reasonably to be expected of the audit<sup>154</sup>”.

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<sup>152</sup> For further information see Atul Shah, *The Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS*, London: Routledge, 2018.

<sup>153</sup> For example, see Parliamentary Commission on Banking Standards, ‘An accident waiting to happen’: The failure of HBOS, London: House of Commons and House of Lords, 2013, <https://publications.parliament.uk/pa/jt201213/jtselect/jtpcb/144/144.pdf>; Bank of England, *The failure of HBOS plc (HBOS) A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)*, London: BoE, November 2015; House of Commons Treasury Committee, *Review of the reports into the failure of HBOS*, London: House of Commons, 2016; <https://publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf>

<sup>154</sup> Financial Reporting Council, *Closure of investigation into KPMG’s audit of HBOS plc*. London: FRC, 19 September 2017

FRC offered no evidence to support its conclusions. Following criticisms from the Treasury Committee, FRC admitted that it “should have adopted a more proactive role and acted more quickly<sup>155</sup>”.

In September 2014, the FCA fined Barclays Bank Plc £37,745,000 for failing to properly protect clients’ custody assets worth £16.5 billion<sup>156</sup>. The main reason was ‘significant weaknesses’ in the bank’s systems and controls during the period November 2007 to January 2012. This raised questions about the quality of external audits performed by PricewaterhouseCoopers (PwC), especially as auditors are required to evaluate systems of internal controls. The matter was referred to the FRC, UK’s accounting regulator. In October 2017, it dropped the case by stating that

”there is not a realistic prospect that a Tribunal would make an Adverse Finding against PwC LLP in respect of the matters within the scope of the investigation”.

## **NO URGENCY**

The FRC has been described as “an extraordinarily useless body even by the standards of UK regulators<sup>157</sup>” and “it has been far too close to the industry it purports to regulate, and its instincts are to delay and conceal”<sup>158</sup>. A parliamentary report on the collapse of Carillion described FRC as “chronically passive”, “timid”, “useless” and “toothless” and added that “we have little faith in the ability of the FRC to complete important investigations in a timely manner ...<sup>159</sup>”. Baroness Sharon Bowles, a former Member of the European Parliament added that “The FRC is fatally flawed in the way it was set up and has been operating, and distance needs to be put between that culture and the future regulator. This is most likely to be effective if the FRC is wound up and a comprehensive, fully accountable companies regulator set up that is not based on trade association relationships and which follows fully all the principles of public life<sup>160</sup>”.

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<sup>155</sup> Financial Reporting Council, The FRC’s enquiries and investigation of KPMG’s 2007 and 2008 audits of HBOS, November 2017; <https://www.frc.org.uk/getattachment/646bb35a-f39f-4d75-a12e-6d2480e0b2a7/HBOS-Report-Nov-2017-FINAL.pdf>

<sup>156</sup> Financial conduct Authority, Barclays fined £38 million for putting £16.5 billion of client assets at risk, 23 September 2014, <https://www.fca.org.uk/news/press-releases/barclays-fined-%C2%A338-million-putting-%C2%A3165-billion-client-assets-risk>

<sup>157</sup> Ruth Sunderland. The bean counters deserve a roasting - it's time for the 'big four' accountants to be held to account, Mail on Sunday, 15 April 2018; <http://www.thisismoney.co.uk/money/article-5616377/Its-time-big-four-accountants-finally-held-account.html>

<sup>158</sup> Ruth Sunderland, How to start an audit of the Big Four accountancy giants... break them up, Mail on Sunday, 17 June 2018; <http://www.thisismoney.co.uk/money/comment/article-5851857/RUTH-SUNDERLAND-start-audit-Big-Four-break-up.html>.

<sup>159</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018, <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>.

<sup>160</sup> Investment Pensions Europe, Former MEP says ‘fatally flawed’ FRC should be shut down, 15 June 2018; <https://www.ipe.com/pensions/pensions/pensions-accounting/former-mep-says-fatally-flawed-frc-should-be-shut-down/10025209.article>

Almost all distressed banks received an unqualified audit report on their accounts, immediately before their collapse. In some cases, the banks collapsed within days/weeks of receiving unqualified audit reports<sup>161</sup>. Auditors had considerable fee dependency on banks as they also sold a variety of consultancy services to banks. The FRC did not investigate the systemic failures.

Regulators and stakeholders place reliance on external auditors and audited financial reports. They attach considerable importance to timely investigations of audit failures, but the FRC has shown little urgency. It has a poor record in conducting robust and timely investigations. Its investigation of audit failures at MG Rover, audited by Deloitte & Touche, was announced in August 2005. The outcome was not finalised until April 2015. On appeal, the fine on auditors was reduced to £3 million, the derisory nature of which is evident when it is appreciated that between 2000 and 2005 Deloitte received £30.7m in audit and non-audit fees.

An investigation into the financial statements of iSoft Group Plc for the years 2003-2005 was announced in October 2006. Interim reports appeared in 2010 and 2011 and the matter being finalised in August 2013. In the case of Cattles Plc, the FRC announced an investigation into the role of PricewaterhouseCoopers in the company's accounts for 2007 and 2008. A report was published in August 2016. In November 2010, FRC announced an investigation of the 2009 audit of Connaught Plc conducted by PwC. The final report appeared on 31 May 2017

In May 2018, a former senior executive at the UK software firm Autonomy was convicted of fraud in the US<sup>162</sup>. The executive had artificially inflated the firm's financial position before its sale to Hewlett Packard in 2011 for £7.1 billion. Prosecutors argued that some of the irregularities went back to 2009. Upon discovering the irregularities, Hewlett Packard was forced to write-off most of the value of Autonomy. Attention focused on Deloitte, Autonomy's auditors. On 11 February 2013, the FRC announced an investigation of the published financial reports of Autonomy for the period between 1 January 2009 and 30 June 2011. It claimed that the investigation had been held up by the court case. On 31 May 2018, it announced possible disciplinary action against Deloitte<sup>163</sup>. A report is still awaited.

## **DISCIPLINARY FARCE**

In its regulatory role, the FRC levies fines upon accountants and auditors but these have not been used to soften the financial blow on stakeholders affected by audit failures. What happens to the fines? The Minister stated that

“Fines imposed on accountancy firms by the Financial Reporting Council as part of an audit enforcement action must be paid by the Financial Reporting

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<sup>161</sup> Prem Sikka, “Financial Crisis and the Silence of the Auditors”, *Accounting, Organizations and Society*, Vol. 34, No. 6-7, 2009, pp. 868-873.

<sup>162</sup> BBC News, Autonomy ex-executive guilty of fraud, 1 May 2018; <https://www.bbc.co.uk/news/business-43959468>

<sup>163</sup> Financial Reporting Council, Disciplinary action in relation to Autonomy Corporation plc, 31 May 2018; <https://www.frc.org.uk/news/may-2018/disciplinary-action-in-relation-to-autonomy-corporation>

Council to the Secretary of State. Any costs awarded to the Financial Reporting Council in recognition of the enforcement costs funded by the recognised audit supervisory bodies must be paid to those bodies. This arrangement applies only in respect of fines paid under the Statutory Auditors and Third Country Auditors Regulations 2016<sup>164</sup>.

The Business Secretary explained that:

“The Financial Reporting Council (FRC) agreed a disciplinary scheme with the accountancy professional bodies in 2004 meeting requirements in company law for it to have in place arrangements with the recognised supervisory bodies for the purposes of disciplining auditors. The funding basis for the scheme was that the professional bodies would fund the costs of disciplinary actions and that any costs and fines ordered against the members of their bodies would be paid to those bodies.

New statutory powers for the FRC to impose fines on auditing firms were introduced in the Statutory Auditors and Third Country Auditors Regulations 2016. The Regulations require that fines imposed under the powers must be transferred by the FRC to the Secretary of State.

The FRC continues to maintain a disciplinary scheme for non-statutory audit matters: for fines recovered under those arrangements, the fines continue to be paid over to the relevant accountancy professional bodies<sup>165</sup>.

The 2004-2016 arrangements are likely to have generated considerable windfalls for the accountancy bodies. The full extent is not known but a Minister informed Parliament<sup>166</sup> that the following fines (Table 4.1) were imposed under the FRC’s accountancy scheme from 2012 to 2016 and passed to the participating body which met the related case costs. (The table does not include the costs that were awarded to the bodies in relation to specific cases or the contributions to case costs by the participating bodies overall).

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<sup>164</sup> Hansard, House of Lords, Written question - HL4543, 9 January 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-01-09/HL4543/>

<sup>165</sup> Hansard, House of Commons, Written question – 105196, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105196/>

<sup>166</sup> Hansard, House of Lords, Written question – HL5096, 25 January 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-01-25/HL5096/>



**Table 4.1**  
**FRC Fines and Their Destination**

| Year | Total fines Received | Fines passed to the accountancy bodies |      |       |
|------|----------------------|--|------|-------|
|      |                      | ICAEW                                  | CIMA | CAI   |
| 2012 | NIL                  | -                                      | -    | -     |
| 2013 | £815k                | £815k                                  | -    | -     |
| 2014 | £1,038k              | £1,025k                                | £13k | -     |
| 2015 | £4,688k              | £4,688k                                | -    | -     |
| 2016 | £6,712k              | £6,552k                                | -    | £160k |

On 3 September 2018, in accordance with the FOI law, the FRC was asked to provide data missing from the above table i.e. from year 2004 onwards. The request was accompanied by a paraphrasing of the ministerial statement (see above)

“My understanding is that FRC agreed a disciplinary scheme with the accountancy professional bodies in 2004. This was to enable it to meet requirements in company law for it to have in place arrangements with the recognised supervisory bodies for the purposes of disciplining auditors. The funding basis for the scheme was that the professional bodies would fund the costs of disciplinary actions and that any costs and fines ordered against the members of their bodies would be paid to those bodies”

On 20th September 2018, FRC declined to provide the requested information and also contradicted the ministerial information by saying that “This understanding is not quite correct; the company law requirement for the RSBs to have in place independent disciplinary arrangements was a requirement placed on the RSBs, not on the FRC. Please see s1217 and Schedule 10 Companies Act 2006 (pre – 2016 amendments)”. Why was the FRC withholding information? Was it confidential? A member of parliament subsequently requested the same information in a parliamentary question and the Minister stated that “the following fines were imposed under the FRC’s Accountancy Scheme from 2004 to 2011 and passed to the participating body which met the related case costs<sup>167</sup>” (see Table 4.2).

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<sup>167</sup> Hansard, House of Lords, Written question – HL10459, 9 October 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-10-09/HL10459/>

**Table 4.2**  
**FRC Fines and Their Destination for the Period 2004-2011**

| <b>Year</b> | <b>Total Fines received</b> | <b>Fines passed to the accounting bodies</b> |
|-------------|-----------------------------|--|
| 2004        | NIL                         |  |
| 2005        | NIL                         |  |
| 2006        | NIL                         |  |
| 2007        | NIL                         |  |
| 2008        | £12,000                     | CAI  |
| 2009        | NIL                         |  |
| 2010        | NIL                         |  |
| 2011        | £1,640,000                  | ICAEW  |

The FRC fines have generated additional resources for the accountancy bodies to reduce the rate of increase in membership/licensing fees (which also benefits big accounting firms) and engage in campaigns to defend the auditing industry.

### **SEE NO PROBLEMS**

FRC's accounting standards have hindered investigation of BHS because they did not require wholly owned companies to provide a cash flow statement that would have helped to track the cash extracted from BHS. Its standards did not require BHS to provide fuller details of transactions with related parties that once again helped the directors/shareholders to extract cash without revealing full details. The FRC needed to be pressurised by the Work and Pensions committee to investigate the BHS audits. Despite BHS and other scandals, the FRC has not revised the accounting standard on cash flow statements.

FRC has also failed to take action against firms consistently delivering poor audits. On 31 December 2016, the Carillion Group had £1,571 million (2015: £1,544.3million) of goodwill. It was the largest single item in the balance sheet and its treatment would have significant effect on the measurement of the company's profits, assets, leverage and solvency. Carillion was audited by KPMG. All assets, no matter how understood, are eventually exhausted; and that is normally recognised in depreciation, or in impairment charges to a company's income statement. However, the FRC had developed accounting rules which enabled companies to avoid making any impairment charges and so report higher profits and assets. Not only were the FRC's accounting standards deficient, and they still are, but KPMG's audit of

goodwill was also deficient. Through its auditor monitoring regime, the FRC was aware of the shortcomings of KPMG's audit practices in relation to goodwill, but made no public statement and despite persistent failures took no action.

