

# AUDITOR INDEPENDENCE – ITS IMPORTANCE TO THE EXTERNAL AUDITOR'S ROLE IN BANKING REGULATION AND SUPERVISION

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## ABSTRACT

*The role of the external auditor in the supervisory process requires standards such as independence, objectivity and integrity to be achieved. Even though the regulator and external auditor perform similar functions, namely the verification of financial statements, they serve particular interests. The regulator works towards safeguarding financial stability and investor interests. On the other hand, the external auditor serves the private interests of the shareholders of a company. The financial audit remains an important aspect of corporate governance that makes management accountable to shareholders for its stewardship of a company<sup>2</sup>. The external auditor may however, have a commercial interest too. The debate surrounding the role of external auditors focusses in particular on auditor independence. A survey by the magazine "Financial Director" shows that the fees derived from audit clients in terms of non-audit services are significant in comparison with fees generated through auditing.<sup>3</sup> Accounting firms sometimes engage in a practice called "low balling" whereby they set audit fees at less than the market rate and make up for the deficit by providing non audit services. As a result, some audit firms have commercial interests to protect too. There is concern that the auditor's interests to protect shareholders of a company and his commercial interests do not conflict with each other. Sufficient measures need to be in place to ensure that the external auditor's independence is not affected. Brussels proposed a new directive for auditors to try to prevent further scandals such as those of Enron and Parmalat.<sup>4</sup> The new directive states that all firms listed on the stock market must have independent audit committees which will recommend an auditor for shareholder approval.<sup>5</sup> It also states that auditors or audit partners must be rotated but does not mention the separation of auditors from consultancy work despite protests that there is a link to compromising the independence of auditors.<sup>6</sup> However this may be because Brussels also shares the view that there is no evidence confirming correlation between levels of non-audit fees and audit failures and that as a result, sufficient safeguards are in place.<sup>7</sup>*

This paper aims to consider the importance of auditor independence in the external auditor's role in banking regulation and supervision. In doing so, it also considers factors which may threaten independence and efforts which have been introduced to act as safeguards to the auditor's independence. It will also support the claim that auditor independence is indeed central to the auditor's role in banking regulation and supervision.

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<sup>2</sup> V.Beattie, S.Fearnley 'Auditor Independence and Non audit services' pg 1.( See <<http://www.icaew.co.uk/publicassets/00/00/03/64/0000036464.PDF>>)

<sup>3</sup> D. Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003, at pg 8

<sup>4</sup> H. Tomlinson 'Brussels seeks to tighten audit rules' *The Guardian* March 17 2004

<sup>5</sup> *ibid*

<sup>6</sup> *ibid*

<sup>7</sup> See House of Commons , Select Committee on Treasury, Minutes of Evidence on the inquiry into the arrangements for financial regulation of public limited companies in the United Kingdom at pg 20 and House of Commons Hansard Debates for 19 Oct 2004 (pt 17) (<<http://www.publications.parliament.uk/cgi-bin/>>)

## INTRODUCTION

Banks are unique institutions in that they are vulnerable to a “run” or a process whereby depositors withdraw money/exhaust their bank accounts if adverse opinions about them are disclosed to the capital markets and depositors<sup>8</sup>. This makes the job of the external auditor more difficult. If an adverse report is given about the bank in the audit, this could have serious implications for the bank. On the other hand, an adverse report or qualified audit could maintain the credibility of the auditor. Faced with this dilemma, the involvement of the auditor in other non-audit engagements could determine his willingness to qualify the audit report. He knows that he would most likely lose his contract if he qualified the report. If this would result to the loss of a lucrative contract, he might consider thinking twice about qualifying the audit.

The UK professional guidelines<sup>9</sup> highlight that independence is about ensuring that the audit is undertaken with a spirit of independence. The guidelines suggest that this can be done even when non-audit services threaten objectivity<sup>10</sup>. However the guidelines do not identify which non-audit services undermine independence.<sup>11</sup>

Factors which have resulted to debates over the issue of the auditor's independence often involve the provision of non audit services by external auditors. Following the collapse of Enron, many argued that the provision of non-audit services such as consultancy services by Arthur Andersen, had caused Enron's problems. However, reports showed that off-balance sheet instruments had created problems. In considering the importance of auditor independence to the external auditor's role in banking regulation and supervision, the first part of this paper considers changes which have taken place over the past two decades and why a general banker now requires the expertise of an external auditor. It will also consider why the imposition of a statutory duty is considered necessary given the fact that there is potential of “conflict of interest” between interests which the external auditor seeks to protect and that which the regulator may seek to protect. The changing role of the audit will then be discussed as this explains its importance in the banking industry. Issues relating to auditor-client confidentiality also abound and even though certain “Statements of Auditing Standards” state a duty of the external auditor to report to the regulator<sup>12</sup>, more accountability would be ensured if the duties were governed by statute as opposed to delegation to self-regulatory bodies.

The self-regulatory regime of the UK accountancy profession is then discussed and this leads to a discussion of “regulatory capture”- regulatory capture being equivalent to compromise of the auditor's independence but applicable to regulators. Efforts to improve independence within the self-regulatory regime and reduce the possibility of capture occurring will also be discussed. Steps to improve accountability also count towards efforts aimed at improving independence. Enforcement related issues are then considered - enforcement being another of the auditor's key tools in banking supervision and also being crucial to the Financial Reporting and Reviewing Panel work. In addition to those regulatory reforms which occurred within the self-regulatory regime of the Financial Reporting Council, the FRC, other regulatory reforms such as the development of a framework for corporate governance and establishment of audit committees will be considered. Measures in place to safeguard the auditor's independence are discussed when issues such as non-audit services, the reporting accountant and mandatory rotation of audit firms are discussed. Following the collapse of Enron, the Financial Accounting Standards Board, the FASB, saw cooperation with the International Accounting Standards Board, the IASB, as a way of restoring its credibility and that of its

<sup>8</sup> Supra note 3 at pg 6

<sup>9</sup> The Institute of Chartered Accountants England and Wales Guide to Professional Ethics; also see D. Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* Volume 4 No 3, 2003, at pg 8

<sup>10</sup> D. Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* Volume 4 No 3, 2003, at pg 8

<sup>11</sup> *ibid*

<sup>12</sup> See SAS 620 Revised and SAS 120 Revised

standards.<sup>13</sup> In this respect and given the problems of non audit services being cited during the collapse of Enron, accounting practices in the UK and the US and the International Accounting Standards Board will also be considered.

An analysis of various parliamentary reports, statutes such as the Financial Services and Markets Act 2000, case law, journals and annual reports will provide a basis for considering the claim that audit independence is still a central element to the external auditor's role in banking regulation and supervision.

### **Definitions of integrity, objectivity and independence**

The APB ethical standards govern issues relating to the integrity, objectivity and independence of auditors.<sup>14</sup> Guidance on other ethical matters and statements of fundamental ethical principles governing the work of all professional accountants are issued by professional accountancy bodies.<sup>15</sup>

Integrity is a requirement for those acting in public interest and it is vital that auditors act and are seen to act with integrity.<sup>16</sup> This requires not only honesty but a wide range of qualities such as fairness, candour, courage, intellectual honesty and confidentiality.<sup>17</sup>

Objectivity is a state of mind which excludes bias, prejudice and compromise and which gives fair and impartial consideration to all matters that are relevant to the present task, disregarding those that are not.<sup>18</sup> Objectivity requires the auditor's judgement not to be affected by conflicts of interests and that he adopts a thorough approach preparing to disagree where necessary with the director's judgements.<sup>19</sup> The necessity for objectivity arises due to the fact that many important issues involved in the preparation of financial statements do not relate to questions of fact but rather to questions of judgement.<sup>20</sup>

The concept of independence is not the easiest to define. Definitions include :<sup>21</sup> “the conditional probability of reporting a discovered breach” by DeAngelo (1981a : 186); the ability to resist client pressure (Knapp;1985) ; a function of character – with characteristics of integrity and trustworthiness being essential (Magill and Previts; 1991) ; and an absence of interests that create an unacceptable risk of bias.<sup>22</sup> The need for independence arises because in many cases, users of financial statements and other third parties do not have sufficient information to enable them judge whether the auditors are, in fact, objective.<sup>23</sup> The reality and notion of auditor independence is vital to public confidence in financial reporting.<sup>24</sup> Public confidence in financial markets and the conduct of public interest entities relies partly on the credibility of the opinions and

<sup>13</sup> J Godfrey and I Langfield-Smith 'Regulatory Capture in the Globalisation of Accounting Standards' at pg 29

<sup>14</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 5  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>15</sup> *ibid*

<sup>16</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 7  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>17</sup> *ibid*

<sup>18</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 9  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>19</sup> Ethical Statement 1 Integrity, objectivity and independence paragraphs 9,11  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>20</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 10  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>21</sup> V. Beattie, S.Fearnley, R. Brandt 'Behind closed doors : What company audit is really about' Institute of Chartered Accountants in England and Wales (2001) at pg 19

<sup>22</sup> The AICPA White Paper definition (AICPA, 1997) defines independence as an absence of interests that create an unacceptable risk of bias.

