

# **ENFORCEMENT IN THE EUROPEAN UNION**

## **A comparative survey: Spain and the UK**

### **1. Introduction**

#### **Enforcement in Europe**

The economic globalization process is undertaking significant changes aiming at the integration of capital markets, which to a large extent depends on the developing and strengthening of factors like property rights, corporate governance mechanisms or companies' financial reporting practices are changing. Under this scenario, an accounting harmonization process is vital. In a global economy, financial information presented by companies, should be understandable, comparable across countries and useful for the decisions taken by stakeholders, who are increasingly internationals.

The strategy of the European Union (EU) was to join the movement towards the accounting harmonization and, in accordance with the Regulation 1606/2002 (Commission, 2002) consolidated financial statements of all EU listed companies must be prepared under IFRS from 1 January 2005. By adopting such strategy, EU is attempting to secure the trust on European companies' financial information and, thereby, to develop a single European capital market based on a robust information environment, characterised by more comparable and transparent information.

IFRS will provide a unique set of accounting standards and its adoption is crucial to the development of a single European capital market. Nevertheless, the adoption of a set of high quality accounting standards is a necessary condition, but not a sufficient condition to guarantee high quality information. There are other factors that shape the quality of information and, therefore, the value relevance of those standards (Ball et al., 2003). Investors might have different expectations and different perspectives about the quality of financial information and country specific factors can also affect the quality of information.

A crucial factor to the success of the accounting harmonization process is the quality of the Enforcement. The EU is aware of this complex problem and advised its member states that only with the existence of effective and efficient enforcement mechanisms it will be possible to enhance the comparability and transparency of European accounts (FEE 1999, 2001, 2002a) The existence of the high quality enforcement mechanisms that secure investor protection rights and recovers the trust in capital markets is vital to the good functioning of the European economic system. Furthermore, strong enforcement mechanisms are also a critical corporate governance tool and are essential to avoid financial scandals like the ones Enron, Global Crossing and World Com in the USA and more recently Vivendi and Parmalat in Europe.

Previous studies also have shown some enforcement's differences cross-countries. For example, Brown et al. (Brown et al. 2005) compares enforcement in UK and Australia. The same authors also compare the enforcement in three European Countries (UK, France and Germany) and the reforms that these countries will have accomplish to secure the adoption of IFRS.

There also are a lot of studies based in La Porta et al. measures and methodology (La Porta et al., 1997, 1998, 2006). La Porta et al. (1998) show that common-law countries, like the UK, have stronger investor protection rights than code-law countries, like Spain. Similar results are obtained in relation to the quality of enforcement mechanisms and quality of accounting standards. Accounting standards and their enforcement in common-law countries are of higher quality than in Code-law countries (Wulandari 2004, La Porta et al. 1998, 2006) Other differences between code-law countries and common-law countries have been tested. For instance, results show that common-law countries are characterised by more disclosure, greater timeliness of earnings, more forecast accuracy, and a mayor transparency. (Ball et al., 2000, Hung 2001, Hope 2002, Leuz et al. 2003)

There is a stream of literature that tests the effectiveness of enforcement in the UK (Brandt et al. 1997, Fearnley et al. 2000, Hines et al. 2001, Peasnell et al. 2001, Fearnley et al. 2002) but there are no studies testing the effectiveness enforcement in Spain or comparing the effectiveness between enforcement in the UK and Spain, two European countries of different legal systems. In addition, the impact on the value relevance of the changes in the enforcement accomplished in Spain and the changes in the enforcement accomplished in the UK, hasn't been tested.

This paper is organised as follows. Section 2 provides the definition of enforcement and enforcement on Europe. Section 3 provides a description of enforcement system in the UK and in Spain. Section 4 provides a comparison of enforcement system in the UK and enforcement system in Spain. Section 5 presents conclusions.

## **2. Concept of enforcement and enforcement on Europe**

The concept of enforcement comprises every instrument and mechanism which ensures and strengthens an accounting standard's compliance, and hence which ensures the relevance, reliability, understandability and comparability of the accounting information. The Commission Exchange Securities Regulator, CESR in its first standard defines enforcement as a group of mechanisms whose "*purpose is to protect investors and promote market confidence by contributing to the transparency of financial information relevant to the investors' decision making process*". Thereby enforcement must secure the following two functions "*monitoring compliance of the financial information with the applicable reporting framework and taking appropriate measures in case of infringements discovered in the course of enforcement*" CERS (2003;4)

Enforcement has three main areas 1) Corporate Governance, 2) Regulation of the statutory auditor, 3) Institutional oversight systems to enforcement of financial reporting standards. In a first stage, our research will not directly address Corporate Governance issues.

We would like to emphasize the need for a harmonized enforcement framework in Europe and how crucial it is for the integrity and credibility of financial information at European level. With the adoption of a unique set of accounting standards, investors expect the differences in the value relevance of financial statements to be reduced. To obtain such reduction, high quality enforcement mechanisms are critical. In Europe,

many changes in the enforcement systems are happening at this moment. For instance, a high-quality audit work as a the guaranty of compliance of compliance of financial information with IFRS are required in all states members (FEE, 2003a, 2003b).

Regarding the harmonization of the different institutional oversight systems, EU believes in the existence of two types of institutional oversight models for the enforcement of financial reporting standards. These types are a regulator-based system, like a securities regulator, CNMV (Comisión Nacional del Mercado de Valores) in Spain and a Review Panel like the Financial Report Review Panel, FRRP used in the UK. (FEE 2002, 2003a).

Concerning the Regulation of the statutory auditor, the FEE (FEE, 2002b, 2003a) considers the existence of a public oversight over the audit profession in each member state essential. In spite of the fact that there is not an effective model to follow, minimum requirements for quality controls and public oversights were included in the “Proposal for a Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC” (Commission, 2004).