The 2016-17 audit inspection report by the FRC based on a sample of KPMG<sup>168</sup> audits, published in June 2017, identified a number of weaknesses in the firm's approach to auditing goodwill. The FRC said that there were:

"Weaknesses in the audit approach adopted for goodwill impairment, including insufficient professional scepticism and challenge of management's assessment; and insufficient evidence of involvement by the group team in the component auditor's work relating to a material acquisition.

Insufficient challenge of management's assumptions in relation to the impairment of goodwill and other intangibles, with undue reliance placed on evidence which supported management's assumptions/ position

We continue to identify a number of concerns in relation to the audit of valuations, loan loss provisions and impairment reviews of goodwill and other intangibles".

The FRC's 2015/16 audit inspection report<sup>169</sup> on KPMG noted the following about the firm's procedures for auditing goodwill and intangibles:

"We identified a number of concerns in relation to the audit of valuations, impairment reviews of goodwill and other intangibles, tax provisions and loan loss provisions. For example:

Insufficient challenge of management regarding, in one case, the consistency of the financial projections which formed the basis for the recognition of deferred tax assets.

For an audit where business combinations were identified as a significant risk, there was insufficient testing relating to key estimates and judgements used in the valuation of acquired intangible assets.

there was insufficient evidence of challenge of management's judgments relating to impairment of stores. In one case the audit team did not sufficiently challenge management's identification of cash generating units. In the other audit there was insufficient evidence of challenge of management as to whether certain stores should have been assessed for impairment."

The 2014/15 Audit Inspection Report reached the following conclusions:

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<sup>168</sup> [https://www.frc.org.uk/getattachment/84251a1d-be78-4590-b284-  
ea47d6c8cc75/KPMG-LLP-Audit-Quality-Inspection-16-17.pdf](https://www.frc.org.uk/getattachment/84251a1d-be78-4590-b284-<br/>ea47d6c8cc75/KPMG-LLP-Audit-Quality-Inspection-16-17.pdf)

<sup>169</sup> [https://www.frc.org.uk/getattachment/93494442-a287-4ac4-a23c-  
96fdcd3edca1/KPMG-LLP-Public-Report-2015-16.pdf](https://www.frc.org.uk/getattachment/93494442-a287-4ac4-a23c-<br/>96fdcd3edca1/KPMG-LLP-Public-Report-2015-16.pdf)

“We reviewed the audit of goodwill and other intangible assets on eleven audits. In four audits there was insufficient testing of the reliability of forecast cash flows used within the impairment assessment of goodwill or the capitalisation of development costs. In one of those audits and one further audit, we identified related financial statement disclosures that were erroneous or potentially misleading. In another audit, we considered the level of challenge regarding the allocation of brand assets to cash generating units to be insufficient.

In one of those audits, there was also insufficient challenge of the assumptions used by management in the impairment assessment of investment property, including insufficient involvement of the firm’s property specialists in assessing the appropriateness of the land valuation. In another audit there was insufficient evidence of scepticism in the assessment of whether a loan receivable was recoverable.”

Despite the above, the FRC did not admonish KPMG, not did it set the firm any targets for improving its practices or alert regulators and stakeholders relying upon the financial statements.

## **ECONOMIC CRIME**

In the absence of joined-up regulation and regulatory bodies, the UK has become a magnet for dirty money<sup>170</sup>. One of the reasons for this is the easy formation of companies as this affords secrecy by concealing or obfuscating the identity of the ultimate beneficiaries, as mentioned in earlier parts of this report. A responsive and publicly accountable regulatory body should have taken steps to address the issues, but that has not happened. When pressed, the Business Secretary told the House of Commons that “Companies House does not have a front-line role in combatting money laundering but it can support and assist law enforcement in their investigations<sup>171</sup>”. This begs questions about how the UK can combat the flow of dirty money, promote confidence in the regulatory system or protect citizens from the fallout from money laundering.

Official statistics show that there were 8,304 prosecutions for financial crime in 2016. In contrast, the Office of National Statistics (ONS) indicates that from July 2015 to June 2016, 627,000 fraud offences were reported to the National Fraud Intelligence Bureau. For the year ending June 2017 that number increased to 653,468<sup>172</sup>. Police data may not provide a good indication of financial crimes because in many instances, bank and credit card fraud and money laundering cases are reported to the relevant financial institutions rather than directly to the law enforcement agencies.

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<sup>170</sup> For example see, Transparency International, *Hiding in Plain Sight: How UK Companies are used to Launder Wealth*, London: TI, 2017.

<sup>171</sup> <sup>171</sup> Hansard, House of Commons. Written Questions, 12 October 2017, <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105218/>

<sup>172</sup> As per <https://www.mishcon.com/news/briefings/government-announces-plans-to-form-a-national-economic-crime-centre-as-part-of-its-anti-corruption-strategy>

A steady stream of scandals, such as the Bank of Credit and Commerce International (BCCI), Panama Papers, HSBC leaks, Luxembourg leaks, Paradise Papers and others have shown that the UK' regulatory structures are not very effective in tackling economic crime. Successive governments have added to the problems by creating overlapping regulators and have paid little attention to resources and effectiveness of the system. Very few police forces have dedicated economic crime squads. The specialist agencies, such as the Serious Fraud Office (SFO), tend to focus on high value white-collar crime. Even then, the SFO and Crown Prosecution's budget has been squeezed.

A Transparency International report<sup>173</sup> noted that the UK is home to a network of Trust and Companies Service Providers (TCSP's) that operate much like Appleby and Mossack Fonseca – companies at the heart of the Paradise and Panama Papers – who create these companies on behalf of their clients. TCSPs will register these companies to UK addresses that are often nothing more than mailboxes. This has created 'company factories', where thousands of companies can be registered to unoccupied buildings with nothing to suggest that any meaningful business occurs. A certificate of incorporation is a key document for opening bank accounts. Such certificates are not difficult to obtain.

Secrecy is a key ingredient in financial crime and the UK has done little to check the identity of individuals forming companies. Transparency International<sup>174</sup> investigated 52 large scale global corruption and money laundering cases involving £80bn. It found that some 766 UK-registered corporations were directly involved in laundering stolen money out of at least 13 countries. These companies are used to hide money that would otherwise appear suspicious; and they have the added advantage of providing respectability uniquely associated with being registered in the UK.

The NCA says that accountants and lawyers facilitate money laundering<sup>175</sup> but they face little regulatory action, even though their associations are designated as anti-money laundering regulatory bodies. Much hot money finds its way into the property market<sup>176</sup>. Estate agents are required to report suspicious activity to regulators, but are very economical in their disclosures. An undercover investigation<sup>177</sup> found that despite being made aware they are dealing with ill-gotten gains, the estate agents agreed to continue with a potential purchase. In several instances the estate agents recommend law firms to help a buyer hide his identity. One estate agent names a "very, very good lawyer ... the last person I put them [in touch] was another minister of a previous Soviet state" in a deal worth £10m. The estate agents suggested that in

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<sup>173</sup> <sup>173</sup> Transparency International, Hiding in Plain Sight: How UK companies are used to launder the proceeds of corruption. London, TI, 2017.

<sup>174</sup> Transparency International, Hiding in Plain Sight: How UK companies are used to launder the proceeds of corruption. London, TI, 2017.

<sup>175</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/655198/National\\_risk\\_assessment\\_of\\_money\\_laundering\\_and\\_terrorist\\_financing\\_2017\\_pdf\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/655198/National_risk_assessment_of_money_laundering_and_terrorist_financing_2017_pdf_web.pdf)

<sup>176</sup> For example, see BBC News, MPs to probe Russian money laundering through UK property, 29 March 2018; <https://www.bbc.co.uk/news/business-43574268>

<sup>177</sup> The Guardian, London estate agents caught on camera dealing with 'corrupt' Russian buyer, 7 July 2015; <https://www.theguardian.com/uk-news/2015/jul/07/london-estate-agents-caught-on-camera-russian-buyer>

London secretive purchases of multimillion pound houses are common. One claims that 80% or more of his transactions are with international, overseas-based buyers and “50 or 60%” of them are conducted in “various stages of anonymity ... whether it be through a company or an offshore trust”. Yet there has been little regulatory action.

Banks are required to comply with the “Know Your Customer” (KYC) guidelines and perform checks on the opening and operating of bank accounts. Yet too many have failed to implement even the basic internal controls. A number of UK banks have been fined at home and abroad for money laundering failures. These include Barclays, Coutts, Deutsche Bank, Lloyds, RBS, Natwest, Standard Bank, Standard Chartered and Ulster Bank. HSBC<sup>178</sup> paid a US fine of \$1.9 billion for violation of the sanctions regime and for permitting money laundering and was also put of probation but even that did not prompt UK investigations.

Bank failures on money laundering also pose serious questions about auditors who are required to evaluate the effectiveness of internal controls. None has ever flagged any concerns about poor internal controls or involvement in illicit practices. Auditor failures have been noted by the FCA<sup>179</sup> and the matters are referred to the FRC, but the FRC uses entirely different benchmarks, and no action has been taken against auditors. The regulatory failures are not mitigated by the existence of at least 25 overlapping anti-money laundering regulators as this obfuscates matters and allows an endless passing of the buck. No convictions were secured under the Money Laundering Regulations 2007 until 2012, when one individual was found guilty. There have been four convictions since and five more proceedings<sup>180</sup>,

The UK institutional arrangements for combating economic crime are in disarray as matters get passed around. The information provided by whistle-blower Hervé Daniel Marcel Falciani (former HSBC employee) showed that HSBC’s Swiss operations turned a blind eye to illegal activities of arms dealers and helped wealthy people evade taxes. Only one individual from the Falciani list of some 3,600 potential UK tax evaders has been prosecuted. In January 2016, HMRC told the PAC that it had abandoned its criminal investigation into the role of HSBC in alleged illegal activities. In relation to the 2016 revelations by Panama Papers, government informed parliament that there have been “civil and criminal investigations into 140 individuals for suspected tax evasion, including high net worth individuals. As part of this HMRC has made four arrests; and carried out six interviews under caution<sup>181</sup>” (i.e. no

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<sup>178</sup> US department of Justice, HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit \$1.256 Billion in Deferred Prosecution Agreement, 11 December 2012; <https://www.justice.gov/opa/pr/hsbc-holdings-plc-and-hsbc-bank-usa-na-admit-anti-money-laundering-and-sanctions-violations>

<sup>179</sup> For example, Financial Conduct Authority, Ten years after Lehman: how accountants can make finance safer, Speech by Charles Randell, Chair, Financial Conduct Authority and Payment Systems Regulator, 6 September 2018; <https://www.fca.org.uk/news/speeches/ten-years-after-lehman-how-accountants-can-make-finance-safer>

<sup>180</sup> The Times, Convictions low for money laundering, 23 March 2017; <https://www.thetimes.co.uk/article/convictions-low-for-money-laundering-zzdchfrg>

<sup>181</sup> Hansard, House of Commons, Written question – 155652, 20 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-20/155652/>

convictions). In relation to the November 2017 Paradise Papers leak, all that the minister said was: “HMRC is looking very closely at the information the ICIJ has released in the Paradise Papers to see if it reveals anything new that could add to their existing leads and investigations<sup>182</sup>”.

The fallout from the 2007-08 banking crash has continued but regulators are unwilling or unable to take robust action though they have levied some fines for rigging interest rates, foreign exchange rates and persistent mis-selling of financial products. Some of the failures have been highlighted in earlier parts of this report. The Attorney General (main law adviser to the government) was asked “how many (a) bank employees and (b) directors have been prosecuted for their role in the 2007-08 financial crisis; and what the outcome was of those prosecutions”. The reply was:

“The SFO has brought charges against four employees including former chief executives of Barclays Plc as part of its criminal investigation into Barclays and its capital raising arrangements with Qatar Holding LLC and Challenger Universal Ltd in June and October 2008. The case is ongoing.

Additionally, a total of 13 employees including former senior bankers have so far had criminal proceedings commenced against them for fraudulently fixing the London Interbank Offered Rate (LIBOR) in the run up to and during the crisis - four trials have concluded including a retrial. So far, in total, there have been five convictions and eight acquittals. Those convicted were jailed for a total of more than 27 years and each received confiscation orders totalling hundreds of thousands of pounds.

The SFO has also charged 11 employees including former senior bankers in respect of fixing the European Interbank Offered Rate (EURIBOR), five of which are currently at trial. One defendant, Christian Bittar, a former Managing Director, has pleaded guilty to the charges. There are currently European Arrest Warrants issued in respect of the remaining five suspects<sup>183</sup>”.

