The role of the external auditor in the regulation and supervision of the UK banking system

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Introduction

The need for indirect supervision[1] of the banking system through the use of intermediaries such as external auditors has become popular over the years. About two decades ago, internal control systems would not have featured highly in an analysis of banks and their supervision.[2] A general banker[3] 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.[4] The benefits of using the external auditor in the bank regulation and supervisory process include the ability of the external auditor to provide a wide range of resources and knowledge and acting as an intermediary for the regulator, thereby helping to protect the regulator's reputation and helping the regulator to avoid regulatory capture. The risks involved in using the external auditor include conflict of interests[5], loss of information during the transfer of information to the regulator and higher costs.[6]

The process of obtaining vital information for the FSA is discussed under the context of the rights and duties of auditors to report to regulators. This will highlight the reporting procedures during the Bank of England's regime with a less extensive discussion of the FSA's regime. The FSA's enforcement process will extensively discuss how external auditors help not only in obtaining vital information for the FSA, but also other tasks such as risk analysis and sampling procedures which external auditors use as a means of evaluating information for the FSA.

An extension of the external auditor's role depends on the nature and environment of the national supervisor.[7] For example, the assistance that might required of the external auditor will usually be minimal where the banking supervisor follows an active approach, with frequent and rigorous inspection.[8] If, however, there has been a history of less direct supervision, which is mainly based on the analysis of reported information provided by bank's management, as opposed to inspection, or if supervisory resources are limited, the assistance that the external auditor can offer in providing assurance on the information obtained could be of immense benefit to the supervisor.[9]
Many countries are however, are currently practising a supervisory approach which combines elements of inspection and analysis of reported information.[10] Inspection is proving more and more demanding in terms of supervisory resources even as banking becomes more complex.[11] As a result, many supervisory authorities that practice on-site inspection are being driven to place greater reliance on reported information, and look to the external auditor for assistance in those areas for which the auditor's skills are particularly suited.[12]

1 Indirect supervision implies a system of supervision whereby the external auditor performs the task of collecting information and 'directly' supervising for the regulator. Where the external auditor merely reports on information collected by banking staff, he does not assume any supervisory responsibilities. See 'The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 57 page 15 <http://www.bis.org/publ/bcbs87.pdf> (last visited 11th July 2007)

2 B Quinn 'The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed) *Internal Controls in Banking* (Oak Tree Press Dublin 1995) p 35

3 These are usually top management of the bank such as bank directors

4 ibid p 37

5 The external auditor in this situation would not only owe obligations to the bank, its shareholders but also to the regulator and those investors whose interests are being safeguarded by the regulator.

6 E Huepkes 'The External Auditor and the Bank Supervisor' p 12

7 'The Relationship between Banking Supervisors and Banks' External Auditors: Additional Requests for the External Auditor to Contribute to the Supervisory Process' January 2002 (page 12) para 64; also see <http://www.bis.org/publ/bcbs87.pdf>

8 ibid

9 ibid

10 Ibid para 65

11 ibid

12 ibid

This paper focuses on how the external auditor can assist the FSA through two of its principal regulatory tools in the FSA's response to risk, namely **supervision** and **enforcement**. The external auditor has a vital role as a supervisory tool in reporting certain matters as obliged by the Financial Services and Markets Act 2000 (FSMA) and also in reporting specific matters through annual reports.[13] As an enforcement tool, external auditors play a key role in their functions as skilled persons. Under section 166 of the FSMA, power is conferred on the FSA to mandate a firm of solicitors or accountants/auditors to report to the FSA matters requiring provision of information under section 165 of the FSMA.[14] The reports produced by external auditors as a result of this process are known as skilled person reports. As well as the FSA's use of external auditors to assist it in obtaining information, performing risk analysis, sampling and other tasks during enforcement procedures, the effectiveness of the FSA's use of external auditors in its off-site and on-site systems of supervision can be efficiently assessed through a holistic examination of the way in which the audit profession is regulated.

The remaining sections of this paper are organised as follows: The first section will discuss the developments which have led to the present role of the audit. This section considers the watch dog nature of the auditor through the performance of traditional audit techniques on internal controls – a stark contrast to the lax attitude demonstrated through his present role of verifying financial statements. The next section will then analyse why the audit is of great importance and the need to restore its reputation amidst creative accounting practices which undermine its value. One of the vehicles required to restore such reputation is the concept of audit independence. This is considered in section three. Threats to auditor independence and safeguards to protect against such threats are then analysed before the external auditor's role in the supervisory process is considered. Under its role of obtaining information for the FSA, the external auditor's right and duty to report, statutes and standards governing those rights and duties will be analysed. The development of a framework for corporate governance, developments leading to the establishment of audit committees and the FSA's enforcement procedures will also be considered. The FSA's enforcement procedures highlight the immense contribution made by external auditors to the supervisory process as demonstrated in the Legal and General Case. Recent developments in audit independence and audit liability are then discussed before a conclusion is arrived at.

