The Role of External Auditors and International Accounting Bodies in Financial Regulation and Supervision.

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THE ROLE OF EXTERNAL AUDITORS AND INTERNATIONAL ACCOUNTING BODIES IN FINANCIAL REGULATION AND SUPERVISION.

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ABSTRACT

The emergence of powerful financial conglomerates operating at a global level has led to unified supervision of financial services in the UK and Germany. These changes in regulatory structures have a higher potential of better utilisation through the involvement of external auditors. The crucial role played by external auditors in banking regulation and supervision has been highlighted in bank collapses like BCCI and Barings. According to the Basel Core Principles for effective Banking Supervision 1997, an effective banking supervisory system should consist of both "on-site" and "off-site" supervision. Off-site supervision involves the regulator making use of external auditors. On-site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors. Following Enron's collapse, debates focussed around why the UK had avoided its Enron. Many argued that it was because the US approach to accounting regulation was rules-based in comparison to the principles-based system of the UK . In addition to adopting an independent standard setting, the International Accounting Standards Board's second principle is aimed at principles as opposed to rules based standards. All public trading companies in the European Union would have to apply new international standards from 2005 in consolidated financial statements (EC Regulation 1606/2002) and huge efforts are now being made towards global convergence.

INTRODUCTION

This article aims to explore the roles of external auditors and international accounting bodies in financial regulation and supervision. The growth of multinational enterprises has to a significant extent, led to the internationalisation of auditing.[2] The demand for international auditing has also resulted to IOSCO, the International Organisation of Securities Commissions considering the removal of barriers for international capital markets.[3] IOSCO is also working closely with the IFAC, the International Federation of Accountants as regards international standards on auditing.[4] International auditing standards have come into force as it is important for multinational enterprises and particularly, international auditing firms to have no differences in auditing requirements between countries.[5] This would also avoid any problems of inconsistencies and misinterpretation during the process of applying these standards.

Sections of this paper are organised as follows : In the first section, the role of the auditor will be considered. This will include factors which are important if this role is to be achieved. Such factors include objectivity, integrity and independence. Brief definitions of these factors will also be given. In the second section, the trend of regulation and supervision in certain jurisdictions and the reasons for adopting a single regulator model are amongst the issues to be discussed. The third section would not only discuss 'regulatory capture' and consider how the external auditor could help the financial regulator avoid the pitfalls of "regulatory capture", but also why the regulator should be employing greater use of the external auditor. Section four then discusses how the collapse of Enron led to the realisation of the need to embrace international auditing

1 School of Social Sciences and Law. Usual disclaimers apply
2 C Nobes and R Parker *Comparative International Accounting* Seventh Edition p 488
3 Ibid p 489
4 ibid
5 Ibid p 578

and accounting standards. In the fifth section, international convergence issues and challenges facing the International Accounting Standards Board will be considered before a conclusion is given.

A) THE ROLE OF THE AUDITOR

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.[6] 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.[7] The move to verification of financial statements arose from the growing investment in the railway, insurance and banking industry[8]. 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.[9] 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.[10]

Factors Affecting the External Auditor's Role

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[11]. 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.[12] 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.[13] The new directive states that all firms listed on the stock market must have independent audit committees which will recommend an auditor for shareholder

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6 V Beattie and S Fearnley 'Auditor Independence and Non Audit Services' pg 1.(See <http://www.icaew.co.uk/publicassets/00/00/03/64/0000036464.PDF>)

7 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 at p 3

8 Ibid p 3

9 ibid

10 ibid

11 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>)

12 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

13 H Tomlinson 'Brussels Seeks To Tighten Audit Rules' *The Guardian* March 17 2004

approval.[14] 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.[15] 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.[16]

Definitions of Integrity, Objectivity and Independence

In the UK, the APB Ethical Standards govern issues relating to the integrity, objectivity and independence of auditors.[17] Guidance on other ethical matters and statements of fundamental ethical principles governing the work of all professional accountants are issued by professional accountancy bodies.[18]

Integrity is a requirement for those acting in public interest and it is vital that auditors act and are seen to act with integrity.[19] This requires not only honesty but a wide range of qualities such as fairness, candour, courage, intellectual honesty and confidentiality.[20]

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.[21] 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.[22] 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.[23]

The concept of independence is not the easiest to define. Definitions include :[24] “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.[25] 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.[26] The reality and notion of auditor independence is vital to public confidence in financial reporting.[27] Public confidence in financial markets and the conduct of public interest entities relies partly on the credibility of the opinions and

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14 ibid

15 ibid

16 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/>)

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

18 ibid

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

20 ibid

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

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

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

24 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 p 19

25 The AICPA White Paper definition (AICPA, 1997) defines independence as an absence of interests that create an unacceptable risk of bias.