<sup>23</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 13  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>24</sup> D. Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003, at pg 18

reports given by auditors in relation with financial audits.<sup>25</sup>

Ethical Standard 1 requires that in complying with integrity, objectivity and independence, responsibility lies with the audit firm.<sup>26</sup> This is where the weaknesses highlighted in the “Enforced Self Regulation Model” appear – in particular, the weaknesses of self regulation.<sup>27</sup> Paragraph 17 of ES 1 goes on to say that the audit firm establishes policies and procedures to promote and **monitor** compliance with those requirements by any person in a position to influence the conduct and outcome of the audit. Direct monitoring of listed companies and other entities in whose financial situation there is major public interest, is the function of the Public Oversight Board.<sup>28</sup> It is bad enough that no state monitoring is involved in this system of delegated self-regulation and one would expect a form of accountability in the shape of increased monitoring than is presently carried out by the POB. Now that the scope of the POB has been extended to cover regulation of the actuarial profession, it is questionable if there is sufficient dedication of resources towards the monitoring of accountancy firms as was the case when the POBA existed. Post- Enron reforms which led to the APB being responsible for setting standards on objectivity, integrity and independence have improved the standard setting process and provided more consistency to the way standards are interpreted. The Financial Reporting Review Panel examines annual accounts of public and large private companies to check whether they are complying with the requirements of the Companies Act 1985 including applicable accounting standards.<sup>29</sup>

In April 2005, the FRRP published a revised Memorandum of Understanding in which the panel will cooperate closely with the FSA on enquiries related matters of listed companies.<sup>30</sup> This is a significant step towards ensuring the co-ordination of accounting enforcement activities in the UK for which the FRRP and the FSA share responsibility<sup>31</sup>. Besides carrying out 286 reviews in 2005/2006, the FRRP also extended its enforcement programme by reviewing the annual accounts of a wider range of entities and reviewing for the first time interim accounts starting with those prepared for periods beginning on or after 1 January 2005.<sup>32</sup>

### **Developments in the banking supervisory process**

About two decades ago, internal control systems would not have featured highly in an analysis of banks and their supervision.<sup>33</sup> A general banker can no longer expect or hope to understand in depth all the activities which go on in a bank because change has occurred over the years that the necessary skills and experiences are held in individual specialist areas.<sup>34</sup> Systems and controls have ceased to be tangible and book keeping has been replaced by electronic pulses.<sup>35</sup>

The high point of the process of reports from accountants on systems was the 'trilateral meeting' when the bank being reported on, the reporting accountant and the Bank of England reviewed the contents of the report together.<sup>36</sup> Not only were the reporting accountants nervous about the effects of some of the exchanges of information on their relationship with their client - the bank, but the bank clients too.<sup>37</sup> As a result, there

<sup>25</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 4  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

<sup>26</sup> See Ethical Standard 1 paragraphs 15 - 26

<sup>27</sup> For more information about the Enforced Self Regulation Model, see article “The Financial Services Authority : A Model of Improved Accountability?” pp 6 and 7. In addition, see I Ayres and J Braithwaite *Responsive Regulation : Transcending the Deregulation Debate* ( New York : Oxford Union Press 1992) pps 100- 125

<sup>28</sup> See Frc Annual Report 2005/2006 at pg 13

<sup>29</sup> See FRC Annual Report 2005/2006 at pg 14

<sup>30</sup> Ibid at pg 14

<sup>31</sup> ibid

<sup>32</sup> ibid

<sup>33</sup> B. Quinn ' The Bank of England and the development of internal control systems' at pg 35

<sup>34</sup> Ibid at pg 37

<sup>35</sup> Ibid at pg 38

<sup>36</sup> Ibid at pg 42

<sup>37</sup> ibid

was potential damage to what could be a co-operative relationship.<sup>38</sup> In the light of the above circumstances, the 1987 Banking Act concluded that auditors should have the ability but not the statutory duty to report to the Bank of England about concerns which related to the ability of their client to meet the criteria for authorisation.

However the protection of stakeholders should be paramount and have priority over the potential for a damaged relationship between auditor and client. As will be shown later on in this paper, co-operative relationships can still exist where there is mutual respect between both parties and where their standards and levels of integrity are not compromised. As a result, the non imposition of a statutory duty is unjustifiable. For the external auditor, there is always the possibility of conflict of interests occurring especially as a result of serving two masters – his client and the regulator . The reality of a situation involving “conflict of interests” occurring to an auditor during the performance of his duties may be more than or equally as probable as that of a potential damage to an auditor-client relationship. A statutory duty would however provide better accountability mechanisms than a system governed solely by self-regulation. As a result, the recommendation made by Lord Justice Bingham that the ability to report to the supervisor should be replaced by a statutory duty to do so in specified circumstances is long overdue.

### **The role of the audit**

The primary aim of the audit today is the verification of financial statements. The audit is an important part of the capital market framework as it not only reduces the cost of information exchange between managers and shareholders but also provides a signalling mechanism to the markets that the information which management is providing is reliable.<sup>39</sup> The auditor provides **independent** verification on the financial statements of a company and as a result, the audit loses its value when such independence which gives credibility to the financial statements, is undermined. According to accounting literature, the traditional role of the audit was mainly the detection and prevention of fraud.<sup>40</sup> The move to verification of financial statements arose from the growing investment in the railway, insurance and banking industry<sup>41</sup>. Suggestions have been made that this situation occurred because in these particular industries, the shareholding was more dispersed and more priority given to financial performance rather than on management's honesty.<sup>42</sup> Bank failures such as those of BCCI and Johnson Matthey resulted to a re-think of the objective of an audit to include the detection and prevention of fraud.<sup>43</sup>

### **The auditor's role and duty**

The first time that the role of the auditor was formally addressed in British banking regulation was when the right to communicate was introduced in the Banking Act 1987.<sup>44</sup> Section 47 of the Banking Act 1987 gave the auditor the right to report any matters of prudential concern to the Bank of England<sup>45</sup>. In its notice to auditors, the Bank's first example of circumstances to be reported is breach of the trigger capital ratio set by the Bank.<sup>46</sup> As long as auditors had communicated in good faith, they were not considered to have breached any duty of confidentiality.<sup>47</sup> Apart from a duty to communicate matters of concern immediately to prudential supervisors, the auditor was granted powers to furnish “special” reports under sections 39 and 41 of the Banking Act 1987.

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<sup>38</sup> *ibid*

<sup>39</sup> *Supra* note 2

<sup>40</sup> *Supra* note 3 at pg 3

<sup>41</sup> *Ibid* at pg 3

<sup>42</sup> *ibid*

<sup>43</sup> *ibid*

<sup>44</sup> Vieten pp 167 and 168

<sup>45</sup> *Ibid* at pg 167

<sup>46</sup> *ibid*

<sup>47</sup> Vieten at pg 167

The Bank of England commissions 2 types of reports namely the section 39 reports<sup>48</sup> and the section 41 reports<sup>49</sup>. During the course of 1995 and 1996, 647 section 39 reports and 2 section 41 reports were commissioned.<sup>50</sup> The collapse of Johnson Matthey Bankers led to the introduction of section 39 reports in the Banking Act 1987. The Bank of England further responded to the failure of JMB by introducing review teams which visited financial institutions for 2 or 3 days and longer for complex reviews.<sup>51</sup> The level of reliance placed on the accounting profession is also demonstrated through the Bank of England's Report for 1994/95.<sup>52</sup>

The Bingham Report on the BCCI affair proposed changing the auditor's right to communicate into a duty.<sup>53</sup> The Board of Banking Supervision recommended extending section 39 reports to subsidiaries in foreign jurisdictions and to replace annual section 39 reports with a more flexible approach based on regulatees' changing circumstances.<sup>54</sup> The relationship between supervisory authorities and the external auditors of a credit institution and the duties of these auditors was identified as an important lesson from the BCCI case.<sup>55</sup> Because of auditors' access to financial undertakings' accounts and other essential material, they are in a position to play an important role in the overall supervisory process.<sup>56</sup>

An analysis of BCCI showed that measures, additional to those already existing, needed to be taken to eliminate (i) The opaqueness of financial structures and (ii) Strengthen co-operation between all bodies or persons involved in the supervision of such complex financial structures<sup>57</sup>. As a result, the Basle Committee for Banking Supervision issued "minimum standards" which lay down rules for effective consolidated supervision and the co-operation of supervisory authorities. This was aimed at strengthening international co-operation between prudential supervisors and to improve transparency of financial and in particular, group and international structures.

Apart from their ability to audit the capital adequacy ratio, bank regulators rely on the expertise of auditors in terms of the technology they possess. Until 1987, banking supervision relied mainly on prudential returns and other disclosures made voluntarily by the management of authorised institutions<sup>58</sup> - however, this practice was open to abuse.