The Changing Roles of the Audit

According to accounting literature, the traditional role of the audit was mainly the detection and prevention of fraud.[15] The move to verification of financial statements arose from the growing investment in the railway, insurance and banking industry[16]. 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.[17] 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.[18]

Evidence has been provided to support the fact that the auditor's role changed during the nineties from that reminiscent of a watch dog to a less vigilant and scrutinising role.[19] Such evidence which include firstly, the widening scope of audit firm services beyond the audit function, resulted to relationships which affected the

13 M Blair and G Walker 'Financial Services Law' 2006 p133

14 Ibid p 135

15 D Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* (Volume 4 No 3 , 2003) 3

16 D Singh 'The role of third parties in banking regulation and supervision' *Journal of International Banking Regulation* (Volume 4 No 3 , 2003) 3

17 ibid

18 D. Singh ' The role of third parties in banking regulation and supervision' at p 3

19 L Cunningham 'Too Big to fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' Boston College Law School Faculty Papers Paper 165 (2006) 23

audit firms' independence.[20] Secondly, increase in accounting irregularities during the 1990s arose in the form of widespread premature revenue recognition and other forms of “creative” accounting.[21] Thirdly, there was evidence of auditor ability to influence audit quality and liability risk as illustrated through dramatic changes in the number of financial restatements, frequency of auditor switching and the degree of qualified opinions issued.[22]

The laxness and complacity resulting from “creative accounting” techniques has not only resulted in continual emphasis on auditor independence but also justifies the requirements by the US Sarbanes Oxley Act that auditors audit internal control over financial reporting.[23] Traditional auditing techniques focus on internal controls and demonstrate the auditor's thorough reputation as compared to the lax and complacent attitude which was characteristic of the nineties.

Traditional auditing techniques may involve overly thorough and expensive procedures but given the complacent attitude that threatens to undermine the audit profession and audit quality in particular, it is worth the exercise and effort. The value of carrying out these procedures is demonstrated in the following section.

The Value of the Audit and Auditor Independence

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.[24] 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. Much of internal audit work can be useful to the external auditor in the audit of the financial statements - even though the external auditor is solely responsible for the audit report and for determining the nature, timing and extent of audit procedures. As part of the audit, the external auditor therefore assesses the internal audit function insofar as he believes that it will be relevant in determining the nature, timing and extent of the audit procedures.[25]

The primary objective of an audit is for the auditor to provide independent assurance to shareholders that the financial statements have been properly prepared by the directors.[26] The purpose of an audit is not intended to detect fraud - **except that which is material to the financial statements.** It aims to give shareholders confidence in the annual accounts prepared by the directors.[27] The reality and perception of auditor independence is essential to public confidence in financial reporting.[28] Public confidence in financial

20 For example, Ernst and Young had a business partnership with its client, PeopleSoft; clients and audit committee members of KPMG received some of its illegal tax shelters; whilst both KPMG and PWC had investments in their audit clients ;ibid.

21 Ibid p 24

22 Restatements rose to an all time record high of 160 by 1999; ibid p 25. See also U.S. Gen. Accounting Office, Report on Financial Statement Restatements:Trends, Market Impacts, Regulatory Responses and Remaining Challenges 4 (2002)

23 Ibid p 41

24 V.Beattie, S Fearnley 'Auditor Independence and Non audit services' p 1 see <http://www.icaew.co.uk/publicass> (12 July 2005)

25 ' The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 20, page 6 see <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

26 Ethical Statement 1 Integrity, objectivity and independence paragraph 3 <http://www.asb.co.uk/apb/publications/index.cfm> (July 16 2006)

27 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 p 12 . Also see <http:// www.publications.parliament.uk/cgi-bin/ > (16 December 2005)

28 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of

ntities relies partly on the credibility of the opinions and reports given by auditors in relation with financial audits.[29]

Effective audits and efficient performance of the external auditor's role in the supervisory process require standards such as independence, objectivity and integrity to be achieved.

Integrity is a requirement for those acting in public interest and it is vital that auditors act and are seen to act with integrity.[30] This requires not only honesty but a wide range of qualities such as fairness, candour, courage, intellectual honesty and confidentiality.[31]

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.[32] 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.[33] 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.[34]

The concept of independence is not the easiest to define. Definitions include :35 "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.36 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.[37]

As well as performing similar functions, that is, the verification of the financial statements, the external

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Chartered Accountants in England and Wales 2001) 18

29 Ethical Statement 1 Integrity, Objectivity and Independence paragraph 4 <http://www.asb.co.uk/apb/publications/index.cfm> (16 July 2006); The EC sought to establish a common framework of independence principles through a Green Paper (EC 1996) and with the help of the Federation des Experts Comptables Europeens (FEE 1995,1998). In 1998, the European Parliament approved a resolution supporting the EC Green Paper and the European Commission issued a Recommendation" Statutory Auditors' Independence in the EU:A Set of Fundamental Principles" on the 16 May 2002. This directive requires all firms listed on the stock exchange to have independent audit committees and that auditors/audit partners must be rotated. However, it does not deal with the separation of auditors from consultancy work-despite the threat of non-audit work to the auditor's independence. See 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 p 18

