Regulating non audit services: Towards a principles based approach to regulation

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ABSTRACT

Based on the argument that the benefits conferred through the provision of non audit services by audit firms outweigh the attributed costs of safeguarding the auditor's independence, this paper will not only seek to justify this argument, advance proposals which do not favour an outright prohibition of the provision of non audit services, but also consider means through which non audit services could be regulated in order to facilitate competition in the audit market. At the same time it will consider various legislation which have been introduced in recent years and which are aimed at facilitating greater disclosure of information – hence improving transparency within the audit and financial markets. "Specific measures," it is contended, "would involve not only the introduction of new standards (for example – the disclosure of client concentration) but also the elimination of current restrictions". Different types of safeguards which exist in order "to mitigate or eliminate threats" to the auditor's independence, as a result of the provision of non audit services, will be considered against the regulator's aim to facilitate competition, enhance disclosure and promote other practices which would advance the regulator's endeavour to be more "market friendly".

The consultation on control structures in audit firms and their consequences on the audit market, a consultation which was launched by the European Commission as part of its efforts to create more market players, could be regarded as a response to such proposals to facilitate a more "market friendly" environment and also to concerns that the financial market is already over regulated. Some of the possible ways advanced by the Commission as channels for facilitating greater entry into the international market include the deregulation of the capitalisation of audit firms as a catalyst for facilitating greater entry into the audit market. Deregulation of the capital structure in this sense is considered to be a "modification of Article 3 (4) of the 2006 Directive on Statutory Audit which should however not be to the detriment of robust independence rules."[1]

Key Words: Principles based regulation; audit; directives; regulation; market; NAS (non audit services)

[1] See IP/08/1727 ". Audit firms: Commission Consults on Ways to Help Create More Market Players" < http://ec.europa.eu/internal_market/auditing/market/index_en.htm>

REGULATING NON AUDIT SERVICES: Towards a Principles Based Approach to Regulation.

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Introduction

In arriving at a decision to how non audit services could be best regulated, this paper will take into account the benefits attributed to non audit services and the need to foster greater level of competition in the audit market. It will therefore commence with a section which addresses the influence of the provision of non audit services, by audit firms, on perceptions of auditor confidence. It will then elaborate on this topic by considering the benefits attributed to the provision of non audit services. Within this context, the benefits generated (by providing non audit services) and contributed to high quality audits, the impact of the level of non audit fees on audit independence and the significance of ensuring that adequate safeguards operate to protect the auditor's independence, will be introduced.

The level of audit and non audit fees will also be considered against the background of standards and legislation such as the Code of Ethics for Professional Accountants[3] , and chapter 8 of the 2002 Commission Recommendation.[4] The second section will then consider arguments in favour of market based regulation. It will also elaborate on why other regulatory strategies such as meta regulation and principles based regulation (and particularly meta regulation), are preferred to a purely oriented market based system of regulation. The third section will then expand on the principles based approach to regulation through a consideration of factors and developments which have contributed to a need for a principles based approach to regulation. In advancing proposals for a change in the existing regulatory arrangements, the fourth section will not only take into account the safeguards which currently exist to ensure that the auditor's independence is not compromised, but also emphasize the need for greater disclosure requirements at EU level. It will make reference to efforts undertaken by the Basel Committee on Banking Supervision as a means of facilitating enhanced disclosure requirements.

The concluding section encapsulates an evaluation of efforts which have been undertaken in response to the evolving financial markets, the level of success attained by recently introduced directives and legislation which are aimed towards promoting more friendly market measures. It also considers how greater informational disclosure requirements have been facilitated within the

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3 Revised July 2009

4 2002/590/EC – Statutory Auditor's Independence in the EU: A Set of Fundamental Principles

markets and what role regulation has assumed – particularly with regards to the monitoring and enforcement of rules and also the form of regulation which would best address an evolving global market.

According to Arrunada[5], regulators should not only focus on policies which would improve transparency of information – hence enhancing market incentives, but should strive towards fostering a greater level of competition. Markets, in his opinion, should be the "driving force behind the evolution of the industry" – since regulators are not well equipped with the necessary knowledge and proper incentives which are required for defining an efficient market framework.[6]

The consultation[7] on control structures in audit firms and their consequences on the audit market, a consultation which was launched by the European Commission as part of its efforts to create more market players, could be regarded as a response to such proposals to facilitate a more "market friendly" environment and also to Arrunada's concerns that the financial market is already over regulated.[8] Some of the possible ways advanced by the Commission as channels for facilitating greater entry into the international market include: [9]

- The deregulation of the capitalisation of audit firms as a catalyst for facilitating greater entry into the audit market. Deregulation of the capital structure in this sense is considered to be a "modification of Article 3 (4) of the 2006 Directive on Statutory Audit, which requires that auditors hold a majority of the voting rights in an audit firm and that a majority of auditors control the management board. This should however not be to the detriment of robust independence rules."

- A broader focus on a spectrum of catalysts which could be utilised in facilitating greater access into the audit market.

What influence (if any) does the provision of non audit services, by audit firms, have on perceptions of auditor independence?

