Comparative Analysis of Corporate Governance Rules in the UK and Ukraine

Auditing Issues

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Abstract

Countries in transition have to go through a long process of changing and creating new institutions, both private and governmental. Ukraine, as a transition economy, needs to stabilize and improve securities and capital market. Given that, one of the requirements for investment is reliability of information, audit is an essential instrument to assess the trustworthiness of information thus to achieve transparent corporate governance system. The aim of this thesis is to identify appropriate solutions for the contemporary auditing issues in the Ukraine in compliance with current Law of the UK. Through the comparative analysis of corporate governance and legal provisions on audit in both countries (i.e. UK and Ukraine), I propose following recommendations for Ukraine to improve its corporate governance system which can also contribute to achieve the higher goal of overall economic growth: a) to replace the existing Auditing Committee with the UK model of an Audit Committee; b) to prohibit the statutory auditors from providing non-audit services; c) to limit ways of keeping company’s accounts; and d) to harmonize international and national accounting standards.
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Introduction

Over the last several decades, the role of corporations as a driving force of economic development and creation of working places all over the world has considerably increased. Considering the global economic and competitive environment, it’s a challenge as well as an opportunity for all countries; particularly the countries in transition, to innovate and improve corporate management pertinent to the present-day requirements. It is a peculiar concern for the countries with transition economies, since they have to establish and institutionalize a private corporate sector from scratch especially in the context of a difficult economic transformation. The long term and effective state policy along with competent legislative support is a strong foundation to propagate precise modus operandi for corporate governance.

Reliable financial statements and its importance in corporate governance cannot be denied as it plays a crucial role in various business activities related to corporations. The company existence, in general is determined by its financial performance in the market. Thus the sustainability of economic and legal environment of country is largely affected by the issue of financial statements. The effective legislation, in turn, is required to cover the interests of investors and creditors, who need to be protected from neglectful directors and auditors who occasionally tend to depart from their duties. To mitigate these problems, country needs to have a strong corporate law which can encourage investors for investments in the corporations and thus help in achieving wider goal of overall economic growth and higher living standards for its citizens.

Roger Adams provides a classic definition for audit that is often quoted by many scholars: "There is no reliability of accounts without the audit. There is no reliability of control without reliability of accounts. And what is the value of governance without control?" This means that audit has a significant place not just in economics, but also in legal regulations and in the whole

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1 Roger Adams, Fundamentals Audit, trans. Y. Sokolova (Moskow: Audit, YUNTI, 1995), 18
business administration. From an economic point of view, good accounting and reliable financial reporting helps society in the efficient allocation of resources. The allocation of limited capital resources in compliance with the production of goods and services with great demand is the principal purpose behind sound economic management. The principal of managing economic resources is relevant to the industries and organizational entities which are displayed in their accounts signifying their capability of using resources to the best advantage.\textsuperscript{2} Inadequate accounting and reporting may hide waste and inefficiency which cause obstacles for an efficient allocation of economic resources.

From the legal point of view, shareholders are considered as ‘remaining claimants’ to the income stream generated by the companies since debt holders have stronger rights and are also preferred by the law in most of the cases. Therefore, shareholders are subject to the risk of opportunistic behavior by managers, which can be limited only by the set of legal rules protecting shareholders’ rights, the effectiveness of enforcing such rules by courts, and the capacity of shareholders to identify violations of their rights.\textsuperscript{3} The latter depends on the transparency of company’s accounts and financial reporting. In addition, it is generally accepted notion that equity market is the most sensitive to the legal provisions preferably in favor of financiers and to the efficiency of judicial enforcement of these provisions.\textsuperscript{4}

Considering the fact that Ukraine is going through a transition phase, its economy is in dire need of improvement and stability of capital and securities market. Increase in the investment activity can be advanced only with a pre-condition of stabilized economy which is an important requirement for countries in transition. Therefore, Ukraine has to make significant steps in

\textsuperscript{2} ibid
\textsuperscript{4} ibid
legislative process in order to overcome problems, which corporations face. As mentioned above one of the essential parts of corporate governance is auditing.

Unfortunately, due lack of prioritizing audit in corporate governance this important section of law has remained ignored so far except with its mention in general works. Most of the economic publications by Bychkova⁵ and Kyzminskyy⁶ highlight the significance and role of audit in financial area. Olena Kibenko and Alla Pendah Sarbah describe mostly the role of an Audit Committee in corporate governance structure.⁷ A lot of worthwhile publications explain the legal provisions of audit in the UK. Principal researchers in the area of corporate governance Sir Adrian Cadbury, Kevin Keasey, Steve Thompson, Mike Wright, and John Armour point out the significance of auditing regulation and provide recommendations for improvement.

The problem of auditing issues cannot be ignored considering its paramount importance in the corporate governance. The lack of research work in this area is a major concern not only for Ukraine but the countries worldwide as more or less same situations are persistent in many countries. To address the problem of auditing issues, I have categorized the auditing issues in three areas namely, a) Internal audit, b) External audit, and c) Accounting standards. Each of this areas has diverse problematic in different countries. Ukraine has an inefficient authority to govern the auditing issues which is similar to an audit committee. Due to its limited functional capacity, it cannot play any significant role in a company. There is also confusion regarding ‘Independence requirements’ and ‘non-audit services’. Moreover, there is a lack of agreement between international and national accounting standards in Ukraine. These issues must be addressed and regulated by taking into account all peculiarities of Ukraine. The solutions might be located in the corporate governing mechanisms of other countries, which needs to be adapted and implemented effectively. Taking into account, all the abovementioned impediments, this

⁵ S. M. Bychkova and T.U. Fomina, Practicheskiy Audit, (Practical Audit), (Moskwa: EKSMO, 2004)
⁶ A. Kyzminskyy, Audit, (Kiev: UCHETINFORM, 1996)
⁷ O. Kibenko and A. Pendah Sarbah, Pravo Tovarustvo, (Company Law), (Kiev:USTINIAN, 2006)
thesis is an endeavor to investigate the Ukrainian auditing issues thoroughly and to seek solutions in the much elaborated UK corporate law.

The method used to answer the research question is principally the analysis of statutes, codes, legal documents, scientific articles and literature available regarding audit. The results of my work are represented as solutions for current auditing issues and recommendations for improvement of Ukrainian regulations that will make efficient contribution in overall auditing policy and corporate law.

The paper consists of three chapters. First chapter is the comparative analysis of general structure and legal framework of corporate governance in the UK and Ukraine. Considering dissimilarities in the legal system and composition of a company in the UK and Ukraine, first of all, it is necessary to reflect on the nature of corporate governance to provide thorough analysis of legal provisions on the existing auditing issues in respective countries. Chapter 2 describes the degree of importance of audit and legal regulations regarding auditing in the UK and Ukraine. It should be noted that, the role, objectives and effectiveness of the audit function in many countries varies according to the existing situation and experience in a particular country. For instance, the statutory auditors of most of the countries are not obliged to be either financial expert or independent whereas in the UK and Ukraine, they must comply with the strict ‘independence requirements’.

The last chapter has a practical orientation as it reveals existing problems in auditing related to three main areas relevant to this paper as mentioned above. After substantive interpretation of the UK provisions, the most appropriate solution for Ukraine legislation is provided through comparative analysis of legal regulations on each issue in Ukraine as well as in the UK. The

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9 ibid
results and findings from the analysis of legal regulations on each issue in the Ukraine as well as the UK are summarized in the conclusion.
Chapter 1 - Legal background and sources of law regarding corporations in the UK and Ukraine

This chapter is devoted to considerations of organizational and legal aspects of corporate law in the United Kingdom and Ukraine. The key issue for understanding corporate governance in any country is to make clear the meaning of the term ‘corporation’, which has diverse meanings in different legal systems. This uncertainty also prevails over the term ‘corporate law’. The term ‘corporation’ in the law of the UK is equal to the ‘legal entity’ in Ukraine. In addition, in the legal literature the terms ‘corporation’ and ‘company’ are used as synonyms. But the term ‘Company law’, which is used for designation of UK legal provisions that regulates an incorporation of a legal entity, its economic activity and going out of business, are often translated as ‘Corporate law’ although it has the same meaning as company law. Based on these definitions, this chapter will initially provide a brief description of corporate structure and ownership, legal framework, board and management structure in the UK and Ukraine. As mentioned in the Introduction, it is very important to understand the general structure of corporate governance in each country in order to understand the current auditing issues and proposed solutions for them, which I will discuss in the Chapter 3.

1.1 Corporate governance in UK

Corporate governance was defined by the Cadbury Report as ‘a system by which companies are directed and controlled’. Furthermore, Cadbury recognized that a system of good corporate governance allows the board of directors to be ‘free to drive their companies forward, but exercise that freedom within a framework of effective accountability’. Therefore, accountability is essential part of effective corporate governance in the UK.
1.1.1 Legal framework

It is known that the legal framework of United Kingdom is based on a common law system, where important aspects of the law applicable to corporate governance is at present almost entirely based on precedents. It is important to mention that there is no single United Kingdom system of law, but three of them: England and Wales, Scotland and Northern Ireland. Legislation related to the company law is generally the same for England and Wales and for Scotland. Differences can be seen only in procedures.

The current legal provisions that regulate the governance of a company and its behavior in the market can be found in: statute and subsidiary legislation; directly applicable European Union law; accounting standard regulations; listing rules applicable to quoted companies; takeover rules; specific company legislation for particular sectors (e.g. banking and insurance); decisions of the courts and extra legislative codes. The current statutory basis of company legislation is the Companies Act 2006.

Traditionally it was considered that case law took precedence in legal procedures. Romanov clearly proves that in modern England there is a principle of predominance of statutes which is caused to confirm the superiority of will of the representatives elected by the people, over will of judges. Cross argues in favor of the same view in his book ‘Precedent in English Law’ in 1991.

The peculiarity of English law is an opportunity to ground a participant’s position in the court to refer not only to form of the statute or common law, but to considerations of famous lawyers, whose works are recognized in the British legal environment. Sources which are often cited in courts are Buckley on the Companies Acts (Butterworths), Palmer’s Company Law (Sweet and Maxwell) and Gore-Brown on Companies (Jordans).

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There is special approach to corporate governance in the UK, which is a self-regulation backed by codes and guidelines. The collapse of Polly Peck\textsuperscript{11} and Coloroll in 1990 and continuing scandals involved published accounts that misrepresented the state of finances. Therefore published information could not be trusted and would cause a bad reputation of the United Kingdom as a business and financial center. A number of reports have been published since then:

- The Cadbury Report\textsuperscript{12}, which recommended that companies should appoint three independent non-executive directors, separate the roles of CEO and chairman, and have an Audit Committee. It also stated that non-executive directors should bring an independent judgment to bear on issue of strategy, performance, resources and standards of conduct. This report is widely recognized as having set the foundations for a ‘best practice’ system of corporate governance, both in UK and subsequently in many countries across the world which incorporated some or all of its recommendations into their own corporate governance codes.\textsuperscript{13}

- The Greenbury Report\textsuperscript{14} examined the director’s remuneration, strengthening accountability and enhancing the performance of directors.