That is it - “five convictions” arising from predatory practices exposed by the biggest banking crash of all times. This compares with 324 in US, 222 of these received a prison sentence; 36 in Iceland, 456 in Vietnam and four in Ireland<sup>184</sup>. Virtually no action has been taken against credit rating agencies, auditors, accountants and lawyers who may have benefited from predatory practices. Where criminal charges have been brought against City traders, as in the LIBOR scandal, they have targeted the small fish, and have usually been brought or instigated by foreign authorities, usually in the US.

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<sup>182</sup> Hansard, House of Commons, Written question – 155663, 20 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-20/155663/>

<sup>183</sup> Hansard, House of Commons, Written question – 155658, 20 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-20/155658/>

<sup>184</sup> Prem Sikka, When will the bankers who’ve rigged our economy be held to account?, 9 August 2018; <https://leftfootforward.org/2018/08/when-will-the-bankers-whove-rigged-our-economy-be-held-to-account/>

## **PUBLIC'S RIGHT TO KNOW IS NOT VALUED**

Regulators need to be accountable to the public. As part of that accountability, people must be able to request information. But that is not case. The RSBs are named as statutory regulatory bodies in the Companies Act 2006, but they are excluded from the freedom of information law. The Business Secretary informed parliament that

“They are independent private bodies and are not subject to the Freedom of Information Act<sup>185</sup>”

As a public body, the FRC should be subjected to the application of the freedom of information FOI) law, but the Business Secretary informed parliament that

“All our regulatory bodies are subject to the Freedom of Information Act 2000 with the exception of the Financial Reporting Council which is subject to the Act for some but not all of its functions<sup>186</sup>”.

Between 2013 and 2018, the FRC received 56 FOI requests for information. It gave a meaningful reply to only six<sup>187</sup>. It rejected requests for information on topics including whether any of its staff have been seconded to the “big four” accounting firms and vice versa and its investigation into the role of KPMG in the collapse of the defunct lender HBOS.

For the purpose of this report, on 30th May 2018 the FRC was asked to provide the following information:

- a) The number of complaints and requests for investigations that the FRC has received from the Recognised Supervisory Bodies (RSBs), other organisations and individuals about the conduct of PwC, Deloitte, EY, KPMG, Grant Thornton and BDO;
- b) the number of such requests rejected by the FRC;
- c) the number referred by the FRC to other professional or regulatory bodies;
- d) the number of instances where the FRC advised the complainant to refer the matter to another RSB or regulator
- e) the number where the FRC subsequently sought to discover the action taken by the bodies referred in c) and d) above.

In its reply of 22 June 2018, the FRC declined to provide the information on the basis that “The information you have requested relates to the FRC’s enforcement

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<sup>185</sup> Hansard, House of Commons, Written question – 105224, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105224/>

<sup>186</sup> Hansard, House of Commons, Written Question 156310, 21 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-21/156310/>

<sup>187</sup> Financial Times, UK accounting regulator rejected 90% of FOI requests, 12 April 2018; <https://www.ft.com/content/a4659b5e-3d93-11e8-b7e0-52972418fec4>



activities, which do not fall within the Delegated Functions ... We are not therefore required by the Act to provide such information”

Accountancy and law professional bodies are amongst the 25 AML regulatory bodies, but are not subjected to the freedom of information law. The Business secretary informed parliament that

“there are 25 Anti-Money Laundering (AML) supervisors in the UK. These include the Financial Conduct Authority (FCA), HM Revenue and Customs, the Gambling Commission and the 22 accountancy and legal professional bodies ... law enforcement agencies, the FCA, HM Revenue and Customs and the Gambling Commission are subject to the Freedom of Information Act whilst the 22 professional bodies ... above are not<sup>188</sup>”.

The above draws attention to an unacceptable situation in that regulatory bodies which explicitly exercise power on behalf of the state, and carry out functions associated with the apparatus of the state are considered to be private. Their actions and policies have consequences for everyday life, but people have no right to demand information from them.

## **SUMMARY AND DISCUSSION**

After drawing attention to the regulatory maze consisting of 41 financial sector regulators and another 14 dealing with corporate governance, accounting and auditing, this chapter provided some evidence of the consequences. The current regulatory system consists of overlapping bodies, working to different standards, benchmarks and priorities. Too many issues are ignored or not dealt with at all. For example, UK-based shell companies are central to global money laundering but agencies dealing with economic crime are hindered because the government pursues a policy of not making any checks on the individuals forming companies. Therefore, the beneficial owners cannot easily be traced, investigated or prosecuted.

Regulatory bodies have poorly formed objectives and the primary focus is to appear to be business-friendly, often at the expense of societal and stakeholder protection. Regulators charged with protecting the public are simultaneously expected to promote industry. Consequently, there is little check on predatory practices. The contradictions are laid bare by the regular parade of scandals. It was shown that companies are entering into strategic bankruptcies and dumping liabilities to pension schemes, suppliers, employees and HMRC. This raises questions about corporate governance, insolvency regulation and pension rights. In the absence of a central enforcer, matters fall within the domain of RPBs, the Insolvency Service, Pensions Regulator, HMRC and others. Yet there has been little concerted action from the regulators.

On a number of occasions, courts have declared tax avoidance schemes marketed by big accountancy firms to be unlawful. This should have result in response from

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<sup>188</sup> Hansard, House of Commons, Written Question 10535, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105355/>

regulators. Instead, matters are shunted between the FRC, the ICAEW and HMRC and no regulatory action is taken at all. It is a similar story with banks. The FCA is an independent regulator, but is close to the finance industry. The inertia over the Tomlinson, RBS and Turnbull reports shows how the buck is passed or suppressed. HM Treasury deemed the investigation and prosecution of frauds to be matter for the FCA, which subsequently claimed that it lacked the statutory authority for such matters. The alleged frauds could not have been carried out without the involvement of lawyers, and insolvency practitioners, but there has been silence from the RPBs and the Insolvency Service. Unsurprisingly, the Treasury Committee considers the existing framework to be “failing<sup>189</sup>” to protect innocent people.

In a fragmented and poorly co-ordinated structure, regulators apply inconsistent standards. The case of Barclays Bank demonstrated this. The FCA fined the bank for poor internal controls and failure to adequately segregate clients’ assets. Auditors are required to evaluate the effectiveness of internal controls and have specific statutory duties in respects of client assets, but their failures are investigated by the FRC, which after a three year wait failed to take action. The FRC also showed little interest in audit failures at HBOS and had to be pressurised to act by parliamentary committees. Even then its investigation was perfunctory. A number of examples were provided to show that the FRC had no urgency in investigating and reporting on audit failures. Reports can take years to appear and consequently, any remedial action which might improve accounting, auditing and corporate governance practices if postponed.

It is also a matter of concern that the public has little or no opportunity to directly exercise influence over regulatory bodies. It is disturbing to note that despite being statutory regulators the RSBs and RPBs are outside the scope of the freedom of information legislation. The FRC has been a ‘public body’ since 2004, but rarely provides meaningful response to freedom of information questions.

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<sup>189</sup> House of Commons Treasury Committee, SME Finance, October 2018; <https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/805/805.pdf>

## **CHAPTER 5**

### **CORROSIVE REGULATORY AND POLITICAL CULTURE**

The dizzying effects of the regulatory maze have weakened confidence in the institutions of democracy and rule of law. One might expect ministers and governments to take remedial steps, enhance regulatory effectiveness and accountability. However, politicians and regulators have stymied and sabotaged regulatory processes, seemingly to appease corporate interests or seek sectional advantages. Lax regulation has made London a global magnet for dirty money. The National Crime Agency<sup>190</sup> states that at least £90bn is estimated to be laundered through the UK financial system. Anonymous companies are used to launder money and they are easy to form, with little or no checks. There is particular concern about Russian money being laundered through UK banks and shell companies. A former senior police officer, who headed the National Crime Agency's international corruption unit in-charge of investigating corruption, has revealed that he was ordered to halt an inquiry into Russian money laundering. He told The Telegraph that "a more senior official linked to the Foreign Office told him to drop his inquiry"<sup>191</sup>. Such interventions are not isolated. On numerous occasions, the UK government and regulators have sought to stymie inquiries to protect wrongdoers, the interests of corporations, banks and wealthy elites. Successive governments have made political decisions to downgrade the parliament's and public's right to know. Such interventions have prevented the development of appropriate laws and policies. In turn, this damages the public's faith in institutions of democracy and the rule of law.

This chapter provides three case studies, drawn from different decades, to show that interventions to stymie inquiries are institutionalised and persistent. The case studies relate to HSBC, BAE Systems and the Bank of Credit and Commerce International (BCCI).

#### **HSBC**

HSBC is a major UK bank. It has engaged in a variety of predatory practices and has been fined by domestic and foreign regulators. A 2012 US Senate report<sup>192</sup> stated that HSBC ignored warning signs that its global operations were being used by money launderers, drug traffickers and potential terrorists. The report said that Mexican and US authorities expressed concern that drug traffickers were able to circumvent the anti-money laundering controls by using HSBC facilities. It found that HSBC Mexico had high profile clients involved in drug trafficking, processed suspicious bulk traveller cheques and resisted closing accounts linked to suspicious activities. HSBC frequently busted sanctions against Iran, Burma, North Korea and Iran and its affiliates HSBC Europe and HSBC Middle East repeatedly altered transaction information to take out any reference to Iran.

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<sup>190</sup> <http://www.nationalcrimeagency.gov.uk/publications/807-national-strategic-assessment-of-serious-and-organised-crime-2017/file>

<sup>191</sup> The Telegraph, Russian money laundering investigation was ordered to stop, says former head of corruption unit, 22 September 2018; <https://www.telegraph.co.uk/news/2018/09/22/national-crime-agency-ordered-stop-investigating-russian-money/>

<sup>192</sup> United States Senate Permanent Subcommittee On Investigation, U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History, 2012,

In December 2012, HSBC was fined \$1.9 billion by the US authorities for violation of the sanctions regime and for permitting money laundering and was also put on probation. The US Department of Justice<sup>193</sup> (DOJ) said that:

“HSBC is being held accountable for stunning failures of oversight – and worse – that led the bank to permit narcotics traffickers and others to launder hundreds of millions of dollars through HSBC subsidiaries, and to facilitate hundreds of millions more in transactions with sanctioned countries ... HSBC’s blatant failure to implement proper anti-money laundering controls facilitated the laundering of at least \$881 million in drug proceeds through the U.S. financial system. HSBC’s willful flouting of U.S. sanctions laws and regulations resulted in the processing of hundreds of millions of dollars in OFAC-prohibited transactions ... Despite evidence of serious money laundering risks associated with doing business in Mexico, from at least 2006 to 2009, HSBC Bank USA rated Mexico as “standard” risk, its lowest AML risk category. As a result, HSBC Bank USA failed to monitor over \$670 billion in wire transfers and over \$9.4 billion in purchases of physical U.S. dollars from HSBC Mexico during this period, when HSBC Mexico’s own lax AML controls caused it to be the preferred financial institution for drug cartels and money launderers ... A significant portion of the laundered drug trafficking proceeds were involved in the Black Market Peso Exchange (BMPE), a complex money laundering system that is designed to move the proceeds from the sale of illegal drugs in the United States to drug cartels outside of the United States, often in Colombia”.

HSBC Group allowed approximately \$660 million in OFAC-prohibited transactions to be processed through U.S. financial institutions, including HSBC Bank USA. HSBC Group followed instructions from sanctioned entities such as Iran, Cuba, Sudan, Libya and Burma, to omit their names from U.S. dollar payment messages sent to HSBC Bank USA and other financial institutions located in the United States. The bank also removed information identifying the countries from U.S. dollar payment messages; deliberately used less-transparent payment messages, known as cover payments; and worked with at least one sanctioned entity to format payment messages, which prevented the bank’s filters from blocking prohibited payments.

Specifically, beginning in the 1990s, HSBC Group affiliates worked with sanctioned entities to insert cautionary notes in payment messages including “care sanctioned country,” “do not mention our name in NY,” or “do not mention Iran.” HSBC Group became aware of this improper practice in 2000. In 2003, HSBC Group’s head of compliance acknowledged that amending payment messages “could provide the basis for an action against [HSBC] Group for breach of sanctions”

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<sup>193</sup> US Department of Justice press release, HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit \$1.256 Billion in Deferred Prosecution Agreement, 11 December 2012; <https://www.justice.gov/opa/pr/hsbc-holdings-plc-and-hsbc-bank-usa-na-admit-anti-money-laundering-and-sanctions-violations>).