Based on academic literature and empirical evidence[10], the impact of the provision of non audit services (by accounting firms to their audit clients) on the confidence in the independence of

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5 See B Arrunada, "The Provision of Non Audit Services by Auditors: Let the Market Evolve and Decide" 1999 International Review of Law and Economics at page 13. Also refer to abstract where he states that "specific measures would involve both introducing new standards and eliminating some current restrictions."

6 ibid

7 A consultation which was launched in November 2008, and whose deadline was scheduled for the end of February 2009

8 See B Arrunada, " Audit Failure and the Crisis of Auditing" (2004) European Business Organization Law Review, vol. 5, no. 4, pp. 635-43

9 See IP/08/1727 ". Audit firms: Commission Consults on Ways to Help Create More Market Players" <http://ec.europa.eu/internal_market/auditing/market/index_en.htm>

10 According to an analysis (by Quick and Warming Rasmussen) of the effects of 19 different non audit services, „a negative effect" was discovered in relation to these. Furthermore, it was demonstrated that "the type of NAS not only influences the degree to which auditor independence is perceived to be impaired," but "that perceived auditor independence does increase if NAS are provided by a separate department of the audit firm." See R Quick

auditors has been demonstrated. In my opinion, it is important to distinguish between the effects attributed to the volume of non audit services being provided by such accounting firms and the type of non audit service[11]. The provision of non audit services by such firms does not necessarily influence the independence of auditors. However where the fees generated from such non audit services are considerably high (in proportion to the audit fees earned by such accounting firms) and insufficient safeguards operate to protect the auditor's independence, this creates a situation whereby the auditor's independence is likely to be compromised – since the auditor may be denied lucrative contracts (in the form of fees generated from NAS) where he decides to give a qualified opinion on the financial statements being audited.

Benefits attributed to the provision of non audit services

Although the level of non audit fees generated from non audit services and provided by an audit firm to its client could determine whether or not an auditor's independence is compromised, the level of competence demanded from auditors in providing high quality audits, could in several respects, only be derived through the provision of non audit services. Furthermore, the principle of professional competence and due care imposes an obligation on all professional auditors to "maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service."[12]

In some cases, the provision of non audit services by accounting firms to their clients is considered to be beneficial – particularly where adequate safeguards operate to ensure that the auditor's independence is not compromised.[13] Where the level of fees (non audit fees) generated by the provision of non audit services by such accounting firm influences the firm's ability to make objective decisions and results in a situation where the firm's independence is impaired, then this would be detrimental to the quality and credibility of the financial statements being audited.

The provision of non audit services in itself does not result in lower quality audits where necessary safeguards operate. The existence of necessary safeguards would not only ensure that the auditor's independence is not compromised, it would also facilitate a process whereby costs

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and B Warming Rasmussen, ' Auditor Independence and the Provision of Non Audit Services: Perceptions by German Investors (2009) International Journal of Auditing (13) 141-162 Blackwell Publishing Limited .

[11] According to results obtained by Ezzamel et al, the relationship between levels of audit fees and non audit services is considered to be dependent on the category of non audit services. See M Ezzamel, DR Gwilliam and KM Holland, " The Relationship between Categories of Non Audit Services and Audit Fees: Evidence from UK Companies (2002) International Journal of Auditing (6) 13-35. They also argue that "even though the theoretical literature points to important potential links between audit and non audit fees operating through either "knowledge spill overs" or differential benefits from "recurring" non audit services, there is no reason to assume that different categories of NAS will have the same effect on audit fees."

[12] See Section 130 Code of Ethics for Professional Accountants (Revised July 2009) at page 13 http://www.ifac.org/Store/Details.tmpl?SID=1247239521617174&Cart=1247239712617245

[13] See M Ezzamel, DR Gwilliam and KM Holland, " The Relationship between Categories of Non Audit Services and Audit Fees: Evidence from UK Companies (2002) International Journal of Auditing (6) 13-35 – for instance where this enables the accounting firm to acquire greater knowledge and understanding of the client being audited.

savings (through "knowledge spill overs", differential benefits from "recurring" non audit services and economies of scale) are maximised. Where such safeguards do not operate then the provision of non audit services to clients would definitely have an adverse effect on audit quality.

Level of non audit fees

Ashbaugh et al "find no systematic evidence supporting Frankel et al's claim that auditors violate their independence as a result of clients purchasing relatively more non audit services."[14] They contest results from Frankel et al's findings which are evidential of the fact that "auditor independence is compromised when clients pay high non audit fees relative to total fees."[15]

Ashbaugh et al also argue that the total fees generated by the audit firm (sum of audit and non audit fees) provides more accurate and complete explanation of how economically dependent the audit firm is on the client.[16] This measure, in their opinion, is a preferred measure to the fee ratio (ratio of non audit fees to audit fees) even though they accept that the fee ratio still "captures the relative monetary value" of the audit v non audit services provided by the audit firm to a client.[17] In my opinion, both ratios are equally important and particularly with regards to the perspective which is being considered – whether the ratios are based on fees derived from a particular client or the total fees obtained from all clients. The extent to which an audit firm is economically dependent on a particular client may not be highlighted where only the fee ratio is considered. By comparing the non audit fees generated from a client, not only with the audit fees from such a client but also with the total fees generated by the audit firm, the degree of reliance placed on such an audit firm (on its client) becomes more evident. Moreover, even though the non audit fee to audit fee ratio for a particular firm may be high – hence indicating that reliance is placed on non audit fees from a particular client, such a perception may also change where the non audit fee earned by the audit firm is negligible in comparison to the total fees earned by the audit firm (from other clients).

