

**THE ROLE OF AUDITORS, REPORTING
ACCOUNTANTS AND SKILLED PERSONS IN UK
FINANCIAL SERVICES SUPERVISION**

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List of Abbreviations

APB	Auditing Practices Board
APC	Auditing Practices Committee
BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
BSC	Building Societies Commission
CCAB	Consultative Committee of Accountancy Bodies
DTI	Department of Trade and Industry
EC	European Commission
EU	European Union
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSC	Friendly Societies Commission
FSMA 2000	Financial Services and Markets Act 2000
GAD	Government Actuary's Department
IAPC	International Auditing Practices Committee
JMB	Johnson Matthey Bankers
OFT	Office of Fair Trading

FOREWORD

The financial services industry has long been recognised as one of Scotland, and indeed the United Kingdom's key industries. In the past banks, building societies, insurers and friendly societies were regulated under separate Acts and by different regulators. However, following the implementation of the Financial Services and Markets Act (FSMA) 2000, the entire industry is regulated by a single regulator, the Financial Services Authority, which assumed its full powers as regulator with effect from 1 December 2001. This has obviously represented a significant change for the firms and other parties involved and the impact of this change therefore makes a fascinating subject for this research report. This is all the more so since it concerns a significant, high profile industry which virtually every member of the public who has a bank or building society account, insurance policy or other financial product has an interest and stake in.

As the researchers note in their study, statutory auditors of financial services firms have additional responsibilities over and above their Companies Act auditing responsibilities. As well as unifying regulation of the financial services industry, the FSMA 2000 also introduced the concept of reporting by "skilled persons" on various matters where "skilled persons" could include lawyers and actuaries as well as accountants and auditors. The researchers have therefore investigated the roles and responsibilities of auditors, reporting accountants and skilled persons as set out in the legislation and the FSA's guidance, the perceptions of key interested parties of these roles and responsibilities, and the dual role played by auditors of financial services firms in reporting to shareholders under the Companies Act and to regulators under other acts and regulations.

The researchers have studied both the pre- and post-FSMA 2000 supervisory regimes by reviewing the literature and conducting interviews with a range of financial services firms, auditors, regulators and others to investigate how well the current and previous systems were perceived as operating, and what lessons can be learnt and taken forward to further develop the supervisory regime, both in the UK and further afield.

In addition, this study has been carried out over a particularly interesting period when the Penrose Inquiry into Equitable Life took place and was reported on, which led to the Government announcing a number of reviews that will affect the financial services industry. This has meant that the financial services industry, and the role of the regulators and others involved with the industry has rarely been far from the front pages of newspapers over the period of this research.

The Research Committee of the Institute of Chartered Accountants of Scotland has been happy to sponsor this project and is pleased that the research becomes available at a time when interest in the financial services industry and its regulation is so high. As such, the Research Committee hopes that this project will make a worthwhile contribution to current thinking about the role of auditors, reporting accountants and skilled persons in UK Financial Services Supervision and how they are, and can be, further developed.

Nigel Macdonald
Convener
Research Committee

April 2005

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EXECUTIVE SUMMARY

Aim of the research study

The Financial Services and Markets Act (FSMA) 2000 unified the regulation of the financial services industry under one regulator, the Financial Services Authority (FSA). Previously, regulation was conducted under separate Acts for each sector of the financial services industry. The FSA assumed its full powers with effect from 1 December 2001, a date referred to as N2, and is responsible *inter alia* for the regulation of banks, building societies, insurers and friendly societies.

Statutory auditors of firms in the financial services industry have additional responsibilities over and above those contained in the Companies Act 1985. For instance, under s.39 Banking Act 1987, the Bank of England (BoE) was responsible for the supervision of banks and had powers *inter alia* to call for reports on a bank by 'reporting accountants', normally the auditors, on certain matters. Under s.342 FSMA 2000 statutory auditors are required to report certain matters to the FSA. Under s.166 FSMA 2000, the FSA may call for reports on a firm by 'skilled persons' on various matters. Skilled persons may include accountants, lawyers and actuaries, and the statutory auditors of financial services firms may be appointed as skilled persons.

The main objectives of this study were to investigate: (i) the roles and responsibilities of auditors, reporting accountants and skilled persons as specified by legislation and guidance; (ii) the perceptions of key interested parties of these roles and responsibilities; and (iii) the nature of the dual role of auditors of financial services firms reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons to supervisors under FSMA 2000 (and previous legislation).

Study method

The study was conducted in three stages. The first stage of the study traced the supervisory frameworks for banks, building societies, insurers and friendly societies pre-FSMA 2000, and the emergence of the dual role for auditors in the supervision of financial services firms. The second stage reviewed the unified framework for the supervision of financial services firms by the FSA introduced under FSMA 2000, and considered the role of auditors and skilled persons under these new supervisory arrangements. The third stage involved semi-structured interviews with three key groups of individuals from financial services firms, accountancy and auditing practices, and regulators. Interview topics covered the pre-FSMA 2000 and post-FSMA 2000 supervisory regimes, particularly the roles of the regulator, auditors, reporting accountants/skilled persons, and the dual role of auditors acting as reporting accountants/skilled persons. Other, more general, interviews were held with representatives from professional bodies and financial services trade associations. The European dimension was explored with representatives from the European Commission and European financial services trade associations.

Themes and implications

Four key themes were identified from the study's findings. The first theme concerned the phases in the development of reporting accountants' reports: innovation; ritual; and reform. The first phase involved coming to grips with the innovation. In this regard setting the scope of reports was crucial as it determined the agenda for the report. It involved a learning process whereby over time this scope became more focused and parties became more comfortable with the associated bilateral and trilateral meetings. As the number of reports increased, what had started as a significant innovation was in danger of

becoming a taken-for-granted ritual. However, following the failure of Barings in 1995, the BoE undertook a reappraisal of its supervisory methods leading to the introduction of a risk-based approach to banking supervision which reinvigorated the process.

The second theme was the FSA's risk-based approach to supervision. The FSA, as the single financial services regulator, developed its own risk-based approach to supervision. The change in the supervisory regime profoundly affected both the relationship between the supervisor and firms and also that between the supervisor and firms' auditors. In banking, the contact between auditors and the supervisor declined from being routine and annual to being exceptional, due in part to the FSA's risk-based approach to supervision and in part to the change from reporting accountants' reports to skilled persons' reports. For building societies and friendly societies the requirement for auditors to make an annual report to the relevant supervisor was also discontinued. Overall, the FSA's supervisory approach led to a reduced role for auditors in supervision.

The third theme was that skilled persons' reports needed to be considered in the context of the high priority that firms attached to maintaining a good relationship with the FSA. Because maintaining a good relationship with the FSA was regarded as paramount, and the fact that skilled persons' reports were potentially more serious, firms were less likely to argue about the scope of the report with the FSA or to press the FSA for a scope that provided benefits to the firm as well. There was a general expectation that skilled persons' reports would continue to be conducted by the auditors, especially the Big Four, who were generally perceived as possessing all the requisite skills.

The fourth theme concerned the dual role of auditors and the audit expectations gap. In general, the dual role of auditors was not seen as a major problem by regulators, auditors or senior management of financial services firms. This was because the interests of shareholders and regulators were perceived to be aligned, or that there were sufficient

checks and balances, or that the dual role could be justified on cost/benefit grounds. Hence, for these parties there were few concerns about auditor independence. The undertaking of a skilled persons' report by a firm's auditors went against the general trend post-Enron of a decline in auditors undertaking non-audit services in order to safeguard independence. In considering auditor independence it was important not to neglect consideration of auditor competence. Measures taken to strengthen auditor independence, coupled with the adoption of a risk-based approach to supervision, might have the unintended consequence of depriving auditors of sources of information previously used to inform their audit of financial services firms.

Developments during the course of the research

The research was undertaken during the period of Lord Penrose's Inquiry into Equitable Life. The Penrose Report identified weaknesses *inter alia* in the internal governance and external supervisory arrangements of life insurers. In response, the government announced a number of reviews, including the corporate governance of mutual life offices, the actuarial profession, and accounting for with-profits business. As part of an overall concern about the insurance sector the FSA is also introducing general reforms to the regulation of insurers and changes to the role of auditors and actuaries in supervision. It is becoming apparent, especially following the FSA's reforms and the Penrose Report, that the actuarial and accountancy professions will in future need to work more closely together.

Areas for further research

The study also considered European and international arrangements for the role of auditors and reporting accountants in financial services supervision. At the EU level, the most significant

development has been the Financial Services Action Plan which aims to create a single EU wholesale market, open and secure retail markets and state-of-the-art prudential rules and supervision. Internationally, the International Auditing Practices Committee, in conjunction with the Basel Committee on Banking Supervision, has issued a Practice Statement to provide guidance as to how the relationship between bank auditors and supervisors might be strengthened. The Practice Statement highlights the value of communication between auditors and supervisors and *vice versa* for the conduct of their respective roles. An important finding is that provisions directly comparable to the dual role in the UK do not exist at the EU level. Following the creation of the EU Financial Services Action Plan, and the common obligations of member states under the EU banking and insurance, and accounting and auditing Directives, it would therefore be instructive to examine the effectiveness of the alternative arrangements to those of the UK. Areas for further research include: the progress towards a single EU financial services market; the efficacy of prudential supervisory arrangements across EU member states; and the involvement of auditors in supervision and the extent of bilateral contact with supervisors.

During the study, the accountancy profession, financial services firms, the UK government and the EU were in the process of coming to terms with post-Enron developments, notably the US Sarbanes-Oxley Act and its implications. A consequence has been the decline of auditors undertaking consultancy or non-audit services. Another area for further research is how independence concerns affect the role of auditors in financial services supervision.