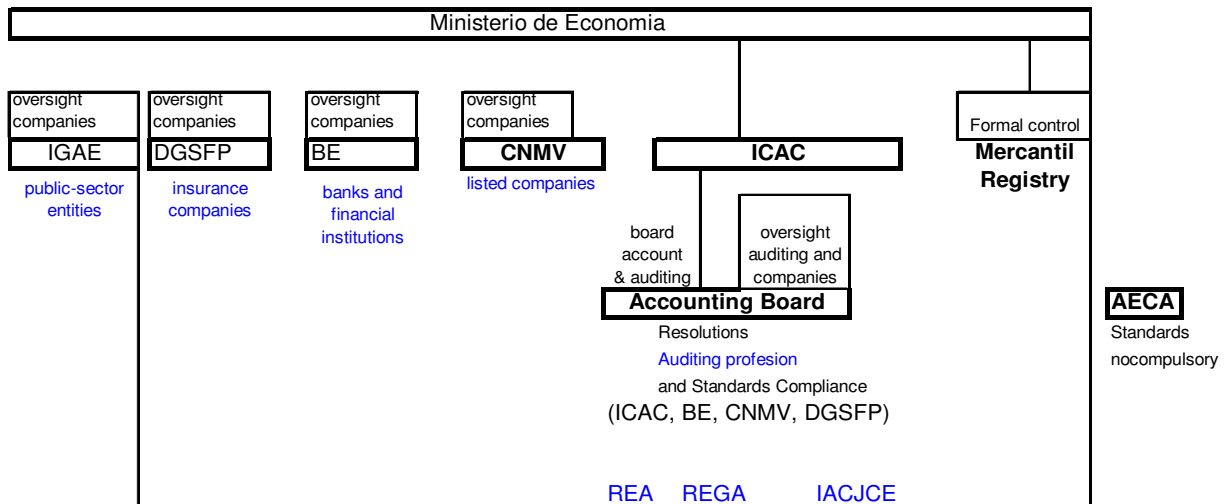
In the UK the audit profession was under self-regulation, this is changing with the implementation of the Professional Oversight Board for Accountancy, POBA in 2005. Whereas in Spain, the main audit regulatory body is the ICAC (Instituto de Contabilidad y Auditoria de Cuentas) which is a governmental institution which was set up under the Audit law, 1988.

In the future, within of the harmonization accounting process in the EU, the audit of financial statements, with its correspondent public oversight system, will continue developing as an important part of enforcement mechanism, but will be an adjunct to the implementation and develop of an institutional oversight system, which will take a place increasingly within the enforcement framework in Europe.

### **3. General Enforcement Framework in Spain and in the UK**

#### **3.1 General Enforcement Framework in Spain**

The timber framework of Spanish enforcement is composed for these following institutions, which are in charge of issue and establishment mandatory audit and accounting standards and oversight companies, auditors and audit firms.



- IGAE: Intervención General de la Administración del Estado. The State Auditing Agency.
- DGSFP: Dirección General de Seguros y Fondos de Pensiones. Directorate-General of Insurances and Mutual Funds Industry
- BE: Banco de España. Bank of Spain
- CNMV; Comisión Nacional del Mercado de Valores. Securities Exchange Comisión.
- ICAC: Instituto de Contabilidad y Auditoria de Cuentas
- Registro Mercantil: Mercantile Registry
- Privates Professional Accounting and Auditing Bodies:
  - REA
  - REGA
  - IACJCE
  - AECA: Asociación Española de Contabilidad y Auditoria

#### a) Creation and establishment of high accounting and auditing standards

Accounting standards are written in a General Accounting Book (*El Plan General Contable de 1990- PGC*). The 1990 PGC is completed with adaptations for specific sectors and standards about specific problems as assessment standards, which are approved through Ministerial Orders. Moreover, from 1997 the ICAC issue resolutions with goal of explaining and amplifying concrete aspects which are undeveloped in the 1990 PGC; all these accounting regulations are compulsory.

There are three specific oversight institutions, the DGSFP, BE and CNMV as well as the ICAC overseeing institutions and issuing accounting standards which are compulsory within its specific supervision area.

The AECA issue accounting Standards, which in spite of not being compulsory, they are useful for accounting professional to elaborate financial statements, in so doing they are considered as generally accepted accounting principles in Spain. The AECA's recommendations influenced the creation of PGC and its posterior modifications. (Canibano et al. 2005)

Audit Technical Rulings in Spain are issued by the ICAC and they are published in the ICAC Bulletin, but the corporations which represent auditors and audit firms participate in the elaboration process.

## b) Oversight of companies, auditors and audit firms

There is a formal control in Spain with the aim to increase the information transparency and back the oversight work of accounting standards, which consists of the obligation of depositing the accounts of every Spanish company in the Mercantile Register. These accounts have to contain financial statements, which will be audited in case of being demanded by law<sup>1</sup>.

If the company does not deposit their accounts in the Mercantile Register it will be penalized, the next year, with the closure of the registry, which in spite of not being a monetary sanction is especially effective, because the company isn't allow to registry any mercantile action such as inscription of new statutes, members of a council, economic transactions and so on, thereby strongly limiting the company activity. Furthermore the ICAC, as stated by law, could penalise the company with a monetary sanction of up to 50 million pesetas. (Jefatura del Estado Espanol 1996)

### b.1) Oversight of auditors and audit firms

The ICAC is the most important institutions in Spain, which is in charge of securing the correct behaviour of the accounting and auditing profession. The ICAC, a governmental institution, was set up under the Audit law, 1988 with two main roles: 1) the accounting regulation and 2) the regulation, control and discipline of the audit profession. (ICAC 1990)

The first role has been explained previously, that's why this section will deal the ICAC's role in relation with the audit profession.

The mechanisms of enforcement used by the ICAC to oversight and control the auditors and audit firms are principally reactive, and consist of: a) technical controls which are completed promptly to oversight specific audit work in defence of public interest, b) keeping and managing the Audit Official Registry (Registro Oficial de Auditores de Cuentas- ROAC) and c) monitoring, overseeing and keeping the guaranty incorporate by the recognised auditors. (Jefatura del Estado Espanol 1988a)

From the Financial law, 2002, a proactive revision mechanism has been incorporated; thereby the ICAC is accomplishing quality controls, where the audit work on listed companies will be supervised at least each six years. Furthermore the corporations which represent auditors continue realizing quality controls and they must send their results to the ICAC each ended year.