The level of fee/s quoted and the services to which these fees apply not only determine whether threats such as self review, advocacy and other forms of threats exist, but also the significance of such threats.[18] According to section 290 (220),[19] "where the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the

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[14] See H Ashbaugh, R LaFond and B Mayhew "Do Non Audit Services Compromise Auditor Independence? Further Evidence" (2003) The Accounting Review (78) No 3 611-639 and also R Frankel, M Johnson and K Nelson "The Relation Between Auditors' Fees For Non Audit Services and Earnings Management" (2002) The Accounting Review (77) 71-105

[15] ibid

[16] See ibid at page 614

[17] ibid

[18] See section 240.2 "Fees and Other Types of Remuneration" Code of Ethics for Professional Accountants (Revised July 2009) at page 29 http://www.ifac.org/Store/Details.tmpl?SID=1247239521617174&Cart=1247239712617245 (last visited 3 December 2009)

[19] ibid

dependence on that client and concern about losing the client creates a self interest or intimidation threat." Such a threat is dependent on factors such as:[20]

- The operating structure of the firm
- Whether the firm is well established or new; and
- The significance of the client qualitatively and/or quantitatively to the firm

Neither Chapter 8.2[21] of the Commission Recommendation 2002/590/EC - Statutory Auditors' Independence in the EU: A Set of Fundamental Principles nor section 290 of the July 2009 Revised Code, stipulate an accepted ratio for non audit and audit services (under subsection 220) in respect of total fees generated by a firm. Both the 2002 Recommendation and the Revised Code supplement this apparent gap by providing a range of safeguards which should be followed by the auditor before providing non audit services to a client. They also appear to demonstrate their commitment towards facilitating a principles based approach to regulation – one which not only allows for greater flexibility than would be the case if a ratio were stipulated, but one which considers the auditor's need to exercise professional judgement.

Some of the poorest audits which have been observed in practice, an example of which is provided by Mr Hayward of "Independent Audit", have been undertaken by audit firms whose ability to deliver high level quality audits was impaired by their "considerable level of ignorance about the client's activities" – "the price for having no non audit work."[22]

On the other hand, it is rightly contended that even if greater knowledge could be acquired about a client – as a result of non audit services being performed for such a client, such "knowledge spill overs" would not necessarily be used in generating better quality audits- where insufficient safeguards operated to ensure that the auditor's independence was not compromised.[23]

Where non audit services are performed and sufficient safeguards operate to ensure that the level of fees generated from such services do not impact the auditor's ability to remain objective and independent, then such services do not pose a threat.

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20 ibid

21 "Relationship between Total Fees and Total Revenues"

22 See observation of Mr Hayward of „Independent Audit" Treasury Ninth Report, May 2009 Banking Crisis: Reforming Corporate Governance and Pay in the City <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51909.htm#a37>

23 Quick and Rasmussen assert that „based on the current situation in audit markets, where audit services have low margins, it could be assumed that knowledge spillovers from consulting services are not used to increase audit quality but to reduce audit costs" and that "even if knowledge spillovers increase auditor's ability to discover a breach in the client's accounting system, such an increase in effectiveness would be worthless if the auditor did not report the breach – owing to lack of independence." See R Quick and B Warming Rasmussen, ' Auditor Independence and the Provision of Non Audit Services: Perceptions by German Investors (2009) International Journal of Auditing (13) at page 155

As stated by the Pensions Investment Research Company (PIRC),[24] in relation to the majority of cases for UK listed banks, " the considerable level of fees paid by such banks to their auditors for non audit work creates a situation which would not only facilitate a conflict of interest, but also affect the auditor's independence and impair objectivity."

Services identified by Quick and Rasmussen as having the potential to generate self review threat include internal control systems, book keeping, tax advisory, legal advisory, actuarial services, accounting information systems, internal audit, valuation, personnel lending, corporate management, risk management and financial services.[25]

2. Arguments in favour of market based regulation

Arguments which favour market self-regulation over government mandated legislation are justified on the basis that "markets excel in adapting to changing circumstances, while legislation and government regulation are notoriously rigid."[26] Further, O'Driscoll and Hoskins argue that " self regulation does not refer to so-called self-regulating industry or professional bodies that frequently protect producers against consumers, but that rather, it refers to evolved orders, rules, and institutions by which the market regulates behaviour."[27] They justify the ability of markets to self-regulate on the premises that "reputation, or the fear of its loss, religious or ethical constraints not only restricts opportunistic behaviour", but that actions involving theft, cheating, telling lies are limited because markets make such behaviours costly.[28]

Such argument however, does not take into consideration meta regulatory strategies and principles based regulation. Even though market based regulation obviously has its advantages, I would not advocate a purely oriented market based approach to regulation. Principles based regulation not only takes into account the legislator's intent, but also considers the changes and developments which have taken or are taking place in the market. In other words, it still incorporates some element of market based regulation. Likewise, Basel II, which is an example of meta regulation, not only embraces vital elements of prudential supervision (capital adequacy requirements), but also the supervisory review process (Pillar 2) and market discipline (Pillar 3). As a result, a purely oriented market based approach to regulation, is not only lacking in several respects, but would not (on its own) offer the much required responses to changes and evolution within the financial and audit markets – from a regulatory perspective.