The problems at Equitable Life and Independent Insurance in the UK, and the failures of Enron and others in the US followed by the demise of Andersen, have also increased audit partners' awareness of risk and the consequences of making incorrect judgements. Since the auditors are no longer able to benefit significantly from the additional remuneration associated with consultancy work, partners

are increasingly reviewing the rewards and risks of audit. In addition, directors, especially non-executive directors, are increasingly aware of the rewards and risks associated with their greater responsibilities as a result of changes to the Combined Code of corporate governance. These problems are especially acute in financial services. Thus, an area for further research is the specific role and responsibilities of auditors and directors in financial services firms, particularly following the publication of the Penrose Report.

Concluding comments

As regards the financial services industry and accountancy profession, two areas of future development are of particular relevance. The first concerns the future role of skilled persons' reports. So far the FSA has been sparing in the use of its powers and most such reports appear to have been conducted by the Big Four accountancy practices. With the evolution of the FSA towards a new phase of policy implementation it will be interesting to observe the extent to which the FSA may extend their use. The second concerns the future regulation of insurers, and changes in the role of auditors and actuaries. With the FSA under its risk-based approach devoting increased resources to the supervision of insurers, the extent of involvement of both actuaries and auditors is a topic of considerable interest.

CHAPTER ONE

BACKGROUND TO THE STUDY

The Financial Services and Markets Act (FSMA) 2000 unified the regulation of the financial services industry under one regulator, the Financial Services Authority (FSA). The FSA is responsible *inter alia* for the regulation of banks, building societies, insurers and friendly societies. Previously, regulation was conducted under separate Acts for each sector of the financial services industry. The relevant Acts issued were: Insurance Companies Act 1982; Building Societies Act 1986; Financial Services Act 1986; Banking Act 1987; and Friendly Societies Act 1992. Further Regulations were issued under these Acts. The FSA assumed its full powers with effect from 1 December 2001, known as N2.

Statutory auditors of firms¹ in the financial services industry have additional responsibilities over and above those contained in the Companies Act 1985². Under s.342 FSMA 2000 statutory auditors are required to report certain matters to the FSA. Under s.166, the FSA may call for reports on a firm by 'skilled persons' on various matters. Skilled persons may be, for example, accountants, lawyers or actuaries. Statutory auditors of financial services firms may be appointed as skilled persons.

The aim of the study is to investigate the role of auditors, reporting accountants and skilled persons in the system of UK financial services supervision, especially as regards banks, building societies, insurers and friendly societies. Thus, the project investigates: (i) the roles and responsibilities of auditors, reporting accountants and skilled persons as specified by legislation and guidance; (ii) the perceptions of key

interested parties of these roles and responsibilities; and (iii) the nature of the dual role of auditors of financial services firms reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons to supervisors under FSMA 2000 (and previous legislation). The specific research questions are set out below.

The chapter is organised as follows: the first section provides some background to the study; the second section outlines the research methods employed; the third section details the number of skilled persons' reports completed to date and their topics; and the final section offers some concluding comments.

Background

The main reason why the dual role of auditors reporting to shareholders under the Companies Act 1985, and reporting to supervisors under FSMA 2000 (and previous legislation) may be perceived as problematic, is because the role of the statutory auditor, on its own, has been perceived as problematic. The debate over the role of the statutory auditor, both in the UK and internationally, is usually discussed under the concept known as the 'audit expectations gap'. The audit expectations gap is of serious concern to the UK accountancy profession and, during the 1990s, the profession took a number of steps to narrow the gap. Building on the work of committees chaired by Chris Swinson (see Consultative Committee of Accountancy Bodies, CCAB, 1998), the Department of Trade and Industry (DTI, 1999) proposed a new framework for independent regulation of the accountancy profession. However, no sooner had this new Accountancy Foundation been established than its role came under review as part of the UK government's response to events in the US, notably, the collapse of Enron and WorldCom, the subsequent demise of Andersen, and the Sarbanes-Oxley Act 2002 (see Co-ordinating

Group on Audit and Accounting Issues, 2003; DTI Review Team, 2003a). This resulted in responsibility for the independent regulation of the accountancy profession becoming the responsibility of the reconstituted Financial Reporting Council.

Humphrey (1997) provides a review of the expectations gap literature which has concentrated on (mis)understandings of the role of the statutory auditor, and suggests that the debate has focused on four main aspects of the gap: audit assurance; audit reporting; audit independence; and audit regulation and reliability. Because of the additional role of auditors and reporting accountants/skilled persons of financial services firms in reporting to supervisors under FSMA 2000 and under previous legislation, there is considerable scope for further (mis)understandings.

Recent developments have highlighted the issue of auditor independence, which Humphrey describes as 'going to the heart of the audit expectations debate' (p. 19). Apart from the structural changes outlined above, Humphrey (p. 20) notes that over the last thirty years a number of recommendations have been put forward including: peer reviews; the development and strengthening of audit committees; the rotation of audit partners and/or auditing practices; the prohibition of auditors performing non-audit services for companies they also audit; and declaration in companies' financial statements of the amount paid for non-audit fees to auditors.

Not least of the problems contributing to the debate on the audit expectations gap has been the high profile failure of financial services firms, beginning with the secondary banking crisis in the 1970s, and followed in the 1980s and 1990s by banks, such as Johnson Matthey Bankers (JMB), Bank of Credit and Commerce International (BCCI) and Barings; building societies, such as Grays; and insurers, such as the recent problems at Equitable Life and Independent Insurance. These failures gave rise to a further round of debate on the audit expectations gap and suggested reforms of auditing practices which, as a result of

apparent regulatory failures, were paralleled by a further round of debates on the regulation and supervision of banks, building societies and insurers, often leading to new legislation (see Chapter 2). These events can be characterised as cycles of ‘failure followed by reform’ (Dewing and Russell, 2002) where failure can be described as the down-swing and reform as the up-swing. The current period may, therefore, represent an up-swing as evidenced by the new arrangements for the regulation of the accountancy profession for audit, and the FSA and FSMA 2000 for financial services supervision. Thus, this research study investigates interesting issues at a particularly interesting time.

Study method

Research questions and research approach

As discussed above, the reform of supervision of the financial services industry has followed a failure followed by reform cycle. An investigation into the failure of a financial firm often seeks to: describe what happened; identify the causes of failure; and make recommendations to strengthen supervisory arrangements. These recommendations often lead to legislation. The development of the dual role for auditors of financial services firms emerged from this process.

The aim of the study is to investigate the nature of the dual role of auditors of financial services firms, especially as regards banks, building societies, insurers and friendly societies, reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons to supervisors under FSMA 2000 (and previous legislation).

The specific research questions to be addressed are:

- (i) What is the exact nature of the role of auditors and reporting accountants/skilled persons for financial services firms as specified

in legislation, and supplementary interpretation and guidance by regulators and the profession?

- (ii) What are the perceptions of key interested parties about the role of auditors and reporting accountants/skilled persons in financial services? Does this accord with the role as set out in legislation and guidance? Has a new expectations gap emerged? If so, what are the elements of this new expectations gap? What are the implications?
- (iii) Does the nature of the dual role of auditors and reporting accountants/skilled persons of financial services firms enhance or compromise the requirements of key interested parties?
- (iv) How do European and international arrangements differ from the UK?

The objective of the first stage of the study was to gain a general understanding of the supervisory framework for banks, building societies, insurers and friendly societies pre-FSMA 2000, and to trace the emergence of the dual role for auditors/ reporting accountants in the supervision of financial services firms. This included reviewing key public documents, such as reports of official investigations into failures of, or problems with, financial services firms, and the response of the government, including new legislation (research question (i), pre-FSMA 2000 situation). These findings are discussed in chapter two.

The objective of the second stage of the study was to gain a general understanding of the new, unified framework for the supervision of financial services firms under a single regulator, the FSA, that was introduced by FSMA 2000, and to identify the role of auditors and skilled persons in the new supervisory arrangements. This included a consideration of the legal requirements of FSMA 2000, and a review of the extensive documentation supplementary to the Act produced by the FSA, such as the FSA Handbook, Discussion Papers, Issues

Papers and Progress Reports (research question (i), post-FSMA 2000 situation). These findings are discussed in chapter three.

The objective of the third stage of the study was to provide empirical evidence on the perceptions of interviewees on the role of auditors and reporting accountants/skilled persons in pre-FSMA 2000 and post-FSMA 2000 regulatory frameworks (research question (ii)). This involved semi-structured interviews with representatives from regulators, auditors, financial services firms and professional bodies/trade associations. The findings pre-FSMA 2000 and post-FSMA 2000 are discussed in chapters four and five respectively. The nature of the dual role of auditors and reporting accountants/skilled persons in financial services (research question (iii)) is discussed in chapter five.

The role of auditors/reporting accountants in other jurisdictions (research question (iv)) is discussed in chapter six. Major changes are currently being developed both in the European Union (EU) and internationally as regards financial services, including, for example, the Financial Services Action Plan (FSAP) and the major programme of work from the Basel Committee on Banking Supervision (BCBS). The European dimension was explored with representatives from the European Commission (EC) and European financial services trade associations but it was beyond the scope of the study to undertake a comparative review of these and other developments³.

Interviews

The reviews conducted about the pre-FSMA 2000 and post-FSMA 2000 regulatory frameworks identified issues which were then discussed in a series of pilot interviews with six key participants. These included: two interviewees from leading international accountancy practices; one interviewee from a leading UK bank; one interviewee from a leading UK insurer; and two interviewees with current and former regulatory experience. The findings of the reviews and the

pilot interviews informed the development of a meeting agenda to guide the subsequent interviews.