- The Turnbull Report\textsuperscript{15} provides guidance on the implementation of the internal control requirements of the Combined Code\textsuperscript{16}, where it is stated that it is responsibility of the board of directors to ensure that internal control of the company has a sound system and is working according to the standards.

\textsuperscript{11} Polly Peck Corporation (electronic industry) was collapsed in 1990.
\textsuperscript{12} The Cadbury Report, \textit{Financial Aspects of Corporate Governance}, (Great Britain: Burgess Science Press, 1992)
\textsuperscript{13} Christine A. Mallin, \textit{The Handbook of International Corporate Governance: A Definitive Guide}, (Edward Elgar Publishing, 2006), 4
\textsuperscript{14} The Greenbury Report 1995
\textsuperscript{15} The Turnbull Report 1999
\textsuperscript{16} The Combined Code 1998
- The Smith Report\textsuperscript{17} is review of audit committees. It made clear the important role of such committee ‘while all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control’\textsuperscript{18}.

Finally, there is the latest Combined Code (June 2008), which builds on the earlier reports and incorporates numerous recommendations from the reviews of Cadbury, Turnbull, Greenbury, Smith and others. This document operates on the ‘comply or explain’ basis, which means a company should comply but if not one must explain the reason. The Combined Code consists of two main parts: one on companies and one on institutional shareholders. The first part regulates organizational relations of directors, their rights and obligations; special attention is directed to remunerations issues, transparency of accountability and audit and also relations between shareholders and directors. Performance, remuneration and liability of institutional shareholders are described in the second part of Code. The main principles and structure of ownership, management and shareholders in UK are described below.

\subsection*{1.1.2 Corporate structure: ownership and management}

The United Kingdom has a wide variety of company structures including: companies limited by shares, which can be private companies or public limited companies; companies limited by guarantee and unlimited ones.\textsuperscript{19} From the economic point of view the most important types of companies are limited by shares, and for the purposes of this thesis, all references to a company are either to a private company limited by shares or to a public limited company. There are various governance requirements for each type of company, but more stringent requirements are

\textsuperscript{17} The Smith Report (2003)
\textsuperscript{18} ibid, para. 1.5
\textsuperscript{19} Institute of Directors, \textit{The Handbook of International Corporate Governance: A Definitive Guide}, (London and Sterling, VA, 2005), 153
set down for public limited company. The principle of drafting UK company law is top-down that is applicable to the public limited companies with exceptions for all or some private companies.

Ownership

Ownership patterns in corporations have changed fundamentally over the past few decades. There is a diminishing tendency of direct shareholder involvement in the management of larger companies until there is almost complete separation of the ownership and the management. During twentieth century, the directors of the companies have much more authorized and become relatively independent of general meeting of shareholders. This issue – division of ownership and management – is more related to common law countries, which are characterized by significant atomism of stock capital.\textsuperscript{20} From 54 per cent of shares being owned by individuals in 1963, this had fallen to 14.3 per cent by the end of 2002. Overseas ownership grew over the same period from 7 per cent to 32.1 per cent.\textsuperscript{21}

Real effect of institutional investors is one of the features of UK Corporate Law. The National Statistics 2002 Share Ownership Survey states that, in December 2001, the institutional shareholders have contributed for 49.4 percent of UK Ordinary shares.\textsuperscript{22} The institutional shareholders mainly consisted of insurance companies and pension funds. Thus institutions have very strong influence on boards through concentration of ownership, since it is more difficult for boards to slight significant shareholders in circumstances with common interests, than a group of incompatible individuals with different requirements. Recently institutional investors take an active part at annual general meetings using their votes, because of the current state of the stock market, where many investors have stocks at a very large lot. It is perceptible that the average duration of institutional holding in UK is no longer than two years, and this makes it hard for

\textsuperscript{21} ibid, p.154
\textsuperscript{22} ibid
corporations as shareholders might take a long-term interest in the company. Although conflict of interests exists even today in many countries, UK corporate governance has an important mission to align the interests of shareholders and boards.

**Board structure**

Part A of Section 1 of Combined Code 2008 describes the main structure and principles of director’s operation. Directors’ basic duties and liabilities do not differ whether they are executive or non-executive directors. The type and size of the company identify the existence of non-executive directors and the division of the roles and responsibilities of chairman and chief executive, where former is obliged to run the board and the latter takes responsibility for running the company’s business. “At least half the board”\(^\text{23}\) (except the chairman) should be independent non-executive directors. The requirement for companies that are outside the FTSE 350 is to have two independent non-executive directors. A senior director is a precondition in any company. The main aim of non-executive directors is to guarantee independent assessment of the company’s business and to improve both accountability and company performance. Standing question concerns measurement of non-executive independence that is related to conflicting criteria and there is no perfect answer for it, because it depends on mentality and individual personality.

Regarding composition, the Original Combined Code requires nearly all listed companies to have audit, remuneration and nomination committees. In a case of high risk business, large companies tend to have a separate risk committee or impose such responsibility on an audit committee. Moreover, corporations have the right to create their own committees which make business operations more effective.

\(^\text{23}\) The UK Combined Code 2008, Part A
Part C of Section 1 is devoted to issues of accountability and audit, and stated that the board is obliged to present a balanced and understandable evaluation of the company’s real position and prospects. The board also has to maintain sound system of internal control, where audit committee requires at least one member to have “recent and relevant financial experience”. Important provisions regulate the review of the effectiveness of internal control, whistle-blowing proceedings and the role of the audit committee in the appointment or removal of external auditors. In addition, there is a requirement to explain how auditor objectivity and independence is safeguarded in case the auditor provides non-audit services.

The analysis of the legal framework and the report of Financial Reporting Council\textsuperscript{24} reveal five key aspects of corporate governance in the UK:

1. Joint responsibility of single board for the success of the corporation.
2. Principle of balance: Separation between Chief Executive and Chairman; stable equilibrium of executive and independent non-executive directors; powerful independent audit and remuneration committees; accountability of the board and annual evaluation of its performance.
3. Directors’ objectivity focuses on the interests of the company.
4. Transparency on accountability, appointments and remuneration.
5. Shareholders have effective rights.

In sum, the UK corporate governance has its own unique company law, which is regulated both by statutory provisions and case law. This legislation has dynamic character and improves almost each year that helps corporations to overcome current problems immediately. The current structure of corporation foresees different conflicts of interest, although it is not perfect in practice because of the existing problems, but it is acceptable for the current market conditions.

\textsuperscript{24} Financial Reporting Council, \textit{The UK approach to Corporate Governance}, November 2006
The Section 1.2 describes the existing corporate governance system in Ukraine which is different in most aspects from the UK. At the end of this chapter I will analyze the main similarities and differences of the corporate governance in both countries.

1.2 Corporate governance in Ukraine

Currently, private businesses play significant role in the economy of Ukraine and are developing rapidly. As the Company Law of Ukraine is fairly new, appreciable efforts are made regarding its effectiveness, stability and coordination. This section, first elaborates legal framework of Ukrainian corporate law and then describes general structure of a company in Ukraine, which differs from the UK model of corporation structure.

1.2.1 Legal Framework

The system of corporate governance in Ukraine includes current legislation, the Corporate Governance Code and best practices recommendations, the stock exchange and trade systems listing rules, charters and other documents of company. The primary sources of law relating to corporate governance constitute the Civil Code and the Commercial Code of Ukraine, that regulate the general principles of establishment, operation, reorganization and liquidation of all types of companies in Ukraine; also the Securities Law and the Business Associations Law, which stipulates the specifics of setting up and functioning of the companies owned by several owners. If conflict of law occurs, the Law ‘On Business Associations’ prevails over the Civil Code or the Business Code. During the last five years, Ukrainian authorities have made steps to improve the safeguard of shareholders’ rights, not because approximately 30 per cent of population holds shares in JSCs, but because particular expertise and professional advice is

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26 The Civil Code of Ukraine of 16.01.2003 № 435-IV, Summary version from 01.04.2005
28 The Law of Ukraine on Securities and the Stock Exchange of 23.02.2006, No. 3480-IV,
29 The Law of Ukraine on Business Associations of 19.09.1991, No. 1576-XII,
lacking. Regulations on JSC can be found in the recent Law of Ukraine ‘On Joint Stock Companies’. As there is obvious increasing progress in creating new corporate provisions there is a lot of inconsistencies between these provisions and laws. Moreover, there is lack of specificity and many rules of the Law are ambiguous, which offers space for multiple interpretation. Therefore this is more evident that it is a very good time to analyze, correct and coordinate such regulations.

Business organizations may be of the following types: Joint Stock Company, Limited Liability Companies, Additional liability companies, General partnership or Limited partnership and Production cooperative. According to the Law any type of company may be established by individuals (both residents and non-residents) and by legal entity. In Ukraine companies are relatively independent in choosing types of activity. Non-state pension funds are active players in the field of corporate governance since the Law of Ukraine ‘On the Non-State Pension Provision’ came in force on 1 January 2004. The Law of Ukraine ‘On Privatization of State Property’ is the main law regulating economic, legal and organizational aspects of privatization of state property of large and medium corporations. Antitrust law exercises its power through the Law of Ukraine ‘On protection of Economic Competition’. The new Law ‘On Holding Companies in Ukraine’ (Holding Companies Law), which came into force on 18th April, 2006, requires new disclosure obligations on 'holding companies', which are defined as open JSCs with control of two or more other companies.

33 The Law of Ukraine ‘On Privatization of State Property’ of 04.03.1992, № 2163-XII
35 See *supra* note 32, p. 420
The corporate governance of Ukraine is in its infancy now. Recently the European Bank for Reconstruction and Development's Corporate Governance Sector Assessment evaluated Ukrainian corporate governance legislation to be in 'very low compliance' with the OECD's Principles of Corporate Governance. But although there is no doubt that government makes positive steps to improve legislative framework starting in December 2003 when the Ukrainian State Commission on Securities and the Stock Exchange (the primary regulator of joint stock companies (JSCs) in Ukraine) issued a number of non-obligatory corporate governance principles, which are based mostly on the OECD Principles of Corporate Governance, they are still optional and even do not have such features as UK incorporated companies listed on the London Stock Exchange, which are subject to the Combined Code on Corporate Governance even though on a 'comply or explain' basis, rather than the 'comply or be punished' basis used in the United States. In practice the implementation by Ukrainian companies of European measures to increase transparency and diversification of corporate culture has not yet occurred in the whole national corporate system, and many companies fail to meet the high standards set by certain developed European countries.