Whilst meta regulation, with its "collaborative approach to rule generation,"[29] is considered to be the most evolved form of regulation, principles based regulation also allows some degree of flexibility which takes into consideration changes and evolvements in the market. Market based regulation does not facilitate the same degree of compliance and monitoring (which are essential

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24 See paragraph 234 of Treasury Ninth Report, May 2009 Banking Crisis: Reforming Corporate Governance and Pay in the City

25 „All non audit services investigated were considered to have the potential to create self review threats, familiarity threats and intimidation threats.

26 See GP O'Driscoll and L Hoskins, "The Case For Market Based Regulation" (2006) Volume 26 No 3 Autumn 2006 at page 483

27 ibid at page 473

28 ibid at page 474

29 See F Haines,'Regulatory Failures and Regulatory Solutions: A Characteristic Analysis of the Aftermath of Disaster', *Law and Social Inquiry* (2009) Volume 39 at page 3

in regulation) as that conferred by meta regulatory based strategies. As stated previously, some element of control and accountability is still required in regulation – even though religious and moral ethics, costs attributed from loss of reputation, may still deter opportunistic behaviour. The recent enhancements to the Basel II framework illustrate how regulation can be harnessed to adapt to an evolving regulatory environment in which risks have assumed such prominence.

Meta regulation can be described as the regulation of self-regulation.[30] Meta risk regulation concerns the management of internal risk and being able to use the firms' own internal risk management systems to achieve regulatory objectives.[31] Another advantage of meta regulation is that it not only provides greater means of overcoming challenges associated with regulation, but also those problems of rigidity resulting from too many prescriptive rules.[32]

O'Driscoll and Hoskins refer to Kenneth Arrow's observation of economics as being "the most important intellectual contribution to the notion that through the workings of an entire system, effects may be very different, and even opposed to intentions."[33] This, in their opinion, mirrors Adam Smith's idea of the invisible hand. In a nutshell, they explain that institutions have evolved in such a way, that their current state was probably not what had been intended – hence illustrating the unpredictable outcomes of evolution. However, O'Driscoll and Hoskins add that "the evolutionary mode of reasoning has not been consistently extended to fundamental institutions such as law."[34]

3. The changing approach to standard setting at EU level – principles based regulation

The growth of financial conglomerates and increased integration within the EU have impacted the financial markets – as evidenced by the approaches adopted in some member states in response to integrated financial services supervision and the ever growing realisation of the need for harmonisation amongst EU member states. Structures of conglomerates and cross sector services risks are factors which to a large extent, have posed immense challenges for supervisors. The structure and system of financial regulation need to adapt to changes and evolutionary outcomes which have arisen within the financial markets in recent years. As illustrated by BCCI, "effective prudential supervision was impeded by lack of information, an opaque conglomerate

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30 The last but one chapter of Christine Parker's book, *The Open Corporation: Self Regulation and Corporate Citizenship*, provides this title. The theme of meta regulation was developed by Peter Grabosky, where he refers to "meta-monitoring" as government monitoring of self-monitoring. See J Braithwaite, 'Meta Risk Management and Responsive Governance' Paper to Risk Regulation, Accountability and Development Conference, University of Manchester, 26-27 June 2003

31 J Gray and J Hamilton, *Implementing Financial Regulation : Theory and Practice* (2006) at page 37 "The Basel II Capital Accord provides an example of the operation of meta regulation in that bank capitalisation is not to be imposed externally by regulators but will be determined by a bank's own internal risk management models provided these models are considered by regulators to be adequate. One major advantage of meta-risk regulation is that it should enable the regulator exploit the expertise of the industry in an age when the complexity and volatility of modern risk calls into question the ability of financial regulators to stay one step ahead."; ibid

32 F Haines,'Regulatory Failures and Regulatory Solutions: A Characteristic Analysis of the Aftermath of Disaster', *Law and Social Inquiry* (2009) Vol 39

33 GP O'Driscoll and L Hoskins, "The Case For Market Based Regulation" (2006) Volume 26 No 3 Autumn 2006 at page 471

34 ibid; To corroborate this, they introduce Carl Manger's statement on the scope of social science :"How can it be that institutions which serve the common welfare and are extremely significant for its development, come into being without a common will directed towards establishing them?"

structure, and the difficulty encountered by all the various regulatory and other financial bodies in exchanging information and cooperating satisfactorily when the group ran into difficulties."[35] The ensuing section attempts to evaluate not only the efforts attained by certain directives and legislation but also the progress which has been sustained over the years in relation to these legislation and also to financial developments which have taken place in the EU and around the globe.