The third stage of the study involved semi-structured interviews with three key groups of individuals from: regulators; accountancy and auditing practices; and financial services firms, including banks, building societies, insurers and friendly societies. Other more general interviews were also held with representatives from professional bodies and financial services trade associations. The European dimension was explored with representatives from the EC and European trade associations.

Interview topics

The new unified system of regulation introduced by FSMA 2000 differs considerably from the previous individual arrangements for each sector of the financial services industry. The interviews, therefore, focused on participants' views of the supervisory process before FSMA 2000, after FSMA 2000 and N2, and on the dual nature of the auditors' role. Some flexibility was exercised over the agenda for each meeting to take into account the exact nature of the role and experience of individual interviewees. Typically, however, interviewees were asked to offer their perceptions on three main topic areas:

- the regulatory framework for the relevant financial services sector(s) pre-FSMA 2000, especially the roles of the regulator, auditors, reporting accountants and, where relevant, actuaries.
- the regulatory framework for the relevant financial services sector(s) post-FSMA 2000 including: the FSA's risk-based approach to supervision and associated risk mitigation programme; and the roles of the regulator, auditors, skilled persons and, where relevant, actuaries.

- auditors' role(s) and responsibilities including: acting as reporting accountants/skilled persons; auditor independence; possible confusion of regulatory roles between firms/auditors/regulators; and reporting publicly to shareholders/members and privately to regulators.

These topics were of less relevance in interviews with representatives from professional bodies and trade associations, and in interviews held to investigate the European dimension of financial services supervision. However, the overall objective remained the same: to obtain perceptions on the current and former regulatory arrangements, and the role of auditors in the supervisory process. Most interviews were held with a single interviewee, but on some occasions two interviewees were present. Interviews generally lasted for approximately one hour. The interviews were tape recorded, transcribed and the text summarised into NVivo, a software package, which assisted the analysis of interview findings. This enabled views on topic areas, for example, s.39 reports, s.166 reports, the dual role of auditors, to be collated and grouped together, from which themes were identified. Quotes from interviewees were selected to illustrate themes and to reflect a range of representative opinions.

Interviewees

In all, 64 interviews (including five pilot interviews and seven interviews exploring the EU/international dimension) were conducted jointly by the researchers, as shown in Table 1.1.

Table 1.1: Interviews

	REFERENCE NUMBER	NUMBER OF INTERVIEWS
Firms	F1-F34	34
Auditors	A1-A11	11
Regulators	R1-R8	8
Others (including European)	O1-O11	11
TOTAL		64

All of those interviewed held very senior positions and included chief executives, finance directors and senior partners. Such individuals work under considerable and intense pressure, and have many calls upon their scarce and valuable time. It is a measure of the topicality and importance of the subject that the researchers were able to obtain access to these high-level individuals in the financial services community. Interviews were conducted between April 2002 and November 2003.

Firms

To obtain a representative selection of views, interviews were conducted at seven banks, five building societies, three insurance firms and one friendly society. The emphasis was on firms that were UK based. The normal procedure was to write to the Finance Director enclosing an outline of the research study and requesting an interview with an individual, or individuals, having primary responsibility for managing relationships with the FSA and with the auditors. On most occasions this was the responsibility of the 'Group Chief Accountant' or the 'Group Compliance/Risk Manager'. The job titles, career

background, and the roles performed by the individuals interviewed, varied across firms. The report uses the term ‘accountant’ to describe individuals in firms whose primary role was accounting or audit related, and ‘risk manager’ to describe individuals in firms whose primary role was compliance/risk related. All interviewees were highly qualified and held senior posts of responsibility, nearly always as ‘Approved Persons’ within their firms⁴. Many had experience of a variety of roles. For example, in banks and insurers a risk manager might have previously been an auditor and have worked as an accountant or internal auditor for another bank or insurance company. Alternatively, a risk manager might be an actuary. A total of 34 interviews were conducted.

Auditors

The auditors, certainly of large financial services firms, are drawn primarily from the (now) Big Four accountancy practices. In contacting these auditing practices a mixed approach was used. In some cases, the financial services firms referred the researchers to a specific partner; in other cases, names of partners specialising in financial services were identified from websites. It should be emphasised that all interviews with partners⁵ discussed *general* issues regarding the role of auditors and reporting accountants/skilled persons, in financial services supervision. In both cases, as before, the normal procedure was to write to the partner enclosing an outline of the research study and requesting an interview. A total of 11 interviews were conducted.

Regulators

Interviews were conducted with individuals who had experience in supervising financial services firms and developing regulatory standards and guidelines from, for example, government departments, the FSA and the Bank of England (BoE). A number of the interviewees

had experience of both pre- and post-FSMA 2000 supervisory arrangements. A total of eight interviews were conducted.

Others

Other specialists were interviewed, including representatives from professional bodies and trade associations. In addition, interviews were held in Brussels to explore the EU and international dimension of financial services regulation. A total of 11 interviews were conducted.

Reporting accountants'/skilled persons' reports

From 1 April 2003 to 31 March 2004, the FSA used its power under s.166 FSMA 2000 to require firms to produce a skilled persons' report on 28 occasions (2002/03: 31 occasions). The estimated range of costs was from £17,000 to £2m (2002/03: £13,000 to £4 million). For 2003/04 topics included: corporate governance arrangements; systems and controls; account-opening procedures and customer documentation; past business reviews; financial resourcing; internal audit; procedures for monitoring solvency; and the adequacy of regulatory returns (FSA, 2004a, Appendix 9, p. 140). For 2002/03 topics included: compliance functions; money laundering; treasury; systems and controls; financial resourcing; actuarial function; past business reviews; solvency; and regulatory returns (FSA, 2003, Appendix 9, p. 214).

This represented a considerable reduction in investigations from the number of reporting accountants' reports commissioned under s.39 Banking Act 1987 which regularly exceeded 600 reports per year. For example, 689 s.39 reports were commissioned during 1996-97 (BoE, 1997, p. 41). However, the FSA supervisory regime is a dynamic, not a static, process. It is, therefore, possible that the use of skilled persons may increase over the next few years. Both reporting accountants'

reports and skilled persons' reports are confidential so the researchers were not able to access copies of these reports, or discuss the topic of these reports other than at a general level.

Summary

The interviews were carried out between April 2002 and November 2003, relatively soon after N2 when the FSA assumed its full powers. This proved to be a fascinating period to be involved in researching financial services supervision. There were a number of advantages for the project, including the fact that many individuals had recent experience of the previous regulatory regimes and, thus, perceptions were fresh in their minds. For many interviewees it was relatively easy to contrast the pre- and post-FSA regulatory environments, and the FSA itself was consulting on the use of skilled persons during the period. The nature of the dual role of auditors in the financial services industry reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons under FSMA 2000 and previous legislation, was a topic of considerable relevance and of genuine interest for virtually all of the interviewees.

ENDNOTES:

- ¹ The FSA uses the term 'firm' to refer to financial services institutions such as companies, mutual societies, partnerships *etc.* The report follows this approach but for reasons of clarity adopts 'accountancy practice' or 'auditing practice' when referring to an accountancy or auditing firm.
- ² The vast majority of financial services firms are constituted as companies, but many smaller, and some very large, firms are constituted as mutual societies. As regards statutory audit, requirements for mutual societies are directly comparable with those for companies. For simplicity, the report therefore only refers to statutory audits conducted under the Companies Act 1985.
- ³ The European and international dimension of financial services supervision is discussed below under 'Areas for further research' (section 6.3.1). We are indebted to an anonymous referee for proposing this structure.

- ⁴ The FSA requires that senior individuals within firms should be registered as Approved Persons.
- ⁵ Some interviews also included senior managers but for simplicity the report refers to partners.

CHAPTER TWO

ROLE OF AUDITORS AND REPORTING ACCOUNTANTS IN FINANCIAL SERVICES SUPERVISION: PRE-FSMA 2000 REGULATORY FRAMEWORKS

The objective of this chapter is to address the first research question about the pre-FSMA 2000 regulatory framework to establish the exact nature of the role of auditors and reporting accountants in financial services, as specified in legislation and supplementary interpretation and guidance by regulators and the profession (research question (i)).

This chapter reviews the development of regulatory frameworks for banks, building societies, insurers and friendly societies pre-FSMA 2000 and, in particular, the involvement of auditors and reporting accountants in the supervisory process. The main focus of the chapter is on banking regulation where the BoE, at the heart of the City, was, arguably, the most influential financial services regulator, and where the involvement of auditors and reporting accountants in the supervisory process was the most developed¹.

This chapter outlines the development of supervision first for banks, second for building societies, third for insurance firms and, finally, for friendly societies.

Banks

Role of the regulator

During the 1970s, the secondary banking crisis, in particular, highlighted the weakness of the current system of self-regulation operated by the BoE. Instead of relying on 'a gentleman's code of ethics and self-regulation', the Banking Act 1979 placed UK banking regulation on a statutory footing for the first time (Penn, 1989). One of the main effects of the Act was to make clearer the separation of the BoE's responsibilities for macroeconomic policy and the prudential supervision of banks.

The new system of regulation appeared to be working satisfactorily until December 1984 when problems at JMB were identified. Following a report by the then Governor of the BoE into the problems of JMB (Leigh-Pemberton Report, 1985), the government issued its response in the form of a White Paper (HM Treasury, 1985), the provisions of which were subsequently enacted in the Banking Act 1987. The functions and duties of the BoE were set out in s.1 of the Act, as shown in Exhibit 2.1:

Exhibit 2.1: Role of the Bank of England

1 Functions and Duties of the Bank of England
(1) The Bank of England (in this Act referred to as ‘the Bank’) shall have the powers conferred on it by this Act and the duty generally to supervise the institutions authorised by it in the exercise of those powers.
(2) It shall also be the duty of the Bank to keep under review the operation of this Act and developments in the field of banking which appear to it to be relevant to the exercise of its powers and the discharge of its duties.
<i>Source: Extract from section 1 Banking Act 1987: subsections (1) and (2)</i>

Penn (1989, p. 18) notes that under s.1(2) of the Act, for the first time an explicit duty was placed upon the BoE to supervise firms authorised by it, although this duty had been implicit under the Banking Act 1979. In addition, the 1987 Act heralded a much increased role for auditors and reporting accountants, normally, but not necessarily, the firms’ auditors in supervision, as set out in sections 39, 41, 46 and 47 of the Act².