The collapse of Johnson Matthey Bankers also drew attention to the possibility of auditors failing to conduct detailed inquiries about quality of bank loans, quality or effectiveness of internal controls and that accuracy of prudential returns could be totally unjustified.<sup>59</sup> As a result of this, more detailed statutory arrangements were introduced, paving the way for a direct involvement of bank auditors in the supervisory process<sup>60</sup> through their role as alternative bank examiners and the extension of auditor liability. Generally producers of consumables owe a "duty of care" to third parties. However it was held in *Caparo Industries plc v Dickman and Others*<sup>61</sup> that generally, auditors only owe a duty of care" to the company as a legal person and that they do not owe a "duty of care" to any individual shareholder, creditor, pension scheme members or any other stakeholder.<sup>62</sup>

<sup>48</sup> These examine aspects of accounting and prudential reporting and internal control systems; see Vieten at pg 169. They are also commissioned regularly.

<sup>49</sup> These are commissioned on an exceptional basis where areas of concern have been identified

<sup>50</sup> Supra note 28 at pg 169

<sup>51</sup> Ibid at pg 172

<sup>52</sup> At page 39; also see Vieten at pg 172

<sup>53</sup> HC 198, 1992; see Vieten at pg 172

<sup>54</sup> HC 673, 1995 pg 261 ; see Vieten at pg 172

<sup>55</sup> J.F Mogg 'The Bank of England and the development of internal control systems' at pg 31

<sup>56</sup> Ibid at pg 32

<sup>57</sup> ibid at pg 28

<sup>58</sup> Hadjiemmanouil at pg 168

<sup>59</sup> Ibid at pg 168

<sup>60</sup> Ibid pg 169

<sup>61</sup> (1990) 1 All ER HL 568

<sup>62</sup> See House of Commons Select Treasury Committee, Further memorandum submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' at pg 21

The government has been criticised for failing to give more protection to audit stakeholders as the regulating accounting bodies often campaign to demand liability and other concessions for auditing firms.<sup>63</sup> It has also not fully considered why auditing firms would have any economic incentives to reflect on the negative consequences of their activities – especially in the absence of a “duty of care”.<sup>64</sup> The Department of Trade and Industry, the DTI, having joint responsibility for regulating the UK auditing industry, has also been criticised for not having adequate staff to perform duties of examining unexpected corporate collapses and frauds.<sup>65</sup> The inspectors it appoints to examine these collapses have been said to rarely examine the impact of organisational culture and values on audit failures.<sup>66</sup> Prem Sikka adds that the threat of a punitive action by the DTI could create **economic** incentives for accounting firms to reflect on the consequences of their actions – as a reduction in their revenue, due to fines incurred, would make them think twice before indulging in acts with negative consequences. Since the Companies Act 1989, the accountancy bodies have formally been given powers to act as regulators of the UK auditing industry and Prem Sikka states that accounting bodies could call for changes to the legal and institutional structures in order to persuade auditing firms to revise values that influenced an audit.<sup>67</sup> However, they are influenced by pursuit of their economic interests<sup>68</sup> - hence a situation involving a 'conflict of interest' arising. The issue relating to the aftermath of BCCI is mentioned where following the Bingham Report, Lord Justice Bingham proposed a statutory duty to be owed by the auditor but the auditing industry still opposed the imposition of any “duty” to report financial irregularities to the regulators<sup>69</sup>.

The use of auditors as bank examiners has transformed the traditional relationship between auditors and their clients. In cases where auditors acted on behalf of regulators and were not directly employed by banks, they were also like third parties. However where auditors were employed by banks - their clients, a duty of confidentiality was still owed to the banks and this would be breached if they communicated information to the Bank of England. As a result, the Banking Act 1987 removed the auditor's duty of confidentiality to their client institution in relation to matters communicated to the Bank in good faith.

Secondary legislation introducing a duty to report apparent irregularities under appropriate circumstances came into force on the 1<sup>st</sup> May 1994.<sup>70</sup> Under domestic provisions, bank auditors and reporting accountants were obliged to report to the Bank their concerns whenever they had reasonable cause to believe that any of the minimum criteria for authorisation as a deposit-taker had been breached.<sup>71</sup>

The prudential returns of authorised institutions and meetings between their senior management and supervisors were the Bank of England's main sources of information.<sup>72</sup> However the Bank expected bank auditors and reporting accountants to play a direct role in the regular supervisory process. Although the Banking Act 1987 paved way for direct bilateral communication between bank auditors and the Bank of England, the Bank recognised that accountants should not be asked to act in ways which would undermine their professional relationship with their clients and accordingly continued to put primary responsibility for conveying any vital information on the authorised institutions themselves.<sup>73</sup>

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<sup>63</sup> *ibid*

<sup>64</sup> *ibid*

<sup>65</sup> *ibid*

<sup>66</sup> *Ibid*

<sup>67</sup> *Ibid* at pg 22

<sup>68</sup> *Ibid*

<sup>69</sup> *ibid*

<sup>70</sup> Accountants (Banking Act 1987) Regulations 1994, S.I. 1994/524 ; see Hadjiemmanouil at pg 172

<sup>71</sup> *Ibid* at pg 172

<sup>72</sup> *ibid* at pg 174

<sup>73</sup> Hadjiemmanouil at pg 174

## **Statement of Auditing Standards (SAS) 620 Revised : The Auditor's Right and Duty To Report To Regulators in the Financial Sector**

The International Standard on Auditing (ISA UK and Ireland) 250 sections A and B also respectively deal with consideration of laws and regulations in an audit of financial statements and the auditors' right and duty to report to regulators in the financial sector .

According to the Statement of Auditing Standards (SAS) 620 which replaced the original SAS issued in 1994, directors of regulated entities have primary responsibility for ensuring that all appropriate information is made available to regulators. Auditors' reports on records, systems and returns, regular meetings with directors and/or senior management supplemented by any inspection visits considered necessary by regulators should provide regulators with all the information they need to carry out their responsibilities. Through the auditor's involvement in the regulatory and supervisory process, the possibility of capture occurring could be reduced significantly as personnel exchange or frequent contact between the regulator and the regulated is reduced.

Auditors have routine reporting responsibilities and also responsibilities to provide a special report required by the regulator. In addition, auditors are required by law to report, subject to compliance with legislation relating to "tipping-off", direct to a regulator when they conclude that there is reasonable cause to believe that a matter is or may be of material significance to the regulator.

Under the Financial Services and Markets Act 2000 ( Communication by Auditors) Regulations 2001 ( " the 2001 Regulations"), the auditor has duties under certain circumstances to make reports to the FSA<sup>74</sup>. The 2001 Regulations also do not require the auditor to perform any additional work because of the the statutory duty nor is the auditor required to specifically look out for breaches of the requirements applicable to a certain authorised firm.<sup>75</sup>

Section 342 of the FSMA 2000 also <sup>76</sup>provides that no duty to which an auditor of an authorised firm is subject shall be contravened by communicating in good faith to the FSA information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.

### ***Confidentiality***

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<sup>74</sup> See ISA (UK and Ireland) 250 section B paragraph 54 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector

<sup>75</sup> *ibid*

<sup>76</sup> See ISA (UK and Ireland) 250 section B paragraph 82 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector



In accordance with SAS 620, auditors are entitled to communicate to regulators information or opinions in good faith about matters relating to business or affairs of the entity or any associated body. However, this relates to information and opinions obtained in their capacity as auditors. Auditors and regulators should be aware that confidential information obtained in other capacities may not be normally disclosed to another party.

Even though confidentiality is an implied term of auditors' contracts with authorised firms, section 343 of the FSMA states that an auditor of an entity closely linked to an authorised firm who is also the auditor of that authorised firm does not contravene that duty if he reports to the FSA information or his opinion, if he is acting in good faith and if he reasonably believes that the information or opinion is relevant to any function of the FSA.<sup>77</sup>

### **Statements of Auditing Standards (SAS) 120 Revised : Consideration of law and regulations**

The revised Statement of Auditing Standards (SAS) 120 replaced the original SAS issued in 1995. According to the Auditing Practices Board, the purpose of this SAS is to establish standards and provide guidance on the auditor's responsibility to consider law and regulations in an audit of financial statements.

### **Responsibilities of the auditors**

According to the Auditing Practices Board,<sup>78</sup> 'it is not the auditor's function to prevent non-compliance with law and regulations. The fact that an audit is carried out may, however, act as a deterrent.' An audit is not expected to detect **all** possible non-compliance with law and regulations. The responsibilities of auditors of private sector entities as regards law and regulations are similar to those of auditors of limited companies and other entities in the private sector.