The 2006 Statutory Audit Directive[36] underlines the importance of harmonisation among EU member states if its objectives are to be realised. A principles based approach to regulation, which the 2002 Recommendation on Statutory Auditors[37] strongly supports, would facilitate the process of harmonising different approaches adopted in different member states and with particular reference to different audit market environments which operate - since what may be beneficial for one member state may not benefit the other.

Whilst the introduction of audit liability caps would also generate certain benefits[38], Bigus and Zimmerman argue that in introducing audit liability caps, consideration should be had towards the possibility that audit incentives may be impaired.[39] As additional measures, actions aimed at the consolidation of competition, actions such as those which would make market entry much easier, have been proposed.[40]Such actions (apart from the introduction of low audit liability caps), include the enactment of less complex and less rigid regulations on accounting and auditing.[41]

i) A principles based approach to regulation would not only facilitate greater harmonisation of the different regulatory approaches adopted in different member states, but would also assist the auditor in performing many functions which require the exercise of professional judgement.[42] The 2002 Recommendation of Statutory Auditor's Independence in the EU acknowledges the benefits attributed to the principles based approach in "catering for the almost infinite variations in individual circumstances that arise in practice and in the different legal environments throughout the EU."[43]

ii) A principles based approach not only facilitates the need to exercise professional judgements, but also a more "market friendly" environment. Further, the tendency by auditors to resort to defensive auditing (a practice whereby auditors use prescriptive rules to justify their actions) is

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35 See M Thorn, „The Prudential Supervision of Financial Conglomerates in the EU" North American Actuarial Journal Volume 4 No 3 page 128

36 See Paragraph 32 of the Preamble to the Directive

37 See particularly paragraph 11, COMMISSION RECOMMENDATION of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles'

38 The introduction of liability caps would not only reduce the likelihood of a large sized audit firm's failure, but could also reduce market concentration in audit markets.

39 J Bigus and R Zimmerman, 'Non Audit Fees, Market Leaders and Concentration in the German Audit Market: A Descriptive Analysis' (2008)International Journal of Auditing Vol 12 at page 174

40 ibid at pages 174-175

41 ibid at 175

42 In relation to the need to exercise professional judgement, please see Chapter 2 of the Commission Recommendation 2002/590/EC - Statutory Auditors' Independence in the EU: A Set of Fundamental Principles

43 See paragraph 11 of the Preamble to COMMISSION RECOMMENDATION of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles

reduced since principles based regulation encourages auditors to apply rules according to the spirit and intent of the legislator.

"Regulation should be market friendly, meaning that it should aim to facilitate market sanctions in the case of audit failure, instead of substituting such market sanctions with regulatory or judicial sanctions. Otherwise regulation risks inducing so-called "defensive auditing", with auditors using only easily verifiable evidence to support their opinions, with the end result that audits become trivial."[44]

The level of non audit services provided by the major accounting firms (the Big Four) needs to be curtailed. Regulation should be aimed at introducing standards and legislation which encourage mid tier firms in providing a greater level of non audit services than they currently provide.

4) **Proposals for a change in the current arrangements**

Having regard to the types of available safeguards - namely prohibitions, restrictions, policies, procedures and disclosures, on which mechanism should the regulator place greater emphasis? In order to facilitate a more market friendly environment where greater disclosure would be enhanced and also to avoid a system of regulation which is based on the prescriptive application of overly detailed rules, it would appear that more emphasis should be devoted towards greater informational disclosure. The previous and ensuing sections justify such a conclusion. The previous section has highlighted why an outright prohibition of the provision of non audit services (by audit firms) is not a desirable option. The following section highlights the wide and seemingly immense range of available safeguards which exist to safeguard the auditor's independence – which is evidential of the fact that sufficient rules already exist.

More extensive prohibitions on the provision of non audit services by major accounting firms to their audit clients

A complete prohibition of the provision of non audit services is not proposed given the benefits which NAS are capable of generating ("knowledge spillovers" and "differential benefits from recurring non audit services"). However, mid tier firms should be encouraged to undertake a greater level of non audit services than is the case at the present – whilst limiting the level of non audit services provided by the Big Four.

Safeguards which exist to mitigate or eliminate threats to an auditor's independence

In applying such safeguards, the 2002 Recommendation on Statutory Auditors in the EU, highlights the fact that regard is to be had to cost- benefit considerations. Paragraph 12 to the Preamble identifies the costs associated with safeguarding the auditor's independence as

[44] See B Arrunada, "The Economics of Audit Quality: Private Incentives and the Regulation of Audit and Non Audit Services 1999 at page 3 Kluwer Academic Publishers

including "costs that are related to developing, maintaining, and enforcing safeguards to independence."