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

27 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.[28]

B) DEVELOPMENTS LEADING TO THE ADOPTION OF A SINGLE REGULATOR MODEL IN CERTAIN JURISDTIONS

The Rationale For a Single Financial Services Regulator

'If a conglomerate provides such financial services as banking, securities, investment management, and insurance, the various authorities responsible for each financial sector need an integrated approach to regulation and supervision' .[29] Conglomerates are referred to as heterogeneous financial groups whose activities for the most part, span all institutional sectors.[30] Factors such as the growth of financial conglomerates and the derivatives markets fuelled by the impact of information technology and increased competition have triggered a change in the way supervision is carried out around the globe. In addition, bank collapses have also contributed to a re - think in the structure of financial regulation , that is, the way in which financial regulation is carried out.

In 1997, the UK government announced the adoption of a single regulator known as the Financial Services Authority, the **FSA,** to oversee the regulation and supervision of the financial system. The subsequent establishment of the Financial Services Authority and enactment of the Financial Services and Markets Act 2000 became fully operational in December 2001. The rationale for a single financial regulator includes *inter alia* the greater level of ease and efficiency with which a "single regulator" can regulate bank financial-conglomerates compared to a system where a multiple number of regulators exist.

The move towards a single regulator is not unique to the UK but is a trend that has gathered pace in the international capital markets. In Germany, the amalgamation of banks, securities and insurance supervisors, with the establishment of a single financial markets supervisory authority known as the Federal Agency for Financial Market Supervision, has taken place. In Italy, there has been a move towards deregulation with the so-called 'de-specialization' of the banking system, which is the first step towards a possible single financial regulator being set up.

Reasons Prompting a Regulatory Change

Reasons prompting regulatory change are usually interlinked. The origins of international regulatory convergence process can be traced back to a sequence of bank crises namely, the collapses of Bankhaus Herstatt in Germany, Franklin National Bank in the US, the secondary banking crisis in the UK and the

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

[29] DH Scott ' The Regulation and Supervision of Domestic Financial Conglomerates' (Policy Research Working Paper No 1329 The World Bank Financial Sector Development Department August 1994)

[30] See 'Supervision of Financial Services in the OECD Area'< http://www.oecd.org/dataoecd/29/27/1939320.pdf> (20 April 2006)

collapse of Banco Ambrosiano in Italy in the early 1980s.[31]

These reasons will now be considered.

(i) Developments in financial markets:

As markets have liberalised and traditional banking business has become less profitable, the line between banking and other financial services is becoming less and less distinguishable. As noted by Vieten[32], there are many reasons as to why a regulatory response is required. The Big Bang (the reform of the London Stock Exchange), focussed on the pace of change in the financial services industry and the differences between the environment in which many regulatory systems came into being and that in which they are currently working.[33]

As a result of globalisation, there is need for all regulators to take account of the whole of a group's activities in assessing the risk faced by the institutions they authorised. This was emphasised in the *Barings* Case where the collapse of the group was due to malpractices in a single subsidiary. The issue of group structures was also highlighted in the *BCCI* Case.

Thirty years ago, financial markets were more distinguishable: there was clearer distinction between commercial banks and securities firms. There was also a further distinction between institutions which catered for wholesale customers like merchant banks and those which catered for retail markets like commercial banks.[34] Supervision focussed then on the activities of the commercial banks rather than securities firms. As deregulation has opened up financial markets to competition from both domestic and foreign institutions, such previous distinctions have become blurred. Deregulation has also promoted the cross-border flow of capital and attracted investors to seek rewards in overseas markets.[35]

Improvements in information technology have also played a crucial role in encouraging both trading of financial instruments across national boundaries and also development of new products including derivative instruments.[36] Key difficulties however relate to identifying and quantifying the risks associated with holding such financial instruments.[37]

(ii) Bank Collapses

The collapse of *JMB, BCCI and Barings* triggered a regulatory response. However, it is also helpful to consider the causes of these collapses in evaluating the proper remedies for those collapses. Some causes

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[31] C Hadjiemmanuil *Banking Regulation and the Bank of England* (Lloyds of London Press 1995) 53

[32] HR Vieten *Banking Regulation in Britain and Germany Compared : Capital Ratios, External Audit and Internal Controls* (1997) 8