The US revelations might have prompted the UK authorities to investigate the bank, but they did not do so. The US authorities had threatened to pursue criminal charges against HSBC but eventually did not do so. Sometime later, it emerged that the then Chancellor of the Exchequers wrote (on 10 September 2012) to the Chairman of the US Federal Reserve and urged the US authorities to go easy on HSBC. The Chancellor warned<sup>194</sup> the US administration that prosecuting a “systemically important financial institution” such as HSBC “could lead to [financial] contagion” and pose “very serious implications for financial and economic stability, particularly in Europe and Asia”. The letter is reproduced in Appendix 1.

The Chancellor’s intervention was not communicated to parliament. It may have persuaded the US authorities to defer prosecution, but it begs serious questions about the seriousness of the UK government in tackling money laundering and errant financial institutions. The number of other cases where ministers may have intervened to stifle investigations at home and abroad is not known.

## **BAE SYSTEMS**<sup>195</sup>

BAE Systems plc<sup>196</sup> (BAES) is the world’s second largest defence contractor. It exports a wide range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology and support services. It has customers in over 100 countries, though most of its business is based around four key markets - the US, the UK, the Kingdom of Saudi Arabia and Australia.

The company’s sales have been the subject of critical media scrutiny for some time. For example, The Guardian newspaper has claimed that:

“Three huge BAE deals with the Saudi royal family kept Britain’s sole warplane manufacturer in profitable existence in the 1960s and 70s. All were corrupt ... successive UK governments, desperate for foreign exchange, took no notice<sup>197</sup>”.

In 1985, the UK and Saudi governments signed a government-to-government contract<sup>198</sup> known as the Al Yamamah contract. The £43 billion contract was Britain’s biggest ever arms export deal, BAE Systems would provide Tornado and Hawk jets and other military equipment. It was soon alleged that the Prime Minister’s son, Mark

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<sup>194</sup> US House of Representatives Committee on Financial Services, Too Big To Jail: Inside The Obama Justice Department’s Decision Not To Hold Wall Street Accountable, 11 July 2016, Washington DC.

<sup>195</sup> For further information see Prem Sikka and Glen Lehman, “Supply-side corruption and Limits to Preventing Corruption within Government Procurement and Constructing Ethical Subjects”, Critical Perspectives on Accounting, Vol. 28, May 2015, pp 62-70.

<sup>196</sup> It is the successor company formed in 1999 after the merger of British Aerospace and Marconi Electronic System.

<sup>197</sup> As per <http://www.theguardian.com/baefiles/page/0,,2095814,00.html>.

<sup>198</sup> In legal terms, this means that BAE sold equipment to the UK government, which then sold it to the government of Saudi Arabia. As the sale is technically by the government, this entitles UK government auditors (e.g. the National Audit Office) to scrutinize the process.

Thatcher, received kickbacks for the contract<sup>199</sup>. In 1989, amidst allegations of the payment of secret commissions to a number of agents and Saudi royals, the National Audit Office (NAO) began an investigation<sup>200</sup>. In 1992, the investigation was abruptly discontinued and the report remains unpublished “amidst fears that its publication would offend the notoriously sensitive Saudis, jeopardising continuing trade relations<sup>201</sup>”. In 2004, it was reported that BAE’s chief operating officer operated a “slush fund” which made corrupt payments of £60 million to Saudi officials, including providing prostitutes, Rolls-Royces and Californian holidays<sup>202</sup>. The company allegedly used an elaborate process of false accounting to make and conceal payments through shell companies. Some of the entries were in code in order to conceal the identity of the recipients. BAE’s response to allegations was a response that it:

“can state categorically that there is not now and there has never been in existence what the media refers to as a 'slush fund'. Neither has BAE Systems or any of its officers or employees been involved in false accounting<sup>203</sup>”.

The media revelations, accompanied by documentary evidence, persuaded the Serious Fraud Office<sup>204</sup> (SFO) to launch an investigation. On 1st December 2006, it was reported that:

“Saudi Arabia has given Britain 10 days to halt a fraud investigation into the country's arms trade ... The country's advisers have made clear through diplomatic channels that unless the inquiry is closed, the kingdom's arms business will be taken elsewhere<sup>205</sup>”.

In 14 December 2006, the Attorney General told parliament that the investigation had been abandoned because of the

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<sup>199</sup> The Independent, Mark Thatcher accused: Sources say he got 12m pounds from arms deal signed by his mother, 9 October 2004; <http://www.independent.co.uk/news/mark-thatcher-accused-sources-say-he-got-12m-pounds-from-arms-deal-signed-by-his-mother-1441851.html>.

<sup>200</sup> The Daily Telegraph, BAE's arms deals with Saudi Arabia: Timeline, 30 July 2008; <http://www.telegraph.co.uk/news/worldnews/middleeast/saudi-arabia/2473238/BAEs-arms-deals-with-Saudi-Arabia-Timeline.html>.

<sup>201</sup> The Daily Telegraph, SFO illegally dropped Saudi arms inquiry, judge rules, 10 April 2008; <http://www.telegraph.co.uk/news/uknews/1584595/SFO-illegally-dropped-Saudi-arms-inquiry-judge-rules.html>.

<sup>202</sup> The Guardian, BAE chief linked to slush fund, 5 October 2004; <http://www.theguardian.com/uk/2004/oct/05/saudi-arabia.armstrade>.

<sup>203</sup> BBC News, BBC lifts the lid on secret BAE slush fund, 5 October 2004; <http://news.bbc.co.uk/1/hi/business/3712770.stm>.

<sup>204</sup> SFO is a government department charged with investigation and prosecution of serious or complex fraud, and corruption.

<sup>205</sup> The Daily Telegraph, Halt inquiry or we cancel Eurofighters, 1 December 2006 (<http://www.telegraph.co.uk/news/uknews/1535683/Halt-inquiry-or-we-cancel-Eurofighters.html>).

“need to safeguard national and international security. It has been necessary to balance the need to maintain the rule of law against the wider public interest<sup>206</sup>”.

Prime Minister Tony Blair defended the action by saying that “the result would have been devastating for our relationship with an important country<sup>207</sup>”. The US authorities<sup>208</sup>, which had launched an investigation in 2005, were not supportive<sup>209</sup> and made a formal protest to the UK government.

Attention then focused on the US investigation into BAE Systems Inc., the US subsidiary of BAE System plc, for its role in the Saudi arms deal, as well as contracts for supplies to South Africa, Chile, the Czech Republic, Romania, Tanzania and Qatar. On 1st March 2010, the US Department of Justice announced that BAE Systems plc had pleaded guilty to conspiring to defraud the United States by impairing and impeding its lawful functions and making false statements about its Foreign Corrupt Practices Act compliance program, and violating the Arms Export Control Act and International Traffic in Arms Regulations. BAE was ordered to pay a \$400 million criminal fine<sup>210</sup>.

The court order<sup>211</sup> relating to sales in Saudi Arabia, Hungary and the Czech Republic stated that:

“BAES knowingly and willfully failed to identify commissions paid to third parties for assistance in the solicitation or promotion or otherwise to secure the conclusion of the sale of defense articles ... ” (p. 6).

In the company’s records, the middlemen were described as “marketing advisers” and BAES took active steps to conceal its relationships with them. BAES used onshore and offshore shell companies to disguise the origins of secret commissions and also advised recipients to use offshore shell companies. There was little internal scrutiny of the payments. The court order noted that

“BAES established one entity in the British Virgin Islands to conceal BAES’s marketing advisor relationships, including who the agent was and how much it

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<sup>206</sup> Hansard, House of Lords Debates, 14 December 2006, col. 1712;

<http://www.publications.parliament.uk/pa/ld200607/ldhansrd/text/61214-0014.htm>.

<sup>207</sup> The Guardian, Dropping BAE inquiry vital to national interest, says Blair, 16 January 2007; <http://www.theguardian.com/world/2007/jan/16/bae.immigrationpolicy>.

<sup>208</sup> Financial Times, US issued protest on axing of BAE probe, 27 April 2007 (<http://www.ft.com/cms/s/0/b008fd02-f45c-11db-88aa-000b5df10621.html#axzz355ZUUp36>).

<sup>209</sup> UK NGOs made attempts to force the government to continue with its investigations, but were ultimately unsuccessful, The Guardian, Lords rule SFO was lawful in halting BAE arms corruption inquiry, 30 July 2008; <http://www.theguardian.com/world/2008/jul/30/bae.armstrade>.

<sup>210</sup> US Department of Justice press release, BAE Systems PLC Pleads Guilty and Ordered to Pay \$400 Million Criminal Fine, 1 March 2010; <http://www.justice.gov/opa/pr/2010/March/10-crm-209.html>.

<sup>211</sup> United States District Court For The District Of Columbia, United States Of America v Bae Systems pic, <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2011/02/16/02-01-10baesystems-info.pdf>

was paid; to create obstacles for investigating authorities to penetrate the arrangements; to circumvent laws in countries that did not allow agency relationships; and to assist advisors in avoiding tax liability for payments from BAES” (p. 8).

BAES’s official records maintained inadequate information about the identity of the advisors and the nature of their work and, frequently the communication was not in writing. Between May and November 2001 alone, BAES made payments of over £135,000,000 (about \$216 million) and over \$14,000,000 to certain of its marketing advisors and agents through offshore entities. (page 9 of the court order). There is little persuasive evidence to show that the advisers performed legitimate activities to justify the receipt of substantial payments. Amongst other things, the court order noted that for the Saudi contract, BAES provided substantial benefits to one public official and his associates (p. 12). These included

“sums totaling more than £10,000,000 and more than \$9,000,000 to a bank account in Switzerland controlled by an intermediary” (p. 13).

For the contract to supply Grippen fighter planes to the Czech Republic and Hungary, BAES made payments of more than £19,000,000 to entities associated with an unnamed agent. BAES made “these payments even though there was a high probability that part of the payments would be used in the tender process to favor BAES” (p. 9-10). In May 2011, the US government levied another fine of \$79 million on BAE for violation of defense export controls<sup>212</sup> for the period 1997 to 2010.

In December 2010, the UK authorities announced that BAE had agreed to make an ex-gratia payment of £29.5 million to the Tanzanian government, which the company’s 2011 annual report referred to as a “charitable contribution<sup>213</sup>” to be used for educating children in Tanzania<sup>214</sup>. A fine of £500,000 was negotiated by the UK authorities for failing to “keep adequate accounting records<sup>215</sup> in relation to a defence contract for the supply of an air traffic control system to the Government of Tanzania<sup>216</sup>”. The background is that, in 1999, BAE, with the support of the UK government, entered into an agreement with the Tanzanian government to supply an air traffic control system at the price of about \$40 million (£28 million). The UK

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<sup>212</sup> US Department of State, BAE Systems plc Enters Civil Settlement of Alleged Violations of the AECA and ITAR and Agrees to Civil Penalty of \$79 Million, 17 May 2011; <https://2009-2017.state.gov/r/pa/prs/ps/2011/05/163530.htm>

<sup>213</sup> Page 49 of the 2011 annual report, available at <http://bae-systems-investor-relations-v2.production.investis.com/~media/Files/B/BAE-Systems-Investor-Relations-V2/PDFs/results-and-reports/reports/2012a/ar-2011.pdf>.

<sup>214</sup> Serious Fraud Office press release, BAE Systems will pay towards educating children in Tanzania after signing an agreement brokered by the Serious Fraud Office, 15 March 2012; <http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2012/bae-systems-will-pay-towards-educating-children-in-tanzania-after-signing-an-agreement-brokered-by-the-serious-fraud-office.aspx>.

<sup>215</sup> This was a statutory requirement under Section 221 of the Companies Act 1985.

<sup>216</sup> Serious Fraud Office press release, BAE fined in Tanzania defence contract case, 21 December 2010; <http://www.sfo.gov.uk/press-room/press-release-archive/press-releases-2010/bae-fined-in-tanzania-defence-contract-case.aspx>.



government helped to secure the finance from Barclays Bank<sup>217</sup>. The World Bank and the International Monetary Fund opposed the deal by arguing that an effective radar system should only cost about \$10 million<sup>218</sup> (£7 million). The UK court order<sup>219</sup> for the fine provides some details of the discrepancies. Some \$12.4 million (30% of the contract value) ended up in two offshore companies operated by an agent. The payments were recorded in accounting records by BAE as payments for the provision of technical services by the agent. The court documentation noted that

“there was a high probability that part of the \$12.4 million would be used in the negotiation process to favour British Aerospace Defence Systems Ltd. The payments were not subjected to proper or adequate scrutiny or review” (para 4.5).