30 Ethical Statement 1 Integrity, objectivity and independence paragraph 7 <http://www.asb.co.uk/apb/publications/index.cfm> (12 July 2006)

31 ibid

32 Ethical Statement 1 Integrity, objectivity and independence paragraph 9 <http://www.asb.co.uk/apb/publications/index.cfm> (12 July 2006)

33 Ethical Statement 1 Integrity, objectivity and independence paragraphs 9,11 <http://www.asb.co.uk/apb/publications/index.cfm> (14 July 2006)

34 Ethical Statement 1 Integrity, objectivity and independence paragraph 10 <http://www.asb.co.uk/apb/publications/index.cfm> (15 July 2006)

35 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) 19

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

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

auditor and the regulator also 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 banking supervisor is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to protect the interests of the depositors.[38] Therefore, the supervisor monitors the present and future viability of banks and uses their financial statements in assessing their condition and performance.[39] The external auditor, on the other hand, is primarily concerned with reporting on the bank's financial statements ordinarily either to the bank's shareholders or board of directors.[40] In doing so, the auditor considers the appropriateness of management's use of the going concern assumption.[41]

The financial audit remains an important aspect of corporate governance that makes management accountable to shareholders for its stewardship of a company[42]. 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.[43] Accounting firms sometimes engage in a practice called "low balling" whereby they set audit fees at less than 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 these 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.

The UK professional guidelines[44] 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[45]. However the guidelines do not identify which non-audit services undermine independence.[46]

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.[47] There are three categories of non-audit services namely[48]: 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. The provision of non audit services by auditors can also result to two other types of threats namely self interest threat and self review threat.

Self interest Threat

This arises when auditors have financial or other interests which might result to them being reluctant to take

38 ' The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 46 page 12 see <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

39 ibid

40 ibid

41 ibid

42 V.Beattie, S.Fearnley 'Auditor Independence and Non audit services' pg 1 see www.icaew.co.uk/publicass

43 D Singh 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003 p 8

44 The Institute of Chartered Accountants England and Wales Guide to Professional Ethics; see D Singh 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003, at p 8

45 D Singh 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003 p 8

46 ibid

47 V.Beattie, S.Fearnley 'Auditor Independence and Non audit services' pg 1 <http://see www.icaew.co.uk/publicass>

48 House of Commons , Select Committee on Treasury, Minutes of Evidence at pp 18 and 19 . Also see <http://www.publications.parliament.uk/cgi-bin/>

actions that would be adverse to the interests of the audit firm.[49]

Self review Threat

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.[50] 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.[51]

Other threats to objectivity and independence include[52]: 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.[53]

Arrangements are well in place to deal with risks posed by non audit services to 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.[54] Secondly, under provisions of the Combined Code of corporate governance, the audit committee, as representatives of the shareholders, is required to supervise the relationship with the auditors and monitor the nature and scope of non-audit services.[55] The audit committee must be sure that the independence and objectivity of the auditor are not compromised.[56]

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49 Ethical Statement 1 Integrity, objectivity and independence paragraph 28 <http://www.asb.co.uk/apb/publications/index.cfm> (last visited 12 July 2006)
50 ibid
51 ibid
52 ibid
53 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.
54 House of Commons , Select Committee on Treasury, Minutes of Evidence at p 19 . Also see <http://www.publications.parliament.uk/cgi-bin/> (12 February 2006)
55 ibid
56 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.

In addition to the above mentioned safeguards, it is worth noting that it has 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.[57]

Other examples of safeguards which exist in the UK to protect the independence of auditors include:[58]

The provision for staff on the audit assignment to communicate concerns to a separate partner; arrangements for an independent partner to act as reviewer; regular rotation of audit partners; effective interaction between the audit committee and the auditor and compartmentalisation of responsibilities and knowledge within the audit firm. Auditor independence is strengthened by systems of inspection to detect breaches of auditing standards and the imposition of penalties or restrictions where offences or failures have occurred.[59]

In view of the immense contribution by external auditors to the supervisory process, it is necessary to consider the risks associated with their involvement and provide for measures which would safeguard against any potential risks or threats to their independence. The immense contribution made by external auditors will now be considered.