[33] Treasury Committee *Barings Bank and International Regulation* (Report No 1, 1996) xxii

[34] Treasury Committee *List of Memoranda included in the Minutes of Evidence* (Report No 1, 1996) 200 -201

[35] ibid

[36] ibid

[37] ibid

may not necessarily have warranted the creation of a single regulator. A specialist regulator may have failed to prevent some failures – not because it is incapable of doing so or not because it is not sufficiently equipped to do so, but because of the style of supervision adopted by such regulator. In other words, a change in style of supervision may be all that was needed to remedy the regulatory problems encountered by the Bank of England. Where lack of sufficient expertise about other sectors (insurance, investment or other sectors) contributed to inability to supervise efficiently, then that could warrant the creation of a "mega" regulator such as the FSA. In this case, the expertise from different required sectors could be enhanced and combined more efficiently.

(iii)International and European Regulatory Convergence Processes

Vieten notes three main factors driving the harmonization of banking supervision in Britain and Germany namely:[38] agreements of the Basle Committee, banking law directives issued by the European Union and perceived competitive pressure to conform to internationally accepted market principles. As also stated by Vieten, harmonization initiatives do not necessarily indicate convergence of banking supervision as individual countries integrate the capital adequacy ratio into their regulatory systems in different ways.[39] In certain cases such as new rules being drafted on capital adequacy for banks, there is indeed a limit to the usefulness of convergence – as factors affecting such rules may vary from country to country.
In response to the Bankhaus Herstatt collapse, an *adhoc* committee, the Committee on Banking Regulation and Supervisory Practices came into being.[40] This consisted of governors of the central banks of the Group of Ten ("G-10") countries and Switzerland and was formed at the end of 1974.[41] The Committee came to be known as the "Basle Committee". The purpose of the Basle Committee is to provide a means whereby study of international aspects of prudential regulation and discussion of issues could be undertaken between participating national authorities.[42] This was aimed at elaborating common principles related to strengthening bank supervision and harmonising prudential standards .

Three elements are essential to convergence.[43] These are: a common definition of capital, a common framework for measuring capital adequacy and a common minimum standard. Over the years the work of the Basle Committee has extended to cover non-credit risks undertaken by banks.[44] This was in response to the development in the global markets – with the advent of the growth of financial conglomerates .

As a result of global changes and development in global financial markets and activities of banks,

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[38] HR Vieten *Banking Regulation in Britain and Germany Compared : Capital Ratios, External Audit and Internal Controls* (1997) 7
[39] ibid
[40] C Hadjiemmanuil *Banking Regulation and the Bank of England* (Lloyds of London press 1995) 55
[41] ibid
[42] ibid p 55 - 56
[43] ibid p 63
[44] especially in relation to banks' securities business; ibid p 68

the scope of bank supervision has also developed. Two areas relevant to this section are initiatives put forward by the Basle Committee on Banking Supervision and the European Union and domestic developments in the UK.[45] With respect to the Basle Committee and the European Union, directives issued must be taken into consideration but Basle guidelines are not legally binding in the national states concerned.

Such environmental and global changes discussed above (which will be classified as external factors) and which may affect industry structure, should be distinguished from internal factors (for example, lack of proper implementation of internal controls) which result from within a particular company - in considering an appropriate regulatory response.

iv) The system prevailing then was not delivering the standards of investor protection or supervision which both the industry and public deserved. This reason would also naturally incorporate failures to achieve other objectives of financial regulation such as sustaining system stability and maintaining the safety and soundness of financial institutes.[46]

v) The distinction between different types of financial institutions and the products which they offered was getting increasingly blurred : this called for a move from supervision which was based on institutional types.

vi) The increasingly global nature of the financial services sector also called for a change.

vii) Consolidated prudential supervision of multi-functional financial groups would provide an efficient way of managing risks related to different financial activities.[47]

viii) The extent to which financial products and contracts are significantly different from general goods and services (these general goods and services not being regulated to the same degree as financial institutions).

The External Auditor's Role in Helping to Avoid Regulatory Capture

Many questions have been raised in relation to a single regulator's ability to be held accountable – given the all embracing nature its role and concentration of powers. Such questions include[48] whether a single regulator could be made sufficiently accountable to industry whilst avoiding regulatory capture. The external auditor can play an important intermediary role in the financial regulatory and supervisory process by

[45] Treasury Committee *Appendices to the Minutes of Evidence* (1996) 201
[46] Research Paper (99/68) 21,22
[47] ibid p 12
[48] See E Ferran 'Examining the UK's Experience in Adopting the Single Financial Regulator Model' at p 24

helping the regulator avoid 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,[49] 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 ...' Characteristics of situations where regulatory capture is likely to occur include[50] : 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.