Role of auditors and reporting accountants in the supervisory process

Section 39

Under s.39, the BoE could call for two kinds of reports: first, on a firm’s accounting and other records and internal control systems (‘controls reports’); and, second, on a firm’s financial returns used for statistical or prudential monitoring purposes (‘returns reports’). These reports were of a ‘routine’ nature. Relevant extracts from s.39 are set out in Exhibit 2.2:

Exhibit 2.2: Reports to the Bank of England and role of reporting accountants

39 Power to Obtain Information and Require Production of Documents
<p>(1) The bank may by notice in writing served on an authorised institution:</p> <ul style="list-style-type: none"> (a) require the institution to provide the Bank, at such time or times or at such intervals or in respect of such period or periods as may be specified in the notice, with such information as the Bank may reasonably require for the performance of its functions under this Act; (b) require the institution to provide the Bank with a report by an accountant or other person with relevant professional skill on, or on any aspect of, any matter about which the Bank has required or could require the institution to provide information under paragraph (a) above <p>(2) The accountant or other person appointed by an institution to make any report required under subsection (1)(b) above shall be a person nominated or approved by the Bank; and the Bank may require his report to be in such form as is specified in the notice.</p>
<p><i>Source: Extract from section 39 Banking Act 1987: subsections (1) and (2)</i></p>

The specific role of auditors and reporting accountants in banking supervision as laid down in the Act required further clarification and elaboration. This was undertaken by the BoE and the accountancy and auditing profession. The BoE issued a consultative paper about the relationship between supervisors, auditors and management of banks (BoE, 1985). This was followed by a series of 'Guidance Notes' for auditors and reporting accountants (BoE, 1987). The accountancy

profession's auditing standards-setting body, the Auditing Practices Committee (APC), produced interim guidance (APC, 1987) that was later followed by a full auditing guideline (APC, 1989), which has been regularly updated.

The two forms of report commissioned under the Act, controls reports and returns reports, were as follows:

Controls reports

Reporting accountants were required to form an opinion as to whether the firm's accounting and other records and internal control systems had been maintained in accordance with the BoE's interpretation of the requirements of the Act. The decision to commission a report was taken by the BoE. The BoE did not commission it directly but instructed the firm to do so. The firm was required to forward a copy of the reporting accountants' report to the BoE. The scope of the report was discussed by the BoE, the firm and the reporting accountants. The report could cover all areas of business ('full scope review') but more usually one or more areas were determined by the BoE in the context of an overall, and ongoing, supervisory programme. Reporting accountants carried out their examination and formed their opinion in accordance with the APC's auditing guideline. The report followed the format specified by the BoE. The opinion could be unqualified, qualified by exception, or adverse. In the last case, the reporting accountants had to inform the BoE immediately of their conclusion.

Returns reports

A firm was required to make prudential and statistical returns to the BoE. Reporting accountants were required to form an opinion as to whether the information was completely and accurately

extracted from the accounting and other records and was prepared in accordance with the BoE's instructions. The BoE reviewed whether its requirements had been met. Again, the BoE did not commission the report but instructed the firm to do so. The reporting accountants were required to report whether, in their opinion, in all material respects the information contained in the returns was complete and accurate and was prepared in accordance with the BoE's reporting instructions. The same accounting policies used in the firm's most recent statutory financial statements were to be applied, except where the accounting policies differed from those of the BoE's reporting instructions, in which case the latter was to take precedence.

Rights and duties of auditors and reporting accountants in the supervisory process

Sections 41, 46, 47

Under s.41, the BoE could appoint one or more 'competent persons' to investigate and report to the BoE about the business, or ownership and control of firms. Under s.46, the BoE had to be informed if a firm proposed to remove or replace its auditors, or if the auditors proposed to qualify the financial statements, or to resign, or not to seek reappointment. Under s.47, auditors or reporting accountants could communicate directly with the BoE on any matter that was relevant to the performance of the BoE's duties. Relevant extracts from s.47 are set out in Exhibit 2.3:

Exhibit 2.3: Communication by auditors and reporting accountants with the Bank of England

47 Communication by Auditor etc with the Bank
(1) No duty to which: (a) an auditor of an authorised institution; or (b) a person appointed to make a report under section 8(5) ³ or 39(1)(b) above, may be subject shall be regarded as contravened by reason of his communicating in good faith to the Bank, whether or not in response to a request made by it, any information or opinion on a matter to which this section applies and which is relevant to any function of the Bank under this Act
<i>Source: Extract from section 47 Banking Act 1987: subsection (1)</i>

Under s.47(2) and (3) the requirements applied to any matter to which auditors or reporting accountants respectively became aware in relation to the business or affairs of the firm or any associated body.

Section 47 reports were ‘non-routine’ and of an exceptional or *ad hoc* nature. Such a report was necessary if, in the course of undertaking their duties, auditors and reporting accountants became aware of matters which would cause the BoE to consider revoking a firm’s authorisation. Auditors or reporting accountants would not be in breach of any duty of confidentiality if communications were made in good faith. In order to decide whether a matter should be reported a two-stage process was followed: first, the matter had to come to the attention of the accountant while acting in the capacity of auditor or reporting accountant; and, second, the matter had to be one which was required to be reported. Only if both stages were satisfied was the matter to be reported. A ‘reportable matter’ could arise if auditors or reporting accountants had reasonable cause to believe that: (i) there

might be a failure to fulfil Schedule 3 of the Act (minimum criteria for authorisation) which was likely to be of 'material significance'; (ii) there had been a breach of the Act likely to be of material significance; or (iii) the continuous functioning of the firm might be affected. Finally, auditors and reporting accountants had a right to report matters which they believed were likely to be of material significance to the BoE's functions as supervisor under the Act.

Other matters

Auditors and reporting accountants were obliged to participate in bilateral meetings with the BoE, and trilateral meetings with the BoE and the firm. The meetings could be 'informal', for example, to discuss the scope of s.39 reports, or 'formal', for example, to discuss matters arising from the statutory audit or from s.39 reports. Normally, at least one bilateral and one trilateral meeting were held each year. The BoE was generally prohibited from disclosing any information that it obtained through exercising its supervisory functions to the auditors or reporting accountants. However, there were 'legal gateways' for disclosure. The BoE could disclose information when it believed the matter was of such significance that it would affect the way auditors and reporting accountants undertook their tasks. This information could not be passed on by the auditors or reporting accountants to the firm without the consent of the BoE.

Building societies

Role of the regulator

Prior to the creation of the FSA, UK building societies were supervised by the BSC most latterly under the Building Societies Act 1986. The general functions of the BSC are set out in section 1(4) of the Act, as noted in Exhibit 2.4:

Exhibit 2.4: Role of the Building Societies Commission

1 The Building Societies Commission
(4) The general functions of the Commission shall be:
<ul style="list-style-type: none"> (a) to promote the protection by each building society of the investments of its shareholders and depositors; (b) to promote the financial stability of building societies generally; (c) to secure that the principal purpose of building societies remains that of raising, primarily from their members, funds for making advances to members secured upon land for their residential use; (d) to administer the system of regulation of building societies provided for by or under this Act; and (e) to advise and make recommendations to the Treasury or other government departments on any matter relating to building societies and the Commission shall have the other functions conferred on it by or under the subsequent provisions of this Act.
<i>Source: Extract from section 1 Building Societies Act 1986: subsection (4)</i>

The Banking Act 1979 influenced the legislation enacted in the Building Societies Act 1986 governing the prudential supervision of building societies (Boléat, 1986). Thus, as a result of the Act the BSC was established with similar prudential supervision responsibilities for building societies to those of the BoE for banks. In addition, the Act extended significantly the rights and responsibilities of auditors. The reforms introduced by the Act also owed much to a number of major frauds perpetrated in building societies during the 1970s. Perhaps the most notable of these arose at the Grays Building Society. In this context Barnes (1984) reviews the Investigation into Grays conducted

under s.110 of the Building Societies Act 1962 which had been the main building societies legislation prior to the 1986 Act⁴. Barnes reports (p. 131) that the Inspectors made the following recommendations *inter alia* in respect of auditors:

... that the auditor's report be extended to state whether proper books had been kept, whether a satisfactory system of internal control was in existence, that they had reported to the directors in writing on the society's accounting and internal control and whether they had attended the meeting of directors at which the annual accounts were approved.

Role of auditors in the supervisory process

The main provisions in respect of accounting and auditing were set out in s.71-82 of the 1986 Act. In contrast to the situation pertaining to banking, the Act did not introduce provisions equivalent to s.39 of the Banking Act 1987 requiring the completion of controls and returns reports by independent reporting accountants. Rather, s.71 set out the provisions in respect of accounting records and systems of business control. Auditors were then required under s.82 to report to the BSC on the compliance of building societies with the provisions of s.71, including the requirement to establish and maintain appropriate systems of control.