The External Auditor's Role in the Supervision Process

External auditors are better placed to carry out such procedures because of their expertise in analysing risks associated with internal controls in banks and firms, their ability to validate processes in the measurement of credit, market and operational risks under Basel II[60] and their ability to undertake other specialised functions which are particularly necessary in a business environment in which computer technology and diverse risks have evolved. The FSA places great reliance on the cooperation of regulated firms to provide information which is timely, accurate and complete in order to be able to gauge whether a firm is complying with its requirements. Auditors can help facilitate efficiency within the supervisory process as they are also required under the FSMA to inform the FSA of certain matters of concern and have to provide annual reports to the FSA. The FSA in its proximity to the market and consumers would also need to be mindful of not getting 'captured' by those it is supposed to be regulating.

Due to lack of transparency, the kind of supervisory regime under which the Bank of England operated, was prone to regulatory capture. This was not as a result of the extent of the Bank of England's use of external auditors in the supervisory process. In fact, the Bank of England used more reporting accountants than the level used by the FSA at present. The lack of transparency resulted from its discretionary and informal approach to supervision. Due to lack of transparency, the kind of supervisory regime under which the Bank operated, a regime of informal and negotiated enforcement, was prone to two forms of abuse.[61] Firstly, it could degenerate into the capture of the regulatory system by the regulated.[62] Secondly, it could conceal selective enforcement and possible harsh treatment of less significant regulatees.[63] In contrast, the FSA's use of risk based supervision facilitates a system whereby transparency is encouraged.

As well as possessing valuable expertise and third party information, external auditors are in a better position to act as intermediaries between regulators and the regulated based on the Basel Committee's

57 ibid
58 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 p 14 . Also see <http:// www.publications.parliament.uk/cgi-bin/ >
59 ibid
60 See E Huepkes 'The External Auditor and the Bank Supervisor' p 11
61 C Hadjiemmanuil p 182; A system of risk-based supervision is more transparent and allows for more accountability
62 ibid
63 ibid

recommendations.[64] Principle 20 of the Basel Core Principles for Effective banking Supervision 'Supervisory Techniques' states that 'An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management'.[65] The external auditor's role in reporting on information supplied by the bank's management[66] or on the application of particular procedures, does not assume any supervisory responsibilities.[67] By providing reports, this enables the supervisor to make judgments about the bank more effectively.[68]

Assisting the Regulator as a **Supervisory Tool** in Obtaining and Reporting on Vital Information

The Auditor's Right to Communicate: Developments During the Bank of England's Regime

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.[69] Section 47 of the Banking Act 1987 gave the auditor the right to report any matters of prudential concern to the Bank of England[70]. 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.[71] As long as auditors had communicated in good faith, they were not considered to have breached any duty of confidentiality[72]. 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.

The Bank of England commissioned 2 types of reports namely the section 39 reports[73] and section 41 reports.[74] During the course of 1995 and 1996, 647 section 39 reports and 2 section 41 reports were commissioned.[75] 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 two or three days and longer for complex reviews.[76] The level of reliance placed on the accounting profession is also demonstrated through the Bank of England's Report for 1994/95.[77]

The Bingham Report on the BCCI affair proposed changing the auditor's right to communicate into a duty.[78] 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.[79] The relationship between supervisory authorities and the external auditors of a

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64 See 'Additional Requests for the External Auditor to Contribute to the Supervisory Process: The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 57 page 15 see <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

65 Basel Committee on Banking Supervision 'Core Principles For Effective Banking Supervision' October 2006 <http://www.bis.org/publ/bcbs129.pdf>

66 The basic responsibility for supplying complete and accurate information to the banking supervisor is to remain with the bank's management; see The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 57 page 15 see <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

67 ibid

68 ibid

69 Vieten pp 167 and 168

70 Ibid p 167

71 ibid

72 Vieten p 167

73 These examine aspects of accounting and prudential reporting and internal control systems; see Vieten p 169. They are also commissioned regularly.

74 These are commissioned on an exceptional basis where areas of concern have been identified

75 Vieten p 169

76 See Vieten p 172

77 At page 39; also see Vieten p 172

78 HC 198, 1992; see Vieten p 172

79 HC 673,1995 p 261 ; see Vieten p 172

credit institution and the duties of these auditors was identified as an important lesson from the BCCI case.[80] 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.[81]

Should there be a Right to Communicate or a Duty to Communicate?

Generally producers of consumables owe a "duty of care" to third parties. However it was held in *Caparo Industries plc v Dickman and Others*[82] 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.[83]

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.[84] 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".[85]

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.[86] The inspectors it appoints to examine these collapses have been said to rarely examine the impact of organisational culture and values on audit failures.[87] 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 there actions – as a reduction in their revenue (as a result of 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.[88] However, they are influenced by pursuit of their economic interests[89] - hence a situation involving a 'conflict of interest' arising. The issue relating to the aftermath of BCCI is mentioned following the Bingham Report where Lord Justice Bingham proposed a statutory duty to be owed by the auditor, and the auditing industry still opposed the imposition of any "duty" to report financial irregularities to the regulators[90].