In assessing the role of the external auditor in financial regulation and supervision, it is important to consider not only the type of regulator but the system of supervision.

The External Auditor's Role According To the System of Supervision

According to the Basle Core Principles for effective Banking Supervision 1997, an effective banking supervisory system should consist of some kind of both "on-site" and "off-site" supervision. Off-site supervision involves the regulator making use of external auditors. On-site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors.
The systems in the UK and Germany both involve both on-site and off-site supervision whilst Italy to a greater degree, is based on the on-site system (even though it still makes use of external auditors). The US position is based on an on-site system of supervision and is focussed on the aim of using external audit to examine financial institutions, but it does not extend beyond that (as it does in the UK where extra auditor functions are acquired).[51]

In Switzerland however, the banks' external auditors are said to " act as eyes and ears of the Swiss Federal Banking Commission (SFBC) or at least provide extra eyes and ears".[52] The Swiss supervisor depends a lot on the external auditor's supply of information and the external auditors carry out regular and direct supervisory functions. This approach is more in line with the requirements of the Basle Core Principles for effective Banking Supervision.

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[49] 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.

[50] I Ayres and J Braithwaite *Responsive Regulation : Transcending the Deregulation Debate* (New York : Oxford Union Press 1992) at pg 115

[51] More information on this : D Singh 'Banking Regulation of UK Financial Markets '.

[52] EHG Huepkes ' The External Auditor and the Bank Supervisor : Sherlock Holmes and Doctor Watson?' *Journal of Banking Regulation, Volume 7 No 1 / 2* 2005 pg 11

C) PROBLEMS IN ENRON AND THE NEED FOR EMBRACING INTERNATIONAL ACCOUNTING STANDARDS

The collapse of Enron raised consideration of the following points namely :[53]

The regulation of auditors : Enron highlighted the fact that self-regulation and peer review in the US were no longer enough
Eliminating conflicts of interests in accounting firms;
Compulsory rotation of auditors – as Andersen had audited Enron since its establishment in 1983; and
Revisiting America's Generally Accepted Accounting Principles.

The collapse of Enron also led to suggestions that the Securities and Exchange Commission (SEC), its standard-setting body – the Financial Accounting Standards Board may have to look to embracing international accounting standards.[54]

Accounting Practice in the UK and the US

Following the collapse of Enron, a lot of comparisons were drawn between the principles based approach which exists in the UK and the US rules-based approach. Under David Tweedie's guidance during the 1990s, the UK Accounting Standards Board developed accounting standards which relied heavily on rules but still looked at the substance of the transactions, and if the rules did not produce the right answer, then one would have to look to the substance to produce the answer.[55] One of the major problems with Enron was the off balance-sheet debt which resulted from direct following of rules without being able because the accounting standards did not permit, to consider the substance of the transaction.[56] Many of the differences between the UK and US practices resulted directly from the changes driven by major corporate collapses of the 80s and early 1990s[57] and such differences need to be considered when deciding whether to adopt certain post Enron reforms.

The International Accounting Standards Board (IASB)

The IASB operates according to two principles namely:[58]An independent standard setting and on principle based standards. The independent standard setting comprises of independent board members; the occurrence of all board meetings in public; a thorough due process; private funding and no political influence.[59] The second principle of principle based standards tries to establish principles that drive the standards. The IASB aims to develop high quality, understandable global accounting standards which require transparent and comparable information , in the public interest.[60]

The year 2005 was a year of major change for many companies with the introduction of international accounting standards and new auditing standards.[61] Countries planning to require IFRS for all domestic listed companies in 2005 include:[62] European Union members; new EU members; European Economic Area (EEA) members -which include Iceland, Liechstenstein and Norway; Australia and South Africa. New Zealand and Canada hope to do so in 2007. A lot of work is currently being done between the Securities and

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53 " Enron : The real scandal" *The Economist* Jan 17th 2002 <http://www.economist.com/displaystory.cfm?story_id=940091>
54 ibid
55 House of Commons Select Committee on Treasury; Examination of Witnesses : Mr Michael Groom, Mr Peter Wyman, Mr David Bishop, Mr Roger Adams, Mr Bruce Epsley and Mr Richard Mallett, Wednesday 10 April 2002 pg 1
56 Ibid p 2
57 House of Commons Select Committee on Treasury , Memorandum submitted by the Institute of Chartered Accountants in England and Wales pg 3
58 K Dasgupta and N Whelan 'A Strategic Overview of the New Accountancy Regulations' Paper Presented at the Institute of Advanced Legal Studies, Russell Square on the 25th May 2005
59 ibid
60 See <http://www.iasb.org/about/index.asp> (last visited August 20 2006>
61 See FRC Annual Report 2005/ 2006
62 K Dasgupta and N Whelan 'A Strategic Overview of the New Accountancy Regulations' Paper presented at the Institute of Advanced Legal Studies, Russell Square on the 25th May 2005