Section 82 of the 1986 Act set out auditors' duties to the BSC and their related rights. The relevant subsections from section 82 are shown in Exhibit 2.5:

Exhibit 2.5: Auditors' reports to the Building Societies Commission and related rights and duties

82 Auditors' duties to commission and related rights
<p>(1) The auditors of a building society shall, with respect to each financial year of the society, make to the Commission in accordance with subsection (5) below a report on the conduct of the business of the society during that year in the respects specified in subsection (2) below.</p> <p>(2) The auditor's report shall deal with:</p> <ul style="list-style-type: none">(a) the accounting records kept by the society under section 71,(b) the systems of control of its business and records of inspection and report maintained under that section, and(c) the system of safe custody of documents maintained under section 12(12). <p>(8) The auditors of a building society, if they are satisfied that it is expedient to do so in order to protect the investments of shareholders of depositors or if they are requested to do so by the Commission on its being so satisfied, shall be entitled, notwithstanding any obligation of confidence incumbent on them and whether or not to do so would be contrary to the interests of the society, to furnish information to the Commission relating to the conduct of the society's business or the business of any of its subsidiaries or other associated bodies.</p> <p>(9) The Treasury may by order impose on the auditors of building societies an obligation to furnish to the Commission, in such circumstances as may be prescribed in the order, relevant information available to them or such descriptions as may be prescribed in the order; and it shall be the duty of an auditor to furnish information to which the obligation extends notwithstanding any obligation of confidence incumbent on him.</p>
<p><i>Source: Extract from section 82 Building Societies Act 1986: subsections (1)-(2), (8)-(9)</i></p>

Overy and Waters (1987), in their commentary on the 1986 Act, note that under s.79(1) (Auditors' duties and powers) auditors, in preparing their report to members, must consider *inter alia* whether the firm has kept satisfactory systems of control, and must make an annual report to the BSC on the firm's compliance under s.82.

In particular, as Overy and Waters (1987) note, s.82(1)-(7) obliges auditors to report annually to the BSC 'on the society's accounting records, its systems of control of its business and records, its system of inspection and report', and that under s.82(5)-(6) the report should be sent by the society to the BSC and that the directors must 'forward any comments to the Commission at the same time as they forward the report'.

Rights and duties of auditors in the supervisory process

In addition, similar provisions to those under the Banking Acts for banks required auditors of building societies under s.82(8) to report matters to the BSC without breaching any duty of confidentiality if *inter alia* it was expedient to do so, in order to protect the investments of shareholders or depositors (see Exhibit 2.5).

Thus, for building societies, there was an obligation on auditors to report formally to the regulator on the adequacy of the systems of control of its business and records of inspection. However, under the 1986 Act, systems of control were not subject to independent scrutiny by reporting accountants. It was arguably the case, therefore, that there was relatively less involvement of auditors/reporting accountants in the supervision of building societies than for banks at this time.

Insurers

Role of the regulator

In comparison with the deposit-taking sectors of the banks and building societies, auditors had less involvement in the supervision of insurers. In contrast to deposit takers, however, the actuarial profession had exercised a significant role in supervision. For example, the involvement of actuaries in UK life insurance supervision can be traced back to the Life Assurance Companies Act 1870⁵.

Prior to the creation of the FSA, UK insurers were supervised by the Insurance Directorate of the DTI, most latterly under the Insurance Companies Act 1982. The main supervisory provisions of the 1982 Act included: prior authorisation from the DTI before carrying on investment business; managers of firms to be 'fit and proper' persons; separate authorisation for each class of insurance business; financial solvency measures to be met; and ongoing accounting and supervisory arrangements to be satisfied.

The 'appointed actuary' concept, first enacted in the Insurance Companies Act 1973, marked the more comprehensive involvement of actuaries in monitoring and controlling UK life insurers (Daykin, 1999). In essence, the appointed actuary had to be satisfied at all times of the soundness of a firm's financial position. Daykin (1999) notes that the link to the supervisor was made by the appointed actuary having a 'professional duty to blow the whistle' if a firm was pursuing policies likely to have a severe financial impact.

Johnston (1989) notes that under the 1982 Act the process of valuation, reporting and certification by the appointed actuary was relied on by the DTI Insurance Directorate to monitor the financial progress of insurers without carrying out its own detailed investigations. Practical supervision, such as the scrutiny of insurers' annual returns,

was undertaken on behalf of the DTI by the Government Actuary's Department (GAD).

Role and rights and duties of auditors in the supervisory process

Under the Insurance Companies Act 1982 two additional responsibilities were placed on auditors of insurance firms. The responsibilities were: to report on matters specified by the regulator in relation to the insurance firm's regulatory returns (s.21); and to report direct to the regulator matters of 'material significance' that came to their attention in the course of their work (s.21A), see Exhibit 2.6. Much of the guidance to auditors was contained in auditing standards, practice notes and bulletins issued by the Auditing Practices Board (APB).

Exhibit 2.6: Communication by auditors with the Department of Trade and Industry

21A Communication by auditor with Secretary of State
<p>21A(1) No duty to which an auditor of an insurance company to which this Part of this Act applies may be subject shall be regarded as contravened by reason of his communicating in good faith to the Secretary of State, whether or not in response to a request from him, any information or opinion on a matter of which the auditor has become aware in his capacity as auditor of that company and which is relevant to any functions of the Secretary of State under this Act.</p>
<p><i>Source: Extract from s.21A Insurance Companies 1982 (as amended), subsection (1).</i></p>

Auditors had to form a judgement as to what constituted 'material significance' and whether 'its nature or potential financial impact' was

‘sufficient to require investigation by the regulator’ (APB, 1999(b), p. 72). This extended to information that an insurer’s auditors had become aware of in their capacity as auditors of other external entities (*ibid.*, p. 74). In respect of the duty to report, professional guidance did not require auditors to undertake any additional audit work. In addition to a statutory duty to report to the regulator under s. 21A, auditors also had a ‘right’ to report where a matter did not give rise to a statutory duty but nevertheless should be brought to the attention of the regulator.

Thus, for insurers, there was not an obligation on auditors to report formally to the regulator on the adequacy of systems of control as was the case with deposit takers. Similar provisions to those applying to deposit takers required auditors to report certain matters to the regulator without breaching any duty of confidentiality. In contrast to deposit takers, the role of the appointed actuary provided an additional check for policyholders with a duty to report to the regulator if the firm was pursuing policies likely to have a severe financial impact. In terms of overall supervision by the DTI, it is arguably the case that this was lighter than the equivalent supervision by the BoE and BSC.

Friendly societies

Role of the regulator

Prior to the creation of the FSA, UK friendly societies were supervised by the FSC, most latterly under the Friendly Societies Act 1992.

The 1992 Act established a new framework for prudential supervision. The intention of the legislation was signalled in the preceding Green Paper (HMSO, 1990):

It is intended that the regulation of insurance business carried on by friendly societies should be broadly the same as that conducted for insurance companies.

The general functions of the FSC are set out in Exhibit 2.7:

Exhibit 2.7: General functions of the Friendly Societies Commission

1 The Friendly Societies Commission
<p>The general functions of the Commission shall be:</p> <ul style="list-style-type: none"> (a) to promote the protection by each friendly society of its funds; (b) to promote the financial stability of friendly societies generally; (c) to secure that the purposes of each friendly society are in conformity with the 1992 Act and any other legislation regulating the purposes of friendly societies; (d) to administer the system of regulation of the activities of friendly societies; (e) to advise and make representations to the Treasury and other government departments on any matter relating to friendly societies.
<p><i>Source: Extract from s.1 Insurance Friendly Societies Act 1992 (quoted in Wilson, 1993)</i></p>

Thus, under s.44 of the 1992 Act, friendly societies undertaking long-term business had to appoint an actuary to the society as the appointed actuary. Wilson (1993) notes that the appointed actuary rules brought friendly societies in line with similar requirement of the Insurance Companies Act 1982.

Role and rights and duties of auditors in the supervisory process

For auditors, similar provisions existed under s.79(8) to inform the FSC of any matters in the interests of protecting policyholders without breaching any duty of confidentiality. In addition, auditors had to make an annual systems report under s.79(1) to the FSC. The provision and its requirements were similar to those of auditors of building societies under s.82 of the Building Societies Act 1986. There was no comparable provision for auditors of insurers under the Insurance Companies Act 1982, although, as discussed above, auditors of insurers were required under s.21 to form an opinion on insurers' regulatory returns.

Thus, the supervisory framework of friendly societies had a number of parallels with both insurance firms and building societies. In common with insurance firms, there was a requirement for friendly societies undertaking long-term investment business to have an appointed actuary. In common with building societies, there was a requirement for management and auditors to make an annual systems report to the regulator. Interestingly, this latter requirement implied that the regulation of friendly societies was more rigorous than that applying to insurers.

Summary

The objective of this chapter was to detail the pre-FSMA 2000 situation regarding the role, rights and duties of auditors and reporting accountants in the supervision of banks, building societies, insurers and friendly societies respectively (research question (i)).

Clearly, the supervision of banks made the greatest use of auditors and reporting accountants. Following the Banking Act 1987 regular reporting accountants' reports (s.39 reports) on systems and controls

were commissioned by the BoE. In addition, bilateral and trilateral meetings involving the firm, BoE and the auditors were common.

For the other sectors of the financial services industry, neither regular meetings involving auditors and supervisors, nor regular reporting accountants' reports, were typical. In building society and friendly society supervision there was a requirement for both the firm and its auditors to make an annual report to the supervisor on systems and controls, but these reports were in much less depth than reporting accountants' reports in banking, and they were not normally accompanied by meetings involving the auditors. In insurance supervision this requirement did not apply at all. Thus, in the insurance industry auditors and reporting accountants were used the least in the supervisory process.