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

80 . JF Mogg ' The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed) *Internal Controls in Banking* (Oak Tree Press Dublin 1995)31

81 JF Mogg ' The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed) *Internal Controls in Banking* (Oak Tree Press Dublin 1995)32

82 (1990) 1 All ER HL 568

83 See House of Commons Select Treasury Committee 'Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 21

84 See House of Commons Select Treasury Committee 'Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 21

85 See House of Commons Select Treasury Committee 'Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 21

86 ibid

87 Ibid

88 See House of Commons Select Treasury Committee, Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 22

89 Ibid p 22

90 ibid

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 1st May 1994.[91] 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.[92]

The prudential returns of authorised institutions and meetings between their senior management and supervisors were the Bank of England's main sources of information.[93] 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.[94]

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.[95] 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.[96] The pressure faced by auditors from directors and creative accounting were major issues. Parliament delegated a lot of reforms to self-regulatory bodies. A system of self regulation is also likely to be more susceptible to regulatory capture[97].

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

Collapses such as those of Maxwell, BCCI and Polly Peck resulted in changes to financial reporting, corporate governance and audit. Three key themes emerge form the lessons learned and they include:[98] substance over form, transparency and the management of risk. The emphasis on internal control and risk management emerged from realisation that due to change in the business environment, even effective safeguards may be insufficient to eliminate all possibility of failure.[99]

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91 Accountants (Banking Act 1987) Regulations 1994, S.I. 1994/524 ; see Hadjiemmanouil p172
92 Ibid p 172
93 Hadjiemmanouil p 174
94 Hadjiemmanouil p 174
95 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) 6
96 ibid
97 See J Godfrey and I Langfield - Smith 'Regulatory Capture in the Globalisation of Accounting Standards' WPG 04-08
98 House of Commons , Select Committee on Treasury, Minutes of Evidence p 17 . Also see <http://www.publications.parliament.uk/cgi-bin/ > (12 Aug 2005)
99 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 p 17 . Also see <http:// www.publications.parliament.uk/cgi-bin/ > (17 December 2005) and House of Commons Select Committee on Treasury Minutes of Evidence Memorandum submitted by the Institute of Chartered Accountants in England and Wales p 4

The Financial Reporting Council's aim is to provide confidence on corporate reporting and governance.[100] Many definitions have been suggested as to what constitutes corporate governance. Whilst Keasy and Wright[101] 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.[102] The two key aspects of governance are: [103] Supervision and monitoring of management performance (the enterprise aspect) and ensuring accountability of management to shareholders and other stakeholders (the accountability aspect).

The Cadbury Report made important references to aspects of internal control systems in the context of all public companies.[104] The Cadbury Report also highlighted that the low level of confidence in financial reporting and auditing was caused by :[105] 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.[106] Compliance with the code was however made compulsory by the LSE for listed companies after June 1993.[107] Recommendations include:[108] 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; that the board report on the effectiveness of internal controls and he company's going concern status and 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;[109] 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;[110] ; the Hampel Committee's Report (1998) which reviewed the implementation of the Cadbury Code to ensure that its

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100 See *FRC Annual Report 2005/2006*

101 See K Keasy and M Wright 'Issues in Corporate Accountability and Governance : An Editorial' *Accounting and Business Research* , 23 (91A) p 291

102 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) 27

103 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001)26

104 B Quinn ' The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed) *Internal Controls in Banking* (Oak Tree Press Dublin 1995) 35

105 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) p 27

106 ibid

107 ibid

108 Ibid p 27

109 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 p 8 . Also see <http://www.publications.parliament.uk/cgi-bin/ > (10 Jan 2006)

110 ibid

original purpose was being achieved[111] and the Turnbull Report which builds on corporate governance – turning it into a positive management vehicle for risk management and corporate reporting.[112] The Turnbull Committee recommended a risk-based approach to establishing a sound based system of internal controls.[113] 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.[114]

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.[115]

Audit Committees

The Cadbury Report highlighted the value of audit committees as internal monitoring device supportive of good corporate governance[116]. 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.[117]

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.[118]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.[119] The Hampel Report also notes that audit committees form an essential safeguard of auditor independence.[120]

111 ibid

112 House of Commons Select Committee on Treasury Minutes of Evidence; Appendix 8; Memorandum from the Chartered Institute of Public Finance and Accountancy at p 2

113 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 at pg 10 . Also see <http://www.publications.parliament.uk/cgi-bin/ > (12 January 2006)

114 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 <http://wwwww.publications.parliament.uk/cgi-bin/ > (12 January 2006)

115 See *FRC Annual Report 2005/2006* p17

116 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) 29

117 ibid

118 V Beattie S Fearnley and R Brandt 'Behind Closed Doors : What Company Audit Is Really About' (Institute of Chartered Accountants in England and Wales 2001) 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, aprivate meeting between each of the external and internal audit leaders be held ; and for self-assessment procedures to exist.