Exchange Commission, FASB and IASB to eliminate differences which exist between themselves. Advantages of such convergence include:[63] The attraction of investment by transparency; the support of cross-border investments; the reduction of cost of capital and the reduction of operational expenses.

D) INTERNATIONAL CONVERGENCE EFFORTS

In the UK, the Accounting Standards Board, the ASB, is working hard to harmonise standards with International Financial Reporting Standards, IFRSs. *EC Regulation 1606/2002* states that all publicly traded companies must apply IFRSs from 2005 in consolidated financial statements. Apart from the convergence efforts in Europe, huge efforts are also being made to converge standards with US GAAP.

International Financial Reporting Standards 32 and 39 (IFRS 32 and 39)

Two International Financial Reporting Standards (IFRS 32 and IFRS 39) deal with off-balance sheet instruments. Off balance sheet instruments created problems in the Parmalat and Enron cases as they were not reflected in the balance sheet – even though sizes could have been as large as two to three times global GDP. The standards bring the financial instruments under the balance sheet.

Challenges Facing the International Accounting Standards Board

One of the biggest challenges facing the International Accounting Standards Board will be reconciling IFRS 32 and 39 globally – with the US in particular. Other debates relating to IFRS 32 and 39 include the distinction between debt and equity as this distinction does not exist in the markets. Bond converts to equity under certain circumstances and vice versa. Under IFRS 32 what you could call equity may not be permitted under banking regulation.

E) CONCLUSION

The UK 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.[64] 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".[65] 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.[66]

In contrast, Huepkes [67] argues that the threat of litigation could lead to further concentration in the auditing industry and also increase the trend towards defensive auditing – whereby audit partners tend to interpret rules prescriptively rather than exercising subjective judgement. The problems at Equitable Life and Independent Insurance in the UK, and the failures of Enron and others in the US with the demise of Arthur Andersen, one of the former Big Five accountancy practices has increased audit partners' awareness of risk and the consequences of making incorrect judgments.[68] Directors, particularly non-executive directors are increasingly aware of the rewards and risks linked with greater responsibilities as a result of changes to the Combined Code of corporate governance following Higgs[69] and Smith.[70] The UK government noted these concerns and issued a consultation document on director and auditor liability.[71] It can be said that unless efforts are made towards limiting liability, it could be harder or even impossible to employ the services of

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63 ibid

64 See House of Commons Select Treasury Committee, Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' at pg 21

65 ibid

66 ibid

67 See EHG Huepkes ' The External Auditor and the Bank Supervisor : Sherlock Holmes and Doctor Watson?' *Journal of Banking Regulation, Volume 7 No 1 / 2* 2005 at pg 10

68 ibid

69 D Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* 2003 Department of Trade and Industry, London

70 R Smith *Audit Committees Combined Code of Governance : A Report and Proposed Guidance by an FRC-appointed group* (2003) chaired by Sir Robert Smith FRC, London

71 The DTI document : DTI *Director and Audit Liability : A Consultative Document,* (2003b), London

external auditors and non executive directors of financial services without a substantial increase in their remuneration.[72] Following the publication of the Penrose Report and potential liabilities surrounding Equitable Life, the specific role of auditors is an important research area.[73]

More work is needed to ensure that the role of the external auditor is better defined and that the possibility of unwarranted liabilities and risks are avoided. The growth of financial conglomerates and globalisation of capital markets has highlighted the need for a clearly defined role for auditing as a vehicle towards providing credibility to financial statements.[74] In order to define this role clearly, International Standards on Auditing have been developed by International Federation of Accountants[75] The International Accounting Standards Board is also working towards providing clearer accounting standards towards the harmonisation of standards around the world. This should help avoid corporate failures which arise as a result of improper application and treatment of accounting standards.

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[72] P Dewing and P O Russell *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* Institute of Chartered Accountants of Scotland (2005) 117
[73] ibid
[74] C Nobes and R Parker *Comparative International Accounting* Seventh Edition p 510
[75] ibid

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