1.2.2 Corporate structure: ownership and management

From 1992 to 2003, 35,000 joint stock companies were established in Ukraine and nearly 17 million people were shareholders in 2002.\textsuperscript{36} Business practice shows that JSCs and LLCs are the corporate forms most generally used in Ukraine and even foreign investors usually prefer to organize their subsidiaries or joint ventures in either of these two forms. A JSC has common characteristic with a US corporation and a UK limited company, to the extent that it is a legal entity with a share capital divided into a specific number of shares, each of nominal value and it

\textsuperscript{36} Institute of Directors, \textit{The Handbook of International Corporate Governance: A Definitive Guide}, (London and Sterling, VA, 2005), 416
may be open (OJSC) or close (CJSC). State Statistic Committee of Ukraine reports that there are 10,058 OJSCs and 20,502 CJSCs on 1st of January, 2009.  

Ownership

Regarding the ownership structure, most JSCs have one or several majority shareholders, who have 50 per cent of all shares. From 1999 till 2004 it was 8.3 per cent annual economic growth each year and “high commodity prices have increased the demand for capital in Ukrainian industry - over 45 companies have issued depository receipts abroad.” In recent years, control and ownership have become concentrated and almost every company has strong and well-established controlling shareholders, in contrast to the UK company structure, where there is division of management and ownership. There is also an additional major distinction from the UK that relates to institutional shareholders who are small players in Ukrainian market. A national peculiarity of the business area is the dominant role of financial-industrial groups. In Ukraine there are five large private sector groups: SCM, Industrial Union of Donbas, Privat Group, Interpipe, and MMW. They “have as many as 200 companies (including major banks and financial institutions) reducing transparency and minimizing taxes.”

Board structure

Generally a company has the ‘two board’ system similar to the German model, where there are a supervisory board consisting of non-executive directors representing mostly majority shareholders and a management board that includes executive directors elected by the general shareholders’ meeting or by supervisory board. In accordance with the Law of Ukraine ‘On Business Associations’ the creation of supervisory board is obligatory for JSC with over 50

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37 State Statistic Committee of Ukraine, Retrieved from: http://www.ukrstat.gov.ua/
39 See supra note 37
shareholders. Supervisory board members are elected by shareholders and they may be neither the members of the management board nor the members of auditing commission. Legislation does not require mandatory number of the supervisory board and the member may be also employee or the head of the elected legal entity. Unfortunately, business practice shows that Ukraine has failed to develop customary accepted standards relating to the operating of supervisory board. There is a lack of professional qualities of officers, a lack of training system and certification. Therefore performance of a supervisory board is mostly nominal and does not play a significant role in the company.

Usually a composition of Ukrainian corporation includes General Shareholders' Meeting (GSM), a Supervisory Board, a Management Board and an Auditing Committee. GSM is the highest body of authority of a JSC, and determines the policy of the company. Each shareholder has the right to be present at each GSM. The Management Board, who can be a single person or collective, exercises management of day-to-day operations and is accountable to the Supervisory Board and the GSM. In compliance with the Civil Code there is a concept of fiduciary duties for officers of the Management Board (and the company’s other governing bodies) to act in good faith in the company's interests within the scope of their powers.

Finally the Auditing Committee must exist in all JSCs and may be requested by holders of more than 10 per cent of the shares to audit the financial and business operations of the company’s management. Its members may be elected from the shareholders and carries out audit control over financial and business activities of Management Board, but they are prohibited from being elected from Management Board or Supervisory Board. The Auditing Committee has broad authority to control the management of the company, to review company documents, participate in management meetings and audit the activities of the company’s managers. Such authority is regulated by statute. Legislation binds the Auditing Committee to prepare an annual report on

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the activities of the company in order to endorse the company's annual balance sheet. “In practice, in some cases the Auditing Committee tends to be a largely toothless corporate body.”

41 The reasons and explanation of this statement will be provided in Chapter 2.

In the light of the above analysis, it is obvious that the Ukrainian corporate system has its own national features and it is very different from UK corporate model. The first and the main difference lie in two diverse legal systems. Moreover, the UK Corporation must comply not only with the United Kingdom law but also with the EU legislation, while company in Ukraine is obliged to meet only local legal law. Due to the nature of a case law the UK has dynamic character of corporate law, while for Ukraine it takes much time to add an amendment to the current law. The significance of experts’ reports has influence on legislation basis only in the UK.

The corporate structure has also differences in both countries. The direct shareholders’ participation in the management of a company is inherent only for Ukraine. Ownership and management are separated in the UK. The presence of variety of committees is also distinction. Even an audit committee has different structure and tasks in both countries. The institutional shareholders play completely opposite roles in the UK and Ukraine. It seems that common feature is only the wish of both countries to create effective and stable corporate governance in order to meet the higher living standards, including economic and legal regulations, and to make significant contribution to the global economic system.

Due to existing of national business practice and own experience appropriate opportunity occurs to analyze and improve Ukrainian corporate system in compliance with other but old and mature international systems like the UK. But it is very important to understand dynamic nature of corporate business and take into consideration all national peculiarities when implementing foreign standards. Therefore the core purpose of my thesis is not just to find weaknesses in

Ukrainian legislation and to impose on it legal norms of UK, but to make a deep investigation concerning audit problems in Ukraine and to find solutions by the instrumentality of European Corporate Law and UK as an example. This will be elaborated in Chapter 3, but, first of all, it is necessary to describe importance of audit and the legal regulations on audit in both countries which is highlighted in Chapter 2.
Chapter 2 - Audit in the UK and Ukraine

In the Chapter 3, I will provide analysis regarding auditing issues in both countries, first of all, it is necessary to understand the degree of practical significance of audit in the UK and Ukraine as well as legal regulations of audit in these countries. Thus, this chapter first explains importance of audit for the UK and Ukraine, and then describes legal framework and regulations on the audit in the corporate governance of both countries.

2.1 Importance of audit

In the framework of developing market relations and expansion of economic transactions between the organizations of different ownership patterns and organizational-legal forms, reliability and accuracy of financial reporting have decisive importance, because in order to have relations with a company other market participants need to rely on it. Audit reports are necessary for shareholders, for the company’s partners, banks and sometimes for clients; therefore very often companies disclose such information for public. The Auditing Practicing Board also states the institutional investors as the persons in demand.

Financial statements and reports are the face of a company; as they constitute financial performance in the market. One can say that financial performance of corporation is like the spine of the body as it holds all the components of comprehensive whole and moreover it represents bearing of the body, which can be attractive or not. The most important aim of any system is to make the pivot of bearing, or simply spine, strong and stable. The Cadbury report states that:

“The annual audit is one of the cornerstone of corporate governance … the audit provides an external and objective check on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its objectivity and effectiveness”.

42 The Cadbury Report 1992, Auditing, Importance of audit, p. 36
This quotation reaffirms the necessity of ensuring of faithful financial information and transfers this duty to auditors. It is important to mention that this statement relates to external audit and provides necessary principles for auditors, however, such fundamentals as objectivity and effectiveness depend on independence of auditor either he is internal or external.

The UK

Auditing was born in England, where the most complete source of English-speaking world, containing records and references to the auditors, were found in the Treasury archive of England and Scotland, dating back to the year 1130; while the City of London subjected to audit at least in the 1200. In the middle of the nineteenth century a number of company laws were established, where it was stipulated that once a year each company is obliged to invite an independent auditor for verification and confirmation of financial reports in front of shareholders. Later the same provision was also stated in legislation of the USA, France and Germany. The first Institute of Internal Auditors was created in the UK in 1941 and the main aim was to guarantee reliability of financial reports. In the famous case Caparo Industries v Dickman (1990) House of Lords gave the following interpretation of auditor’s function:

“… to ensure … that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing … secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.”

Within this definition the auditor’s function is to protect financial interests of shareholders. To be more precise, audit is the only device in the hands of shareholders that has the power to prevent fraud of directors concerning financial aspects.

43 U.D. Kyzmina, Organizatsiya i Regulyirovanie Auditorskoy Deyatel’nosti v Razvituyh Stranah, (The organization and regulation of the auditing activities in the developed countries), (Moskow, 2003)
Carrying out an audit is essential for public listed companies because it ensures that the company applies fair policies and follows the law, so that the investor’s money is in safe hands. The main advantage of an audit is that it makes it easier to provide comparative analysis of different companies as the auditor’s state their opinions about the fairness of business procedures. Furthermore, audit helps company in following certain standards and asserts reliability and integrity of the financial results. Such a check prevents directors from indulging in fraudulent practices as it is a means of accountability. The only disadvantage of an audit can be the high costs paid to the auditors to ensure that the company maintains detailed records of all the transactions which involve extensive costs, but such sacrifice is worth the final result and solid reputation of the company.

It is the task of auditors and directors to provide reliable financial information. Usually business experts and lawyers consider audit as a device to reduce risks, especially in compliance with the world corporate experience. For instance, importance of auditors is well known since the past from the big corporation scandals: collapse of giants like Maxwell Corporation and Polly Peck in the UK, Enron in the USA in 2001. Two years later after Enron, the Italian Corporation Parmalat was declared insolvent. “The lessons learned from those collapses caused a re-assessment in accounting and auditing standard-setting and in ethics for the accountancy profession.” Clearly, if a company has confident and fair financial performance it has no way to become insolvent and to have such huge debts as in abovementioned corporations. Therefore, the core question relates to effectiveness of keeping accounts and auditing, which is fundamental device to prevent illegal and fraudulent business transactions.

45 The Maxwell scandal (1991) relating to a company pension scheme has been identified as the greatest fraud of 20th century, forcing the issue of corporate governance into the public, business and political area.

47 Report on: The role of financial reporting and auditing in good corporate governance. 24.05.2002
Retrieved from: http://www.ifac.org/MediaCenter/?q=node/view/290
James McConvill states that auditors had a significant role in the collapse of Enron and HIH, because there was evidence concerning the lack of accountability in the auditing process of these corporations. Moreover, there was no transparency because of the close relationship between audit firms and their clients. Maxwell Corporation was an extensive publishing empire, which collapsed in 1990 due to the fraudulent financial transactions committed by the company to support its business, including illegal pension funds. After analyzing company’s accounts, experts revealed a number of corporate governance deficiencies, two of which are concentrating the power of both chief executive and chairman in one person and the ineffectiveness of non-executive directors. The current UK corporate legislation obliges mostly large companies to have the separation of chief executive and chairman powers between two persons and also legal provisions provide considerable power to the non-executive directors, including significant importance of auditors.

Thus it is obvious that the role of auditors was also shown through the real experience both in one single market and in the whole economic environment, and inappropriate auditor’s behavior concerning financial reports leads to the problem of an unstable spine that can be the cause of the company’s complete destruction.