119 APB, 1996, Next Steps S Fearnley p 30

120 See paragraph 6.9

Enforcement by the FSA

The FSA, in considering disciplinary action, has tried to focus on the organisation concerned as opposed to individuals.[121] At the same time, considerable efforts are being made to highlight concerns which emanate from the apparent lack of management oversight.[122] The difficulty in reconciling the desire of senior management to operate a compliant business and the ability of the organisation to deliver according to the standards expected by the FSA has been attributed partly to inadequate training, processes or understanding of allocated responsibilities.[123]

In order for the enforcement tool to be effective, it must justify the act for which it has been imposed. As mentioned previously, the public "naming and shaming" by means of press communication. is very effective as companies will try to avoid their name and reputation from being tarnished. However, as the *Legal and General* Case has highlighted, not all regulated institutions may accept such sanctions.

Following the *Legal and General* Case, an Enforcement Process Review was set up to review the use of, approach to and decision-making process for supervisory actions and enforcement actions to address breaches of regulatory requirements and, where appropriate, to make recommendations.[124] The review evaluated the lessons from the FSA's experience over the last three years under the Financial Services & Markets Act 2000 (FSMA) regime including the comments of the Tribunal in the Legal & General case but did not explore any options which would require changes to FSMA.[125] The review considered the procedures followed by supervisors, enforcement staff and decision makers in considering possible breaches of statutory or regulatory requirements, and the nature and extent of the communications and interactions between them; the role and involvement of senior FSA management throughout these processes; options for making regulatory decisions based on a fair procedure by persons separate from the investigators; and the accountability of decision makers to the FSA Board.

Recommendations made to the FSA Board following the *Legal and General* Case include four key principles for the FSA's enforcement process review that have driven the Review's recommendations and these are:[126] That the FSA should provide: a clear view of its holistic approach to the use of enforcement; adequate safeguards and controls to help ensure balance and fairness during the investigation phase[127]; transparency for those subject to enforcement action so that they are well-informed about the case they have to answer and the evidence on which it is based; and clarity as to the distinction (required by FSMA) between those who investigate a case and those who decide[128].

121 R Turner 'The Interaction between FSA Enforcement Action and Compliance Culture: A Help or a Hindrance?' *Journal of Financial Regulation and Compliance* Volume 13 Number 2 2005, Henry Stewart Publications at p 144

122 ibid

123 ibid

124 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> at p 65

125 ibid

126 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> pp 13 -15 (last visited 10 June 2007)

127 As the FSA is a risk-based regulator, it has to focus its limited resources on those issues which are likely to have greatest impact on its statutory objectives. As a valid enforcement tool, a practical consequence of the risk based approach is that the FSA cannot, and does not, attempt to investigate every rule breach.The FSA instead, selects cases carefully, according to their seriousness and its priorities. The Review recommends no change to this approach but it is important that the FSA continues to explain how it will use enforcement to help meet its objectives and what the practical consequences of this are for firms and consumers.
To help facilitate the decision-making process functions most effectively, investigations must be of a high quality and any alleged breaches properly supported by evidence. A number of recommendations to strengthen the investigation process and one which is particularly recommended by the Review, is that before a case is referred to the decision makers, there be a thorough legal review by lawyers in the Enforcement Division who are not part of the investigation team. This is not generally current practice; ibid

128 In order to operate fairly and in order to be seen as operating fairly, there must be separation between those who investigate possible rule breaches and those who decide whether the conduct in question should be sanctioned

Other recommendations include the fact that the FSA is to continue to promote transparency about its **risk-based approach to enforcement and the consequences flowing from it, particularly for case selection.**[129] The FSA Board and the Executive are to consider at least once a year, the approach to enforcement and how this tool can be utilised to help achieve its overall objectives.[130] The FSA's enforcement approach for medium-sized and smaller firms is also to be developed and communicated to complement its approaches for the larger and for the smallest firms.[131]

Expected Effect of Recommendations

Greater confidence in the FSA on the part of regulated firms and individuals, encouragement of self-reporting, remedial action and co-operation will be facilitated by improved enforcement procedures.[132] There is a danger that firms and individuals may react by introducing over-elaborate procedures to protect themselves from any risk of being thought to have breached an FSA requirement where there are concerns about the FSA's enforcement process in terms of case selection, conduct of the investigation or the decision-making process itself.[133] The changes recommended by the Review will not only help reduce any such 'over-compliance' that may exist but consumers will also benefit in that the more judicious and well respected the enforcement process is, the more it may encourage better compliance by regulated firms and individuals without recourse to enforcement action.[134]

It is anticipated that more cases will be settled earlier as a result of the Review's recommendations which consequently should reduce costs and assist consumers, both in terms of securing redress earlier and sending clear reminders to firms about the standards which the FSA expects of them.[135] Where cases do proceed to the RDC, the net effect of these recommendations will be to add to the overall costs of the FSA's enforcement process hence making it lengthier.[136]

The Role of the External Auditor as an **Enforcement Tool** in the Regulatory Process.