Moreover, from the Financial law, 2002, with the aim to assist in their oversight role of the ICAC, the audit firms and auditors must be communicate to the ICAC, the hours and fee invoice to the client, differing between audit works and other services.

Under the Financial law, 2002, an Auditing Fee per auditing reports has been set up to achieve this proactive activity of oversight. Before this fee the ICAC was financed mainly with the general state budgets.

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<sup>1</sup>A company must be audited if it meets two out of three criteria: Turnover not more than 4.15 million €, Balance sheet total not more 2.35 than million €, Average number of employees not more than 50

If the ICAC detect wrong auditing services, it may impose disciplinary action, which ranges from a fine to the expulsion from the ROAC and the disablement as an auditor. From the Financial law, 2002, the sanctions are imposed only to the responsible auditors, and will be published in the ICAC Bulletin when the sanctions are either very strong or strong.

The ICAC investigate cases which affect public interest through technical controls. These cases, which might be liable to ICAC's disciplinary action, are selected thanks to quality controls achieved by either corporations which represent auditors or the ICAC and denouncements of any member of the society (CNMV or other Institutions)(Gonzalo Angulo, 2002). Before the Financial Law, 2002, it was enough a denouncement realised by a party with a legal interest to the ICAC investigate a case, but with the new law this has been suppressed.

The audit profession, besides being overseen by an institutional control, is self-regulated by three corporations which represent auditors which compound the ROAC. The corporations which represent auditors are: the (Registro de Economistas Auditores- REA), the (Registro General de Auditores- REGA) and the (Instituto de Auditores-Censores Jurados de Cuentas de España- IACJCE).

The REA and REGA are expert bodies which depend, respectively, of the following corporations: the "*Consejo General de Economistas*" and the "*Consejo de Titulados Mercantiles y Empresariales*". The IACJCE is an independent corporation, which is founded upon to the Economy and Taxes Minister, and it is the only Spanish corporation with representation in international audit bodies, as a member of the IASB.

Every auditor and audit firm must be registered in one of these three corporations, which are recognised under the Audit Law, 1988 as Statutory recognised professional audit corporations. Their responsibilities, besides the continued formation<sup>2</sup> of their members are:

a) Elaboration of audit principles, standards and technical procedures which only have validity when they are published by the ICAC.

b) Convocation of unified Examination Access Test to the ROAC. Since the Financial Law, 2002 this test is unified under the ICAC's supervision.

c) Quality Control of the audit activity of their members. These oversight activities may be assisted in sanctions. The ICAC must be informed of procedures utilised and results found and must take disciplinary actions if necessary. Since the Financial Law, 2002, the results must be sent at the end of each year.

The big four audit firms are registered in different corporations which represent auditors. Deloitte and Ernst & Young are registered in the REA, and KPMG and PricewaterhouseCoopers in the IACJCE. Likewise all of them are under the oversight of the ICAC, because they are registered in the ROAC.

## b.2) Oversight of companies:

In spite of the fact that the ICAC is the most significant institution to secure the compliance with the accounting standards in Spain, there are four specific oversight institutions to definite areas: 1) The Directorate-General of Insurances and Mutual

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<sup>2</sup> It is an obligatory requisite to be auditor since the Financial Law, 2002.

Fund Industry (Dirección General de Seguros y Fondos de Pensiones- DGSFP), which oversees and monitors insurance companies 2) The Bank of Spain (El Banco de España- BE), which oversees and monitors banks and financial institutions, and 3) The National Securities and Exchange Commission (Comisión Nacional del Mercado de Valores- CNMV), which oversees and monitors the capital market and the companies with capital market activities 4) The State Auditing Agency (Intervención General de la Administración del Estado- IGAE) It is the body which oversees and monitors public sector entities. Besides preparing their financial statement under the 1990 PGC, they also do it under 1994 PGC for public sector entities.

This paper analyzes enforcement to secure the compliance with accounting standards to listed companies and in so doing the DGSFP, BE and IGAE will not be explained.

The CNMV is an independent body funded by the Government with the Securities Market Law, 1988 that has been revised by the Laws 37/1998 and 44/2002. Its main goal is securing the correct capital market functioning and protects the investor rights whereby this body is authorized to oversee the Spanish capital markets and the activities of both the individual and/or the legal entity, who take part in them and so.

The CNMV's roles are overseeing and monitoring the stock market activities such as insurance of securities, takeover bids, trading in futures and options and so on; also regulating and overseeing and monitoring investment firms such as listed companies, mutual funds, stockbroker companies and so on. Within this last CNMV's function is to guarantee the compliance of listed companies' financial information with the accounting standards.

Regarding securing the compliance of listed companies' financial information with the accounting standards, the CNMV must ensure that the information is sent complete. This information must be audited and contains individual and consolidated financial statements and management report. If this financial information is not sent or is incomplete, the CNMV demand it from the company which will be penalized.

The types of sanctions ranges from a fine to the suspension the company's securities, if the company does not send the information.

With the aim to protect the investor rights this information is disclosed, for this, the CNMV possess its own registry. In addition there are public registries for other kind of listed companies' information such as prospectuses, sanctions, relevant information and takeover bids.

Moreover the CNMV may review this financial information, which is selected principally, through qualified audit opinions (CNMV 2004b). Furthermore the CNMV could initiate an investigation either for own initiative or when relevant data is presented by any member of the society to department of investor rights, others oversight institutions, press comments and so on.

In particular, the CNMV does not usually analyze the whole of the financial statements, only the problems referred in qualified audit opinions. For the correct revision of the qualified audit opinions, the CNMV may require additional information from the company about why they have decided to present their financial statements with a qualified audit opinion and how they are going to solve those problems referred to by the auditors. Moreover the amplification of information

contained in the memory may be demanded. This required additional information may be found in the web page of the CNMV.

On the other hand, it is compulsory that auditors send a special audit report for each qualified audit report of listed companies. These “Special audit reports” are published in one of the CNMV official registries and inform us if the company has or has not solved the problems referred to by the auditors at the close of the first six month period of the next exercise.

From 2000 the CNMV have published a report where the study of the audit qualifications is explain. This report contents a general summary of audit qualifications of listed companies and its general features of the audit qualifications, but does not explain whether the company has been sanctioned by accounting irregularities or whether it has restated its information by CNMV demand or voluntary action.