ENDNOTES:

- ¹ It is only possible in this report to provide an overview of previous supervisory arrangements. Readers wishing further details are referred to: Penn (1989) for banks; Overy and Waters (1987) for building societies; Fisher and Bewsey (1997) and McGee (2001) for insurance; and, Wilson (1993) for friendly societies.
- ² What follows relies heavily on Dewing and Russell (2001) which reviewed the role of auditors and reporting accountants in UK banking supervision.
- ³ s.8 of the Banking Act 1987 deals with applications for authorisation under the Act. s.8(5) empowers the BoE to appoint reporting accountants to provide a report on an application under the section.
- ⁴ Further details of the Grays affair can be found in Barnes (1984) and Boléat (1986). The Investigation was undertaken by Ian Hay-Davidson of Arthur Andersen and Murray Stuart-Smith, QC (HMSO, 1979).
- ⁵ Further details of the historical involvement of actuaries and auditors in UK insurance supervision can be found in Dewing and Russell (2002). The following section relies heavily on this article.

CHAPTER THREE

ROLE OF AUDITORS AND SKILLED PERSONS IN FINANCIAL SERVICES SUPERVISION: THE FSMA 2000 REGULATORY FRAMEWORK

This chapter examines the post-FSMA 2000 regulatory framework and outlines the role of auditors and skilled persons in financial services, as specified in legislation, and supplementary interpretation and guidance by regulators and the profession. The initial focus of the chapter is on the main elements of the statutory framework, and the ways in which the FSA has implemented this framework. The role of auditors and skilled persons within the new framework for financial services supervision is then considered (research question (i)).

The Act itself provides no more than a ‘framework for regulation’ (Freshfields Bruckhaus Deringer, 2001) and gives the FSA the power to make detailed rules and to provide guidance. The FSA has provided an explanation of its overall approach through a series of publications and progress reports. The first was *A New Regulator for the New Millennium* (FSA, 2000a) which was published as the Financial Services and Markets Bill was going through Parliament. This has since been supplemented by three further progress reports (FSA, 2000b; 2002a; 2002b). With the advent of N2, the FSA published a booklet *Introduction to the Financial Services Authority* (FSA, 2001a) summarising its main activities and outlining how its organisation was structured to operate as a single statutory regulator.

The FSA’s detailed rules and guidance are set out in the *FSA Handbook* which is constantly being updated through a process of

consultation¹. It is divided into six Blocks, each containing various sourcebooks or manuals. The Blocks are as follows: *High Level Standards*; *Business Standards*; *Regulatory Processes*; *Redress*; *Specialist Sourcebooks*; and *Special Guides*. The blocks most relevant to the research study are *High Level Standards* and *Regulatory Processes*. The *High Level Standards* Block sets out the fundamental principles and guidelines by which senior management should conduct the affairs of financial services firms. The most important sourcebook/manual as background for the research study is the *Principles for Business* (FSA designation *PRIN*). The *Regulatory Processes* Block sets out in detail how the FSA will exercise its powers to authorise and regulate firms. The most important sourcebook/manual for the research study itself is *Supervision* (FSA designation *SUP*) which contains chapters on the role of auditors (Chapter 3, *SUP 3*) and the reports by skilled persons (Chapter 5, *SUP 5*).

This chapter, therefore, principally makes reference to relevant sections of the following: the FSMA 2000; general FSA publications explaining how it undertakes its role; the FSA *Handbook*; and FSA consultation and issues papers.

FSA – a new regulator for the new millennium

The main effect of FSMA 2000 was to bring together in one body, the FSA, the functions of a series of existing financial services regulators. The FSA is, thus, responsible for the supervision of:

- deposit takers (including banks, building societies and credit unions)
- insurance firms (including friendly societies and certain aspects of Lloyd's)

- investment firms (including fund managers, investment banks, stockbrokers, financial advisers and professional firms undertaking investment business)
- markets and exchanges (including the London Stock Exchange)

In addition to these responsibilities, the FSA is the competent authority for the admission of securities to the official list (UK Listing Authority). The bulk of new regulatory requirements came into force on 1 December 2001, known as N2.

In comparison with previous regulators, the FSA had to take into consideration a much wider range of objectives, obligations and functions which are set out in s.2(2)-(4) of the Act, as shown in Exhibit 3.1:

Exhibit 3.1: FSA's regulatory objectives and obligations

2 The Authority's general duties	
(2)	The regulatory objectives are: <ul style="list-style-type: none"> (a) market confidence; (b) public awareness; (c) the protection of consumers; and (d) the reduction of financial crime.
(3)	In discharging its general functions the Authority must have regard to: <ul style="list-style-type: none"> (a) the need to use its resources in the most efficient and economic way; (b) the responsibilities of those who manage the affairs of authorised persons; (c) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction; (d) the desirability of facilitating innovation in connection with regulated activities; (e) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom; (f) the need to minimise the adverse effects of competition that may arise from anything done in the discharge of those functions; (g) the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.
(4)	The Authority's general functions are: <ul style="list-style-type: none"> (a) ... making rules; (b) ... preparing and issuing codes ...; (c) ... giving general guidance; and (d) ... determining general policy and principles
<p><i>Source: Extract from section 2 FSMA 2000: subsections (2)-(4)</i></p>	

In FSA (2000a), the FSA sets out its interpretation of its obligations under s.2(2) of the Act as ‘Principles of Good Regulation’, see Exhibit 3.2:

Exhibit 3.2: FSA's Principles of Good Regulation

- ***efficiency and economy***

This principle relates to the way in which the FSA will allocate and deploy its resources. When addressing a specific risk, the FSA will aim to select the options which are most efficient and economic ...

- ***role of management***

A firm's senior management is responsible for its activities and for ensuring that its business is conducted in compliance with regulatory requirements. This principle is designed to guard against unnecessary intrusion by the regulator into firms' business and requires us to hold senior management responsible for risk management and controls within firms ...

- ***proportionality***

The restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry. ... One of the main techniques which the FSA will use is analysis of the costs and benefits of proposed regulatory requirements ...

- ***innovation***

We should facilitate innovation, for example by avoiding unreasonable barriers to entry or restrictions on existing market participants launching new financial products and services.

- ***international character of financial services and markets and the desirability of maintaining the competitive position of the UK***

The FSA will consider the impact on UK markets and consumers of the economic, industry and regulatory situation overseas. ... This will involve co-operating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively.

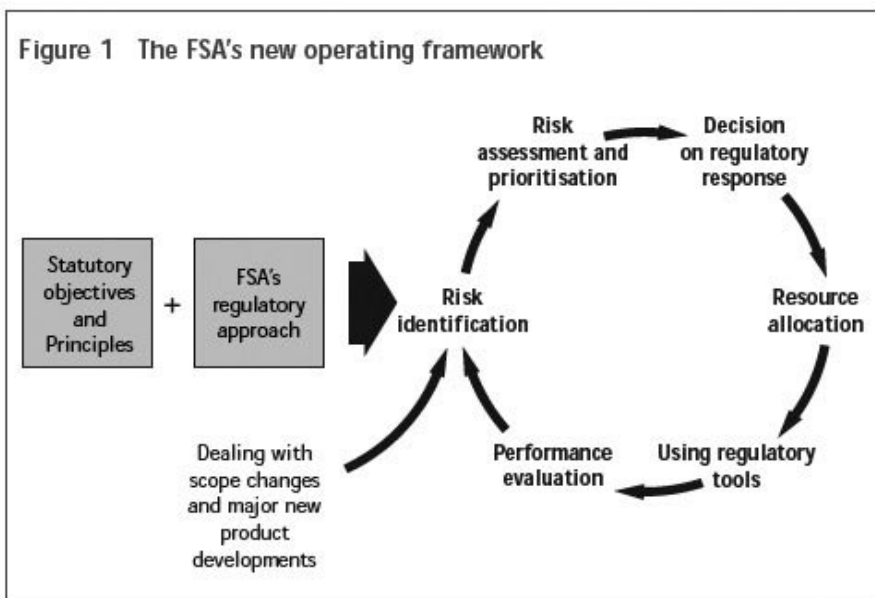
- ***competition***

The FSA must avoid unnecessarily distorting or impeding competition. This includes avoiding unnecessary regulatory barriers to entry or business expansion ...

Source: Extracts from FSA (2000a).

The key to the FSA's approach to regulation is its new operating framework (see FSA, 2000a). The framework is designed to identify the main risks to the FSA's statutory objectives as they arise and to help plan how to address these risks. It is, thus, a risk-based approach. The FSA's operating framework can be shown diagrammatically in Exhibit 3.3:

Exhibit 3.3: FSA's new operating framework

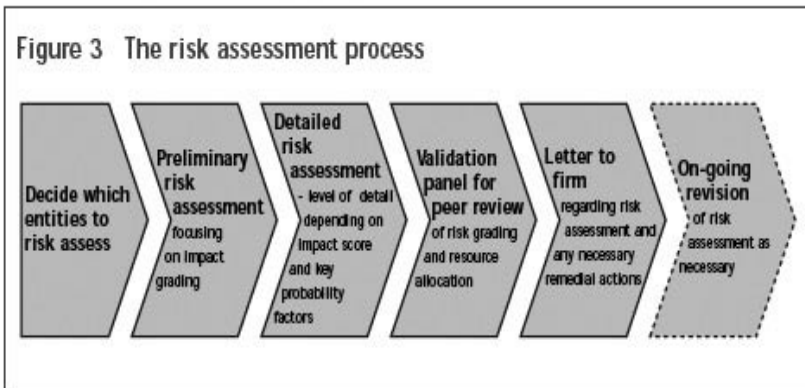


Source: FSA (2000a, para. 23, figure 1)

Under the FSA's risk-based approach each firm is given an individual risk assessment based on a number of factors including: (i) impact – the effect on the FSA's statutory objectives if the risk crystallises; and (ii) probability – the likelihood of a risk crystallising (see FSA, 2000a). The FSA subsequently formalised four internal

relationship categories into which firms are placed as a result of the risk assessment process – firms are categorised as of High, Medium High, Medium Low or Low impact (FSA, 2002a). The categorisation determines the level of ‘supervisory intensity’ such that a higher proportion of FSA resources will be devoted to those firms that pose a higher risk to the FSA’s objectives. Thus, high impact firms will be subject to a ‘close and continuous relationship’ (FSA, 2002a, para. 36). The risk assessment process is known informally as the ARROW process, following ‘project ARROW’ which developed the FSA’s new approach. The process is represented diagrammatically by the FSA (2000a), as follows in Exhibit 3.4²:

Exhibit 3.4: FSA’s risk assessment process



Source: FSA (2000a).