According to statistics, the FSA uses the enforcement tool selectively and this is consistent with the fact that the FSA is not an enforcement-led regulator. Evidence also shows that the FSA has decided a majority of rule breaches by firms through supervisory tools rather than enforcement action.[137] The reason for the selective use of the enforcement tool can be attributed to the fact that it is a relatively expensive tool. As well as highlighting the importance of the FSA's reliance on work carried out by external auditors and the importance of verifying such work carried out by external auditors, the Legal and General Case[138] also contributed to the debate about the need for greater reliance on on-site supervision by the FSA. The case

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within the FSA's enforcement process. This fundamental distinction in respect of decision-making is required by FSMA, but its terms are sufficiently wide to allow the FSA considerable flexibility as to how it achieves this.
Currently, the FSA facilitates this separation by entrusting the more foundational and contentious regulatory decision making to the RDC. The RDC is a Committee of the FSA's Board, but operationally independent of it. Apart from the Review recommending that the RDC be maintained and that its membership continue to include practitioners and non-practitioners, the FSA Board is also to maintain its current policy of non intervention in, or attempting to influence, the RDC's individual decisions; ibid

129 ibid p 29
130 ibid
131 ibid
132 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> p 63
133 ibid
134 ibid
135 ibid
136 ibid
137 ibid p 17
138 *Legal and General Assurance Society (L & G) v FSA*

highlighted that the presence of an opinion from a skilled person – in particular one who works for the regulated firm and is also paid by that firm, should merely assist in informing the FSA's decision making and should not act as a substitute to relieve the FSA from reaching its own decisions.[139]

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.[140] The role of the reporting accountant has become so important that it will be incorporated into the entire regulated sector.[141] Even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.[142] This raises the question of independence since both roles of auditors of the regulated firm and skilled persons employed by the FSA (reporting accountants) are distinct roles which still overlap occasionally.[143]

The normal relationship between the external auditor and the audited bank needs to be safeguarded.[144] If no other statutory requirements or contractual arrangements governing the external auditor's work exist, all information flows between the banking supervisor and the auditor are usually chanelled through the bank except in exceptional circumstances.[145] As a result, the banking supervisor will request the bank to arrange to obtain the information it requires from the auditor and such information will be submitted to the supervisor through the bank.[146] In addition, the tasks that the banking supervisor requires of the external auditor need to be within the auditor's technical and practical competence.[147]

Measures have been adopted by the FSA to safeguard against possibilities of a conflict of interest between the auditors of the regulated firm who are commissioned by the FSA as skilled persons but are paid by the regulated firm. Chapter 5 of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. The use of skilled person reports requires compatibility with the circumstances envisaged by s166 of FSMA and with the further guidance set out in the Supervision and Enforcement manuals.[148] 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

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139 See 'Drawing Conclusions From Skilled Person Reports' p 37 para 5.38 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf>

140 See J. Hitchins, M.Hogg and D.Mallett 'Banking : A Regulatory Accounting and Auditing Guide' PricewaterhouseCoopers at p 295

141 D Singh 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003 p 9

142 ibid

143 ibid

144 For this and other safeguards, see ' The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 58 page 15, pages 15-17 <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

145 ibid

146 ibid

147 Ibid para 61 page 16

148 http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf at p 36; The SUP5.3 and ENF2.3.11 sections of the FSA Handbook set out wide range of circumstances for which a skilled person report may be suitable and the use of such a report for investigative (i.e. information gathering) purposes is, in the FSA's view, clearly contemplated both by FSMA and its own guidance; ibid

matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.[149] The increased use of on site supervision with external auditors paid for by the FSA, would however reduce the potential problems that could arise where the FSA uses auditors of regulated firms as skilled persons.

Other provisions which should assist the FSA's enforcement process include statutory powers being conferred by sections 165-169 and section 284 of the FSMA. These deal with the right of approval or removal, and the right to commission an independent audit to help the banks in ensuring that external auditors with the required experience, resources and skills are appointed to perform their duties.[150]

Recent Developments in Audit Independence and Audit Liability

A post Enron consequence is the decline in auditors' undertaking consultancy or non-audit services and an increased perception of auditor independence.[151] Post Enron developments, in particular the US Sarbanes – Oxley Act meant that financial services firms with a US listing were not allowed to have their auditors undertaking consultancy work.[152] Section 166 skilled persons' reports being commissioned by the FSA and if undertaken by auditors, arguably should not be classified as "consultancy".[153] However if the FSA perceived a conflict of interest, it had the power to require others to be appointed.[154]

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.[155] 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[156] and Smith.[157] The UK government noted these concerns and issued a consultation document on director and auditor liability.[158] It can be said that unless efforts are made towards limiting liability, it could be harder or even impossible to employ the services of external auditors and non executive directors of financial services without a substantial increase in their remuneration.[159] Following the publication of the Penrose Report and potential liabilities surrounding Equitable Life, the specific role of auditors is an important research area.[160]