In addition from the Financial Law, 2002, is compulsory that a report on its oversight functions is published, within it a small part describes the actions and procedures achieved to secure the compliance of listed companies’ financial information with the accounting standards.

In spite of the fact that the sanctions imposed by the CNMV, are predominantly related with infractions related with fraudulent stock market operation such as accomplishment of disallowed activities, manipulation of prices, using of privileged information and so on. The non compliance of investment firms’ financial information with the accounting standards could be penalised. In 2003 1 in 23 very strong sanctions and 2 in 29 strong sanctions, were imposed for accounting irregularities and in 2004, 0 in 25 very strong sanctions and 1 in 23 strong sanctions were imposed. (CNMV 2004a)

The sanctions may be imposed to any physic and juridical person who had unfulfilled law. There are sanctions very strong, strong and light. The sanctions range from monetary sanctions and/or the disqualification of directors to the suspension the company’s securities (Jefatura del Estado Espanol 1988b)

From the Financial Law, 2002, the very strong and strong sanctions must be published in the Official State Bulletin and furthermore the CNMV publish them within one of its own registries which is found on its own web page. Strong infractions completed before 2002 might not be published. The light sanctions are never published. (Jefatura del Estado Espanol, 2002)

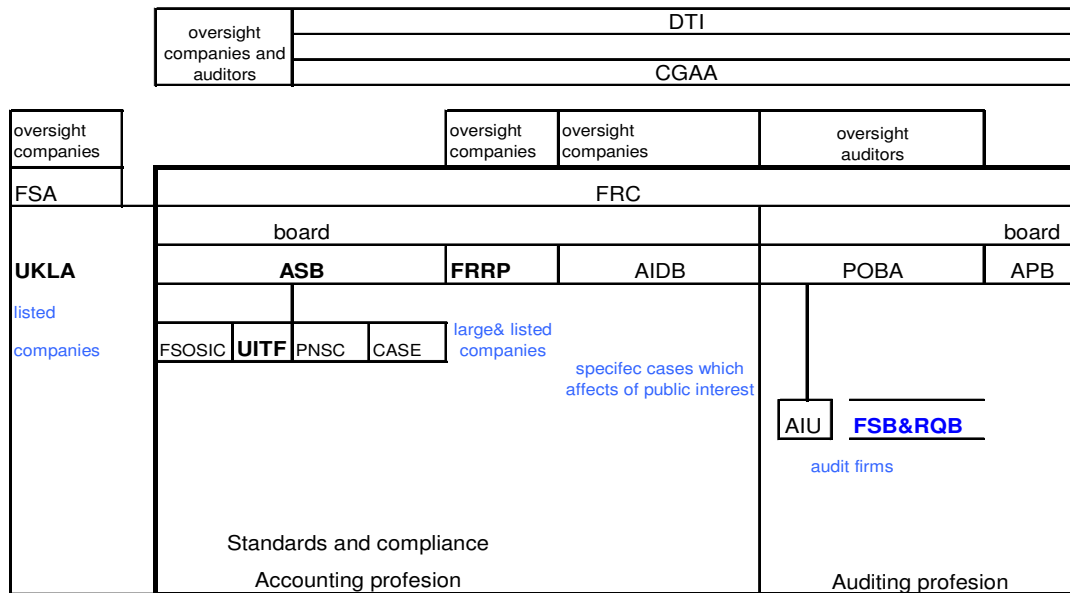
### **3.2 General Enforcement Framework in the UK**

Within enforcement in the UK I can find 3 main groups of private sector bodies: 1) the Financial Reporting Council- FRC, 2) Statutory recognised professional accountancy bodies and 3) the Financial Services Authority- FSA.

These institutions depend on the Department of Trade and Industry (DTI) and more concertedly depend on the Co-ordinating Group on Audit and Accounting Issues (CGAA) which was created by the DTI in 2002 to avoid scandals like WorldCom and Enron which happened in the United States.



**Enforcement of Accounting and Auditing Standards and Company law**



These groups of institutions perform the following functions: a) creation and establishment of high accounting and auditing standards and, b) oversight of companies, auditors and audit firms.

a) Creation and establishment of high accounting and auditing standards

The organisations in charge of the creation and establishment of high standards are FRC’s subsidiaries. The Auditing Practice Board- APB is responsible for auditing standards and the Accounting Standards Board- ASB is responsible for accounting standards and it is supported by its four committees:

1. the Urgent Issues Task Force, (UITF) 1991
2. the Financial Sector and Other Special Industries Committee, (FSOSIC) 1991
3. the Public Sector and Not-for-profit Committee, (PNSC) 1994
4. the Committee on Accounting for Smaller Entities, (CASE) 1997

b) Oversight of companies, auditors and audit firms

The main control is a formal control which demands the companies’ public information. The Companies Act 1985 requires all UK companies to be registered. Companies House is an executive agency of the DTI where all limited public companies, limited private companies and private unlimited companies in the UK are registered, and send their accounts with an annual account’s report audited<sup>3</sup> periodically. If the company doesn’t send such information it will be penalised with a

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<sup>3</sup> The account’s report could not be audited for dormant companies and small companies. A company is qualified as a small company if it meets two out of three criteria: Turnover not more than £5.6 million, Balance sheet total not more than £2.8 million, Number of employees not more than 50.

monetary sanction of up to £ 5000 and if it definitely don't send theirs accounts it may prosecution in court.

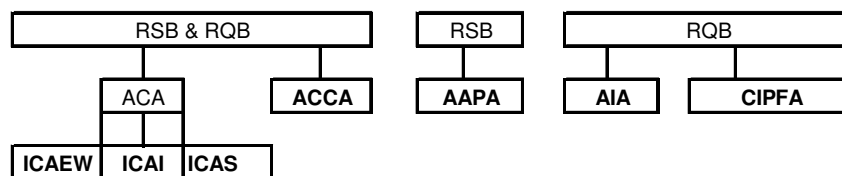
### b.1) Oversight of auditors and audit firms

Within the oversight of the audit profession, there are two types of recognised bodies under the Companies Act 1989: 1) The recognised qualifying body- RQB, an auditor regulatory body and 2) the recognised supervisory body- RSB, an audit firm's regulatory body.