The failure to record the information accurately was the result of a deliberate decision by officials. The judge expressed his surprise that the UK’s law enforcement officers had given BAE officials blanket immunities from any future prosecutions. In paragraph 5 of the court judgement, Mr Justice Bean said:

“It is relatively common for a prosecuting authority to agree not to prosecute a defendant in respect of specified crimes which are admitted and listed in the agreement: this is done, for example, where the defendant is an informer who will give important evidence against co-defendants. But I am surprised to find a prosecutor granting a blanket indemnity for all offences committed in the past, whether disclosed or otherwise. The US Department of Justice did not do so in this case: it agreed not to prosecute further for past offences which had been disclosed to it<sup>220</sup>”.

Despite the admission that the company had failed to keep adequate accounting records, its annual financial statements continued to receive unqualified audit opinions. How did directors manage to prepare financial statements and auditors manage to audit them? In October 2010, the UK’s accounting regulator, The FRC, announced that it would investigate audits and professional services advice provided by KPMG to BAE in the period 1997 to 2007, but in 2013, the investigation was abruptly abandoned. The FRC’s explanation was that:

“proper assessment of KPMG’s conduct would require consideration of work undertaken in earlier years. Because there is no realistic prospect that a Tribunal will make an adverse finding in respect of a complaint relating to work done so long ago it has been concluded that it is not in the public interest to extend the investigation to the years preceding 1997<sup>221</sup>”.

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<sup>217</sup> Hansard, House of Commons Debates, 25 June 2002, cols. 228-236.

<sup>218</sup> BBC News, World Bank hits out at Tanzania deal, 22 December 2001; [http://news.bbc.co.uk/1/hi/uk\\_politics/1723296.stm](http://news.bbc.co.uk/1/hi/uk_politics/1723296.stm).

<sup>219</sup> R and BAE Systems PLC [2010] EW Misc 16 (CC) (21 December 2010) available at <http://www.bailii.org/ew/cases/Misc/2010/16.pdf>.

<sup>220</sup> <https://www.bailii.org/ew/cases/Misc/2010/16.pdf>

<sup>221</sup> Financial Reporting Council press release, Closure of investigation into the conduct of: KPMG Audit plc, Member Firm of the ICAEW, 1 August 2013; <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/August/Closure-of-investigation-into-the-conduct-of-KPMG.aspx>.

## **BANK OF CREDIT AND COMMERCE INTERNATIONAL (BCCI)<sup>222</sup>**

BCCI began life in Pakistan but eventually expanded with offices in London, Luxembourg, Lebanon, Dubai, Sharjah and Abu Dhabi. By the mid-1980s, it had assets of US\$22 billion and operated from 73 countries. It was regulated by the Bank of England. On 5 July 1991, following evidence of fraud, kickbacks, money laundering and racketeering, the Bank of England closed BCCI's operations. At the time of its closure BCCI had some 1.4 million depositors across the world. BCCI was the site of the biggest banking fraud of the twentieth century. New York District Attorney Robert Morgenthau<sup>223</sup>, who mounted a number of criminal prosecutions, said that:

“BCCI operated corruptly for 19 years prior to its closure. It systematically falsified its records, laundered the money of drug traffickers and other criminals. It paid kickbacks and bribes to public officials. BCCI had links with senior government officials in many countries. It handled money transfers for dictators, such as Saddam Hussein, Manuel Noriega, Hussain Mohammad Ershad and Samuel Doe. It provided accounts for the Medellin Cartel and Abu Nidal”.

The closure of BCCI prompted critical reports by US Senate Committees together with the release of some hitherto secret files held by the Central Intelligence Agency (CIA). A US senate inquiry<sup>224</sup> reported that “In 1988 and 1989, the Bank of England learned of BCCI's involvement in the financing of terrorism and in drug money laundering, and undertook additional, but limited supervision of BCCI in response to receiving this information ...”. It further further stated that

“By agreement, Price Waterhouse, Abu Dhabi, BCCI, and the Bank of England had in effect agreed upon a plan in which they would each keep the true state of affairs at BCCI secret in return for cooperation with one another in trying to restructure the bank to avoid a catastrophic multi-billion dollar collapse. Thus to some extent, from April 1990 forward, BCCI's British auditors, Abu Dhabi owners, and British regulators, had now become BCCI's partners, not in crime, but in cover-up. The goal was not to ignore BCCI's wrongdoing, but to prevent disclosure of the wrongdoing from closing the bank. Rather than permitting ordinary depositors to find out for themselves the true state of BCCI's finances, the Bank of England, Price Waterhouse, Abu Dhabi and BCCI had together colluded to deprive the public of the information necessary for them to reach any reasonable judgment on the matter, because the alternative would have been BCCI's collapse”.

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<sup>222</sup> Further details of this episode are provided in Prem Sikka, Using freedom of information laws to frustrate accountability: Two case studies of UK banking frauds, *Accounting Forum*, Vol. 41, No. 4, 2017, pp. 300-317

<sup>223</sup> As per US Senate Foreign Relations Subcommittee on Narcotics, Terrorism and International Operations, *The BCCI Affair: Hearings Part 1 – August 1, 2 and 8 1991*, Washington DC: US Senate Committee on Foreign Affairs

<sup>224</sup> United States Senate Committee on Foreign Relations, *The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown*, December 1992. Washington: USGPO.

The BCCI closure was followed by some prosecutions<sup>225</sup>, but unlike other banking frauds of the late twentieth-century the UK government did not appoint inspectors to investigate the frauds and indeed to this day there has not been an independent investigation.

As a way of managing the crisis, on 19 July 1991, the UK government appointed Lord Justice Bingham to conduct an inquiry<sup>226</sup> "into the supervision of BCCI under the Banking Acts; to consider whether the action taken by all the UK authorities was appropriate and timely; and to make recommendations" (page iii). The Prime Minister told parliament that "The conclusion of the inquiry will be made public<sup>227</sup>".

On 22 October 1992, the Chancellor of the Exchequer told parliament that the government has decided to publish the report "... unamended and in full but without the supporting appendices<sup>228</sup>". The appendices are thought to have contained extracts from the Sandstorm Report, a secret report commissioned by the BoE from Price Waterhouse<sup>229</sup>, BCCI auditors, which explained some of the frauds and the parties involved in them. The Bingham report briefly alluded to the Sandstorm Report (pages 138 to 140) and considered its contents as "fairly damning" and "devastating" (para 2.447 and 2.448), but the appendices remained unpublished.

Initially, the US Senate Committee on Foreign Affairs secured a censored version of the Sandstorm Report from the Bank of England via the US Federal Reserve. In accordance, with the US laws, this document was placed in the Congress Library though it remained a state secret in the UK. Subsequently, the US Senate Committee secured an uncensored copy and wrote that it "revealed criminality on an even wider scale than that set forth in the censored version<sup>230</sup>". The US Senate report stated that the Sandstorm Report provided

"An insider's account of BCCI's fraud created by BCCI's own auditors, Price Waterhouse, and provided to the Bank of England dated June 22, 1991, the "Sandstorm Report," was the final evidence that lead to the shutdown of BCCI globally on July 5, 1991. That draft report, based on a review of banking records from several countries and interviews carried out through the spring of 1991, found evidence of "widespread fraud and manipulation," at BCCI,

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<sup>225</sup>The Guardian, Files closed on BCCI banking scandal, 17 May 2012; <http://www.guardian.co.uk/business/2012/may/17/files-close-bcci-banking-scandal>.

<sup>226</sup> Bingham, The Right Honourable Lord Justice. Inquiry into the Supervision of The Bank of Credit and Commerce International, London: HMSO: 1992.

<sup>227</sup> Hansard, House of Commons Debates, 22 July 1991, col. 755, 761.

<sup>228</sup> Hansard, House of Commons Debates, 22 October 1992, cols 574-89

<sup>229</sup> In March 1991, the Bank of England asked BCCI auditors Price Waterhouse to prepare the report under Section 41 of the Banking Act 1987. An interim report was submitted on 22 June 1991. It was not finalised.

<sup>230</sup>Page 53, United States Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, December 1992. Washington: USGPO.

reflecting "the general scale and complexity of the deceptions which have undoubtedly taken place over many years"<sup>231</sup>.

In accordance with the US freedom of information laws, the censored copy of the Sandstorm Report was deposited in the US Congress Library and also made available to 1,250 regional libraries. In view of the public availability of some parts of the Sandstorm Report, the Prime Minister<sup>232</sup> and the Chancellor<sup>233</sup> were urged to publish the full version, or at least equivalent to that found in the US Congress Library. They declined. The standard response was that the contents are covered by the confidentiality provisions of Part V of the Banking Act 1987.

A number of UK parliamentary committees examined the BCCI closure but none were given sight of the Sandstorm Report. In 2006, after the enactment of the UK Freedom of Information legislation, a copy of the Sandstorm Report was requested by Prem Sikka. After a two year wait, the government refused to release it by claiming that

"...the release, by the UK government, of this information would be likely to provoke a negative reaction that would damage the UK's international relations and may harm its ability to protect and promote UK interests abroad"

In 2008, an appeal was made to the Information Commissioner who sided with HM Treasury. Subsequently, the matter was taken to courts. In July 2011, after a five and half year legal battle, three judges unanimously ordered the government to release most of the Sandstorm Report<sup>234</sup>. The judges said that

"In our view there is considerable public interest in the public seeing the whole of the Sandstorm Report so that it can be seen, not just what happened, but what role was played by the governments, institutions and individuals who were involved with an organisation guilty of what the authors of the Sandstorm Report (paragraph 10.1) described as *"an enormous and complex web of fictitious transactions in what is probably one of the most complex deceptions in banking history"*(paragraph 29).

The judges also rebuked HM Treasury and the Information Commissioner for their interpretation of the data protection and privacy laws to shield individuals who were "the architects of a group-wide programme of fraud and concealment, not to mention the creation of a culture that led others with positions of responsibility within the bank to follow their lead" (paragraph 42 of the judgment).

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<sup>231</sup> Page 52, United States Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, December 1992. Washington: USGPO

<sup>232</sup> For example, letters from Austin Mitchell MP on 26 October 1998, 22 April 1999, 22 June 1999, 14 October 1999; replies on 10 December 1998, 16 June 1999, 2 August 1999, 9 December 1999.

<sup>233</sup> For example, letters from Austin Mitchell MP on 17 June, 23 June 1998, 20 January 2000; replies dated 22 July 1998, 9 December 1999.

<sup>234</sup> the case of Professor Prem Sikka v Information Commissioner, EA/2010/0054, 11 July 2011

By comparing the version held in the US Congress Library (and also on the internet) with the version released by the UK Treasury, the information suppressed by the UK government could now be read<sup>235</sup>. It mainly related to the names of individuals and organisations. The individuals included Sheikh Sultan bin Zayed, ruler of Abu Dhabi; various members of the royal family of Abu Dhabi; Prince Turki, a member of the Saudi royal family; Sheikh Kamal Adham, thought to be the one-time head of Saudi intelligence services; Sheikh Sharqi, the Emir of Emir of Fujaira; Pharon, a Saudi businessman and financier and Clark Clifford, a former US Defence Secretary and Presidential adviser. The UK government even shielded the identity of some individuals who had died in the intervening years. These included BCCI founder Agha Hassan Abedi (died in 1995<sup>236</sup>) and Saudi billionaire Sheikh Khalid bin Mahfouz (died 2009) who in 1993 paid \$225 million to settle US charges of bank fraud<sup>237</sup> in 1993. The names of a number of corporations, including Bear Stearns, Abu Dhabi Investment Authority, Capcom, Credit Suisse, Dubai Islamic Bank, Gokal Brothers, Habib Bank and National Bank of Georgia were also concealed.

Even today, in 2018, the Sandstorm Report cannot be found on the UK Treasury's website. Under the FOI legislation, the public authorities are only obliged to release the information to the party requesting it. Therefore, the UK Treasury's obligation was discharged by releasing the information to Sikka, rather than to the public at large. The government has refused to file it in the House of Commons Library.

## **SUMMARY AND DISCUSSION**

A commonsensical understanding is that the regulatory apparatus exists to protect the interests of the people. This assumption is challenged by the evidence provided in this chapter. We have provided examples from different decades show that the political interventions to sabotage and stymie investigations are institutionalised. Without making any announcement to parliament, politicians have intervened to suppress information. In the case of HSBC, the Chancellor intervened to plead for the bank but parliament was not informed. BCCI was the biggest banking fraud of the twentieth-century, but ministers suppressed investigation and publication of reports to protect defence contracts. The same story is repeated in the suppression of BAE investigations. The secret interventions have effectively disenfranchised a vast number of people and impeded the shaping of institutional structures appropriate for combating corrupt practices. The secret and underhanded interventions damage public faith in the institutions of democracy and their capacity to serve and protect the public interest.