Safeguards which currently exist and which should be implemented (when necessary) as means of eliminating threats to the auditor's independence or reducing such threats "to an acceptable level" include:

- Making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee[45]
- Assigning appropriate time and qualified staff to the task[46]
- Obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities[47]
- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the audit engagement and the purpose, nature and scope of the work to be performed by the auditor[48]

In all of the above situations, the auditor is required to evaluate the significance of threats which could compromise his independence before determining whether or not the stated safeguards should be applied.

Other safeguards relate to particular "emergency situations" where "accounting and book keeping services which would otherwise not be permitted under section 290 of the Revised Code[49] are allowed in emergency or other unusual situations when it is impractical for the audit client to make other arrangements."[50] In such emergency situations,[51] the following pre requisites should be satisfied:

- Those who provide the services should not be members of the audit team
- The services should be provided for only a short period of time and should not be expected to recur; and
- The situation should be discussed with those assigned with governance responsibilities

Under Section 2, Chapter 8.1[52] of the 2002 Recommendation on Statutory Auditor's Independence in the EU, safeguards (in the form of obligations) are imposed on the auditor to ensure that "fee arrangements for audit engagements in which the amount of the remuneration is contingent upon the results of the service provided" are not concluded without a prior assessment of the risks that could be generated for the auditor's independence. Further, such arrangements

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45 See Section 240.2 "Fees and Other Types of Remuneration" Code of Ethics for Professional Accountants (Revised July 2009) at page 29

46 ibid

47 Section 210.3 "Professional Appointment" Code of Ethics for Professional Accountants (Revised July 2009) at page 23

48 Section 210.7 Code of Ethics for Professional Accountants (Revised July 2009) at page 23

49 ibid

50 Such situations embraces examples such as where i) Only the firm is equipped with the resources and necessary knowledge of the client's systems and procedures to assist the client in the timely preparation of its accounting records and financial statements and ii) where a restriction on the firm's ability to provide the services would result in significant difficulties for the client

51 See i) and ii) ibid

52 Which deals with contingent fees

should not be concluded also without ensuring that necessary exist to reduce such risks (to independence) to “an acceptable level.”[53]

The 2002 Recommendation on Statutory Auditor’s Independence in the EU[54] also stipulates safeguards which should exist in relation to non audit services - where a statutory auditor, an audit firm or one of its network member firms provides services other than statutory audit work (non audit services) to an audit client. Under chapter seven, and 7.1 in particular, an obligation is imposed on the statutory auditor to ensure that:

- Individuals employed by either the audit firm or its network member firm neither take any decision nor take part in any decision making on behalf of the auditor or one of its affiliates, or its management while providing a non audit service and;
- Even when not involved in decision making, the statutory auditor is obliges to determine from a list of provided safeguards[55], which of these could be best implemented in order to mitigate any residual threats to independence.

Disclosure

According to the Basel Committee,[56] “ as public disclosure increases certainty in the market, improves transparency, facilitates valuation, and strengthens market discipline, it is important that banks publicly disclose information on a regular basis that enables market participants to make informed decisions about the soundness of their liquidity risk management framework and liquidity position.” The involvement of market participants in the process whereby the Committee strives to facilitate market discipline through the development of “a set of disclosure requirements which will allow such market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence capital adequacy of an institution”[57] constitutes a vital means whereby effective corporate governance could be facilitated.

Do sufficient disclosure requirements exist at EU level?

If compliance[58] with rules could always be guaranteed, then market based regulation would probably be preferred to meta regulation or principles based regulation. In this respect, the

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53 Part (b) of Section 2, Chapter 8.1 states that “unless the Statutory Auditor is satisfied that there are appropriate safeguards in place to overcome the independence threats, either the non-audit engagement must be refused or the Statutory Auditor must resign from the Statutory Audit to allow the acceptance of the non audit work.”

54 Commission Recommendation 2002/590/EC - Statutory Auditors' Independence in the EU: A Set of Fundamental Principles

55 These safeguards include arrangements to reduce risks of self review, routine notification of any audit and non audit engagement to those in the audit firm or network who are responsible for safeguarding independence, secondary and external reviews.

56 See „Revisions to Pillar 3“ (Market Discipline) paragraph 73 at page 24

57 See „Enhancements to the Basel II Framework“ Basel Committee on Banking Supervision publications July 2009 at page 29

58 See R Johnstone and R Sarre (eds), “Regulation: Enforcement and Compliance” and particularly section 8 by C Parker, “Is there a Reliable Way to Evaluate Organisational Compliance Programs?” Canberra Australian Institute of Criminology 2004 Research and Public Policy Series No 57

importance of transparency and disclosure, which would be facilitated through good corporate governance and the role of the audit (in holding the management and directorship of a company accountable to its shareholders) is particularly relevant. Furthermore, this section aims to highlight legislative responses to developments which have taken place over recent years and to draw attention to the need for continued legislative amendments.

The Post BCCI Directive[59] is considered to have " considerably widened the scope of information exchange with other official bodies (within the EU) who are not responsible for prudential supervision."[60] Paragraph 7 of the Preamble to the Directive draws attention to the principles of mutual recognition and home member state supervision which require "that member states' competent authorities should not grant or should withdraw authorisation" where certain factors[61] reveal that the legal system of one member state has been chosen for the purposes of evading more stringent standards which exist in a particular member state where the financial undertaking is presently[62] undertaking a large part of its activities.