**Auditors should plan and perform their audit procedures, evaluate and report on the results thereof, recognising that non-compliance by the entity with law or regulations may materially affect the financial statements (SAS 120.1).** This can be done through <sup>79</sup> : (a) obtaining a general understanding of the legal and regulatory framework applicable to the entity and the industry, and of the procedures followed in order to ensure compliance with that framework; (b) inspection of correspondence with relevant licensing or regulatory authorities; (c ) making enquiries with directors as to whether they are aware of notice of any such possible instances of non-compliance with law and regulations; and (d) obtaining written confirmation from the directors that they have disclosed to the auditors all those events of which they are aware which involve possible non-compliance, together with the actual or contingent consequence which could arise there from.

<sup>77</sup> See ISA (UK and Ireland) 250 section B paragraph 75 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector

<sup>78</sup> see [www.frc.org.uk](http://www.frc.org.uk)

<sup>79</sup> SAS 120.3

### **Procedures to be followed when possible non-compliance with law or regulations is discovered.**

According to SAS 120.5, auditors should obtain an understanding of the nature of the act, the circumstances in which it occurred and sufficient other information to evaluate the possible effect on the financial statements when they become aware of information which indicates that non-compliance with law may exist.

They should then document their findings and subject to compliance with legislation relating to “tipping off” and any other requirement to report them direct to a third party, discuss them with the appropriate level of management (SAS 120.6).

Auditors should also consider the implications of suspected or actual non-compliance with law or regulations in relation to other aspects of the audit (SAS 120.7).

### **Reporting non-compliance with law or regulations**

Action taken by auditors to report a suspected or actual non-compliance with law or regulations varies according to their statutory responsibilities. In accordance with SAS 120.8 and subject to compliance with legislation relating to “tipping-off” and, save where SAS 120.15 applies, auditors should as soon as practicable, either : (a) communicate with management and the board of directors including the audit committee, or (b) obtain evidence that they are appropriately informed.

Auditors can also : (a ) Report to addressees of the auditor’s report on the financial statements (SAS 120.10); (b) Report to third parties (SAS 120.12).

### **The external auditor's involvement in the banking supervisory process**

The FSA operates through a mixed system of supervision whereby it inspects banks (on-site supervision) and whereby it utilises external auditors (off-site supervision).

The effectiveness of this combination of on-site and off-site supervision can be efficiently assessed through a holistic examination of :

- 1) The way in which the audit profession is regulated
- 2) The enforcement of principles and rules relating to the audit profession.

### **Self-regulation and regulatory capture**

The UK accountancy profession is regulated through a process of self regulation – even though there is state oversight. In this sense, UK accounting may be said to be governed by a mixture of state and self-regulation.<sup>80</sup> The weakness of self regulation stems from the fact that the accountancy profession is acting as a watch dog over its own members’ affairs and as a result, is more prone to regulatory capture. The Financial Reporting Council (FRC) regulates the accounting profession. Amongst its components, the most important in relation to issues of compliance, is the Financial Reporting Review Panel

<sup>80</sup> Supra note 12 ; Also see page 5 of this paper where it states that the Department of Trade and Industry has joint responsibility for regulating the UK auditing industry.

(FRRP). The FRRP acts as a watch dog - to ensure compliance of financial accounts with requirements of the Companies Act 1985 and applicable accounting standards. However, it does not offer advice on the application of accounting standards or the accounting requirements of the Companies Act 1985.<sup>81</sup>

### **Regulatory Capture**

Regulatory capture is generally defined as capture of the regulator by the regulated. The theory of regulatory capture was introduced by Richard Posner,<sup>82</sup> who argued that 'regulation is not about the public interest at all, but is a process, by which interest groups seek to promote their private interest ... Over time, regulatory agencies come to be dominated by the industries regulated.' Characteristics of situations where regulatory capture is likely to occur include<sup>83</sup> : Where: only one industry is being regulated, where the regulator is part of a larger organisation, where there is conflict between regulator and the regulated, where regular contact occurs between the regulator and the regulated and/or where a regular exchange of personnel occurs between the regulator and the regulated. Standards (SASs) could help prevent conflict between the regulator and the regulated as the external auditor's involvement in the regulatory and supervisory process, according to the SASs, presents a situation whereby the regulator becomes less involved – through the external auditor acting on behalf of the regulator. Hence there is likely to be less conflict between the regulator and the regulated. The possibility of regular contact between the regulator and the regulated is also less likely where the external auditor acts on behalf of the regulator. Where the regulator is part of a larger organisation, the external auditor could still help prevent regulatory capture. The external auditor's role is to work on behalf of the regulator, with the relevant department/s which make up the regulator and communicate with the regulated.

### **The Financial Reporting Council**

In 1991, the Financial Reporting Council (FRC) and its subsidiaries were established to address problems in the UK related to the quality of financial reporting.<sup>84</sup> The previous regime had been inadequate as accounting standards were flexible, compliance was poor and no effective enforcement mechanisms were in place to deal with directors who breached accounting standards.<sup>85</sup> The pressure faced by auditors from directors and creative accounting were major issues.

Parliament has delegated a lot of reforms to self-regulatory bodies. As illustrated earlier, statements of auditing standards (SASs) govern the duty of auditors<sup>86</sup> rather than statutory imposition of a duty as recommended by Lord Justice Bingham. Statutory control should however provide better accountability and provide more effective enforcement measures than a system of self-regulation. A system of self regulation is also likely to be more susceptible to regulatory capture<sup>87</sup>.

The subsidiaries of the Financial Reporting Council included the Accounting Standards Board (ASB) – which became responsible for setting standards; the Urgent Issues Task Force and the Financial Reporting

<sup>81</sup> See [www.frc.org.uk](http://www.frc.org.uk) (last visited 19 December 2005)

<sup>82</sup> See R. Posner 'Theories of economic regulation' (1974) 5 Bell Journal of Economics and Management Science pp 335-358; G. Stigler 'The theory of economic regulation' (1971) 2 Bell Journal of Economics and Management Science pp 3-21; J Laffont and J Tirole 'The politics of Government Decision Making : A Theory of Regulatory Capture' (1991) 106 Quarterly Journal of Economics pp 1089-1127.

<sup>83</sup> I Ayres and J Braithwaite *Responsive Regulation : Transcending the Deregulation Debate* ( New York : Oxford Union Press 1992) at pg 115

<sup>84</sup> Supra note 12 at pg 6

<sup>85</sup> *ibid*

<sup>86</sup> See SAS 620 Revised : The Auditor's Right and Duty to report to regulators in the financial sector; SAS 120 Revised : Consideration of Law and Regulations

<sup>87</sup> See J.Godfrey and I Langfield - Smith 'Regulatory Capture in the Globalisation of Accounting Standards' WPG 04-08

Review Panel.

On the 24 July 2002, an immediate review of the regulatory arrangements for the accountancy and audit professions was called for by Patricia Hewitt, Secretary of State for Trade and Industry. The purpose of this review was to look at the way the accountancy and audit professions were regulated, consider whether changes should be made and whether there should be a statutory basis for regulation.<sup>88</sup> On the 11 March 2003, the Department of Trade and Industry published a consultation document “Review of the Regulatory Regime of the Accountancy Profession : Legislative Proposals” and the aims and objectives of the new FRC and its Boards have since been published.<sup>89</sup>

In 2004, improvements were made to the FRC and its operating bodies now include :  
The Accounting Standards Board (ASB), the Auditing Practices Board (APB), the new Professional Oversight Board for Accountancy (POBA), the Financial Reporting Review Panel (FRRP) and the Accountancy Investigation and Discipline Board , the AIDB.

The FRC's aim is to promote confidence in corporate reporting and governance.<sup>90</sup> On 1 April 2004, the FRC became the UK's unified independent regulator for corporate reporting and governance, with the following functions:<sup>91</sup>

- setting, monitoring and enforcing accounting and auditing standards
- statutory oversight and regulation of auditors
- operating an independent investigation and discipline scheme for public interest cases
- overseeing the regulatory activities of the professional accountancy bodies
- promoting high standards of corporate governance

Responsibilities have been widened to include new activities, including setting and monitoring auditing standards, and deepened to undertake existing tasks, such as the enforcement of accounting standards more intensively.<sup>92</sup>

The FRC's five key objectives are to promote:<sup>93</sup>

- high quality corporate reporting
- high quality auditing
- high standards of corporate governance
- the integrity, competence and transparency of the accountancy profession
- its effectiveness as a unified independent regulator

**The FRC's fourth objective aimed at promoting the integrity, competence and transparency of the accountancy profession includes :**<sup>94</sup>

**a) Overseeing the way in which the professional bodies exercise their regulatory responsibilities in relation to their members**

- Discussing with individual professional bodies their regulatory processes and following up where necessary progress on specific issues.
- Developing a programme of cyclical test checks on the regulatory activities of the professional bodies.

<sup>88</sup> Review of the Regulatory Regime of the Accountancy Profession, Report to the Secretary of State for Trade and Industry, see [www.dti.gov.uk/cld/post\\_enron.htm](http://www.dti.gov.uk/cld/post_enron.htm).