Every audit firm and every person responsible for an audit firm in the UK has to be registered, for this an audit qualification, a practicing certificate, which consist in a training period of 3 years under a member of a statutory recognised professional accountancy body, and passing a series of examinations set, are necessary. Each statutory recognised professional accountancy body has their own series of examinations set; therefore there is no uniform system.

The Statutory recognised professional accountancy bodies in the UK are: 1) Association of Chartered Certified Accountants- ACCA, 2) Institute of Chartered Accountants in England and Wales- ICAEW, 3) Institute of Chartered Accountants in Ireland- ICAI, 4) Institute of Chartered Accountants of Scotland- ICAS, 5) Association of Authorised Public Accountants- AAPA 6) Association of International Accountants- AIA and 7) The Chartered Institute of Public Finance and Accountancy- CIPFA. The ACCA, the ICAEW, the ICAI and the ICAS are both RSB and RQB, the AAPA is only RSB, and the AIA and the CIPFA are RQB.

**Statutory recognised professional accountancy bodies**



The role of each statutory recognised professional accountancy body regulates their members in relation to matters such as qualifications, monitoring, complaints and discipline, to make sure an acceptable audit work is done.

Each statutory recognised professional accountancy body has to guarantee compliance of accounting standards established by the APB; furthermore they have of its own regulation contained within ethical and technical standards and its own disciplinary actions, which are included in its own members' handbook.

Furthermore the ICAEW and ICAS refer cases of public interest to the Joint Disciplinary Scheme (JDS) which initiate independent investigations and take disciplinary action if it is necessary.

If the statutory recognised professional accountancy body detects a case of misconduct on the part of auditors and/or the audit firms, they could be penalised with a disciplinary action, which ranges from a monetary sanction to the cessation of membership; these actions will also be published.

The complaints about members and members' firms, which might be a liable to disciplinary action, may be made by any person of society, such as members, other regulators like the FRRP, DTI, FSA, other accounting professional bodies and so on. Additionally, a monitory unit routinely inspects the audit firms. The Joint Monitory unit- JMU inspects audit member's firms of the ICAEW, ICAS and ICAI and the member's firms of ACCA are inspected by the ACCA's monitoring unit.

In the UK, the Institute of Chartered Accountants in England and Wales is the most important, because "the big four audit firms"<sup>4</sup> are registered in it. (DTI, 2004)

In 2005 a new FRC's subsidiary was created under the Companies Act 1989, the Professional Oversight Board for Accountancy- POBA, which has three important roles: 1) Oversight "the big four audit firms" and others audit firms trough an independent Audit Inspection Unit- AIU.(POBA, 2005)

2) The oversight audit profession through the oversight of the Statutory recognised professional accountancy bodies, RSB's and RQB's.

3) The oversight of the regulation of the accountancy profession through the oversight of professional accountancy bodies<sup>5</sup> and its activities such as education and training mainly of accountants, number and qualification of its members, standards, monitoring and so on.

#### b.2) Oversight of companies

Principally the oversight of large and listed companies<sup>6</sup> is realized by an independent regulator of the private sector, the Financial Reporting Review Panel (FRRP), which is an FRC's subsidiary. The Secretary of State of the UK authorises the FRRP to secure the compliance of financial information with accounting standards and with the Companies Act 1985. In case of detecting no compliance, the FRRP may apply to the courts, if the company don't correct its defects. Until now (2005) every company with no compliance financial information has restatement voluntarily their accounting.

The FRRP classifies the cases of no compliance as an apparent substance, a minor issue and without problems. Only the cases of apparent substance, which are or not resolved, are published. (Peasnell et al. 2001)

When the FRRP detect a case of no compliance which hasn't been referred by the auditors, the FRRP report the case to the statutory recognised professional accountancy body, where the auditors are registered. (Peasnell et al. 2001).Until 1999 there were 50 cases of no compliance found by the FRRP, of these, 49 cases were audited by audit firms registered by ICAEW. (Fearnley et al. 2000a)

The FRRP is a reactive body, because it investigates cases referred by: 1) auditors and professional accountings bodies, 2) the UKLA and 3) press comment. But from 2004 the FRRP will also be a proactive body and work together with the UKLA. (Peasnell et al. 2001)

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<sup>4</sup> The big four audit firms are: Deloitte & Touche, Price Water House Cooper, KPMG and Ernst & Young.

<sup>5</sup> Professional Accountancy Bodies: private bodies which regulate, control, and enhance the audit and accounting activity.

<sup>6</sup> Medium and small companies are oversighted by the DTI.

In the case of listed companies, the UK Listing Authority (UKLA) plays an important role, because it works together with the Financial Services Authority on the reviewed of listed companies' financial reports. Securing the compliance of large and listed companies' financial information with accounting standards and with the Companies Act 1985 is FRRP function. Besides this, all listed companies' financial reports are subject to approval by the UKLA which review the financial information and determine if the preparation and presentation of this information is correct and complete. When the UKLA detect cases of non-compliance with accounting standards it could accomplish determinate the following actions: a) suspending the company's securities in profit of interest of investor protection, b) demanding announcement of additional information, c) referring the company to the FRRP and/or d) financing penalising issuer, director and sponsors. (CGAA 2003)

The enforcement's framework in the UK is completed with the Accountancy Investigation and Discipline Board- AIDB, FRC's subsidiary, which was created, together with the POPA, as answer to the review of the regulatory regime of the accountancy profession by the DTI, and it began in 2004.

The AIDB is responsible for investigating specific cases because they affect the public interest in the UK. In general these cases usually are relative to publicly traded companies, significant financial institutions, insurance undertaking or pension funds, public bodies, significant charities or very large UK utilities companies, such as providers of energy, water and telecommunications.

On its investigation the AIDB is assisted by the members of the following four professional accountancy bodies, of which three of them are statutory recognised professional accountancy bodies as well:

1. Association of Chartered Certified Accountants (ACCA)
2. Institute of Chartered Accountants in England and Wales (ICAEW)
3. Chartered Institute of Public Finance and Accountancy (CIPFA)
4. Chartered Institute of Management Accountants (CIMA)<sup>7</sup>

The cases can be referred to the AIDB by the professional accountancy bodies but only the AIDB decide if the company and those who are relative to the case, such as its audit firm, adviser, director, employees and so on will be investigated.