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<sup>235</sup> The comparison is available at <http://visar.csustan.edu/aaba/BCCISandstormRelease.html>.

<sup>236</sup> New York Times, 6 August 1995 (<http://www.nytimes.com/1995/08/06/obituaries/gha-hasan-abedi-74-dies-in-the-shadow-of-a-vast-fraud.html> )

<sup>237</sup> New York Times, 26 August 2009 (<http://www.nytimes.com/2009/08/27/world/middleeast/27mahfouz.html>).

## CHAPTER 6 OBJECTIVES, PRINCIPLES OF REGULATION AND REFORM

Regulation can be understood as the “sustained and focused control exercised by a public agency over activities that are valued by the community<sup>238</sup>”. In this context, regulation is best seen as directive and responsive to social developments and an ongoing engagement addressing matters of societal concern. The point here is that regulatory intervention uses a range of methods in addition to formal law but must remain aligned to the law, both in establishment and deployment. Equally, although regulation involves a wide variety of bodies and institutions, it must be responsive and accountable to citizens and the general public, and focus on community or social welfare. However, that is not always the case with existing architecture which has numerous uncoordinated and overlapping regulators, resulting in duplication, waste, inefficiencies and obfuscation and little public control or accountability.

Previous chapters provided examples of regulatory failures and the resulting misalignment with social welfare, especially in the area of companies and finance. For example, the NCA seeks to combat economic crime, but successive governments have been more committed to easy formation of corporate vehicles and Companies House is not empowered to carry out checks to establish the authenticity of information provided about ownership and control of companies. As a result, little is known about the ownership of many corporate vehicles and their ultimate owners and economic beneficiaries. Inevitably, law enforcement agencies struggle to combat economic crime. The FCA complains that many banks have weak internal controls and therefore illicit transactions occur. The task of evaluating internal controls falls upon external auditors, but in a fragmented system the FRC exonerates auditors as it evaluates their performance with a different benchmark. For a regulatory system to deliver benefits to community, it needs to act speedily, but regulators take too long to investigate and issue reports. Too many regulatory bodies, most notably the accountancy bodies, are too close to those who are to be regulated. There is little direct public representation on the boards of regulatory bodies to check their ‘capture’. Too many regulators are exempt from the freedom of information laws and their main mode of public accountability is carefully selected press releases and glossy reports. There is an urgent need to redesign the regulatory architecture and align it with societal interests.

The path through the regulatory maze and a redesign of the regulatory architecture needs to be guided by durable objectives and principles of regulation that act to enhance social welfare and reduce scope for malpractices. A number of previous studies<sup>239</sup> have advanced objectives and principles of good regulation. This report is

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<sup>238</sup> Philip Selznick "Focusing Organizational Research on Regulation." in *Regulatory Policy and the Social Sciences*, edited by Roger Noll. Berkeley: University of California Press., 1985.

<sup>239</sup> For example, Sir David Clementi, *Review of the Regulatory Framework for Legal Services In England and Wales*, London: Department for Constitutional Affairs, 2004, [http://webarchive.nationalarchives.gov.uk/+/http://www.legal-services-review.org.uk/content/consult/consult\\_reviewpaper.pdf](http://webarchive.nationalarchives.gov.uk/+/http://www.legal-services-review.org.uk/content/consult/consult_reviewpaper.pdf)

Philip Hampton, *Reducing administrative burdens: effective inspection and enforcement*. London: HM Treasury, March 2005, ([http://news.bbc.co.uk/nol/shared/bsp/hi/pdfs/bud05hampton\\_150305\\_640.pdf](http://news.bbc.co.uk/nol/shared/bsp/hi/pdfs/bud05hampton_150305_640.pdf)); Richard

informed by them, though it does not slavishly follow them as the depth and severity of regulatory failure calls for fresh thinking.

## THE ROLE OF REGULATION

This report ascribes two broad roles for regulation.

1. Protecting consumers, taxpayers and the public in general from harmful practices.
2. Promoting stability, predictability and confidence in the system by addressing systemic factors which transcend the concerns of individual consumers and producers.

These functions can come into conflict with another role that has increasingly been ascribed to contemporary regulation: promoting and protecting particular activities or industries. This should not be the primary role of regulatory bodies.

The conflicts are particularly acute where trade associations are permitted to act as regulators. For example, accountancy bodies perform regulatory functions in relation to accounting, auditing, insolvency, taxation and enforcement of money laundering laws. Yet they simultaneously act as promoters and defenders of their members' interests. Accountancy bodies have opposed obligations for auditors to detect and report fraud<sup>240</sup> and also rules which might restrict auditors to sell consultancy services to their audit clients. Their actions conflict with their statutory duty to ensure that auditor independence and objectivity is not impaired. As a consequence, auditors are permitted to sell tax avoidance schemes to companies, and then claim to report independently and objectively on the same transaction. The failures of the bodies responsible for auditing and insolvency affect the distribution of income, wealth, wages, dividends and risks. In democratic societies, the elected representatives of the people also have a mandate to redistribute income, wealth and risks. While they can be held accountable by being voted out of office, there is no equivalent recourse against private interest bodies making and enforcing regulations. Trade associations should not be statutory regulators.

Then there is the issue of enforcement and penalties imposed on those found to be in breach of regulatory requirements. This presupposes the existence of appropriate benchmarks, the quality of which depends on the independence of the regulators from the regulated. In the field of accounting, the regulatory and trade bodies, such as the Financial Reporting Council (FRC) and CCAB are too close to corporations and big accounting firms. One consequence of this is that despite considerable public anxieties the FRC has failed to develop accounting standards requiring

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Macrory, Regulatory Justice: Sanctioning in a post-Hampton World, London: Cabinet Office, 2006

(<https://restorativejustice.org.uk/sites/default/files/resources/files/Regulatory%20Justice%20Sanctioning%20in%20a%20post-Hampton%20World%201.pdf>).

<sup>240</sup> Prem Sikka, Anthony Puxty, Hugh Willmott and Christine Cooper, The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence, *Critical Perspectives on Accounting*, 9(3) 1998: 299-330.

companies to disclose their tax avoidance strategies or even the amount of corporation tax that they actually pay in each country of their operation. Despite a plethora of auditing standards, there is no standard on public accountability of auditors. The silence is primarily perpetuated by conflicts emanating from the desire to promote/protect industry and at the same time claiming that regulators can somehow serve the broader public interest or secure required transparency to empower societal stakeholders.

## **OBJECTIVES OF REGULATION**

Any regulatory system and its constituent elements must seek to achieve a number of objectives and be guided by a number of principles. Making these objectives and principles explicit enables appropriate regulatory action to be taken and provides benchmarks against which regulators are to be held to account. These are:

1. To apply the law and the rules made thereunder equally to all parties subject to the regulatory process.
2. To promote and protect the interests of citizens.
3. To ensure that regulated entities are honest, fair and accountable for their practices.
4. To ensure that citizens have confidence in the trustworthiness of the object of regulation
5. To investigate complaints and matters of public concern swiftly, efficiently and effectively.
6. To enable citizens to secure justice and redress.
7. To promote public understanding of the citizen's legal rights and the regulators' capacity to act. Therefore, the system should be concerned with advice, redress and the provision of information.

## **PRINCIPLES OF REGULATION**

1. Regulators' duties are to protect the interests of the people, and not promote the interests of the industry.
2. Regulators must be independent of government departments so that ministers cannot stymie investigations or prevent publications of critical reports.
3. Regulators must be independent of those who are to be regulated. The same organisation should not be both responsible for lobbying and representing the sectoral interests of an industry and provide supervision and enforcement actions over that sector.
4. People should be able to exercise strategic oversight on regulators.



5. Regulators must be publicly accountable for the efficiency and effectiveness of their action and activities, while remaining independent in the decisions they take.
6. Regulators must operate with transparency especially as regards decisions involving enforcement and settlement of complaints and charges.
7. Regulators must investigate shortcomings on a timely, efficient and effective basis.
8. Regulators must be proactive, anticipate emerging issues and ensure that the system is capable of dealing with them.
9. The proliferation of regulatory bodies results in duplication, time-wasting, obfuscation and buck-passing, leading to omissions, overlaps, duplications, neglect and poor accountability.
10. It is difficult and more expensive to have a comprehensive risk assessment system if data is split across several regulators with similar areas of responsibility.
11. The appeasement of sectional interests has resulted in too many small regulators. Small regulators are less able to join-up their work, and are less aware of the cumulative burdens that this imposes on businesses. Small regulators are more expensive and cannot achieve economies of scale.
12. Regulators, and the regulatory system as a whole, should use comprehensive risk assessment to concentrate resources on the areas that need them most.
13. All regulations should be written so that they are easily understood, easily implemented, and easily enforced, and societal stakeholders should be consulted when they are being drafted.
14. No regulatory action should take place without a reason.
15. The architecture of the regulatory system should ensure that citizens and businesses should not have to give unnecessary information, nor give the same piece of information twice.
16. The businesses that persistently break regulations should be identified quickly and face proportionate and robust sanctions.
17. Regulators should provide authoritative, accessible advice easily and cheaply.
18. When new policies are being developed, explicit consideration should be given to how they can be enforced using existing systems and data to minimise the administrative load.
19. Regulators should be of the right size and scope, and no new regulator should be created where an existing one can achieve the policy objectives.

20. Regulators should recognise that a key element of their activity will be to allow, or even encourage, economic progress. They should consider the consequences of the change and business innovation for protection of the citizens' rights.
21. Businesses, trade bodies and individuals should contribute to the full cost of the regulatory structures through an overall system of levies based on the size, turnover and ability to pay of those regulated; the levies should be fixed by the Business Commission and subordinate commissions in consultation with their relevant supervisory boards.
22. Financial sanctions, fines and other penalties imposed by regulatory commissions should be used in priority to compensate victims of abuses or where appropriate to contribute to the overall costs of regulation; sanctions by way of criminal prosecution should where possible be focused on the imprisonment or other punishment of responsible individuals and the recovery of ill-gotten personal gains.

Guided by the above objectives and principles, the next Labour government should:

1. Redesign the UK regulatory architecture to make it more efficient, effective and accountable. The architecture should prioritise enforceable rights for citizens, and transparency and accountability of all regulatory bodies.

Ever since the 1980s and 1990s scandals relating to the collapse of Alexander Howden, Atlantic Computers, Barlow Clowse, Blue Arrow, Bestwood, British and Commonwealth, Coloroll, De Lorean Dunsdale, Edencorp, Homes Assured, Johnson Matthey, Levitt, Lloyd's, London United Investment, Maxwell, Queens Moat Houses, Sock Shop, Polly Peck. The Bank of Credit and Commerce International (BCCI) and others, have highlighted weaknesses in the scope and enforcement of company law. Rather than addressing these failures, successive governments have succumbed to pressures from economic elites and failed to develop appropriate laws and enforcement mechanisms. Corporate elites have been permitted to displace an enforceable legal framework with voluntary codes of corporate governance<sup>241</sup>. These codes do not give societal stakeholders any enforceable rights and they have also failed to protect citizens from predatory practices. Corporate codes have a role to play but they should not be a substitute for legally enforceable rights and penalties.

One consequence of the voluntary codes is that the UK does not have a dedicated enforcer of company law though some aspects come under the jurisdiction of the Competition and Markets Authority (CMA), the Financial Conduct authority (FCA) the Financial Reporting Council (FRC), the Insolvency

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<sup>241</sup> For example, see Committee on the Financial aspects of Corporate Governance, The Financial Aspects of Corporate Governance (Cadbury Report) London@ Gee, 1992; Committee on Corporate Governance (1998), Committee on Corporate Governance: (Hampel Report, Final Report, London: Gee, 1998.

Service, Companies House, the Panel on Takeovers and Mergers<sup>242</sup>, and the London Stock Exchange amongst others. The fragmentation has resulted in gaps, poor co-ordination, oversight and accountability.

Many of the regulatory problems are caused by poor regulatory architecture, with regulators promoting and defending industry, lacking independence and public accountability. This then leads to the next policy recommendation.

2. Replace most of the current regulators where feasible with a single well resourced body. A Business Commission needs to be established with a number of specialised Commissions, and in-house investigation and enforcement units to build internal expertise and institutional memory as an alternative to reliance upon accountants and lawyers drawn from the very firms that have been implicated in scandals. The removal of duplication and improved communication achieved by an integrated body is the means of upgrading the regulatory system. Further details are provided in the next chapter.