<sup>89</sup> See [www.accountancyfoundation.com/neworganisation.cfm](http://www.accountancyfoundation.com/neworganisation.cfm) and <http://www.dti.gov.uk/cld/cgaai-final.pdf>

<sup>90</sup> See FRC Annual Report 2004/2005 at p 6 <http://www.frc.org.uk/about/annual.cfm> last visited 19 December 2005

<sup>91</sup> See FRC Annual Report 2004/2005 at p 6 <http://www.frc.org.uk/about/annual.cfm>

<sup>92</sup> See <http://www.frc.org.uk/about/annual.cfm>

<sup>93</sup> *ibid*

<sup>94</sup> *Ibid* at pg 25

- Publishing reports on:
  - Training and Education, which made recommendations for the enhancement of existing training and education arrangements for accountants
  - the professional accountancy bodies' procedures for dealing with complaints and member discipline.
- Publishing, in February 2005, a new edition of 'Key Facts and Trends in the Accountancy Profession'.

**b) Operating an independent investigation and discipline scheme for matters which raise or appear to raise important issues affecting the public interest<sup>95</sup>**

- Finalising and adopting, and keeping under review, the Accountancy Investigation and Discipline Board, the AIDB, Scheme and Regulations.
- Preparing and keeping under review procedures for investigation, case referral and case call-in.
- Establishing links with other investigating authorities and regulators.
- Establishing a panel of 36 disciplinary tribunal members.
- Monitoring developments and carrying out preliminary enquiries relating to potential disciplinary cases.
- Investigating matters relating to Mayflower Corporation plc referred to the AIDB.

**c) Establishing standards and guidance for accountants providing assurance services**

- Updating the existing SIRs for changes in listing rules arising from the Prospectus Directive, and developing new SIRs on reporting on prospective and pro forma financial information.

***The Financial Reporting Review Panel (FRRP)<sup>96</sup>***

**Enforcement of accounting/audit principles**

Enforcement can be defined as all procedures in a country in order to assure the proper application of accounting principles<sup>97</sup>. The FRRP is a privately organised review panel which investigates complaints that are brought to its attention. The strength of this mechanism lays in the public "naming and shaming" by means of press communication. This is very effective as companies will try to avoid their name and reputation being damaged. The FRRP is an "oversight system" and watch dog for large and listed companies. Weaknesses are however inherent in the FRRP and they include :

- i) Not being able to detect significant non – compliance in company accounts.
- ii) There is also a gap in the regulatory framework in respect of how certain accounting issues should be treated.

Some commentators have suggested that the effectiveness of the FRRP may be improved through introduction of pro-active monitoring and that any proposals for a change should be co-ordinated closely with developments in Europe<sup>98</sup>.

Despite these weaknesses, the argument for the use of external auditors is very strong. The Basel Committee for banking supervision has highlighted the need for a continuing dialogue between

<sup>95</sup> Ibid at pg 25

<sup>96</sup> Ibid pp 12, 13

<sup>97</sup> The Federation des Experts Comptables Europeens (FEE)

<sup>98</sup> House of Commons Select Committee on Treasury Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies in the UK at pg 5 . Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/)

banking supervisors and the accountancy/audit profession. Other reasons for the need of external auditors include:<sup>99</sup>

- 1) Banking supervisors need to be making more use of external auditors if they are to meet the requirements of the Basel Principles ( Core Principles for effective Banking Supervision).
- 2) The increasing supervisory focus on corporate governance and on internal controls will require supervisors to take account of the views of external auditors.
- 3) The increasing sophistication of control and risk management systems requires the expertise of external auditors.
- 4) Increased reliance on IT systems requires the expertise of external auditors.
- 5) Move of banking supervision to oversight of process rather than detailed examination requires skills which can be provided by external auditors.
- 6) The perception of a conflict of interest between the role of reporting to shareholders and that of reporting to supervisors is more apparent than real and is addressed by appropriate guidance and standards, including principles laid down by the Basel Committee.

Enforcement of audit standards appears in most European countries at 6 levels namely :<sup>100</sup>

- 1) Self Enforcement : Preparation of financial statements
- 2) Statutory audit of financial statements
- 3) Approval of financial statements
- 4) Institutional oversight systems
- 5) Court : sanctions and complaints
- 6) Public and press reactions

The Financial Reporting and Review Panel's role is to examine apparent departures from the accounting requirements of the 1985 Companies Act, including applicable accounting standards and to seek an order from the court to remedy them – if necessary.<sup>101</sup> Following the collapse of Enron, reforms were put in place by the government. These reforms included giving the FRRP the task of proactively investigating listed company accounts for inaccuracies rather than waiting for a complaint to be made.<sup>102</sup> Bittlestone disagrees with the views shared by Stella Fearnley and Tony Hines in their column<sup>103</sup> that proactive investigation would be costly for little benefit. He argues that technology could be adopted by the FRRP at a fraction of the costs feared by Fearnley and Hines and that a proactive FRRP would help restore investor faith in the ability of financial reporting following such failures as Enron.<sup>104</sup>

The FRRP has commenced a risk-based approach to the enforcement of accounting requirements in addition to the existing reactive, complaints-driven approach.<sup>105</sup> This new combined approach was one of the main decisions resulting from the Government's review of the regulatory regime for accounting and auditing and required significant changes to the way in which the FRRP operates and a significant increase in the resources devoted to enforcement<sup>106</sup>.

During 2004/2005, the FRRP also worked with other regulators and Government to complete the necessary

<sup>99</sup> The Role of External Auditors in Financial Services Supervision, Report by PricewaterhouseCoopers researched by Dr Oonagh McDonald, summary prepared by Richard Quinn, foreword by John Tattersall, Chairman, PricewaterhouseCoopers UK Financial Services Regulatory Consulting Group, November 2000.

<sup>100</sup> Federation des Experts Comptables Europeens : Enforcement Mechanisms in Europe.

<sup>101</sup> R. Bittlestone, 'Now for the quake test' , Financial Times, 6<sup>th</sup> November 2003 ; also see [www.metapraxis.com/publications/business/quaketest.html](http://www.metapraxis.com/publications/business/quaketest.html)

<sup>102</sup> *ibid*

<sup>103</sup> See S.Fearnley, T. Hines ' Sour taste of bad law' 25/09/2003

<sup>104</sup> *Ibid* at pg 2

<sup>105</sup> FRC Annual Report 2004/2005 See <http://www.frc.org.uk/about/annual.cfm> at pp 12,13

<sup>106</sup> *ibid*

preparations for the additional responsibilities which the Panel has acquired under the C(AICE) Act 2004.<sup>107</sup> The extension of the FRRP's remit to include the monitoring of the accounting requirements of the Listing Rules, coupled with the need for the UK to demonstrate compliance with the EU Standards on national enforcement arrangements, prompted a thorough review and overhaul of the Memorandum of Understanding with the FSA.<sup>108</sup> The revised MoU reflects a new working relationship between the two authorities in which there is co-operation to promote effective monitoring of financial information in the UK and in which commitment is made to the sharing of relevant information<sup>109</sup>. At the same time, the FRRP developed an MoU with the Inland Revenue which sets out the arrangements through which the Revenue may disclose matters relevant to the FRRP's function.<sup>110</sup>

The FRRP's new responsibilities and powers were reflected in a revised set of operating procedures which, for the first time, were issued in draft for public comment.<sup>111</sup> During the year 2004/2005, the FRRP contributed to the development of a harmonised approach to the enforcement of accounting requirements across the EU through its role as technical adviser to the FSA.<sup>112</sup>

### ***The Accounting Standards Board (ASB)<sup>113</sup>***

The ASB's work during 2004/2005 was dominated by the international standard-setting agenda. The ASB contributed to the development of IFRS, working with the IASB and other national standard setters. The ASB also influenced EU policy on accounting standards, including the adoption of IFRSs. Of the 36 international accounting standards which are mandatory from 1 January 2005, all but one have been adopted without amendment for use in the EU. The exception is IAS 39 'Financial Instruments: Recognition and Measurement'. The ASB has been considering its future role in the light of international and EU developments and, in March 2005, issued an Exposure Draft of a Policy Statement 'Accounting Standard-setting in a Changing Environment: The Role of the Accounting Standards Board'.

The ASB published seven UK standards based on IFRS during 2004/2005.<sup>114</sup> The Exposure Draft proposes that the ASB will continue its work to bring about convergence between UK standards and IFRS - adopting UK standards based on IFRS with no changes other than those that were essential or justifiable.

During 2004/2005, the ASB also issued a major new standard on life assurance accounting (FRS 27)<sup>115</sup>. This followed a request from HM Treasury to carry out an urgent study into the accounting for with-profits business by life insurers, in the light of the issues raised by the Penrose Report on Equitable Life.