The AIDB is also a disciplinary body, but no disciplinary actions have been taken, because at the moment have been investigated just two cases, Mayflower Corporation plc and MG Rover Group Limited which are still been investigated. (FRC 2006)

#### **4. Differences and Similarities between enforcement in the UK and in Spain.**

With the goal of identifying the differences, similarities and transformations of enforcement systems in the UK and in Spain, a framework with the elements of an

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<sup>7</sup> The CIMA is important because although it is neither a RSB nor a RSQ, it pertain to the CCAB. The Consultative Committee of Accountancy Bodies- CCAB is composed by six member bodies and subsumes the major accountancy professional bodies in the UK and Ireland. The six members are: CIMA, ICAEW, ICAS, ICAI, CIPFA and ACCA.

effective enforcement system have been created, which is based on official information issued by official European bodies.

On the one hand the framework of enforcement to the audit profession contains the nature and characteristics of an effective oversight system to secure the compliance with the audit regulation. This part is based on, “Discussion Paper European Co-ordination of Public Oversight” issued by the FEE (FEE 2003a), the eighth Directive on Company Law (Commission 1984) the proposal for a Directive on statutory audits of annual accounts and consolidated accounts (Commission, 2004) And, on the other hand the framework detects the characteristics of an effective institutional oversight system to enforcement of financial reporting standards. The sources utilised in this part are the paper issued by the FEE (FEE 2002a) “Discussion Paper on Enforcement of IFRS within Europe” and the Standard n1 on financial information: Enforcement of standards on financial information in Europe (CESR 2003) where the essential features and oversight mechanisms of an effective institutional oversight system are described.

After comparing essential features and oversight mechanisms of enforcement systems in the UK and Spain, we will analyze the effectiveness of such enforcement systems.

#### Enforcement to the Audit Profession

In relation to enforcement to the Audit Profession we will analyze how the oversight system that secures the compliance with the audit regulation. To that, the first step is to identify who is the responsible of guarantying the compliance with the regulation of the auditor. This role may be either only the responsibility of accounting professionals, where the profession is self-regulated, or a function of two parts where the self-regulation is under public oversight.

The FEE and the European Commission (Commission 2003, FEE 2003a, Commission, 2004) do not believe in the effectiveness of self-regulation, thereby they consider that self-regulation is successful only if it is under public oversight.

The audit profession in the UK was always under self-regulation until 2005 because a new body was created to publicly oversee the self-regulation of the audit profession, which is in crisis from the collapse of Enron. In Spain the audit profession is self-regulated under public oversight by a governmental body, the ICAC, which was set up under the Audit Law, 1988. With the creation of the POBA, the oversight system of the audit profession is harmonized between these two European countries. Self-regulation might be appropriate for the conditions existent in the UK, but the decision of change and/or improvement of this system has been taken in concordance with the Strategy of Harmonization of the EU, to solve the possible lack of independence of self-regulation and to solve the lack of confidence and credibility existent in the self-regulation from the collapse of Enron. Furthermore the creation of POBA is in line with the changes accomplished in the USA.

The main differences found between the public oversight system in the UK and in Spain are due to the fact that the regulation of the auditor in the UK has traditionally been self-regulated by statutory recognised professional accountancy bodies, and in Spain, have always been self-regulated under oversight of ICAC.

In brief, to compare the two oversight systems, we will concentrate on the ICAC and the POBA, the public oversight bodies required by the EU, respectively, in Spain and in the UK. In addition, with the goal of showing the changes accomplished in the UK, we will give attention to ICAEW<sup>8</sup>, as a sample of statutory recognised professional accountancy body, because it is the most significant body and with largest number of registered auditors.

The goal of comparing the features of the oversight bodies is to detect whether there is a lack of independence or transparency on the enforcement systems.

In order to secure the independence of the body in charge of public oversight, the FEE (FEE 2003a) and the European Commission, within the proposal for a Directive, article 31 (Commission 2004) recommend that on the one hand “*persons involved in public oversight must be selected under an independent and transparent nomination procedure*” and on the other hand the funding should originate from a greater diversity of sources to avoid potential influences under the oversight body.

In the UK, the statutory recognized professional accountancy bodies are not independent because they are composed only of accounting professionals, which is justified with the argument that accounting professionals are the most qualified people to regulate the audit profession, because they are the most enabled to understand and solve the issues that may appear. But the lack of independence might not secure the compliance with the regulation, because if a statutory recognised professional accountancy body, like the ICAEW, take a lot of disciplinary actions, it might mean that the ICAEW is not doing its work properly. The more sanctions imposed the greater the loss of prestige of the audit profession, but if the necessary disciplinary actions are not taken the audit profession could not be regulated correctly.

Fearnly (Fearnley et al. 2000b) proves that there is a lack of confidence in the ICAEW’s process of regulation due to the lack of independence in that process, and he also said that to solve this issue, the FRRP and the DTI are thinking about introducing two new private bodies inside the audit regulatory framework, two new FRC’s subsidiaries. As a result of this, in 2005 the POBA was created to supervise self-regulation, and in 2004 the AIDB was set up to investigate and take disciplinary actions when necessary.

The lack of independence may also be detected attending to the structure of the public oversight body. The FEE (FEE 2003a) declare that this body may be a public body such as the securities regulator or a new body, and the European Commission, within the proposal for a Directive, article 31 (Commission 2004) written that the personnel’s selection process must be independent and transparent; As the ICAEW like POBA has a personnel’s selection process that is more independent and transparent than that of the ICAC, because the ICAC personnel’s selection process relies completely on the Government.

In the UK, the statutory recognised professional accountancy bodies like the ICAEW are not independent, because they rely principally on members taxes. This has been solved with the creation of POBA, a FRC’s subsidiary. In Spain, the ICAC is financed

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<sup>8</sup> the big four audit firms, most of the audits of listed companies and 55% of auditors in the UK were registered under ICAEW

mostly by the Stage General Budgets; thereby under the Financial Law 2002, an Auditing Fee has been created to solve this problem of lack of independence; this Auditing Fee has to be paid by auditors per auditing report.