Such rules on authorisation are intended to facilitate disclosure and reporting requirements where information is required by "competent authorities" for purposes of facilitating their functions, which in turn contribute to consolidating stability within the financial system. Furthermore, the Directive makes reference to the reporting requirements of auditors[63] and to the fact that such duties should cover all situations where the discoveries are made by an auditor during the course of performing tasks in an undertaking which has close links with a financial undertaking.[64] The Directive qualifies such duties to report[65] with the "good faith requirement"[66] under Article 5 , paragraph 2.

The Need for Enhanced Disclosure Requirements

Having regards to Pillars 1 and 2 of Basel II, it can be observed that immense focus has already been dedicated to the role and responsibilities of banks (Pillar 1) and the supervisory review process (Pillar 2). In relation to Pillar 3, greater efforts are being undertaken to involve market participants by encouraging them to assess a bank's risk profile. Even though it could be argued

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[59] Directive 95/26/EC

[60] See M Thorn, "The Prudential Supervision of Financial Conglomerates in the EU" North American Actuarial Journal Volume 4 No 3 at page 129

[61] Such as details contained within its programmes of operations and the geographical allocation of activities actually undertaken

[62] Or intends to undertake a greater part of its activities

[63] See paragraph 15 of the Preamble to the Directive which states that " ….for the purposes of strengthening the prudential supervision of financial undertakings and protection of clients of financial undertakings and protection of clients of financial undertaking, it should be stipulated that an auditor must have a duty to report promptly to the competent authorities, wherever as provided for by the Directive, if he becomes aware, while carrying out his tasks, of certain facts which are likely have a serious impact on the financial situation of a financial undertaking."

[64] See paragraph 16;ibid. Furthermore paragraph 17 adds that such duties of auditors to communicate, wherever appropriate, does not in itself alter the nature of their tasks in such an undertaking nor the manner in which they must perform those tasks in that undertaking.

[65] As stated under Article 5 paragraph 1 of the Directive

[66] It does so by highlighting the fact that such disclosures "shall not constitute a breach of any restriction on disclosure of information imposed by contract of by any legislative, regulatory or administrative provision and shall not involve such persons in liability of any kind"

that the three pillars complement one another[67] – hence the seemingly unnecessary need to consider whether efforts should evenly balanced between the three pillars, it becomes necessary to re evaluate efforts where a particular pillar appears to have been overwhelmingly ignored.

Recent reports have revealed the lack of knowledge demonstrated by financial institutions in relation to risks involved when engaged with “businesses and structured credit products.”[68] The fact that banks “did not adhere to the fundamental tenets of sound financial judgement and prudent risk management” was also highlighted.[69]

As mentioned in the previous paragraph, greater efforts have been undertaken to involve market participants by encouraging them to assess a bank’s risk profile. Such proactive efforts are more desirable than “allowing markets to evolve and decide.” As identified by the Basel Committee, “improvements in risk management must evolve to keep pace with rapid financial innovation.[70] Furthermore, it states that “ this is particularly relevant for participants in evolving and rapidly growing businesses.[71] Innovation has increased the complexity and potential illiquidity of structured credit products – which in turn, could make such products not only more difficult to value and hedge, but also lead to inadvertent increases in overall risk.”[72] “Further, the increased growth of complex investor specific products may result in thin markets that are illiquid – which could expose a bank to large losses in times of stress, if the associated risks are not well understood and managed in a timely and effective manner. Stress tests have been identified as means whereby investors’ uncertainty about the quality of bank balance sheets, could be eliminated.[73]

As a result even though markets should be allowed to evolve, checks and controls should exist to ensure that such market activities are effectively managed and controlled. Management information systems (MIS) and banks’ credit risk models should be flexible (and not overly sensitive) in order to adapt to the evolving market whilst providing for some element of control. The Basel Committee furthermore, acknowledges the role assumed by management information systems and risk management processes in assisting the bank “to identify and aggregate similar risk exposures across the firm, including legal entities, and asset types (eg loans, derivatives and structured products).”[74]

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67 As stated by the Basel Committee under paragraph 809 , “ The purpose of Pillar 3 is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2).
See „Enhancements to the Basel II Framework“ Basel Committee on Banking Supervision publications July 2009 at page 29 < http://www.bis.org/publ/bcbs157.pdf?noframes=1>

68 ibid at page 10

69 ibid

70 ibid at page 12

71 ibid

72 ibid

73 See “Economic Crisis in Europe: Causes, Consequences and Responses” Section 3.2.1’ Crisis Resolution Policies: Stress Testing of Banks” http://ec.europa.eu/economy-finance/thematic_articles/article15893_en.htm It is also highlighted in the report that stress tests could serve as “decisive tools in accomplishing this task since they provide information about banks’ resilience and ability to absorb possible shocks.”