### ***Auditing Practices Board (APB)<sup>116</sup>***

As a result of its post-Enron review of audit and accounting issues, the Government concluded that the APB should take responsibility for setting standards for the independence, objectivity and integrity of auditors ("ethical standards").<sup>117</sup> In November 2003, the APB issued exposure drafts of five new ethical standards for auditors.<sup>118</sup> In developing these exposure drafts, the APB took account of international

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<sup>107</sup> *ibid*

<sup>108</sup> *ibid*

<sup>109</sup> *ibid*

<sup>110</sup> *ibid*

<sup>111</sup> *ibid*

<sup>112</sup> *ibid*

<sup>113</sup> *Ibid* pp 8,9

<sup>114</sup> *ibid*

<sup>115</sup> *ibid*

<sup>116</sup> *Ibid* pp 10,11

<sup>117</sup> *ibid*

<sup>118</sup> *ibid*

developments, including the requirements of the EU Recommendation on the independence of statutory auditors.<sup>119</sup>

***The Professional Oversight Board for Accountancy (POBA)***<sup>120</sup>

This is a new operating body which has established its role in the regulation of auditing and in overseeing the accountancy profession during its first full year (2004/2005)<sup>121</sup>. The POBA has undertaken a comprehensive review of the training and education of accountants in the UK, focusing on the way in which this influences the quality of financial reporting.<sup>122</sup> The objective of the review is to support confidence in financial reporting through evaluating the adequacy of the training and education arrangements in the accountancy and audit profession<sup>123</sup>. The POBA has actively participated in the development of a consistent approach to international regulation of auditors - advising the DTI on the European 8th Directive, sharing best practice with other international bodies as they evolve<sup>124</sup>. In 2005/2006, the POBA responsibilities were extended to include the oversight of the regulation of the actuarial profession.<sup>125</sup> To reflect its new responsibilities, the POBA changed its name into the Professional Oversight Board.<sup>126</sup>

***Accountability***<sup>127</sup>

The FRC has taken significant steps to ensure that it is accountable for its work, by:

- inviting comments on its Plan & Budget for 2005/06, which it published in December 2004 alongside the Regulatory Strategy
- starting to implement new measures to assess and report on its performance

Apart from the regulatory reforms which involved the introduction of the FRC, the development of a framework for corporate governance took place and such developments led to the establishment of audit committees, concepts such as the separation of duties between chairman and chief executive and an emphasis on the need for non-executive directors.

**Corporate governance**

The Financial Reporting Council's aim is to provide confidence on corporate reporting and governance.<sup>128</sup> Many definitions have been suggested as to what constitutes corporate governance. Whilst Keasy and Wright<sup>129</sup> define it as the examination of the “structures and processes associated with production, decision-making, control and so on within an organisation, the Cadbury Committee defined it as “the system by which companies are directed and controlled”. Following financial scandals such as those of Polly Peck and BCCI, the Cadbury Committee was set up in 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance.<sup>130</sup> The two key aspects of governance are: <sup>131</sup> Supervision and monitoring of management performance ( the enterprise aspect) and ensuring accountability of management to shareholders and other stakeholders (the accountability aspect).

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<sup>119</sup> *ibid*

<sup>120</sup> *Ibid* at pp 11,12

<sup>121</sup> *ibid*

<sup>122</sup> *ibid*

<sup>123</sup> *ibid*

<sup>124</sup> *ibid*

<sup>125</sup> See FRC Annual Report 2005/2006

<sup>126</sup> *ibid*

<sup>127</sup> FRC Annual Report 2004/2005 at pp 16,17

<sup>128</sup> See FRC Annual Report 2005/2006

<sup>129</sup> See K.Keasy and M.Wright 'Issues in Corporate Accountability and Governance : An Editorial' *Accounting and Business Research* , 23 (91A) pg 291

<sup>130</sup> V. Beattie, S.Fearnley, R. Brandt 'Behind closed doors : What company audit is really about' Institute of Chartered Accountants in England and Wales (2001) at pg 27

<sup>131</sup> *ibid* at pg 26



The Cadbury Report made important references to aspects of internal control systems in the context of all public companies.<sup>132</sup> The Cadbury Report also highlighted that the low level of confidence in financial reporting and auditing was caused by :<sup>133</sup> The absence of a clear framework whereby the directors reviewed the company's internal controls; the looseness of accounting standards; and pressures on auditor independence.

The report's recommendations were presented as a voluntary Code of Best Practice.<sup>134</sup> Compliance with the code was however made compulsory by the London Stock Exchange for listed companies after June 1993.<sup>135</sup> Recommendations include :<sup>136</sup> That board of directors include a significant number of independent non-executive directors and that an audit committee comprising independent directors be formed; that audit committee should (i) Review financial statements before submission to the full board (ii) Ensure adequate resources for the internal audit function and co-ordination of such function with the external auditors (iii) Appoint and assess remuneration of the external auditors; (iv) that the board report on the effectiveness of internal controls and the company's going concern status and that (v) the external auditor review this report.

The Cadbury Report was the first of a series of reports to strengthen corporate governance. Other reports include : The Rutterman Report (1994) which recommended that directors disclose the key procedures that they had established to provide effective internal financial control;<sup>137</sup> the Greenbury Report (1995) which recommended the establishment of a remuneration committee comprising non-executive directors and the publication of information on directors' remuneration and compensation in the annual report;<sup>138</sup> ; the Hampel Committee's Report (1998) which reviewed the implementation of the Cadbury Code to ensure that its original purpose was being achieved<sup>139</sup> and the Turnbull Report which builds on corporate governance – turning it into a positive management vehicle for risk management and corporate reporting.<sup>140</sup> The Turnbull Committee recommended a risk-based approach to establishing a sound based system of internal controls.<sup>141</sup> The link between companies' objectives, internal control and risk management in the Turnbull Report which requires directors to examine their control of the company on a regular basis further strengthens corporate governance.<sup>142</sup> In October 2005, an updated version of “Internal Control : Guidance for Directors on the Combined Code “ - also known as the Turnbull Guidance was published and took effect for financial years beginning on or after 1 January 2006.<sup>143</sup>

## Audit Committees

The Cadbury Report highlighted the value of audit committees as internal monitoring device supportive of

<sup>132</sup>B. Quinn 'The Bank of England and the development of internal control systems' at pg 35

<sup>133</sup> V. Beattie, S.Fearnley, R. Brandt 'Behind closed doors : What company audit is really about' Institute of Chartered Accountants in England and Wales (2001) at pg 27

<sup>134</sup> ibid

<sup>135</sup> ibid

<sup>136</sup> Ibid at pg 27

<sup>137</sup> House of Commons Select Committee on Treasury Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies in the UK at pg 8 . Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/)

<sup>138</sup> ibid

<sup>139</sup> ibid

<sup>140</sup> House of Commons Select Committee on Treasury Minutes of Evidence; Appendix 8; Memorandum from the Chartered Institute of Public Finance and Accountancy at pg 2

<sup>141</sup> House of Commons Select Committee on Treasury Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies in the UK at pg 10 . Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/)

<sup>142</sup> House of Commons Select Committee on Treasury Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies in the UK at pg 11

. Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/)

<sup>143</sup> See FRC Annual Report 2005/2006 at pg 17

good corporate governance<sup>144</sup>. Audit committees were also seen as a mechanism to ensure that an appropriate relationship existed between the auditor and the management whose financial statements were being audited.<sup>145</sup>

Recent Pricewaterhouse survey of chief executive officers (CEOs) and audit committee chairmen of the FTSE 250 companies revealed ten characteristics that the “best” audit committees had in common.<sup>146</sup>

External auditors and audit committees have significant roles to play in ensuring directors' accountability. The Auditing Practices Board notes the potential importance of audit committees in both enhancing the value of external audit to shareholders and helping to re-inforce auditor's objectivity and commitment to high quality auditing.<sup>147</sup> The Hampel Report also notes that audit committees form an essential safeguard for auditor independence<sup>148</sup>.

## Threats to objectivity and independence

### Non audit services

Non-audit services may be defined as any services other than audit provided to an audit client by an auditor.<sup>149</sup> There are three categories of non-audit services namely<sup>150</sup>: Services required by legislation or contract to be performed by auditors of the business; services that will be better performed by auditors because of their knowledge of the business and services which could be provided by a number of firms.

Ethical Standard 5<sup>151</sup> describes the general approach to be adopted by audit firms and auditors in relation to the provision of non audit services to their audit clients. This approach is adoptable regardless of the nature of the non-audit services which are addressed in a given case. Ethical standard 5 paragraph 6 addresses “non audit services” as involving any engagement in which an audit firm provides professional services to an audit client other than pursuant to :

- a) The audit of financial statements; and
- b) Those other roles which legislation or regulation state can be performed by the auditors of the entity.