For the purposes of this report the key issues were: how the FSA formed its risk assessment; the resultant risk mitigation programme; and the use of regulatory tools, especially external auditors and skilled persons. It is important to appreciate that the FSA was concerned with how risks might affect its own statutory objectives, which was

a different perspective from how a firm itself might view the risks to its activities.

The main types of risk arise from the external environment, specific firms, consumers, products, markets or industries (FSA, 2002a). At the level of the individual firm risks are assessed under 40 risk elements grouped as either 'business risk' or 'control risk'. Identified risks are then assessed against the risk to the FSA's statutory objectives under seven groups, as shown in Exhibit 3.5:

Exhibit 3.5: FSA's Risk to The Objective (RTO) groups

financial failure misconduct and or/mismanagement consumer understanding incidence of fraud or dishonesty incidence of market abuse incidence of money laundering market quality
<i>Source: FSA (2002a).</i>

Risk elements are scored against the RTO groups using a High, Medium High, Medium Low or Low assessment to achieve an overall score against the FSA's statutory objectives where 'business risk is mitigated by strong controls and magnified by weak controls' (FSA, 2002a). Assessments are completed on a one-year to three-year cycle depending upon the risk of the firm. Once the risk assessment is completed by the FSA the outcome is communicated to the firm together with a risk mitigation programme (excluding low impact firms) detailing any necessary remedial action 'where risks have been identified which could have a material bearing on the FSA meeting the regulatory objectives' (SUP, 1.3.10).

In attempting to mitigate identified risks before crystallisation, the FSA has a number of regulatory tools available. In its ‘regulatory tools matrix’ (FSA, 2002a, Appendix C) the 32 regulatory tools are categorised by the FSA into four, as follows in Exhibit 3.6:

Exhibit 3.6: FSA’s categories of regulatory tools

Diagnostic	-	tools used to identify and/or measure risks.
Monitoring	-	tools used to monitor risk.
Preventative	-	tools used to mitigate risk.
Remedial	-	tools used to address crystallised risks.
<i>Source: FSA (2002a, Appendix C)</i>		

The most significant regulatory tools for this report are ‘reliance on firm’s external auditors’, which is a diagnostic or monitoring tool, and ‘use of/reliance on skilled persons’, which is a diagnostic or preventative tool.

The role of auditors in the supervisory process

Interestingly, the FSMA 2000 deals with external auditors and actuaries in the same way. Thus, the following sections contained in Part XXII of the Act, introduce common rules for both, as noted in Exhibit 3.7:

Exhibit 3.7: Role of auditors and actuaries

340 Appointment
341 Access to books <i>etc.</i>
342 Information given by auditor or actuary to the authority
343 Information given by auditor or actuary to the authority: persons with close links
344 Duty of auditor or actuary resigning <i>etc.</i> to give notice
345 Disqualification
346 Provision of false or misleading information to auditor or actuary
<i>Source: sections 340-346 FSMA 2000</i>

Rules and guidance on the role of auditors and actuaries in FSA supervision are set out in *SUP Chapter 3: Auditors* and *SUP Chapter 4: Actuaries* respectively. As regards actuaries, the FSA is currently in the process of consulting on proposals that would change significantly the role of the appointed actuary (see section 6.2.2). As regards auditors, the Act imposes additional requirements to the statutory audit requirements embodied in the Companies Act 1985 and 1989. The following discussion of the role of auditors in the supervisory process relies heavily on *SUP Chapter 3*.

In addition to their role under the Companies Acts, auditors act as a source of information for the FSA and can be required to report on the financial resources of a firm, the accuracy of a firm's reports to the FSA and its compliance with particular rules (*SUP*, 3.2.1). The rules place responsibilities on both a firm and its auditors to inform the FSA of a change in status of an auditor. Thus, firms must notify the FSA of any vacancy in the office of auditor and advise the FSA of the auditor appointed (*SUP*, 3.3.2). The FSA is permitted to appoint an auditor directly to a firm should a vacancy exist for more than 28 days (*SUP*, 3.3.7). The FSA requires firms to take reasonable steps to ensure

not only that an auditor is eligible to be appointed, but also that an auditor has the required skill, resources and experience commensurate with the nature, scale and complexity of a firm's business both to undertake an audit and perform related functions under the regulatory system, for example, possessing or having access to actuarial expertise for the audit of insurers or friendly societies (*SUP*, 3.4.1-2 and 4). The FSA reserves the right to seek further information from an auditor about an auditor's experience and skills (*SUP*, 3.4.7-8). The FSA also requires a firm to take reasonable steps to ensure that an appointed auditor is independent of the firm (*SUP*, 3.5.1-2).

Auditors have a statutory duty to report matters to the FSA, without breaching any duty of confidentiality, so long as the auditor is acting in 'good faith' and 'reasonably believes that the information or opinion is relevant to any functions of the FSA'. Similar rules direct auditors to advise the FSA if they are removed/resign/or are not re-appointed, together with a requirement that the auditor provides a statement to the FSA containing any matter the auditor believes should be brought to the FSA's attention, or a statement that there is no such matter (*SUP*, 3.8.11). The FSA places an onus on auditors to take reasonable steps to ensure there is no conflict of interest in respect of firms from which bias may be reasonably inferred (*SUP*, 3.8.5-6). The FSA is permitted to pass on to the auditor any information it considers relevant to the auditor's function (*SUP*, 3.8.9).

To help the auditing profession in interpreting FSA rules, and to assist auditors in the context of financial services, the APB has issued a number of auditing standards, practice notes and bulletins (see APB, 1994; 1998; 1999a-b; 2001a-c).

The role of skilled persons in the supervisory process

Guidance on the use of the FSA's powers to commission a skilled person's report under s.166 FSMA 2000 are set out in the *SUP*,

Chapter 5, Reports by skilled persons. The guidance was developed after a consultation process, see FSA (2001b). Section 166 is derived from s.39 Banking Act 1987 but is widened to apply across other sectors of the financial services industry. An extract from s.166 of the Act is shown in Exhibit 3.8:

Exhibit 3.8: Skilled persons' reports

166 Reports by skilled persons
<p>(1) The Authority may, by notice in writing given to a person to whom subsection (2) applies, require him to provide the Authority with a report on any matter about which the Authority has required or could require the provision of information or production of documents under section 165³.</p> <p>(2) This subsection applies to:</p> <ul style="list-style-type: none">(a) an authorised person ('A');(b) any other member of A's group;(c) a partnership of which A is a member; or(d) a person who has at any relevant time been a person falling within paragraph (a), (b) or (c) who is, or was at the relevant time, carrying on a business. <p>(3) The Authority may require the report to be in such form as may be specified in the notice.</p> <p>(4) The person appointed to make a report required by subsection (1) must be a person:</p> <ul style="list-style-type: none">(a) nominated or approved by the Authority; and(b) appearing to the Authority to have the skills necessary to make a report on the matter concerned.
<p><i>Source: Extract from section 166 FSMA 2000: subsections (1)-(4).</i></p>

The FSA gives guidance as to its policy on the use of skilled persons as one of its regulatory tools (SUP, 5.3.1). It will normally be used as

part of a firm's risk mitigation programme, or as a result of an event or development relating or relevant to a firm, or to verify information provided by a firm to the FSA (*SUP*, 5.3.2).

The FSA considers on a case by case basis the need for a skilled persons' report. Relevant factors that the FSA will take into account include *inter alia*: alternative tools, including other statutory powers; legal and procedural considerations; the objectives of the FSA's enquiries and the relative effectiveness of its available powers to achieve those objectives; cost considerations, especially since the costs of the report are borne by the firm not the FSA; and the FSA's own expertise and use of its resources (see *SUP*, 5.3-10). It is likely, therefore, that the incidence of skilled persons' reports will be lower proportionately than under the previous s.39 provisions for banking.

Before finalising its decision to require a skilled person's report, the FSA may hold discussions with the firm, which may include the person who is expected to be appointed as the skilled person. If the FSA concludes that a skilled person's report is required, the FSA gives the firm written notification of the purpose of the report, its scope, the timetable for completion and any other relevant matters (see *SUP*, 5.4.1-5). The skilled person, although appointed by the firm, must be nominated or approved by the FSA. The FSA must be satisfied that the skilled person has the skills necessary to make a report. The skilled person may be an accountant, lawyer, or actuary, or any other person with relevant business, technical or technological skills. The FSA must also be satisfied *inter alia* that the skilled person appears not to have any professional difficulty or conflict of interest in undertaking the assignment and has enough detachment in cases of an existing professional or commercial relationship. The FSA recognises that it may be cost effective to nominate or approve the appointment of a skilled person who has previously acted for, or advised, the firm; a notable example would be the auditors (see *SUP*, 5.4.6-9).