## **SUMMARY AND DISCUSSION**

This chapter has set out the principles, purposes and objectives that would guide a regulatory system. The key idea is to develop independent, robust, effective, joined-up and publicly accountable system that is accountable to parliament and protects citizens from malpractices. The next chapter puts the principles into practice by outlining the contours of a redesigned regulatory system.

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<sup>242</sup> This is a statutory body (see sections 942 to 965 of the Companies Act 2006). Its funding is derived from three main sources - Document charges (scale charges are payable on offer documents), Panel on Takeover and Mergers Levy or PTM (100p on contracts over £10,000 on most trades in securities of companies incorporated in the UK, the Channel Islands and the Isle of Man) and Exempt/recognised intermediary status charges (entities benefitting from recognised intermediary status are required to pay a charge of £6,000 for each group entity, payable at the time of the annual review).

## CHAPTER 7 CONTOURS OF A NEW REGULATORY STRUCTURE

### INTRODUCTION

The preceding chapters drew attention to a regulatory maze consisting of 41 financial sector regulators and another 14 deal with some aspects of corporate governance, accounting and insolvency. The sprawling structure consists of overlapping, uncoordinated and unaccountable regulators. This invites obfuscation, neglect and buck-passing and has evidently failed to protect citizens from malpractices. A large part of the regulatory authority is exercised by trade associations who are rarely held to be publicly accountable for failures of accounting, auditing, money laundering and insolvency practices. The futility of making any complaints to such bodies was noted in previous chapters. Private regulators cannot be voted out of office and as previously noted, are even beyond the freedom of information legislation. Regulation is enacted for the benefit of the public, yet the public has very limited opportunity to guide or scrutinise the work of regulators.

Yet the lessons of failures have not been learnt and the tendency to rearrange the regulatory deckchairs remains a dominant strategy, as evidenced by Sir John Kingman's review of the operations of the FRC<sup>243</sup>. The Kingman review acknowledges the numerous failures of the FRC and its lack of independence from the auditing industry and big corporations. It recommended that the FRC needs to be replaced by a new statutory regulator. However, the RSBs have no independence from audit firms, but in the Kingman schema they would continue to act as statutory regulators, leaving the auditing industry with at least five (FRC successor body plus four RSBs) regulators. This does not check duplication, waste, obfuscation and poor public accountability. Kingman sees a role for stakeholders in the operations of the new body but fails to put forward any proposals for institutionalising stakeholder interests as a bulwark against capture. Corporate failures, such as Carillion, have raised regulatory questions about information for markets, the role of accounting, auditing, insolvency, director duties, corporate governance, pensions and other matters. The problems are interconnected but the issues are handled on a piecemeal basis by diverse and compartmentalised regulators. As previous chapters have shown, they work to different benchmarks with little/no co-ordination. So the regulatory maze remains unchecked. The strategy of replacing one failed regulator with another continues to neglect the broader context and purpose of regulation.

The challenge is to redesign the regulatory architecture which addresses the fault lines of the current system. Instead of the current compartmentalised approach, a joined-up approach is necessary because business themselves operate in diverse markets and the regulatory system needs revised structures to tame corporate power and rebalance the relationship between corporations and society. Concerns about corporate power span both their immediate market domains and also across issues about consumer protection, tax avoidance, economic crime, politics,

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<sup>243</sup> John Kingman, Independent Review of the Financial Reporting Council, London: Her Majesty's Stationery Office, December 2018;  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/767387/frc-independent-review-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf)

employment, executive pay, civil rights, environmental degradation and broad social welfare. Such matters cannot be dealt with by compartmentalised or private sector regulators. Many of the banking, insolvency, accounting and auditing problems are framed by the irresponsible autonomy enjoyed by the sectors and the regulators failing to bring societal concerns upon the industries. The misalignment of corporate practices with social welfare has already resulted in the 2007-08 banking crash, the biggest economic crisis for nearly a century. If anything, despite a plethora of regulators, the misalignment seems to have intensified and threatens to overwhelm society. Some of the political institutions on which a sustainable market economy rests are also compromised. Ministers and current regulators stymie investigations, intervene to protect wrongdoers and prevent publication of crucial reports. Corporate malpractices and illegitimate power can only be dealt with by changes to the regulatory architecture and direction of regulation. This chapter puts forward a societal stakeholder model of regulation that is independent of government departments and regulated entities and puts citizens in a position to oversee regulatory effectiveness.

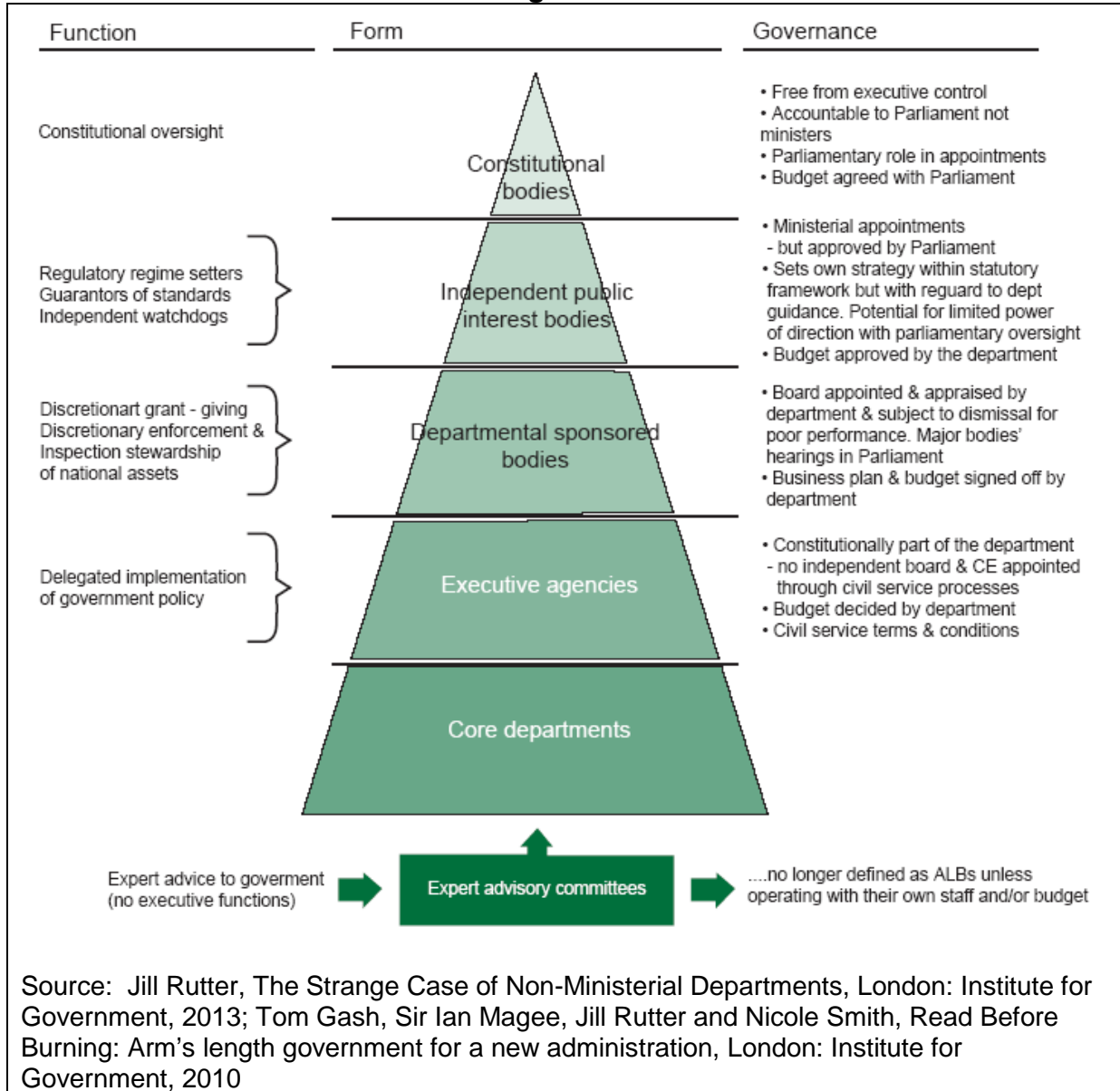
## **INDEPENDENT REGULATION**

A fundamental principle is that regulators must be independent of government departments. This is necessary for regulators to discharge their duties. Ministers should not be able to stymie investigations or suppress critical reports in pursuit of narrow short-term political party or economic advantages<sup>244</sup>. Figure 7.1 encapsulates the proposed regulatory model.

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<sup>244</sup> Such a view has considerable support. For example see Tom Gash, Sir Ian Magee, Jill Rutter and Nicole Smith *Read Before Burning: Arm's length government for a new administration*, London: Institute for Government, 2010, <https://www.instituteforgovernment.org.uk/sites/default/files/publications/Read%20before%20burning.pdf>; Jill Rutter, *The Strange Case of Non-Ministerial Departments*, London: Institute for Government, 2013.

**Figure 7.1**



The regulatory bodies must have a statutory basis so that the possibilities and limits of their authority are known. Membership of these bodies can be nominated by ministers but formal appointment must be made by Parliament. Regulators must be answerable to Parliament for all aspects of their operations after inviting the general public to comment on the desirability of particular appointments. Regulatory bodies should submit their budgets to parliament for approval which will involve some negotiations with HM Treasury, but they need to be operationally independent of government departments.

The 2004 Clementi Review<sup>245</sup> recommended that the same organisation should not be both responsible for professional lobbying on behalf of their sector membership and provide supervision and enforcement actions over their sector. This principle has

<sup>245</sup>[http://www.avocatsparis.org/Presence\\_Internationale/Droit\\_homme/PDF/Rapport\\_Clementi.pdf](http://www.avocatsparis.org/Presence_Internationale/Droit_homme/PDF/Rapport_Clementi.pdf)

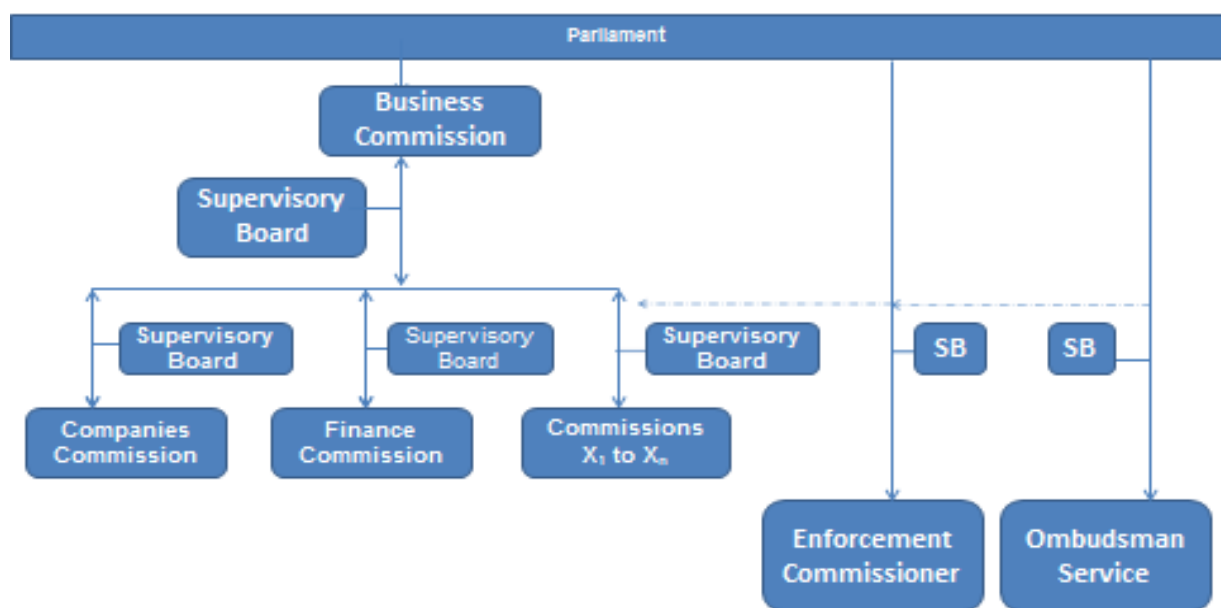
yet to be applied to financial, accounting and insolvency industries. Typically, corporate grandees go through revolving doors for a stint at a regulatory body and then return to the industry. There is an urgent need to develop mechanisms that no longer gives big business inbuilt advantages and prevents regulators going easy or delaying action. To this end, the public must exercise oversight on all regulatory bodies. Some details are sketched out in the next section.