The risks by auditors from providing these services is that it may affect the auditor's independence because

<sup>144</sup> Supra note 12 at pg 29

<sup>145</sup> ibid

<sup>146</sup> V. Beattie, S.Fearnley, R. Brandt 'Behind closed doors : What company audit is really about' Institute of Chartered Accountants in England and Wales (2001) at pg 29. These are as follows : That non executive directors have relevant industry experience; that there should exist at least some members with a sound grasp of current developments in financial markets; that there be openness to regular training; that there be distinct appointment policies and criteria, succession planning and membership rotation; that there be clear delineation between their role and that of the full board; that there be clear brief and strategies for setting an appropriate control culture within their organisations; that there be regular, clearly structured meetings held at least four times a year; that there exist regular flow of relevant, timely information from company executives; that at least annually, a private meeting between each of the external and internal audit leaders be held ; and for self-assessment procedures to exist.

<sup>147</sup> APB, 1996, Next Steps S. Fearnley at pg 30

<sup>148</sup> See paragraph 6.9

<sup>149</sup> Supra note 2

<sup>150</sup> House of Commons , Select Committee on Treasury, Minutes of Evidence at pp 18 and 19 . Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/) Services required by law or contract include regulatory returns eg to the FSA, legal requirements in many countries including the UK, for auditors to report on matters such as share issues for non-cash consideration; contractual requirements, for example to report to lenders or vendors on net assets, covenant requirements etc. Services that are most efficient for the auditors to provide because of their existing knowledge of the business include those services listed in category (1) above but where the information derives mainly from the audited financial records and such include : tax compliance, where much of the information results from the audited financial records and “short form” or other reports in acquisition or reorganisation situations where completion is necessary in a very short time. The third category namely services which could be provided by a number of firms, include management consultancy, tax advice and human resources consultancy.

<sup>151</sup> Paragraphs 6 to 38

they may either become too close to the company they are auditing or because their objectivity may be challenged due to reliance on income from a single source.<sup>152</sup> Arrangements are well in place to deal with these risks to protect the auditor's independence.

Firstly, the Institute of Chartered Accountants in England and Wales' ethical code forbids auditors to provide non-audit services to audit clients if that would present a threat to independence where no sufficient safeguards were available.<sup>153</sup> Secondly, under provisions of the Combined Code of corporate governance, the audit committee, as representative of the shareholders, is required to supervise the relationship with the auditors and monitor the nature and scope of non-audit services.<sup>154</sup> The audit committee must be sure that the independence and objectivity of the auditor is not compromised.<sup>155</sup>

It has however been concluded that there is no evidence confirming correlation between levels of non-audit fees and audit failures and that as a result, sufficient safeguards are in place.<sup>156</sup> This issue continues to generate different opinions and outcomes. Under the Sarbanes-Oxley Act 2002, the provision of nine kinds of non-audit services from a company's own auditors is now banned.<sup>157</sup>

The Chartered Institute of Public Finance and Accountancy submitted its 'public sector model' to the Treasury Select Committee following the collapse of Enron. This public sector model provides many measures to safeguard the auditor's independence – in comparison to that which operates in the private sector.<sup>158</sup> Most public service bodies do not appoint their auditors and in the central government, the auditors are appointed either by Parliament or by the Secretary of State of the sponsoring department.<sup>159</sup> However this public sector model was developed for a different sector which requires a wider scope of audit, does not directly address multinational entities and the number of appointments made under this model is much lower than that for the private sector.<sup>160</sup> Nonetheless, it is a model worth considering as it helps a long way in catering for the problems brought about where there is no auditor independence.

### **Self interest threat**

This arises when auditors have financial or other interests which might result to them being reluctant to take actions that would be adverse to the interests of the audit firm.<sup>161</sup>

### **Self review threat**

<sup>152</sup> House of Commons , Select Committee on Treasury, Minutes of Evidence at pg 19 . Also see [www.publications.parliament.uk/cgi-bin/](http://www.publications.parliament.uk/cgi-bin/)

<sup>153</sup> ibid

<sup>154</sup> ibid

<sup>155</sup> Ibid ; UK Auditing Standards specifically require that for listed companies, audit engagement partners responsible for a company's audit must: Disclose in writing to the audit committee all relationships between the audit firm and the client that may affect independence and objectivity; confirm in their professional judgement, the firm's independence and objectivity and thirdly, the ethical code specifies that an audit appointment to a listed company should not be accepted if the client provides a significant portion ( 10%) of a firm's gross income. Fourthly, shareholders themselves are able to assess the extent of non-audit services provided by auditors. Companies Acts have for some years required the total amount of non-audit fees paid to auditors to be disclosed.

<sup>156</sup> House of Commons , Select Committee on Treasury, Minutes of Evidence on Lessons from Enron at pp 18 and 19 and House of Commons Hansard Debates for 19 Oct 2004 (pt 17) Column 806.

<sup>157</sup> House of Commons Hansard Debates for 19 Oct 2004 (pt 17) Column 806.

<sup>158</sup> House of Commons Select Committee on Treasury Minutes of Evidence; Appendix 8; Memorandum from the Chartered Institute of Public Finance and Accountancy at pp 2-5

<sup>159</sup> Ibid at pg 2

<sup>160</sup> ibid

<sup>161</sup> Ethical Statement 1 Integrity, objectivity and independence paragraph 28  
<<http://www.asb.co.uk/apb/publications/index.cfm>>

This arises when the results of a non audit service performed by the auditors or by others within the audit firm are included in the figures disclosed in the financial statements.<sup>162</sup> As a result of providing non audit service, the audit firm is associated with aspects of the preparation of the financial statements and may be unable to give an objective view of relevant aspects of those financial statements.<sup>163</sup>

Other threats to objectivity and independence include<sup>164</sup> : Management threat, advocacy threat, familiarity threat and intimidation threat.

Apart from the responsibility which the audit firm has in establishing policies and procedures designed to ensure that it ( the audit firm) and all those who are in a position to influence the conduct and outcome of the audit act with integrity, objectivity and independence, the audit firm also has to identify and assess “threats” to auditors' objectivity and apply procedures which would either :

- i) eliminate the threat; or
- ii) reduce the threat to an acceptable level.<sup>165</sup>

### ***The reporting accountant (skilled persons)***

Section 166 of the Financial Services and Markets Act 2000 deals with the powers of the FSA to obtain a report by a skilled person (reporting accountant) to assist the FSA in performing its functions under FSMA 2000. Under sections 167 and 168 of the Financial Services and Markets Act 2000, the FSA also has the powers to appoint competent persons to carry out investigations. The differences between the roles of reporting accountants (now known as skilled persons) and competent persons are demonstrated by the bearer of the costs for work carried out by these persons. For work undertaken by skilled persons, the bank bears the cost directly whilst for work undertaken by competent persons, the FSA bears the cost.<sup>166</sup> The role of the reporting accountant has become so important that it will be incorporated into the entire regulated sector.<sup>167</sup> Even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.<sup>168</sup> This raises the question of independence since both roles of auditor and reporting accountant are distinct roles which still overlap occasionally.<sup>169</sup> Measures have however been adopted by the FSA to safeguard against possibilities of a conflict of interest. Chapter 5 of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. The FSA may nominate or approve the appointment of the auditor of a bank as a skilled person if it is cost effective to do so but also takes into account any conflicts the auditor may have in relation to the matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.<sup>170</sup>

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<sup>162</sup> *ibid*

<sup>163</sup> *ibid*

<sup>164</sup> *ibid*

<sup>165</sup> See Ethical Standards 1 paragraph 27. Ethical Standards 5 (Non audit services provided to audit clients) paragraph 12 also states that before the audit firm accepts a proposed engagement to provide a non-audit service to an audit client, the audit engagement partner should : a) Consider whether it is likely that a **reasonable** and **informed** third party would regard the objectives of the proposed engagement as being inconsistent with the objectives of the audit of the financial statements; and  
b) Identify and assess the significance of any related threats to the auditors' objectivity, including any perceived loss of independence; and  
c) Identify and assess the effectiveness of the available safeguards to eliminate the threats or reduce them to an acceptable level.