Ukraine

Corporate governance in Ukraine is fairly new and has always faced different problems in the business area that concerns audit issues as well. After the collapse of Soviet Union, Ukraine needed to establish its own new economy as well as creating a legislation basis. Private business began to grow very quickly in the transition economy. Therefore, company law has had to respond to the ongoing processes through legislation. In December 1994 the Law of Ukraine

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50 Stephanie Maier, *How global is good corporate governance*, EIRIS, August 2005
‘On Taxation of Business Profits’ was established, which defined the concept of "disclosure of statements" not only as the publication of reports (balance) on the financial status of enterprises in the media, but also as a formal submission to the bodies of the Main State Tax Inspectorate of Ukraine, National Bank of Ukraine, the State Property Fund of Ukraine, Antimonopoly Committee of Ukraine, Committee on Oversight of the insurance business and other agencies and organizations authorized to receive financial statements (balance sheets) of economic entities. Moreover, Article 10 of the Law of Ukraine ‘On Auditor Activity’ requires a mandatory audit to confirm the accuracy and completeness of the annual balance sheet and statements of commercial banks, funds, stock exchanges, companies, enterprises, cooperatives, associations and other business entities regardless of ownership, and activity reporting formally published. The only exception is for the agencies and organizations that are fully contained by the state budget and are not engaged in entrepreneurial activities, as well as subjects with an annual turnover of not more than two minimum wages (approximately $115). Therefore, audit has started to play a significant role both in an internal business activity of company and in external relations with other participants of the market.

The conduct and appropriate regulations of audit procedures are considered in a large number of significant works of local famous scholars in the areas of economic studies such as Bychkova, Kamyshanov and Zagorodniy, Mnuh together with Rudnitsky, and legal studies such as Kibenko, Pendah-Sarbah, Usenko and others. They agree to regard an audit as verification and financial activity concerning analysis of information reliability, which reflects protection from risks and maintains effective corporate governance.

52 P.I. Kamyshanov, Practicheskoe Posobie po Auditu (The Practical Guide on Audit), (Moskow: INFRA, 1996)
53 V. G. Zagorodniy, E. F. Mnyh, V. S. Rudnitskiy, Oblick, Analiz ta Audit (Accounting, Analysis and Audit), (Kiev: Kondor, 2009)
As the current Ukrainian economy is in process of transition, investment activity plays crucial role in this country. Therefore, investors have to assess Ukrainian companies, their financial situation and potential. But investors usually face the problems not only in assessment the value of the property to acquire companies, but also in assessment business as a whole, that includes such categories as established by the enterprise and the capital efficiency of its use, business reputation and trade mark. In this situation an auditor’s report of approval may be determinant. However, the assessment issue is not limited only to domestic enterprises; it was discussed at the Annual Congress of the European Association of Accountants. Thus, the problem of audit can appear in many areas of business activities and to conduct a proper audit is vital for any company. Ukrainian enterprises are not exception of this rule.

In sum, despite the time difference of existing of auditing in the UK and Ukraine, audit has the crucial importance in both countries and even in equal aspects. But regarding the age of the company law of Ukraine, this country needs much more improvements for its regulations of audit than the UK. Therefore I will compare both legal systems in this Chapter and then try to find solution for auditing issues in Ukraine by the instrumentality of the superior law of the UK.

2.2 Legal regulations on the audit in corporate governance of the UK and Ukraine

The UK

Legal regulations on the audit in the UK corporate governance are composed of the following three main parts: the statutory framework, which is represented by the Companies Act 2006 and EU Directives; non-statutory framework that consists of Combined Codes, Cadbury, Greenbury, Hampel, Turnbulls and others reports in the United Kingdom; and case law. I provide general overview of regulations on the audit in the UK, to which I will refer in Chapter 3 while analyzing auditing issues in both countries.
Part 15 of the Companies Act 2006 (Chapter 46) regulates accounting and reporting issues while Part 16 of the same Act provides legal provisions concerning audit questions. Much of the law in this area reflects EU Company Law Directives, mostly including EU Eighth Directive on Audit (sometimes called ‘Europe’s SOX’). In addition, parts of the EU Fourth Directive on Company Accounts (78/660/EEC) as well as parts of EU Seventh Directive on Consolidated Accounts (83/349/EEC) can be also found in the Companies Act 2006, which includes one part relating to internal auditors and one part concerning the statutory auditors. To be more precise, Part 16 of Companies Act 2006 regulates requirements for audited accounts, appointment of internal auditors, including the power of Secretary of State to appoint auditors, furthermore, removal and resignation of auditors, right of members to raise audit concerns at accounts meeting (Quoted Companies) and final chapter regulates liability of auditors. Statutory auditors are instructed in Part 42 regarding the following aspects: auditors and audit firms, an appointment and removal, independence requirements, the register of auditors and registered third countries auditors.

The EU regulations

On 21 May 2003 the Commission presented the Action Plan “Modernizing Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward”, where the main objective was to strengthen shareholder’s right and protection for creditors and employees rights as well as for third parties. Later, the European Parliament insisted on the addition to the legal provisions which prevent conflicts of interests, and stressed the necessity for listed companies to have audit committee. Finally, the Eighth Company Law Directive on Statutory Audit\(^\text{54}\) came into force on 29 of July, 2006. It includes strict rules relating to conflicts

of interest. For instance, the directive instructs auditors or audit firms to be “independent from the audited entity and is not involved in the decision-taking of the audited entity.” Moreover, they should not conduct audits if any relationship or additional services are “such that the independence of the statutory auditor or audit firm is compromised.” In addition, the Directive obliges the auditors of a multinational group’s consolidated accounts to take full responsibility for audits of national branches and subsidiaries.

‘Europe’s SOX’ Directive has a special place in audit regulations, because it clarifies duties of statutory auditors and provides ethical principles for them. This legal act also sets up requirements for external quality guarantee and provides for the public blunders of the audit profession and improved coordination between oversight bodies in the EU. Furthermore, the Directive includes fundamental regulations for international cooperation between EU regulators and those in third countries. In the UK the deadline for implementation of the Directive was 29 June 2008. Mostly, amendments relates to company reporting periods beginning on or after 6 of April 2008. As well as the approach on Part 15 (accounts and reports), most of the provisions affect the audits of accounts for financial years beginning on or after 6 of April 2008.

However, there is the latest EU Directive 2008/30/EC of the European Parliament and of the Council of 11 March 2008 that amends Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, as regards the implementing powers conferred on the Commission.

Directive updates provisions of the earlier Eighth Company Law Directive and introduces new provisions on public oversight, third country auditors and various other matters.

55 DIRECTIVE 2006/43/EC, Article 22 (1)
56 DIRECTIVE 2006/43/EC, Article 22 (4b)
The Combined Code on Corporate Governance, June 2008

The Combined Code on Corporate Governance executes its power only to UK incorporated companies, which are listed on the UK Stock Exchange, but not on AIM. Erik H. J. Mouthaan\textsuperscript{58} used the Combined Code as only UK legal source concerning auditing issues in his research paper “The Audit Committee from a European Perspective”.\textsuperscript{59} The UK Code is not enforced by law, but it has ‘comply or explain’ bases. As the disclosure of general structure and principles of the UK Combined Code was provided in Chapter 1, there is a need to highlight special parts relating to audit aspects. Section 1C of the Combined Code provides instructions for accounting and audit in a company. There are three main parts: Financial Reporting, Internal Control, where the main principle is obligation of the board to maintain ‘a sound system of internal control to safeguard shareholders’ investment and the company’s assets’, and the final Audit Committee and Auditors\textsuperscript{60} part. The last part requires the following core provision: “The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company’s auditors”. This means that significant attention should be paid to the audit and negligence in this area is not permitted.

\textit{Standards and good practice principles of audit}

To set down the standards and principles for the auditing profession in the UK and Ireland is in competence of the Auditing Practicing Board (APB), which is the part of the Financial Reporting Council (FRC). From December 2004 APB has published a series of International Standards on

\textsuperscript{58} Erik H. J. Mouthaan is a partner of Deloitte Accountants at Amsterdam, responsible for corporate governance related services, and lecturer at Leiden University, Faculty of Law.


\textsuperscript{60} The Smith guidance suggests means of applying this part of the Code. www.frc.org.uk/corporate/auditcommittees.cfm
Auditing (ISA) and issued a “Glossary of terms” as well as International Standards on Quality Control (ISQ). The recent Auditor’s Report on Financial Statements was published in March, 2009 and contains following provision ‘An explanation of APB’s approach to revising ISA 700 to facilitate more concise auditor’s report’ and also provides Illustrative Auditor’s Reports. Thus, the APB has significant influence on auditors in the UK.

In addition, an important function of the FRC and its subsidiaries\(^6^1\) is to promote and secure good financial reporting. Obviously, this function has influence on all market participants according to the importance of audit for business. Due to the fact that this body is also charged with omissions of the Combined Code, the FRC took forward the recommendations of such documents as the Higgs Review and the Smith Report, which include suggestions mostly related to the standards of corporate reporting and accounting ability of board as well as to the audit issues.

After the collapse of Polly Peck and Coloroll it was declared that if published information could not be trusted there would be earnest consequences for the reputation of the UK as a business and finance centre. Therefore, over the last seventeen years a number of reports\(^6^2\) concerning corporate structure and financial reporting have been published. The Cadbury Report has special place among other reports, because it includes a Code of Best Practice and the recommendations regarding financial aspects of corporate governance. So, the UK has also strong basis of legislation as self-regulation backed by reports, codes and guidelines.

According to the abovementioned, the UK has abundant legal basis regarding auditing, which includes different statutory sources as well as self-regulation codes and reports. Ukraine has a

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\(^{6^1}\) The Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP)

completely opposite situation regarding sources of law on auditing due to the age and peculiarity of legal system.

Ukraine

In world practice there are two basic approaches to create legislative regulations of auditor activity. First approach is characterized by the state legislative leadership and state regulation (Continental). The legislative leadership of professional public organizations and regulation together with the state is inherent in the second one (Anglo-American). Ukraine follows the second approach as its regulation is conducted by the Union of Auditors of Ukraine (UAU) - the initiator of an adoption of the Law of Ukraine «On auditor activity», Auditor Chambers of Ukraine (ACU) as independent self-management body. The government is represented in audit regulation by the National Bank of Ukraine, State Commission on Securities and Stock Market, and also recent State Commission on Regulation of Equity Market.

The main regulatory acts which define the fundamental bases of auditor’s activity in Ukraine are The Commercial Code of Ukraine63, the Law of Ukraine ‘On Auditor Activity’64, the International standards of audit and the Code of professional ethics of auditors of Ukraine. Due to the inevitability to develop and improve auditing, new Law of Ukraine ‘On Amendments to the Law of Ukraine “On auditor activity”’ was established on September, 14th, 2006. There are number of other laws (e.g., Law on Financial Services and State Regulation of Financial Services Markets, Law on Banks and Banking Activities, Law on Securities and Stock Market, Law on Insurance), which establish additional requirements for audits and auditors for selected industries, but it is not covered by this paper due to settled orientation on corporations in general, that do not belong to specific areas of market.