It is appropriate to use external auditors to perform direct supervisory functions in the supervisory process even where risks of conflict may exist - provided there are safeguards to protect against such risks[161]. However external auditors used in this way should not also be protected by the immunity that shields

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

150 See E Huepkes p 10

151 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)116

152 Ibid p 116

153 ibid

154 ibid

155 ibid

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

157 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

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

159 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

160 ibid

161 In particular, regulators should also play a more proactive role in the supervisory process and be involved not only in the investigations but also the whole enforcement process.

regulators from tort of negligence actions. In addition, the FSA should have some form of responsibility for loss caused to depositors as a result of its negligence – as is the case in Germany and Italy.

Audit Liability

Auditors should be held more accountable for negative consequences of their actions. Present situation of the law does not help provide an incentive for them to be accountable for their actions. [162] 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.[163] 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.

In contrast, Huepkes [164] 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 interprete rules prescriptively rather than exercising subjective judgement. Whilst some evidence supports the fact that concentration encourages specialisation which reduces financial misstatement risk, other findings show that having a large number of audit firms reduces the risk of a dominant firm establishing practices which could encourage low standard financial reporting.[165]

The issue of further concentration in the auditing industry has also provided an interesting forum for debates relating to government intervention to bail out any of the Big Four audit firms given the potential consequences of having a Big Three. Even though Arthur Andersen was allowed to fail, many large audit firms still believe that they are "too big to fail" and it is not irrational for such firms to think so given the potential effects of having a Big Three.[166] Apart from the moral hazard problem which could result from a "too big to fail" attitude, there is also the neglect of smaller institutions as a result of rescuing large organisations.[167] The use of financial statement insurance (FSI) has been suggested as a means of improving the effectiveness of auditing and helping to neutralise moral hazard.[168] It is also considered to be a better alternative to liability insurance.[169]

CONCLUSION

It is appropriate to use external auditors to carry out direct supervisory functions in the supervisory process even where risks of conflict may exist - provided there are safeguards to protect against such risks[170].The *Legal and General C*ase resulted not only in a review of the FSA's enforcement process, but also led to a

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162 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

163 See House of Commons Select Treasury Committee, Further memorandum submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' at p 21

164 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

165 See Cunningham "Too Big To Fail" pg 33

166 Arthur Andersen's demise and KPMG's survival has also encouraged many large audit firms to believe that they are too big to fail. Such belief can present moral hazard even if shared by few members of the audit engagement team. Another concern is that Arthur Andersen's exit and KPMG's survival may be doing more to impair audit quality than Sarbanes Oxley is doing to improve it. For more on this, See Cunningham "Too Big To Fail" pp 36-38

167 ibid

168 Ibid p 58; At first it was suggested that Financial Statement Insurance (FSI) be made a voluntary rather mandatory component of US federal securities regulation.

169 Ibid p 59

170 In particular, regulators should also play a more proactive role in the supervisory process and be involved not only in the investigations but also the whole enforcement process.

realisation that the FSA needed to perform a more proactive role in verifying the external auditor's work. The regulator should not rely solely on the work of the external auditor but should also be involved in the investigative processes and on-site examinations. This would help safeguard against the risks of using external auditors as direct supervisors in a system of indirect supervision by regulators, that is, using external auditors as intermediaries in the supervision process. Supervisors should have measures of validating the information they receive either through on-site inspections or the use of external auditors. On-site work, whether done by the banking supervisor's own staff or commissioned by the supervisor but undertaken by external auditors, is designed to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable.[171]

Debates still persist, not only in relation to the actual threats to the auditor's independence but also in relation to the safeguards which exist to protect against such threats. The provision of non audit services by the external auditor has always been a subject of debate. Following the collapse of Enron, many argued that the provision of non-audit services (consultancy services) by Arthur Andersen had caused Enron's problems. However reports showed that off-balance sheet instruments had created the problems.

Debates 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 rotating audit partners of firm (since the knowledge acquired from a firm by an auditor is valuable), why not 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. In addition, since 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.

The past few years have seen a growing trend towards the focus on audit liability.[172] This is not to imply that

171 ' The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 41 , page 10 see <http://www.bis.org/publ/bcbs87.pdf> (last visited 11 th July 2007)

172 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)

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. However, there has also been a realisation that more work is needed in the area of audit liability. Unless there are punitive measures to deter an auditor or audit firm from the negative consequences of its actions, efforts by the Sarbanes Oxley Act and other various legislation to improve audit quality may be in vain. The creation of an audit firm similar in size to that of the Big Four, through the conversion of a large medium sized audit firm and aided by governmental funds could help create an alternative situation similar to that which existed when the Big Five were still in operation. This would also send signals to the Big Four that they are not too big too fail and that an alternative replacement firm could be set up should one of the Big Four fail to comply with audit requirements.

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