74 See ibid at paragragh 29, page 17. The Basel Committee attributes the increased likelihood that different sectors of a bank are exposed to a common set of products, risk factors or counter parties, to the growth of market based intermediation.

Pillar 3 requirements are aimed at supplementing the other two pillars of the Basel II framework " by allowing market participants to assess a bank's capital adequacy through key pieces of information on the scope of application, capital, risk exposure and risk assessment process."[75] Even though it is acknowledged that these requirements: a) facilitate a common disclosure framework which accordingly, ii) would not only promote comparability between banks but also allow a bank to interpret the specifics of each requirement, iii)increase flexibility for effective disclosures which reflect its risk profile to a greater extent, as well as facilitating greater consistency, the potential of such increased flexibility in impairing comparability between banks, is also highlighted.[76]

Chapter 5 of the 2002 Recommendation on Statutory Auditors[77] not only sets out how total fee income, audit or non audit fees should be treated, but also stipulates situations whereby fees from an audit client for audit and non audit services provided during the client's reporting period, are required to be "publicly and appropriately disclosed."[78]
Pillar 3 revisions also include disclosure requirements that will assist market participants in acquiring greater understanding in relation to the risks profile of an institution.[79] The Committee believes that such enhanced disclosure requirements will be instrumental in helping to avoid a situation where a "recurrence of market uncertainties about the strength of banks' balance sheets" in relation to their securitisation activities, could occur.[80]

Disclosure requirements: Close links

A further measure which serves to enable banks and regulators identify risks, mitigate these risks, limit market activities which generate theses risks, is embodied in the Post BCCI Directive . Article 2 paragraph 2 not only states that "where close links exist between the financial undertaking and other natural or legal persons, the competent authorities shall grant authorization only if those links do not prevent the effective exercise of their supervisory functions"

But that
"the competent authorities shall require financial undertakings to provide them with the information they require to monitor compliance with the conditions referred to under paragraph 2 on a continuous basis."

In light of what has been discussed under this section, it will be concluded that even though efforts have been undertaken to address evolutionary outcomes within the market and changes in the global markets, such efforts would be fruitless in the absence of continual updates and changes to legislation – updates and changes which should respond to evolutionary outcomes within the market.

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75 Ibid at page 29
76 ibid
77 Commission Recommendation 2002/590/EC - Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, "Public Disclosure of Fees"
78 Also see "Disclosure of Fees" under section 4.1.2 of Annex at page 18 of 36 and section 5 "Public Disclosure of Fees" page 20 of 36.
79 See „Enhancements to the Basel II framework: Changes to the Pillar 3 Disclosure Requirements“ at page 29
80 ibid

Conclusion

Amongst other stated benefits, a principles based approach to regulation serves as a vital instrument in efforts aimed at facilitating competition and harmonisation. Disclosure requirements should not only aim to facilitate greater disclosure to the regulator and regulated institutions, but also strive towards engaging market participants in the disclosure process. Auditors and audits are important tools in corporate governance and the provision of non audit services could also enhance the quality of financial statements and financial information conveyed to investors where adequate safeguards exist to ensure that such auditor's independence is not compromised whilst providing an opinion on the financial statements.

Perceived benefits arising from the provision of non audit services should be taken into consideration – hence the support for proposals which do not favour a complete prohibition of non audit services. By encouraging mid tier firms to undertake a higher level of non audit services, this would not only foster greater competition within the audit market, but should also consequentially improve the quality of audits.[81] Even though comparisons have been drawn between the 2006 Statutory Audit Directive and the 8th Council Directive, the scope of the requirements in the field of auditing have been expanded under the 2006 Statutory Audit Directive.[82] The 2006 Statutory Audit Directive " redefines ownership/control arrangements away from their jurisdiction-specific nature towards a more European approach although firms still have to register in the EU member states where they have audits."[83] Furthermore, in light of its strong support for a principles based approach to regulation, the 2006 Statutory Audit Directive cannot be considered to be a replica of the 2002 Sarbanes Oxley Act (SOX).

If compliance could be ensured, then there would be no need for monitoring and market based regulation would probably be the ultimate option. However, there will always be a need for constant monitoring and compliance – hence a meta regulatory based strategy such as that provided by Basel II which not only incorporates essential elements of prudential supervision, the supervisory review process, but also market discipline. Enhanced disclosures under Basel II (Pillar 3) and several other measures which include stress testing procedures have not only contributed to enhanced disclosures but also more market friendly measures.

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81 For more information on this, please see paper M Ojo on "Regulating the International Audit Market and the Removal of Barriers to Entry: The Provision of Non Audit Services by Audit Firms and the 2006 Statutory Audit Directive" http://mpra.ub.uni-muenchen.de/18624/ and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1504703

82 See „Up-date on the EU Statutory Audit Directive (2006/43/EC)" <http://www.icaew.com/index.cfm/route/147481/icaew_ga/Technical_Business_Topics/Topics/Audit_and_assurance/Update_on_the_EU_Statutory_Audit_Directive_revised_8th_Company_Law_Audit_and_Assurance_ICAEW/pdf> (last visited 11 December 2009)

83 ibid

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