63 The Commercial Code of Ukraine, 2004
64 The Law of Ukraine ‘On Auditor Activity’, 2006
Under the Commercial Code of Ukraine it is defined that verifications of financial activity of economic entity are carried out by state tax authority, by other public authorities within the limits of certain defined by the law plenary powers, by the auditing committee (by an inspector) of economic entity and/or by auditors. It is very important to mention that an auditing committee in Ukraine is not the same authority as an audit committee in Europe, so the differences and overview of an auditing committee are provided in Chapter 3, where the problem of external audit will be analyzed.

The Law of Ukraine on amendments i.e. ‘On auditor activity’ ‘covers relevant references and citations in this section. According to this law, audit is defined as “a validation of accounting and indicators of the financial statements of the economic agent for the purpose receptions (judgment) of independent opinion of the auditor about its reliability in all essential aspects and meetings the requirements of laws of Ukraine, to principles (standards) of book keeping or other rules (internal principles of the economic agent) according to requests of users”. In the same way, the law identifies auditing activity as the entrepreneurial business, which includes “organizational and methodological maintenance of audit, practical fulfillment of auditor inspection (audit) and granting of other auditor services”.

Auditor activity can be provided only by auditor firms or auditors included in the Register of auditor firms and auditors, which is governed by the Chamber of Auditors of Ukraine (UCA). The auditing firm is the legal entity which is created according to the legislation and carrying out exclusively auditor activity, where only the auditor can be the chief. The general size of a share of founders (participants) of the audit firm which is not auditors in the authorized capital cannot exceed 30 %. The auditor is the physical person who has a certificate, which justifies auditor’s

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65 The Commercial Code of Ukraine, Section 1, Chapter 9, Article 90(2)
qualifying suitability on employment by auditor activity in territory of Ukraine. Unlike other kinds of professional work, the auditor can be not only the citizen of Ukraine, but also the other state. The law forbids auditors to attend to any other entrepreneurial business that does not exclude the right to receive dividends and incomes of other corporate rights. This prohibition prevents an auditor from having personal interest in assets and property of the corporation, which is his client. Article 20 prohibits from conducting audit in situations, which violate necessary independence of auditor. The latter can be jeopardized in case of parentage relationship with managers of economic entity, which is verifying; private interest in assets or property of such enterprise, as well as in situations when auditor is owner or member of founders, supervising board or even employee in this company and in its subsidiaries.

General conditions of realization of audit and other auditor services are defined by standards of audit which are approved by the Chamber of Auditors of Ukraine, which is responsible for approving audit regulations and standards, carrying out the certification of auditors, approving programs of professional training for auditors, and maintaining the register of audit firms and auditors in individual practice that are acceptable to provide audit services in Ukraine. Audit is conducted on the basis of the contract. According to Article 17 any provisions of the contract which are directed at an outright release of the auditor (audit firm) from statutory property responsibility for unauthenticated audit report or other document with displayed results are void.

In compliance with the contract and the law auditor (audit firm) is account for civil responsibility in case of not corresponding with fulfillment of his obligations.67

In compliance with Article 8, audit for acknowledgement of reliability and completeness of the annual financial reporting and the consolidated financial reporting is mandatory for a range of enterprises, in particular: open joint-stock companies, banks; insurance companies and bond

67 Article 21(1) of the Law of Ukraine ‘On Amendments to the Law of Ukraine ‘On auditor activity’ ’
14.09.2006
issuers; investment funds, trusts and other financial enterprises; brokers and traders; other companies identified in the "Ukraine accounting regulations" section above that are required to publish their financial statements. In addition, the law implies that audit is obligatory in other cases provided by laws of Ukraine.

According to European integration, the government of Ukraine makes efforts in harmonizing national legislation and in practical application of International Standards of Accounting and Audit. Especially, authorities make an attempt to maintain required quality control of audit and deep investigation an issue of auditor’s responsibility as to the client as to third party. Sergiy Golov, the President of Ukrainian Federation of Certified Accountants and Auditors, argues there is lack of proper training thus there is essential need for Ukraine to focus on professional development of accountants, financial managers and auditors.

In sum, the main aim of providing all abovementioned theoretical framework regarding auditing in the UK and Ukraine is to show importance of this issue for each country and differences of legal background, in spite of which the principal purpose of both countries is to improve their corporate governance, where audit plays crucial role. According to this overview, it may be concluded that audit is very significant for corporate governance of the UK as well as of Ukraine. But Ukrainian legislation needs much more improvements regarding regulations on audit than the UK. Therefore, in following Chapter 3 I highlight auditing weaknesses in corporations first, and then analyze how regulations in both countries cover these problems. Due to the fact that the UK law is more sophisticate than Ukrainian one, I focus more on problems in Ukraine, and then identify appropriate solution in the UK legal provisions.
Chapter 3 - Auditing issues: analysis of legal provisions in the UK and Ukrainian law

The practical value of this paper is not just to provide comparative analysis of auditing in corporate governance in the UK and Ukraine, but to examine the three very important problematic areas: internal audit, external audit and accounting standards as well as to find the best appropriate solution for Ukraine concerning audit weaknesses in corporations. Therefore, this Chapter examines practical part of auditing issues, which can face any company in any country. At the beginning, I will describe the main problems regarding audit in the three above areas. Afterwards, I provide analysis for existing problems in the mentioned areas in the UK and Ukraine.

3.1 Weaknesses in corporations regarding audit

In this section I will identify the main auditing problems that can arise in any corporation. These weaknesses are not recent observations, although they still have a place in corporate governance of many countries. Therefore, in this section I discuss several important issues regarding the three abovementioned areas.

The first area relates to internal auditors, who are employed by some entities and usually are employees of a company. They perform routine tasks and undertake monitoring of the entity’s accounting operations. In addition, their function may go beyond the financial accounts. In such cases an audit committee may be formed, the main aim of which is to monitor and control questions related to company’s accounting system, financial statements and auditing. In different countries such a committee has different characteristics and level of the efficiency in a company. Thus, the first auditing issue I analyze concerns relations between shareholders and auditors in internal audit area, which directly depends on the company’s structure and coordination of members’ relationship. It is obvious that any auditor should act according to shareholder’s interest, but actually there is no direct link between their two positions. Auditors are very close to
management board but far from shareholders, although exactly the last formally appoint
auditors. Due to this fact, shareholders can not control auditors and if there is a conflict of
interests between shareholders and management board most probably auditors will protect
interests of the board. This again causes an internal destruction of the company. The issue of
auditor’s independence and impartiality arises in such situation and can be solved by regulations
in charter or legislation. According to this problem, models of an audit committee in the UK and
Ukraine will be analyzed in the next section.

The second main area concerns external auditors, who are usually appointed by the owners of
the company. These auditors are independent and they are not employed by the entity.\textsuperscript{68} External
auditors provide services for the company and report to the shareholders, but not to managers.
Mostly, all limited liability companies are obliged to have an external audit. The main task of an
external auditor is to ensure that the financial accounts correspond to what is called ‘a true and
fair view’ of the company’s affairs for a particular period of time. They are also responsible to
report their findings even in case of financial or legal mistakes to shareholders. Moreover, these
auditors must make report of approval, which represents the real financial situation in the
audited company.

Therefore, some issues relate to auditors and audit firms as representatives of external audit.
These firms tend to compete on price and on meeting the needs of corporations with another
audit firms in the market. This phenomenon may lead to negative consequences that may be at
the expense of purpose to meet the needs of the shareholders. These firms are interested in
satisfying the best expectations of their clients, which means that the probability of getting false
reports is very high. In this case, market participants face financial distortion instead of true and
fair presentation of company’s financial situation. In addition, according to the survey of
“The Financial Director”, the fees derived for non-audit services are significant in contrast with fees

\textsuperscript{68} J.R. Dyson, \textit{Accounting for non-accounting students}, (Pearson Education Limited, Sixth edition 2004), 13
generated through auditing.\textsuperscript{69} Consequently, it is obvious that the auditor's interests to protect shareholders of a company and his profit-making interests do conflict with each other and adequate provisions should regulate such conflicts in order to ensure that the external auditor's independence is not compromised. Therefore, I will analyze the following three issues in Section 3.2: whose interests an external auditor protects, independence requirements and non-audit services.

The last area discusses problems, which concern both external and internal auditors and relate to accounting standard. Factually, the board has a degree of freedom in presenting facts and figures in financial reports. This means that the accounting standards allow plenty of ways of keeping enterprise accountings, and therefore auditors sometimes “cannot stand firm against its own financial system.”\textsuperscript{70} In addition, this issue concerns national and international standards and may lead to inconsistence in general system of accounting. Thereafter shareholders and the market have a negative outcome because of misrepresented financial reports or moreover absolute fraud as well as mistake, and consequences are bad reputation, problems in corporate structure and functioning or even more collapse. According to the above, I will devote the last section of this chapter to the accounting standards problem and analyze the issues of keeping accounts as well as financial reporting standards.

Cadbury mentioned in his report about the ““expectation gap’ - the difference between what audits do achieve, and what it is thought they achieve, or should achieve.”\textsuperscript{71} This gap is the core of each abovementioned issue, because one always expect an auditor to be honest, clear and impartial but auditors do not always meet our expectations. Market participants want to see real situation according to which they can make significant decisions and rely or not rely on company. Thus auditors become security in these circumstances, but unfortunately it can be too

\footnotesize{\textsuperscript{69} Ojo, Marianne, \textit{Audit Independence : Its Importance to the External Auditor’s Role in Banking Regulation and Supervision}, MPRA Paper 231, (University Library of Munich, Germany, revised Jul 2006)}

\footnotesize{\textsuperscript{70} The Cadbury Report 1992, p.38}

\footnotesize{\textsuperscript{71} The Cadbury Report 1992}
risky to rely on them according to different reasons, which concern structural and functional peculiarity of corporation and of course may be cause of uncertainty or liberty in company law. Therefore it is necessary to have powerful and restrictive legal regulations, which will help to avoid undesirable consequences.

3.2 Internal control: auditing committee issue

It is known that internal auditors are part of the company and regulated by legislation acts and charter. Moreover, an auditor’s purposes are determined by professional standards, the supervisory board, and management, where the last two are primary clients of internal auditors. This internal representative part of any corporation in Ukraine is an auditing committee, which is not the same as an audit committee in European countries. Thus, in this section I will describe the main problem of internal audit in Ukraine from legal and structural point of view. After that, similarities and differences will be discovered in comparative analysis of the audit committee in the UK and Ukraine. In the end, recommendations and suggestions relating to auditing committee issue in Ukrainian law are provided.