The second point to analyze is the transparency of the enforcement system. A quality public oversight mechanism should be transparent, thereby, as the FEE (FEE 2003a) and as the European Commission in article 31 of its proposal for a Directive (Commission 2004), demand the publication of annual reports and activity Reports of the public oversight bodies. The ICAC does not publish its annual report and activity report on its web page, and as the ICAEW as the POBA publish its annual report on its web page, furthermore the first activity report of the POBA is on its web and in spite of not being published the activity report of the ICAEW, there is information about their activities on its web page. For the reasons previously explained, we could consider the enforcement to the audit profession in the UK is more transparent than the enforcement to the audit profession in Spain.

To this end, regarding the effectiveness of the enforcement to the audit profession we can not affirm that one system is more effective than another; but since the collapse of Enron the self-regulation of the audit profession has been in crisis, because the independence of the statutory recognized professional accountancy bodies as the ICAEW is questioned, furthermore Fearnley (Fearnley et al. 2000a) infers that both the FRRP and the DTI have doubts about the effectiveness of the detection and application of disciplinary actions of the ICAEW, because, between 1991 and 1999, of the 50 non compliance cases of the FRRP, where 49 were audited by firms registered in the ICAEW, only seven were referred by auditors, and until 1999 no disciplinary actions were taken (Fearnley et al. 2000a). The ICAEW will go on with their activities but these will be supervised by a new independent private body, the POBA.

### Institutional Oversight System to Enforcement of Financial Reporting Standards

An effective institutional oversight system must secure the compliance of financial information with accounting standards, principle 3 (CESR, 2003). The FEE (FEE, 2002a) suggests two models of independent institutional oversight, a securities regulator and a review panel. It believes that both could be efficient, it also say that if the election is the review panel, this must works together with the securities regulator.

In Spain, the body in charge of securing the compliance of financial information with accounting standards is the CNMV, which is moreover the Spanish securities regulator, thereby it is also in charge of securing the good capital market functioning. In the UK, there are two bodies in charge of securing the compliance of financial information with accounting standards, the FRRP, whose only role is this, and the FSA, the British securities regulator. The FRRP and the UKLA, a body inside the FSA in charge of securing the compliance of listed companies' financial information, work together with the FRRP. Since 2005, with the start-up of the proactive mechanism these bodies have started to work together more actively.

The main difference between the British institutional oversight system and the Spanish institutional oversight system is due to the fact that the FRRP is more developed and accepted than the CNMV. Next the differences founded will be show, additionally it will be show whether the weak points in the British institutional

oversight system and in the Spanish institutional oversight system have been and/or are being reinforced.

As we have been done with the features of the different public oversight bodies, the features of the institutional oversight system will be analyzed with the aim of identifying whether there is a lack of independence or transparency, which are vital features of effective enforcement bodies (FEE 2002a, CESR 2003)

In Principle 6 of the standard no 1 on Financial Information (CESR 2003) it is declared that an institutional oversight system “*shall have adequate independence from government, and market participants*” Accordingly, it could be affirmed that in spite of there not being significant differences between the independences of the two systems, FRRP seems to be more independent than the CNMV for three key reasons, origin, structure and funding of the different bodies.

The differences in origin are due to the CNMV being funded only by the Government under the Securities Market Law, 1988, and the FRC and its subsidiary FRRP was established in 1991 funded by both governmental, (the DTI) and private bodies (professional accounting bodies and the FSA). For this reason the CNMV could be less independent from the government than the FRRP. Furthermore, while the CNMV has been implemented, developed and improved only with the support of the Government, the FRRP has always support and influenced by both, private and governmental bodies.

The second key reason is about the bodies’ structure where it is shown that the CNMV rely more on the government than the FRRP, in spite of the two bodies being independent regulators. The FRRP is a private sector body and the CNMV is a governmental body where the chair is designated by the government for a fixed period of 10 years.

The last reason concerning the bodies’ funding, the FRC and its subsidiaries such as the FRRP is financed by the accounting profession, and governmental and private sector organisations such as the DTI, FSA, Bank of England or Associations of British Insurers. And the CNMV is financed by the government through transferences from the Economy Minister with money from the General State Budgets, and market participants through taxes for their activities or services such as supervision of their members.

In spite showing a major independent system in the UK than in Spain, no measures have been taken in Spain with the goal of reducing such differences; thereby if it was not a crucial issue to solve under the Financial Law, 2002, it is reasonable to think the independence of the Spanish institutional oversight system might be adequate for the conditions existent in Spain.

To detect the lack of transparency in the institutional oversight system the amount of information available will be analyzed. “*Transparency and Clear procedures*” is a feature identified by the FEE (FEE 2002a) In addition Principle 21 of the standard no 1 on Financial Information says that “*enforcers should periodically report to the public on their activities providing at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters*”. (CESR 2003)



In the UK, the FRRP publish press comment with their procedures and enough information on its web page, furthermore the annual report of the FRC is published on the web. In 2005 the first activity report was published, in it the proactive mechanisms are explained. The CNMV have published from 1997 an annual report and an activity report in a combined report and from 2004 separately, but there is only the last year available on the web page of the CNMV. Due to the activities of supervision of the CNMV not being only the oversight of the compliance with the accounting standards, the information available about the oversight's activity is greater on the page web of FRRP than on the web page of the CNMV.

In relation to the cases of non compliance published, the FRRP has published only the cases of apparent substance and the CNMV have not a specific registry for cases of restatement. The information available about cases of non compliance with accounting standards detected by the CNMV was published in the Official State Bulletin (Boletín Oficial del Estado- BOE) if the company was sanctioned very gravely and possibly if the sanction imposed to the company is strong. With the Financial Law, 2002, this improves because the publishing of all very strong and strong sanctions is compulsory, and a registry was created, where besides other sanctions, sanctions for accounting irregularities are included. As a result of this we could say that the publishing of cases is more transparent under the FRRP than under the CNMV, but that this lack of transparency has been reduced under the Financial Law, 2002.