<sup>166</sup> See J. Hitchins, M.Hogg and D.Mallett 'Banking : A Regulatory Accounting and Auditing Guide' PricewaterhouseCoopers at p 295

<sup>167</sup> D. Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003, at pg 9

<sup>168</sup> *ibid*

<sup>169</sup> *ibid*

<sup>170</sup> According to chapter 5 of the Supervision Manual, the FSA stated that firms are to appoint skilled persons only for specific purposes; not to use them as a matter of routine; to use skilled persons only after having considered alternatives; to use skilled persons because of the added value to be gained due to their expertise or knowledge and

## **Mandatory rotation of audit firms**

The risk of having an auditor becoming too familiar with a particular business, hence becoming too close to a company and compromising his independence is the main reason why mandatory rotation of audit firms has been proposed. However, ISA ( UK and Ireland ) 315 requires the auditor to obtain an understanding of the entity and its environment in assessing the risks of material misstatement.<sup>171</sup>

Whilst supporters of mandatory rotation believe that the auditor's independence would be strengthened as a result of making companies change their auditor after a fixed period of years, many have opposed the idea of mandatory rotation, arguing that it is a costly exercise. At present, there is no regulatory requirement for UK listed companies to change auditors after a number of years in office.<sup>172</sup> However due to the threat posed where the same audit engagement partner acts for an audit client for a long period, the UK regulatory requirements are that, for listed companies, the audit engagement partner cannot act for more than seven years and cannot return to that position for a further five years.<sup>173</sup> Overseas studies performed in Italy and Spain identify:<sup>174</sup> (i) The significant additional costs incurred by firms and management and (ii) the adverse effects on audit quality in the early years of appointment (due to lack of cumulative client knowledge) that arise from mandatory rotation. Recent reviews in Australia and the Republic of Ireland also concluded that the costs of mandatory rotation outweighed the benefits.<sup>175</sup>

The Recommendation issued by the European Commission *Statutory Auditor's Independence in the EU: A Set of Fundamental Principles* on 16 May 2002, does not require mandatory rotation of firms but does require mandatory partner rotation on listed clients after seven years.<sup>176</sup> This differs in some aspects from the UK requirements as :<sup>177</sup> (i) It allows a return after two years ( not five years as in the UK); (ii) It applies to 'public interest clients' not just listed clients and (iii) In a group context, it extends to key audit partners other than the audit engagement partner. No country within the EU, with the exception of Italy presently undertakes a system of mandatory audit firm rotation.<sup>178</sup>

At the end of the audit process, when forming an opinion on the financial statements, the audit engagement partner should reach a conclusion that any threats to objectivity and independence have been adequately addressed in accordance with APB ethical standards.<sup>179</sup> If such a conclusion cannot be reached, the partner should not report and the audit firm should resign as auditors.<sup>180</sup>

## **CONCLUSION**

### **Gaps/Inconsistencies existing in debates**

#### **Dual role of reporting accountant and external auditor**

Even though there is support for the dual role of the reporting accountant and external auditor<sup>181</sup>, the question

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not because of resource restraints; to take into account cost implications and to use the tool in a focused and proportionate way.

<sup>171</sup> See [www.asb.co.uk/apb/publications/index.cfm](http://www.asb.co.uk/apb/publications/index.cfm)

<sup>172</sup> S. Fearnley 'Mandatory rotation of audit firms' pg 1 ; see [www.icaew.co.uk/publicass](http://www.icaew.co.uk/publicass)

<sup>173</sup> *ibid*

<sup>174</sup> *Ibid* pg 1 ; Studies carried out in Spain by Arrunada and Paz-Ares entitled 'Economic consequences of mandatory auditor rotation' published in 1995 and in Italy by SDA Universita Bocconi in 2002 entitled 'The impact of mandatory audit rotation on audit quality and on pricing : the case of Italy' .

<sup>175</sup> *Ibid* at pg 3

<sup>176</sup> S. Fearnley 'Mandatory rotation of audit firms' pg 9 ; see [www.icaew.co.uk/publicass](http://www.icaew.co.uk/publicass)

<sup>177</sup> *ibid*

<sup>178</sup> *ibid*

<sup>179</sup> Ethical Standard 1 Integrity, objectivity and independence paragraph 43

<sup>180</sup> *ibid*

<sup>181</sup> See *supra* note 3 at pg 10. The Bank of England encouraged the performance of the roles of reporting accountant

of independence still arises since both roles of auditor and reporting accountant are separate roles and the external auditor could be said to be performing a non-audit service. More safeguards should be in place in relation to the dual role of the external auditor and reporting accountant (skilled person) and more alternatives should be provided before the role of the reporting accountant is taken as a means of last resort. More restrictions should also be placed on circumstances which require the use of a skilled person. Through the Financial Services and Markets Act 2000, the Financial Services Authority issues rules dealing with the appointment of auditors and skilled persons in its Supervision Manual.<sup>182</sup> These measures help to some extent to reduce the possibility of a conflict of interest when skilled persons are required to act objectively when assessing matters where they were acting in another capacity – for example as auditors.<sup>183</sup> SUP 3 of the Supervision Manual also highlights the importance of undertaking audit work independently and avoiding conflict of interests with the firm.<sup>184</sup> The regulated firm, however has the responsibility of ensuring that necessary steps are taken to have an auditor independent of the firm.<sup>185</sup> This form of “Enforced Self-Regulation” may not be as effective as a situation whereby more responsibility of ensuring auditor independence is given to the FSA (as opposed to the regulated firm).

### **Mandatory rotation**

Debate revolving round mandatory rotation also proves that mandatory rotation of auditors may be detrimental. A cost benefit analysis of mandatory rotation of auditors is necessary before deciding on whether or not to implement it. There is also the question of how much familiarity the external auditor is expected to have before being deemed as having too much familiarity with the firm he audits. Instead of only rotating audit partners of firm (since the knowledge acquired from a firm by an auditor is valuable), why not also rotate financial directors or company executives that deal with audit engagement partners/ external auditors? Companies should have a policy of rotating their finance directors or persons in contact with auditors after a certain period of time – that certain period of time probably being shorter than the time stipulated under the financial director's original contract of employment .

In addition, since the cost of acquiring a new external auditor is highest in the first year of engagement, techniques could be employed to help enable the auditor acquire knowledge of the business at a quicker pace. These techniques could include training sessions organised by the company via a company trained employee to help the external auditor improve his knowledge about that company. These sessions should not be costly – in comparison to the alternative of a previous auditor who could help train the newly engaged external auditor during the first year of his audit work. Here the issue relates to cost and who is able to educate the newly appointed auditor at the cheapest and most efficient available means. An external auditor with a high level of integrity would also perform as well in one company where he spent only five years as in another company where he spent twenty years. This due to the fact that he would not allow his sense of integrity to be compromised as a result of additional services or any other factors which would compromise his independence. In such a case, it could be argued that mandatory rotation would be a wasteful exercise.

### **Audit liability**

Auditors should be held more accountable for negative consequences of their actions towards third parties. Present situation of the law does not help provide an incentive for them to be accountable for their actions <sup>186</sup>. As mentioned earlier on page 3, the reality of “conflict of interests” occurring to an auditor during the performance of his duties may be more than that of a potential damage to an auditor-client relationship. As a result, more priority should be given to stakeholders of a firm affected by the consequences of any acts of commission or omission rendered by the external auditor. The investigation of auditor liability in certain jurisdictions will help to address how effective the imposition of audit liability in relation to third parties

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and auditor by the same firm. The Bank justified its stance on the argument that the two roles promoted greater efficiency because of the prior knowledge of the client.

<sup>182</sup> *ibid*

<sup>183</sup> *ibid*

<sup>184</sup> *ibid*

<sup>185</sup> *ibid*

<sup>186</sup> See *Caparo v Dickman* (1990) 1 All ER 568-608; *Caparo v Dickman* highlights the fact that there are limitations to what an auditor is responsible for

could be and if, the imposition of liability in these jurisdictions is effective.

### **Audit independence or audit liability – which is more important?**

The collapse of Enron not only brought about an increased focus on the mode of application of accounting standards ( whether a principle based or rule based approach should be adopted) and enforcement procedures. The past few years have also seen a growing trend towards the focus on audit liability.<sup>187</sup> The IASB's approach to application of standards is principles-based and IFRSs 32 and 39 provide solutions to problems of creative accounting posed by off-balance sheet transactions – a major issue in the Enron case. The FRRP has adopted a more proactive based approach (similar to post Enron reform adopted in the US).

This is not to imply that audit independence has lost its importance or is less important than audit liability. A lot of work and improvements on audit independence have been carried out over the years and there should be an ongoing process of review and further efforts aimed at improvement.

This research carried out on audit independence has also led to a realisation that even though audit independence is a very important area – and probably more important than audit liability, more work is needed in the area of audit liability. Current problems relating to the regulation of hedge funds could be resolved through standards introduced by the accounting profession – as demonstrated on an international level by the International Accounting Standards Board through FRSs 32 and 39.

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<sup>187</sup> See News reporters 'The year that was 2005' *Accountancy Age* ( 15 December 2005); P. Grant ' Bill could mean jail for innocent auditors' *Accountancy Age* ( 2 June 2005) ; P. Grant 'Auditors' liability wishes in company law bill' *Accountancy Age* ( 17 March 2005) ; P. Grant 'Auditors to get proportionate liability' *Accountancy Age* ( 18 July 2005) ; P. Grant 'A bit of a liability' *Accountancy Age* ( 28 July 2005) ; P. Grant 'Investors fear liability cap by the back door' *Accountancy Age* ( 28 July 2005) ; S. Perrin 'Duty Bound' *Financial Director* ( 24 November 2005); P. Grant 'Reform means audit fees should fall : minister' *Accountancy Age* ( 11 November 2005) ; P. Grant 'Watchdog urged to lead on liability' *Accountancy Age* ( 25 August 2005)

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