_Ukraine_

Article 146 of the Civil Code of Ukraine states that, the general meeting may form authority which can exercise permanent control over the financial activity of an executive board and the competency of general meeting also allows it to set down an order of creation and obligations of governing authority. Thus Civil Code allows the existence of corporations without auditing committee that does not entirely conform to the Law of Ukraine “On Business Associations”. Auditing committee is obligatory authority in Stock Corporation and it must control governance

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72 An auditing committee in Ukraine is ‘reviziya komissiya’. It is not factually an audit committee, because it differs in tasks and obligations of an audit committee.
of financial activity in the company.\footnote{The Law of Ukraine ‘On Business Associations’ of 19.09.199, No. 1576-XII} Due to the fact the company is governed not only by shareholders but also by appointed directors and employees, whose interests do not always coincide with the company owners’ interests, such authority provides its necessity. For example, a manager who is not shareholders is interested in overestimating the value of his work; moreover he can abuse his position in a company to the detriment of the last (e.g. make a contract or do any transfer for private or third party’s benefit for a consideration).\footnote{O.M. Vinnuk and V. S. Sherbina, \textit{Akcionerne pravo (The Law of the Join-Stock Companies)}, (Kiev: Atika, 2000), 135} The role of an auditing committee is obvious and it is hard to contradict this fact until it concerns the exact legal provisions and its analysis.

Company law states that an auditing committee is authority of shareholders, which is responsible for monitoring of company’s commercial (financial) activity.\footnote{The Law of Ukraine ‘On Business Associations’ of 19.09.199, No. 1576-XI} Based on this definition it is clear that auditing committee is elected from shareholders, who are not required to have financial or legal education in auditing area, which makes this authority incompetent and very weak link in controlling accounting department of the company. Ukrainian corporate practice suggests concerning that this authority is “obvious atavism” in corporate law system and it is formed exclusively for legal requirements, thus its functioning is absolutely formal.\footnote{O. R. Kibenko, \textit{Suchasnyi stan ta perspektyvy pravovogo reguluvannya korporativnykh vidnoznyh: porivnyli-no-pravovy analiz prava ES, Velikobrytanii ta Ukrainy, (The current situation and perspectives of legal regulation of corporate relations: comparative analysis of the legal rights of the EU, the UK and Ukraine)}, (Kharkiv, 2006), 307} Members of an auditing committee are not liable for their activity; moreover they are not included in the managing officer’s list except the chief of the auditing committee. Therefore this liberated status of authority leads to absolute irresponsibility and inefficiency of its operating.

There was an attempt in Civil Code of Ukraine (Article 146) to set companies free from appointment an auditing committee, but this action is still blocked by another provision in the
Law of Ukraine ‘On Business Associations’ Article 49\textsuperscript{78} for Stock Corporation and Article 63\textsuperscript{79} for Limited Liability Company. But according to part 2 of Article 146\textsuperscript{80} of Civil Code, a Limited Liability Company may form other authorities (besides auditing committee) to monitor financial operations of the company. For example, it is mentioned in the Commentary to Civil Code that a Limited Liability Company may form a monitoring committee that factually functions as auditing committee, but consists of one independent member in contrast to three members, where there is nobody from directors, as it is obligatory for auditing committee.\textsuperscript{81} There is no well-defined coordination and compliance between Civil Code and the Law. The last example provides too much room for financial monitoring, which can lead to biased assessment and even incompetence of such a controlling member. According to existing loophole in Ukrainian legislation my task is to find appropriate solution for this issue, which I am going to discover in Europe. Having identified problems and loopholes in Ukrainian legislation, I now turn to the UK legislation in order to identify appropriate solutions.

\textit{The UK}

The legislation of European Union and member-countries provides that supervisory board or management board of a large Stock Corporation may form an audit committee from their members and mainly it should be formed from independent directors.\textsuperscript{82} Article 41 of the EU Statutory Audit Directive of May, 2006 states that it is mandatory for Public Corporations to

\textsuperscript{78} Article 49. An Auditing Committee of the JSC. Monitoring the financial activities of a JSC is conducted by an Auditing Committee, which is elected from among the shareholders. (author’s translation)
\textsuperscript{79} Article 63. Monitoring of the management of a Limited Liability Company is conducted by the Auditing Committee, which is formed by the General Meeting of the Company according to the number, which is provided in the charter, but not less than 3 persons. Members of the Management Board can not be members of the Audit Committee. (author’s translation)
\textsuperscript{80} Article 146. 1. Monitoring of the Executive Body of the Limited Liability Company is in the order established by the charter and the law. 2. The General Meeting of a Limited Liability Company may form bodies that exercise constant control over financial and economic activity of the Executive Body. (author’s translation)
\textsuperscript{81} A. S. Dovgerta and N. S. Kuznetsova, \textit{Tsivil'nyy Codex Ukrainy: Postateyny Komentar (The Civil Code of Ukraine: Commentaries)}, (Kiev: USTINIAN, 2005), 106
\textsuperscript{82} ibid
establish an Audit Committee, including listing companies. The Commission sees the purpose of Audit Committee and effective internal control in minimizing financial and operational risks as well as strengthening the quality of financial statements.

In general, an Audit Committee differs from an Auditing Committee in its structure and functions. An Audit Committee consists of members from a supervisory board, independent directors, who are obliged to be grounded in finance and chief must be a specialist in finance. There is provision from the recent Combined Code on Corporate Governance of the United Kingdom, July 2008:

“C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience”

There is the clear requirement for members of an audit committee to have not only knowledge, but also a proper experience in finance, while the Ukrainian model does not have such obligations. This means that auditing committee is not professionally qualified to execute its duties while members of the UK audit committee can be trusted regarding their competence.

In addition, the tasks and obligations of audit committee are defined more precisely and wider than in Ukraine. Table 1 provides list of obligations of an audit committee in the UK according to the above legal source. It also shows which tasks of an auditing committee in Ukraine correspond to those in the UK.

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83 A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.
Table 1. Comparative analysis of the obligations of an audit committee and an auditing committee

<table>
<thead>
<tr>
<th>An audit committee must (the UK)</th>
<th>An auditing committee must (Ukraine)</th>
</tr>
</thead>
<tbody>
<tr>
<td>must monitor the integrity of the financial statements and formal announcements relating to the financial performance of the company</td>
<td>monitoring company’s financial activities, verifying compliance of financial operations with current legislation, charter and internal statutory act; monitoring appropriate use of company’s assets and property; making report according to annual financial statements and enterprise’s balance sheet</td>
</tr>
<tr>
<td>review internal financial controls and risk management system</td>
<td>-</td>
</tr>
<tr>
<td>monitor effectiveness of the internal audit function;</td>
<td>monitoring appropriate use of company’s assets and property; monitoring the relevance the value of proposed non-cash contribution</td>
</tr>
<tr>
<td>make recommendations to the board according to any operations with external auditors</td>
<td>-</td>
</tr>
<tr>
<td>“monitor the external auditor’s independence and objectivity and the effectiveness of the audit process</td>
<td>-</td>
</tr>
<tr>
<td>develop policy, which regulates rendering of non-audit services by auditors</td>
<td>-</td>
</tr>
</tbody>
</table>

The main similarities in both countries are the functions of the committee to monitor financial accounts, to verify financial information according to transactions and current legislation as well as to make annual financial report. The Ukrainian auditing committee does not have any relation to the risk management system, internal auditors and non-audit services provided by independent auditors while even Article 41 of the EU Statutory Audit Directive obliges the independent statutory auditors should be subordinated to the committee. So, an auditing

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84 U. M. Krupka, Naykovo-Praktuchny Komentar Zakonu Ukrainy ‘Pro Gospodars’ki Tovaristva’ (Theoretical and Practical Commentary on the Law of Ukraine ‘On Business Associations’), (Kiev, 2008), 211
committee has limited power and does not have such significant influence on company’s audit policy as UK audit committee has.

In fact, effectiveness of an auditing committee suffers for the following reasons: its isolation from executive board, meetings happen once a year, it consists of non-qualified members, thus as it was mentioned earlier this committee has formal nature; while audit committee has meeting quarterly, consists of competent members and it is very close to supervisory board. Therefore it is time to replace an auditing committee with an audit committee, because an audit committee fits much better for development of company’s activity, moreover it is absolutely necessary for corporate governance.

According to all the above, certain legal provisions must be established in Ukrainian law. Due to the crucial importance of financial statements an audit committee should be created and an independent auditor (audit firms) should be involved, thus the part 2 of Article 146 of Civil Code of Ukraine must be excluded to make company law regarding monitoring of financial activities more concerted. New provisions should consist of detailed regulations according to which all functions of auditing committee have to be relocated to supervisory board operations in Stock Corporations. It is essential for a supervisory board to form audit committee (prototype of the UK audit committee) in large companies (more than 1000 shareholders). The same proposition must be extended to Limited Liability Company.

Regarding the UK audit model and the EU auditing provisions the appropriate framework for audit committee effectiveness should consist of proportioned and balanced membership with independent non-executive directors, who must be financially literate and at least one member is financial expert; of clear duties of each member, including relations with internal and external auditors; of direct access to all relevant financial information; of the right to seek
independent advice concerning competent questions; of the right to make company’s audit policy and provide recommendations to the supervisory board.

The core task of the proposed amendments is to improve general effectiveness of corporate governance in Ukraine, but not just apply foreign rules. Any transitional economy needs accurate and efficient legal regulations in order to improve economic stability, therefore harmonizing of the Ukrainian corporate governance legislation is significant contribution to the economic development in the country.

3.3 External audit

In any monitoring system of the company’s financial activity, external independent audit plays a very important role as security of financial statement’s reliability, which requires such standards as independence, objectivity and integrity in the supervisory process. Despite these principles, auditors serve a particular interest, because of their representing functions. On one hand, there is a regulatory function, which has the aim to safeguard financial stability and investors’ interests, but, on the other hand, external auditor meets the private interests of the shareholders. Thus the core issue focuses especially on external auditor independence.

A legal background and general principles of audit already described in the Chapter 2, the problems related to external audit system in Ukraine and the UK will be considered in the following section. First, the paper identifies interests, which auditor follows; then it highlights regulations concerning independence of external auditors in both countries. General suggestions related to auditor’s independence and non-audit services will be the conclusive part of this section.
Whose interests does the external auditor protect?

In order to speak about independence of auditors, first of all, it is necessary to determine whose interests an external auditor protects. This question is very important regarding independence, because in any case there are preferences of auditors while providing audit services. The current issue relates to legal regulations and the meaning of external auditor in the country. There is no debate on this issue in the UK literature and legislation. Therefore, it may be concluded that there is no issue for the UK corporate governance in identifying legal preferences of external auditors. In England, it is accepted that financial statements must be prepared, audited and published not only for the benefit of the members and creditors of the audited entity, but also for the public generally. In addition, in the UK external auditor automatically has meaning of independent auditor. Unfortunately, there is confusion regarding identification of external auditor in legislation of Ukraine.