In general, the FRRP is an institutional oversight body which is more transparent than the CNMV, because besides there being more information published on its web page, the information is clearer. In addition due to the CNMV having more functions besides the detection of cases of non compliance with accounting standards, the oversight process to enforcement of financial reporting standards, seems to be less clear.

To this end, with the goal of measuring effectiveness and acceptance of the enforcement will be compare common points which are the number of non compliance cases published, body's effectiveness to demand the rectification of the misstatements detected and the impact on companies and auditors of body's activities and the body's reaction in the present of financial scandals.

Regarding the number of non-compliance cases published; the FRRP have published 75 cases, between 1991 and 2005. All of those non-compliance cases have been considered as cases of apparent substance. On the other hand the CNMV have no registry where publish non-compliance cases are published, therefore it is more difficult determine how many non compliance cases have been published, but regarding non-compliance cases which have been resolved when the company have restatement their financial statement, between 1988 and 2006, three cases have been published whose companies are Avanzit, La seda de Barcelona and Carroggio. The CNMV does not communicate if the restatement of the financial statement has been the decision of the company directors or has been done in response to a requirement of the CNMV, but it is most important is that the case has been detected and corrected. The CNMV also publish non compliance cases in the BOE, from 2003 a registry has been created and the sanctions may be found on the web of the CNMV. As there was a not registry it was difficult determine number of non compliance cases but if these sanctions were compared those impose by UKLA should be considered.

With regard to the number of non compliance cases detected and corrected, the FRRP seem to be more efficient an enforcement than the CNMV, but it is important to consider that the number of cases detected might not be an indicator of the enforcement body's effectiveness, as it might be there are fewer cases detected because there are fewer non-compliance cases, in this case such an enforcement body would be really efficient. For this reason is important to compare more factors in order to determine the enforcement body's effectiveness.

Regarding the power to rectify the misstatement, the effectiveness of the FRRP of demanding the restatement is 100%. There are not cases in which the FRRP has applied to the courts, because the company directors prefer restatement than to have to go to court and be the subject of press comments. The effectiveness of the CNMV to require restatement can not be tested, because there is not information about the cases where the company has been expelled to the securities exchange by not restating their financial statement. But there are cases which the company has been expelled to the securities exchange because other requirements have not been followed such as the publishing of financial information each three month period; therefore the effectiveness is not 100%.

Concerning the impact on company directors and auditors of the body's activities, the FRRP's activities have improved the quality of audit, because it positively influences the independence of auditors and their attitudes to compliance with accounting and auditing standards the FRRP's activities reduce the risk of inequality audit work, because if the FRRP detect a non compliance case, the risk of lossing of clients and possible disciplinary action from the ICAEW increase and besides this, the audit firm losses time and money and time because will have more work. (Fearnley et al. 2002). Moreover the press comment of non-compliance increase the risk of loss of prestige of the audit firm. It has not yet been shown if the CNMV activities influence the quality of audit, but due to the fact that almost every non compliance case are referred by auditors, we could say that if there is an impact, it is minimum.

On the other hand the FRRP influence positively the attitudes of company directors to compliance with accounting standards (Fearnley et al. 2000b) because if the FRRP detects a non compliance case the company losses money and time because they will have more work, will have to pay the cost of restatement and could be subject to a disciplinary action from the ICAEW. Furthermore In spite of the fact that there is no evidence of a share price reaction as an answer to the publishing of non compliance cases by the FRRP (Hines et al. 2001), company directors admit that they prefer to avoid the risk of been an subject to FRRP's press notice. (Hines et al. 2001, Fearnley et al. 2002b), because the press comment increases the risk of loss of confidence and prestige of the company. If the CNMV activities influence the attitudes of company directors has not been proved, but we could affirm that there is an impact, because if the company present an qualified audit opinion the CNMV demand additional information to the company which could be penalized, also the CNMV could require the restatement of its financial information, thereby the company losses money, time and prestige. But the non-compliance cost for companies in Spain, due to lack of transparency in the enforcement process such impact is minor compared with that of the UK.

In conclusion the FRRP might be a body more accepted and effective than the CNMV. Because there are more cases detected by the FRRP, its process is more transparent,

the impact of their activities on attitudes of auditors and company directors is higher and the lack of financial scandals in the UK might indicate that the FRRP is a more effective body to prevent accounting frauds.

## **5. Conclusions**

Effectives Enforcement systems are essentials for the success of the adoption of IFRS in the EU, because the purpose of enhancing the comparability and transparency of European financial information will only be achieve if besides the application of a unique set of quality accounting standards there is enforcement to secure the compliance with those accounting standards. For this reason all European countries are improving and harmonizing their enforcement systems.

As a result of this, measuring the effectiveness of enforcement systems across European countries is a matter of importance; this study compared the enforcement system in the UK and in Spain, and showed that while in the UK the changes completed in its enforcement system are aiming to harmonize its system with the rest of European countries, in Spain those changes are fundamentally aiming at improving its enforcement system.

The enforcement system in Spain is characterized by a lack of transparency and independence, deficiencies which were improved with the Financial Law 2002. And regarding the future issues in need of solving and in the process of being solved within enforcement in the UK, two significant changes have completed, on the one hand a new body, the POBA was set up to give credibility to audit work and on the other hand the lack of coordination between the FRRP and the FSA was resolve by 2005.

Furthermore, there is a convergence between both enforcement systems, as a consequence of the harmonisation accounting process of the EU, thereby Spanish enforcement tends to develop and to be increasingly effective and, in the UK tends to regulate its system more.

It is risky to conclude that one system is more effective than the other because while enforcement's effectiveness in the UK has been proved in a lot of studies (Hines et al. 2001, Fearnley et al. 2002), in Spain, there aren't studies which test the enforcement's effectiveness. And in spite the enforcement system in the UK being more transparent and independent and being more developed than the enforcement system in Spain, each system could be adequate for the exiting historical, legal, economic and political conditions of each country. Therefore we cannot affirm that one system is more effective than the other, hence the question of whether enforcement in UK will be more effective in secure the adoption and compliance with IFRS than enforcement in Spain, remains an open issue.

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