## REGULATORY ARCHITECTURE

### Business Commission

In the interest of a joined and co-ordinated regulatory system, this report recommends the creation of a Business Commission. The Commission is to be responsible for checking compliance and enforcement of all aspects of business laws. It would replace the accounting, auditing, insolvency and financial sector regulators described in the earlier parts of this review. The Business Commission would be accountable to Parliament and it would be independent of all government departments for its daily operations. It would be headed by a Business Commissioner and its Board shall contain a representative, ideally the head of the Board of each of its sub-Commissions.

**Figure 7.2**  
**Proposed Regulatory Architecture**



### Companies Commission and Finance Commission

The regulatory architecture would consist of a pyramid structure of regulators, all subordinate to the Business Commission. A Companies Commission would oversee all aspects of company law. A Finance Commission would oversee all aspects of laws relation to the finance sector. It would contain additional Commissions, ranging from  $X_1$  to  $X_n$ .

Each Commission would be headed by a Chief Commissioner and a board of Commissioners. If the board of each Commissioner deem it fit, they can create appropriate internal subdivisions within their domain. For example, the Companies Commission may contain subdivisions to handle auditing, insolvency and other jurisdictions. The membership of all Commissions must include a plurality of interests and be dominated by none. All members of the Commissions must sever connections with employers and serve for a maximum of five years.

### **Supervisory Boards**

To ensure that neither the Business Commission, nor any of the sub-Commissions become captured by corporations or elites, each Commission shall have a Supervisory Board consisting of representatives of a plurality of stakeholders. In the interest of continuity and co-ordination, one representative from the Supervisory Board of each of the sub-Commissions shall also sit on the Supervisory Board attached to the Business Commission. The Commissioners shall be responsible for the day-to-day operations of the regulatory apparatus. They may make rules and interpretations, within the statutory powers delegated to them. However, they will not be responsible for investigation and enforcing them.

The Supervisory Boards shall be responsible for strategic oversight, resources, direction, accountability and effectiveness of the respective Commissions. In co-operation with the heads of the sub-Commissions, they shall appoint other members of the Boards responsible for operating the Companies Commission, the Finance Commission and any other Commission. The general public must be invited to apply for membership of the Supervisory Board. The nominations can be made by ministers but appointment must be made by Parliament. The Supervisory Board membership must be for a fixed period as that would maintain its robustness and independence. The Supervisory Board attached to the Business Commission must develop policies for protecting and rewarding whistleblowers. These must be operationalised by all sub Commissions.

### **Enforcement Commission**

The Enforcement Commission, an independent unit within the Commission, will be responsible for enforcement. Its sole task will be to investigate cases and report to the Business Commission and liaise on the possible course of action within the parameters defined by law. It should have in-house investigation and enforcement capacity so that the institution develops an institutional memory and capacity. The Business Commission should have the authority to fine and prosecute and agree financial settlements with the third parties, within a statutory framework. Where legislation is weak it should be strengthened to give the Enforcement Commission teeth and additional powers. Consideration should be given to bringing the Serious Fraud Office (SFO) and other prosecutorial agencies under one roof within the Enforcement Commission. It should also consider building regional presence so that people can report economic crime directly to it. It would be accountable to parliament.



## **Sunshine and Openness**

The Business Commission and all sub-Commissions shall have 'open' meetings and pursue a 'full sunshine' policy, with agenda papers, working papers, policy notes, correspondence, reports, background papers and minutes all freely accessible to the public. Unlike the present money laundering, accounting, auditing and insolvency regulators, the entire apparatus shall be subjected to the Freedom of Information Act. The same openness must also apply to the Supervisory Board meetings. At the commencement of each meeting, each Commissioner must state whether s/he is subject to any conflict of interests in relation to any of his/her duties. The Business Commission must maintain a register of interests of all Commissioners and Supervisory Board members. At regulator meetings (e.g. monthly, quarterly), the Supervisory Boards must hold an open meeting to scrutinise the operations of each of the Commissions. The Heads of each Commission must attend such meetings and answer any questions from the Supervisory Boards. Public hearings should be an integral part of the proceedings of the Business Commission.

All Commissions must be periodically scrutinised by Parliamentary Select Committees. Any document, no matter how confidential, must be made available to the Committees. If in doubt, legal advice can be taken and the documents may then be scrutinised in private meetings of the Committees.

## **Dispute Resolution - Ombudsman**

The revised architecture must have an independent Ombudsman to adjudicate on disputes between regulators and stakeholders. Currently, this system is uneven. The financial sector has an ombudsman but there is no equivalent for auditing and insolvency. In the case of insolvency, many stakeholders lack sufficient resources to take practitioners and/or regulators to court and are often frustrated that there is no alternative speedy dispute resolution method. Either party may approach the Ombudsman but will still retain the option of a legal review, if that is deemed to be appropriate.

## **Funding**

The Business Commission can be funded by licence fees from banks, auditors, insolvency practitioners, companies and other regulated entities. Previous chapters noted that the fines levied on accounting firms for audit failures have been handed by the FRC to RSBs. Such practices would not be permitted and the fines would be used to fund the regulatory apparatus and enforcement. This can be supplemented by increases in the cost of company incorporations, by higher charges for the filing of annual returns and accounts of large companies, and, as necessary, out of general taxation. Financial penalties should also be used to compensate victims directly affected by predatory practices.

## **SUMMARY AND DISCUSSION**

Based upon the principles developed in the previous chapter, this chapter has sketched out the contours of a revised regulatory architecture which would eliminate duplication, waste and buck-passing. Its coordinated structure would require the

Commission(s) to take a comprehensive view of the issues. The precise duties of each Commission would depend on the legislation. There would be no statutory regulatory role for trade associations.

The revised architecture would be robust as it is independent of business and government and accountable to parliament. In view of the perpetual danger of capture by the regulated, this chapter proposed a system of Supervisory Boards to enable people to exercise oversight of the regulatory process. The Supervisory Boards would be responsible for oversight whilst the executive boards or Commissioners would be responsible for the day-to-day operations. Open meetings, working and background papers and full application of freedom of information laws would add a powerful dimension to public accountability. It is often said that in a parliamentary system citizens are supreme. The redesigned architecture gives citizens the opportunity of realigning corporate practices with social welfare.

## **CHAPTER 8 CONCLUSION**

This report examined some aspects of the UK regulatory architecture. A comprehensive examination of every area of regulation and every single regulatory body has not been possible. This in itself demonstrates how pervasive the problem of regulation has become. Instead, it focused on the architecture for the financial sector and corporate governance, which are central to a successful economy and affect every citizen. In the absence of a comprehensive official list of regulatory bodies, the report compiled a list of 41 regulators for the financial sector and another 14 for some aspects of corporate governance. Even then vital areas, such as enforcement of company, lacked any enforcer.

The architecture is riddled with overlapping bodies which duplicate and waste regulatory effort and pass the buck. All regulatory bodies are susceptible to 'capture' by the very interests that are to be regulated. This often happens in the guise of claims that 'we need people with technical knowledge' and before long their worldviews become naturalised within the regulatory bodies. The capture is evident in almost all sectors examined in this report. Accountancy trade associations were formed to advance and protect the interests of their members, but act as statutory regulators and shun public accountability. We have been unable to find even one example where accountancy firms marketing tax avoidance schemes have been fined or disciplined, even after the courts declared their schemes to be unlawful. There is the same lack of urgency in dealing with audit failures and reports can take years to appear. Such bodies are unfit to perform regulatory roles.

There is little co-ordination and control amongst the regulatory bodies. The bodies do not apply consistent standards. Rather than protecting citizens too many promote the interests of big business. They do not always investigate scandals efficiently or produce timely reports. Some reports have been suppressed by regulators and when subsequently released by parliamentary committees, they show institutionalised corruption. Prosecutions for malpractices are rare. One would expect governments to intervene and cleanse the regulatory system to ensure that it serves and protects the people from predatory practices, but all too often governments have intervened to stymie investigations and suppress reports. Such practices diminish public confidence in institutions of democracy and rule of law.

This paper has called for a revised regulatory architecture which is independent of government departments and directly accountable to parliament. It recommends that the bodies be consolidated into a Business Commission consisting of a number of sub-Commissions, such as a Companies Commission and a Finance Commission to eliminate duplication and waste. The consolidation would streamline the system. The revised architecture would be overseen by Supervisory Boards and would enable societal stakeholders to exercise strategic oversight of the system. It would be accompanied by an Enforcement Division which is independent of the day-to-day operations of the Commissions. It would its own investigative and prosecutor capacity so that it can have in-house expertise, memory and specialisms rather than outsourcing investigations. An independent Ombudsman would adjudicate on disputes between regulators and stakeholders. The entire system would be accountable to parliament and have complete sunshine.

**APPENDIX 1**  
**Letter from UK Chancellor George Osborne to US Federal Reserve**

TREAS EXEC SEC 9/21/2012 2:43:48 PM 2012-SE-002282



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

10 September 2012

Ben Bernanke  
Chairman  
The Federal Reserve System  
20th and C Streets NW  
Washington DC 20551  
USA

The ongoing US investigations into HSBC and SCB for breaches of US anti-money laundering (AML) and sanctions regulations have attracted significant market attention in the UK and elsewhere. Following publication of the Order by the New York Department for Financial Services (DFS) on 6 August, Standard Chartered Bank's (SCB) share price fell by almost 30% in a single day of trading. Even though SCB's market value has now recovered much of this loss, the incident raises broader concerns, and gives us an opportunity to reflect more generally on how we might collectively ensure that regulatory and enforcement action does not lead to unintended consequences.

The SCB case raises three main issues. First, it serves as a further illustration of the importance which financial markets attach to access to the US dollar market. It was the perceived threat of SCB's loss of access to this market, rather than any potential financial penalty, that triggered such a significant reaction. To date, the majority of US enforcement action for AML/sanctions breaches has ended in settlements involving a Deferred Prosecution Agreement: the suggestion of a criminal indictment or, worse, conviction implies a problem that is more akin to the Riggs case, and therefore a more severe outcome. Markets price in this risk accordingly.

Second, the reaction was almost certainly more severe in the SCB case because markets were not prepared for the news. While SCB had disclosed that it was under investigation, nobody expected an Order of this sort to be served. Its unannounced publication and some of the language used ("rogue institution") created uncertainty over the magnitude of the offences and what regulatory action would follow, especially as it quickly became evident that the DFS action had not been co-ordinated with the other US agencies involved.

Thirdly, it highlighted the potential financial stability risks of enforcement action. In particular, if such action created a liquidity crisis for the bank concerned – as might have been the case with SCB, and as might still be the case for HSBC – this could jeopardise its stability. For a systemically important financial institution, this could lead to contagion. I do not want to overstate these risks but I think that they bear consideration.

#### Next steps

It is not my intention to interfere with criminal or regulatory action and procedures in the US. The UK and the US share an extremely strong partnership on AML and sanctions issues, whether through the Financial Action Task Force or in seeking to exert pressure on the Iranian and Syrian regimes. It for you, and your partners in other departments and agencies, to decide how best to supervise, regulate and enforce compliance within your jurisdiction. And Adair Turner, Mervyn King and I are together committed to ensuring that UK financial institutions are fully compliant with global standards and rules.

Going forward, however, I would appreciate your assistance in ensuring that enforcement action does not have unintended consequences. In particular, I would appreciate early warning of such action before it is announced. I know that you recognise the consequences of uncoordinated actions by the authorities, and I appreciate that the SCB Order was not within your control. But, in future, prior sight would help us to manage some of the potential market and stability risks, and consider what (if anything) we should collectively do to manage them.

I would also ask that the outcome of current and future investigations against UK-headquartered banks is consistent with previous settlements, and with US settlements made with banks headquartered throughout the world. I understand, for example, that HSBC is currently facing a series of settlements with US authorities that may cumulate at around \$1.9bn. I have not seen the details of this case, but it has been highlighted to me on a number of occasions that a settlement of this nature would be around three times greater than the largest US settlement to date for comparable AML/sanctions breaches. In HSBC's case, I understand that a criminal conviction would require US regulators to consider whether to revoke its banking authorisations in the US. Questions about HSBC's continued ability to clear US dollars would risk destabilising the bank globally, with very serious implications for financial and economic stability, particularly in Europe and Asia.

The scale of this enforcement action, particularly following the SCB case, is leading many to suggest that UK banks are being unfairly targeted. This narrative is unwelcome, not least given the extremely strong partnership that we continue to enjoy. I would therefore be grateful for your assistance in demonstrating that the US is even handed and consistent in its approach.

I would welcome a discussion of these issues when we see each other next.



I am copying this letter to Treasury Secretary Geithner, with whom I have also discussed this issue.

*Best wishes,*

*George*

GEORGE OSBORNE

## About the investigating team

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