The Law of Ukraine “On Audit Activity” includes the statement that auditor activity is intended for protection of interests of those who use financial and other economic information. The Code of Professional Ethics of Auditors of Ukraine, adopted in December 1998, reports that profession of independent auditors has been identified as recognition of the responsibility before the Ukrainian society, which in terms of auditors was made up of customers, creditors, the executive and the government, employers, investors, entrepreneurs and other state entity. The Law of Ukraine “On Audit Activity” specifies only general users of financial information, including shareholders, all workers of the company and external users whereas the Code identifies only society, but not shareholders. In contrast, the Head of the State Commission on Securities and Stock Market (SCSSM) Elena Velichko expressed her view on the strong awareness of the role of audit by shareholders and that it (the audit) is not for the commission,

not for anyone, but especially for them, for the owners. Ms. Velichko expressed incomprehension of those leaders who belong to the formal audit and for whom the only thing that matters is the seal of approval. According to Ms. Velichko, SCSSM proposed to amend the Law on Joint Stock Companies that the firm of auditors should be elected by shareholders, to whom auditors are accountable.

Therefore, there is no consensus in Ukraine regarding the interests of external auditors and this fact causes violation of the most important principle of external auditor that is independence. By the way, the fact that there is no certain person or entity may be also indication of the auditor’s neutrality and independence from any market participants. Notwithstanding, the ‘public watchdog’ function requires total independence of an auditor from the audited company always, both in appearance and in fact, and total fidelity to the public trust is obliged.

**Provisions on independence**

Independence is an essential requirement for external auditors, thus legal regulations include provisions, which have the aim to secure auditor’s independence while to reduce situations that can cause certain dependence and preconception. Such provisions usually concern restrictions for particular auditors to conduct an audit and to provide non-audit services for the verifiable company.

**Independence requirements**

Article 20 of the Law of Ukraine “On Audit Activity” provides special prohibition for auditors who have direct family relationship with management and supervisory boards’ members of the

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87 G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersche, Reforming Company and Takeover Law in Europe, (Oxford, 2004), 517
verifiable company; who have private interest in assets or property of such enterprise, as well as in situations when auditor is owner or member of founders, supervising board or even employee in this company and in its subsidiaries. If there is not enough time to conduct an appropriate audit, a lack of necessary skills as well as professional qualification and absence of proper liability level, it will not lead to reliable auditor’s approval. Furthermore, there is also general provision in Article 20, which states that auditor is prohibited from conducting audit in cases where the requirement of independence is not assured.

The Section 1214 of the Company Act also includes independence requirements, which prohibit acting as statutory auditor in cases if he (she) is officer or employee of the verifiable entity; if the auditor has any business relations with partners of this company; if there is business link between the auditor and associated undertaking of the audited enterprise. For the purpose of the current provisions, an internal auditor of an audited entity is not to be regarded as officer or employee of the audited company. Associated undertaking means a parent or subsidiary undertaking as well as a subsidiary undertaking of parent company of the audited entity. In addition, an auditor is prohibited from acting as statutory auditor if he (she) has any parental or private relationship with any person from the audited company. The description of such relations is specified in regulations established by the Secretary of State. The EU Audit Directive imposes a ban to be a statutory auditor for persons, who have

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88 The Company Act 2006 (c.46) Part 16, Chapter 2, Section 1214 (1-3)
89 The Company Act 2006 (c.46) Part 16, Chapter 2, Section 1214 (5)
90 The Company Act 2006 (c.46) Part 16, Chapter 2, Section 1214 (6)
“any direct or indirect financial, business, employment or other relationship — including the provision of additional non-audit services — between the statutory auditor, audit firm or network and the audited entity from which an objective, reasonable and informed third party would conclude that the statutory auditor’s or audit firm’s independence is compromised. If the statutory auditor’s or audit firm’s independence is affected by threats, such as self-review, self-interest, advocacy, familiarity or trust or intimidation, the statutory auditor or audit firm must apply safeguards in order to mitigate those threats. If the significance of the threats compared to the safeguards applied is such that his, her or its independence is compromised, the statutory auditor or audit firm shall not carry out the statutory audit.”\textsuperscript{91}

This provision foresees not only types of relationship such as those in the Companies Act, but also describes other possible ways as to how the statutory auditor’s independence may be affected. According to the existing independence requirements in both countries, it may be concluded that provisions of the Ukrainian legislation predicts much more situations for violation of the main principle then the UK Companies Act. But according to the existence of the EU Audit Directive, independence requirements are completely and equally represented in both countries. Moreover, the EU Directive has much more precise description of conditions to forbid an auditor to act as statutory auditor. Therefore, it will be useful to extend provisions on independence requirements in the UK Company Act according to the EU Directive in order to have one common company act, which includes recent regulations. In addition, Article 20 of the Law of Ukraine “On Audit Activity” may revise the last abstract section and include more accurate description of possible conditions concerning the auditor’s independence.

Non-audit services

In reality, Ukrainian auditors are dependent on their clients. There is tendency to establish "corporate" audit firms that serve the interests of a particular client. But mainly, the dependence of the auditor lies in frequent practice of external auditors to provide their clients the consulting services. After the Enron and also the well-known fact that Disney company paid the auditing firm Price Waterhouse Coopers 8.6 million dollars for audit and 32 million dollars for other, non-audit, services in 2001, it is considered to be impossible to conduct an independent audit of the company by the same audit firm, which simultaneously provides consulting services to the audited company. Due to those events the Ukrainians were forced to look at their case on this occasion, which nobody noticed before. Therefore, in Ukraine percentage of non-audit services to the whole services of audit firms was 98% in 1995, but in 2002 it decreased to 47%. It happened only because of real example and the unfortunate experience from the West.

The Law of Ukraine on Business Associations includes Article 75, prohibits following persons from acting as an independent auditor: affiliated person of the company; affiliated person of company’s officer and person, who provides consulting services to the audited company. But Article 3 of the Law of Ukraine “On Auditor Activity” states that auditors or audit firms may provide other auditing services, which are connected with their professional activity, including keeping accounts, financial reporting and different consulting services. The list of such services is provided by the Chamber of Auditors of Ukraine. So, according to Article 75, the auditor does not have right to provide audit of the company in case he or she consults this company. Therefore, other services (except of advisory activity) as well as audit are allowed to be provided for the company in the same time. Consequently, Ukrainian law considers consulting services as the only non-audit services.

92 Informatsionnyy Bulluten APU “Audit v Ukraine” (Information Newsletter of the Chamber of Auditors of Ukraine “Audit in Ukraine”), 2002
93 The Law of Ukraine ‘On Business Associations’, 2008, Chapter 13, Article 75 (3)
The situation in the UK regarding regulations the current issue is different. Generally, providing non-audit services violates the auditor’s independence as it was stated in the cited provision of the EU Audit Directive, which identifies additional non-audit services as the example of “threat to the independence of a statutory auditor or audit firm”. The UK Combined Code is softer, because it provides obligations of the audit committee to develop and implement policy on the appointment of the external auditor to provide non-audit services as well as to explain in the annual report how the independence of auditor, who provided non-audit services, was safeguarded. There is no stipulation in the UK Companies Act that highlights this issue. So, the current UK legislation requires listed companies and other large companies only to disclose in the annual report the amount of non-audit services fees paid to the external auditor while the EU Audit Directive states obligation for independence, which can be violated by providing non-audit services. Furthermore, the recent Recommendation on Statutory Auditors' Independence suggests that disclosure of non-audit services should be presented into assurance, tax advisory and other.\textsuperscript{94} The composition of the last part should have detailed description.

Consequently, there are different situations in both countries and the obvious concern is whether to impose specific limitations concerning non-audit services or not? In 2003, the Smith Report stated that:

\begin{quote}
`... we do not believe it would be right to seek to impose specific restrictions on the auditors supply of non services through the vehicle of Code guidance. We are skeptical of a prescriptive approach, since we believe that there are no clear-cut, universal answers ... there may be genuine benefits to efficiency and effectiveness from auditors doing non-audit work'.
\end{quote}

It is clear, that by imposing restrictions, regulations reduce the possible amount of profit of audit firms as well as depriving a company the chance to choose freely the best expert for non-audit services if he or she conducts audit of this company. It is true that when an auditor is familiar with financial and accounting policy of the firm, on the one hand, it takes less time to provide external audit for this company. But on the other hand, this violates independence and there is no sense in the term ‘independent external audit’. In this case external auditor does not mean independent person. So, if society needs an external auditor, it should be ensured that he or she is absolutely independent.

Therefore, it is essential for Ukraine to have particular restrictions regarding non-audit services. Thus, at least such soft provisions, which are in the UK Combined Code, should be accepted by the Ukrainian law. Mandatory transparency of fees of non-audit services must be provided in the annual financial reports. Moreover, an Audit Committee should control issues related to an external and statutory audit. As far as the corporate governance of Ukraine is striving for European standards of the Best Practice, I think it is necessary to draft strict prohibition such as ban non-audit services for statutory auditors. In addition, Ukraine has problems with qualified professionals, who deal with international accounting standards. So, such restrictions will stimulate auditors to improve their qualification in the one specific area. If a company allows the same auditor to provide audit and non-audit services, the auditor might neglect some aspects of accounting process or audit, because he (she) knows that he (she) is the only person who can check accounts and financial statements. Maybe in future it will be possible to divide market of auditors on internal and absolutely external independent audit sectors in order to ensure auditor’s independence and transparency of financial operations. But still there is a need to regulate current market situation. It is clear, if audit quality is reduced, market participants will suffer because of absence of adequate reliable information. As a result, functional efficiency will decrease in securities and capital markets. Therefore, according to the issue of non-audit services
Ukraine should pay attention to the UK Combined Code provisions and the EU Audit Directive. Definitely, a high degree of separation between audit and non-audit services within an audit firm must be maintained in Ukrainian law.

3.4 Accounting standards problem

The problem of accounting standards is very important for auditing, because it makes obstacles for thorough verification of factual business transactions and financial statements. This section describes two core problems in Ukrainian law concerning the different ways of keeping business accounts and compliance of international and national standards. I also provide examples of the UK regulations relating to the accounting standards problems and general solutions for them.

Ways of keeping accounts

Issue related to different ways of keeping the books takes into account internal accounting policy of a company and has direct link with final financial reporting. According to the Law of Ukraine ‘On Accounting and Financial Reporting in Ukraine’ an enterprise has the right to define its own accounting policy but in compliance with only principles stated in this law. Although, provisions of this law require mandatory documents that compose financial reporting i.e. balance sheet, financial results report, cash-flow, equity capital report and comments although there is no obligation on certain standards to keep books. Such composition of financial reports is obligatory for all companies except state-financed organization, foreign legal entity and small enterprises that have provide only balance sheet and financial results report. In comparison, company’s individual account in UK must comprise a balance sheet and a profit and loss

\textsuperscript{96} Ibid Chapter 4, Article 11 (2)
Every company in the UK has the duty to “keep adequate accounting records”, which must meet all necessary requirements set down in this act. Section 387 describes a liability for persons, who are guilty of an offence under current section. There are the same terms of imprisonment or fine in England and Wales, but differ from Scotland and Northern Ireland. In contrast, there is no such liability in Ukrainian legal provisions. However, according to Article 1631 Code of Administrative Violations in the absence of tax accounting, breach of the directors and other officials of enterprises, institutions and organizations established by law and taxation accounting provides fine in size from five to ten times the income of citizens (85 - 170 UAH), and by repeated violations during the year a fine ranging from ten to fifteen times the minimum income of citizens (170 - 255 UAH). In other words, it is hard to compare imprisonment for the term not exceeding twelve months or fine not exceeding the statutory maximum in England with a fine not exceeding 1700 UAH, which is approximately 160 Euro. Ukrainian legislation does not prevent the desire to commit financial offence.

There are common standards according to the form of accounting reports in both countries, but there is a lack of unity in internal accounts and insignificant liability in Ukraine. In other words, company is free to choose the way of accounting policy but must comply with the legal sphere of financial statement. Obviously, this way is very convenient for company, but causes problems for external auditors, who are not familiar with company’s particular way of keeping business accounts. Factually, it takes too much time to understand unknown accounting system; moreover it is hard to be completely sure that current transactions lead to faithful financial statements. Some corporations may be interested in making their accounting policy very complex and unclear to hide real financial situation. Usually, such companies aim to obtain fast profit and deceive their shareholders or client. In order to solve this problem and to exonerate auditor from

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97 The Companies Act 2006 (c. 46); Part 15; Chapter 12; Section 396 (1)
98 Ibid; Chapter 2; Section 386 (1)
liability to give resolution even without complete understanding reasons and consequences in company’s account, limited number of ways for keeping accounts should be stated in Ukrainian legal provisions. This limitation will prevent companies from establishing bad faith, will protect creditors and outsider users of financial information and will reduce problems concerning auditing. Furthermore, strict liability for keeping business accounts in compliance with the Ukrainian law will also prevent company to commit financial offences relating to accounting standards.

Financial reporting standards

In 2006 the round table entitled “How Strong Professional Accountancy Bodies Can Help Government Attract Investments and Ensure Stability” was held in Kiev. Neil Wallace101, Ann Wallace102, Tetiana Tymoshenko103, Vadim Lynnyk104 and other experts participated in this round table. As Neil Wallace noted that every country has problems in the growth of the economy, but also it has an opportunity for improvement and it is “need to admit the existence of problems and try to address them”. Thus at the end of discussion the general problem was pointed out as lack of single agreed legal regulation and system of audit and accounting in Ukraine. To be more precise the core issue concerned implementation of International Financial Reporting Standards (IFRS). Due to task of this paper the following problem will be discussed in general in order to find right direction in improvement of Ukrainian Corporate Governance.

100 The CIPA Examination Network (CIPAEN), There will be no effective economic development without the strong and modern accountancy profession: opinions of professionals, governmental agencies, International Federation of Accountants, September 14, 2006 http://cipa.org.ua/eng/articles/articles.php?id=6
101 Technical Manager of the International Federation of Accountants (IFAC) Developing Nations Committee
102 The Chief of Party for the Capital Markets project
104 The President of Ukrainian Association of Certified Accountants and Auditors
The provision in Article 1 of the Law of Ukraine “On Accounting and Financial Reporting” states that “National Accounting Regulations (Standards) … do not contradict the international standards”. In legal regulation it seems to be clear, but in practice experts notice gaps between the National Accounting Regulations Standards (NR(S) AU) and IFRS. In order to explain the aspects in which there is contradiction between the two standards, brief overview of the Law indicated above is provided. National accounting regulations oblige all legal entities located in the territory of Ukraine to maintain all its financial reports and accounting records in compliance with NR(S)AU. In addition, financial statements should be drawn up in reporting currency, which is Ukrainian UAH, for a calendar year and relevant interim periods and must be submitted to the shareholders or owners of a legal entity, the state statistics authority and registrar. Responsible persons for organizing the accounting operation and reflection of all economic transactions in documents and financial statements must be “proprietor(s) or a specially designated body (official)”. Financial institutions and companies are obliged to publish their annual financial reports and consolidated financial statement in the periodical press or in the form of separate editions. Also, there are such state agencies as National Bank of Ukraine, State Commission on Regulation of Financial Services Markets in Ukraine and others, which have the right to appoint supplementary requirements for enterprises under their jurisdiction.

A thorough review of this law makes it clear that, its provisions are very general and there is a lack of specific regulations and disclosure of particular local areas as Interim Financial Reporting and Accounting for Government Grants and Disclosure of Government Assistance. As

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106 Ibid, Article 8(3)

107 Public Joint-Stock Companies, bonds issuers, insurance companies, banks, trusts, stock exchanges, investment funds and investment companies, credit unions, non-state pension funds.
Valentyna Legkaya argued in her presentation (2008)\textsuperscript{108} NR(S) AU does not include following principles at all:

- FRS 1: First-time Adoption of International Financial Reporting Standards (revised 2009);
- IFRS 2: Share-based Payment (revised 2009);
- IFRS 3: Business Combinations (revised 2009);
- IFRS 4: Insurance Contracts (effective 2006);
- IFRS 5: Non-current Assets Held for Sale and Discontinued Operations (revised 2009);
- IFRS 6: Exploration for and Evaluation of Mineral Resources (effective 2006);
- IFRS 7: Financial Instruments: Disclosures (effective 2007);

It also concerns following International Accounting Standards:

- IAS 16: Property, Plant and Equipment (revised 2009);
- IAS 20: Accounting for Government Grants and Disclosure of Government Assistance (revised 2009);
- IAS 26: Accounting and Reporting by Retirement Benefit Plans (effective 1998);
- IAS 34: Interim Financial Reporting (effective 1999);

Such an absence of regulations does not completely contradict the IFRS, but it confuses regulation system according to comparability, assurance and truth of financial statements in Ukraine. In order to create conformity between two types of standards national legislation needs appropriate improvements in compliance with IFRS, which concern drafting legal regulations for specific economic areas (especially indicated above) and disclosure requirements according to

accounting and financial reporting. Ultimate goal of all these betterments is to eliminate risks and uncertainty in financial information that is vital requirement for perfect business activity with benefits as transparency and protection for each member of the market.

The main legal provisions which regulate accounting and reporting in the UK are laid down in the Companies Act 2006 that incorporates the requirements of European law. The Companies Act sets out certain necessary accounting obligations for companies and also holds limited liability companies liable to file their accounts with the Registrar of Companies who makes them available to the public. But from 2005 this framework is completely changed in compliance with European law which makes it obligatory for all listed European companies to use International Financial Reporting Standards (IFRSs). Other companies have the right to choose between IFRSs and UK Generally Accepted Accounting Principles. In compliance with Section 395 a company may prepare its accounts in accordance with individual standards that are characterized in Section 396 or with international accounting standards. Companies Act 2006 identifies international accounting standards as “… standards, within the meaning of the IAS Regulation, adopted from time to time by the European Commission in accordance with that Regulation”

As to above analysis with respect to the problems of accounting standards, there is no difference between the UK and Ukraine in applying both national and international standards. But according to content and fulfillment of these standards the first country does not have contradictions among IAS and GAAP. Furthermore, recently issued UK FRSs reduces the distinctions between the two sets of standards significantly. Therefore, the principal task for Ukraine in this area is to follow the UK example and coordinate national legislation in harmony with reliable international standards.

109 Company Act 2006 Companies Act 2006 (c. 46); Part 15; Chapter 12; Section 395 (1)
110 Company Act 2006 Companies Act 2006 (c. 46); Part 15; Chapter 12; Section 474 (1)
Conclusion

The professional audit of an entity’s financial statements is the cornerstone of any modern corporate governance system and is a vital requirement for the appropriate functioning of capital and securities markets. In turn, a functioning securities market is an essential part of the market for corporate control known as the external corporate governance system whereas financial accounting, auditing and disclosure of audited financial and non-financial information contribute towards the effectiveness of the system of internal corporate governance.\textsuperscript{111}

The aim of comparative analysis was to identify the best appropriate solutions for auditing issues in Ukraine in compliance with the UK legal regulations. The research paper findings state that, absence of the Corporate Governance Code in Ukraine is a major obstacle in providing key solutions to emerging problems related to corporations. The dispersal or a lack of legal provisions pertaining company law create hurdles in steady business activity and also leads to disconformities of many corporate regulations. Therefore the existence of a legal device such as the Corporate Governance Code will prove helpful for Ukraine to kick-start the economic activity with renewed higher level of business relations.

As stated in Section 3.2, main proposal regarding the internal audit is to replace existing Auditing Committee in Ukraine with an Audit Committee similar to the UK model. First, the current obligations of an Auditing Committee should be relocated to supervisory board in Stock Corporations and Limited Liability Companies. This amendment will facilitate incorporation of new legal provisions as well as regulation of composition, functioning, tasks and duties of an audit committee. In addition, Article 146 (2) of Civil Code of Ukraine must be excluded to make company law more concrete with respect to monitoring of financial activities.

\textsuperscript{111} G. Ferrarini, K.J. Hopt, J. Winter, E. Wymeersche. \textit{Reforming Company and Takeover Law in Europe}, 2004
Section 3.3 described a genuine necessity to make amendment to the provisions of the external audit. So, the last abstract section of Article 20 of the Law of Ukraine “On Audit Activity” may be improved by including more accurate description of possible conditions concerning the auditor’s independence. In addition, Ukrainian regulations should stipulate that an independent Auditor must act in the interests of public in general. With respect to the provisions regarding non-audit services by statutory auditors, Ukraine legislation should apply particular restrictions. To be more precise, audit activity and non-audit services should be separated in order to ensure independence of an external Auditor.

As discussed in Section 3.4, solutions to the problems of accounting standards include: a) Ukrainian legal provisions should incorporate limited number of ways for keeping accounts; b) If providing limited number of ways is not feasible then, at least more precise and accurate requirement for all the ways should be stated, c) follow up and compliance with the UK example as well as coordination of national legislation on Accounting in conformity with reliable International standards.

Finally, it may be concluded that improvement and harmonizing of legal provisions on audit are essential requirements for corporate governance in Ukraine. The main goal of this harmonization is to create the transparent environment for investment activity and contribute to the development of stable and efficient economic and financial systems.
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