Once completed the skilled persons' report is initially submitted to the firm. The firm provides written comments on the report before

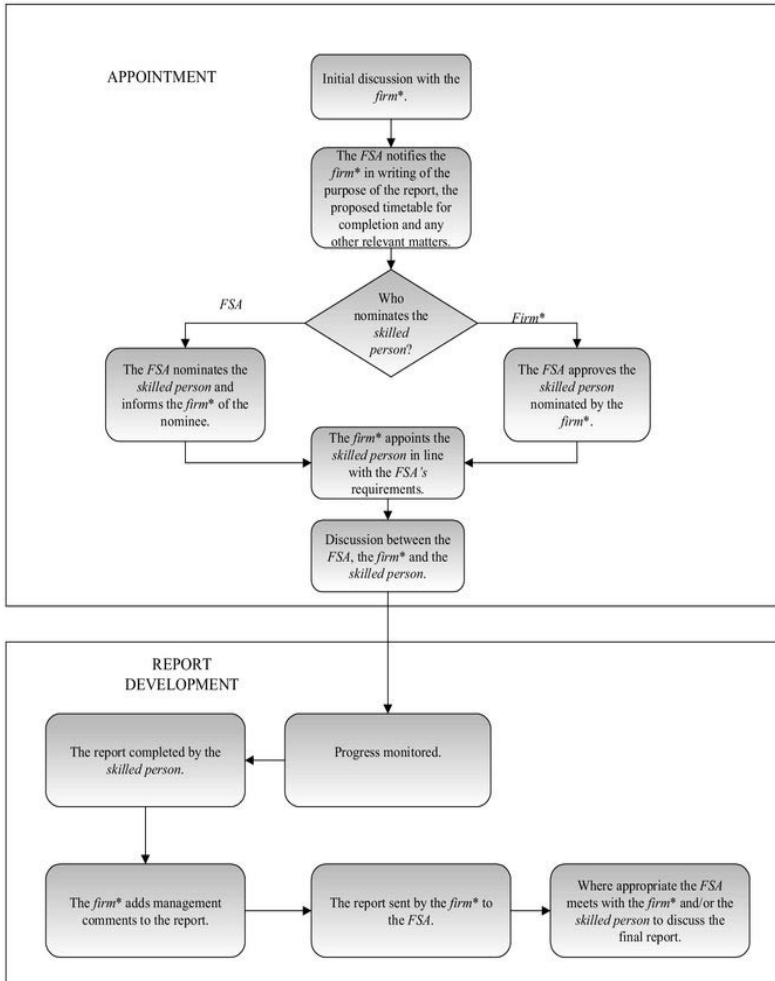
submitting the report and comments to the FSA. The FSA may then convene a bilateral and/or trilateral meeting with the skilled person and firm to discuss the findings of the report (see *SUP*, 5.4.10-13).

Interestingly, the FSA sets out detailed conditions which must be included in the contract between the firm and the skilled person. Thus, the firm must *inter alia*: require and permit the skilled person during, and after, appointment to cooperate with the FSA and to communicate with the FSA where the skilled person, in the course of undertaking the report, becomes aware of circumstances of significance to the FSA, for example, whether the firm satisfies, or will continue to satisfy, threshold conditions or whether the firm may not be, or may cease to be, a going concern. The contract should also make provision for the skilled person to provide at the request of the FSA: interim reports; source data documents and working papers; copies of draft reports given to the firm; and specific information about the planning and progress of the work. The FSA will take into account the cost of the skilled person complying with the request. For substantial or complex reports periodic updates may allow for a re-focusing of the report if necessary. Firms would normally be kept informed of communications between the skilled person and the FSA (see *SUP*, 5.5.1-8). Under s.348 FSMA 2000 the FSA may pass confidential information to the skilled person, but this may not be passed on without further legal authority (*SUP*, 5.6.1-2).

For skilled persons' reports guidance has been issued by the Institute of Chartered Accountants in England and Wales (ICAEW). In June 2003 the ICAEW issued a Technical Release providing guidance to assist members undertaking skilled persons' reports, which acknowledged the advice and assistance of the FSA in developing the release, but emphasised that it did not constitute guidance from the FSA (ICAEW, 2003).

A helpful overview of the complex appointment and reporting process is shown in Exhibit 3.9:

Exhibit 3.9: Overview of the FSA’s appointment and report development process for skilled persons



* or where applicable the other persons in SUP 5.2.1G

Source: FSA Handbook (SUP 5, Annex 2).

Summary

The objective of this chapter was to detail the post-FSMA 2000 situation regarding the role, rights and duties of auditors and skilled persons in financial services supervision under the unified regulator, the FSA (research question (i)).

One of the most significant differences between the current regime and previous regimes for financial services supervision is that the FSA places responsibility for running firms on a firm's senior management. The FSA's risk-based approach enables it to focus its resources on those firms categorised as of relatively higher risk and larger potential impact. However, the FSA is concerned with the risk to its statutory objectives, which are not necessarily the same as how firms perceive and manage their risks.

It is interesting to note that in its formal guidance on supervision the FSA attaches a lower importance to the involvement of external auditors in the supervisory process, especially for banks and building societies. For example, there are no comparable provisions for auditors to report formally on an annual basis to the regulator on the adequacy of a firm's system of controls, as was the case for building societies under s.82 Building Societies Act. Similarly, no comparable provisions exist for regular bilateral and/or trilateral meetings with the regulator to discuss matters of concern to the regulator, as was effectively the case for banks under s.39 Banking Act 1987, the reporting accountants' regime.

There are also a number of important differences between the former regime's role for reporting accountants and the current skilled persons' regime. Not least is the widening of the list of possible appointees to include other professions, such as actuaries and lawyers, and those having relevant business, technical or other skills. In part, this reflects the increased range of firms supervised by the FSA compared with the BoE, but it also reflects the FSA's need to call upon

a wider range of expertise to investigate a wider range of potential issues. Further, because the FSA has adopted a risk-based approach to supervision, skilled persons' reports are only one of a wide range of risk mitigation tools and are commissioned only after consideration of a range of alternative possibilities, whereas reporting accountants' reports were commissioned annually on a routine basis without undue regard for cost. Nevertheless, similarities remain, notably, that costs continue to be borne by the firm, not the regulator, and the interaction between a firm, a skilled person and the supervisor continues, although not necessarily as previously structured, with formal annual bilateral and trilateral meetings.

ENDNOTES:

- ¹ The latest version of the FSA Handbook is available electronically at: www.fsa.gov.uk/handbook/ It is beyond the scope of this report to review this document in detail.
- ² Exhibits 3.4 and 3.5 are taken from FSA (2000a) which first set out the new framework for risk assessment. This framework has since been refined by FSA (2000b, 2002a). The diagrams as shown in FSA (2000a) are included because firstly, they provide a representation of the operating framework as originally conceived; secondly, they were the context for the majority of interviewees when discussing the new FSA approach.
- ³ Section 165 FSMA 2000 is concerned with the FSA's power to require information from authorised firms.

CHAPTER FOUR

INTERVIEW FINDINGS: PRE-FSMA 2000 SUPERVISORY REGIMES

This chapter examines the perceptions of key interested parties on the role of auditors and reporting accountants in financial services in the pre-FSMA supervisory regimes. In particular, it examines whether this accorded with their roles as set out in legislation and guidance, whether a new expectations gap emerged and, if so, the elements of this new expectations gap together with any implications (research questions (ii) and (iii)).

The chapter proceeds by focusing on the perceptions of interviewees on the role of auditors and reporting accountants in the pre-FSMA 2000 supervisory regime for banks under the Banking Act 1987, reviewing in particular the role of reporting accountants under s.39 of the Act. The second section considers more generally the perceptions of interviewees on the role of auditors and reporting accountants in other pre-FSMA supervisory regimes for financial services firms including building societies, insurers and friendly societies.

The FSA did not acquire its full powers until 1 December 2001 (N2). Until then it conducted its supervisory responsibilities under prior legislation. Thus, for example for banks, under the Bank of England Act 1997, banking supervision passed from the BoE to HM Treasury which delegated its responsibilities to the FSA. For simplicity, the original supervisors are referred to prior to N2, and the FSA thereafter. Thus, for example, up to N2 the BoE is named as

the banking supervisor, even though from 1 June 1998 the role was undertaken by the FSA.

Banks

Senior management

Interviews began by focusing on the role of auditors and reporting accountants under s.39 of the Banking Act 1987 where the BoE could call for two kinds of reports: a 'controls' report on a bank's accounting and other records and internal control systems; and a 'returns' report on a bank's financial returns used for statistical or prudential monitoring purposes. In addition, the interviews considered the obligation of auditors and reporting accountants to participate in bilateral meetings with the BoE and trilateral meetings with the BoE and the firm.

The returns reports, although clearly important, were generally regarded by interviewees as involving only what might be termed a high-level clerical check. A typical comment from a risk manager at a banking group [F8] who had previous experience as a regulator was:

The way the s.39 worked on the returns then was that the BoE were really looking for the auditors to give them some comfort on the accuracy of the numbers in the return.

Controls reports, and the obligations of auditors and reporting accountants, were generally regarded by interviewees as addressing more substantive concerns, and are the focus of this section.

One accountant from a major bank [F2] identified two issues of considerable importance for the structure of the BoE supervisory regime. The first issue was that, unlike other banking supervisory regimes, for example in the US, the BoE did not favour undertaking detailed inspections on its own account, but nevertheless needed a mechanism by which a detailed investigation could be undertaken.

This resulted in the involvement of auditors in the supervisory regime. The interviewee noted that:

One of the key points all along through this is that the BoE rejected the idea of an inspection-based regime and therefore had to supplement its own supervision with the role of the auditor.

The second issue mentioned by this interviewee, and as identified in the literature review, was that changes to the BoE supervisory regime were influenced by a series of individual bank collapses, in particular, JMB and Barings.

A key feature of s.39 reports was that they were undertaken at the behest of the BoE but were commissioned and paid for by banks who made the results available to the BoE. This raised a potential cause for conflict between the BoE and the banks. Since they were paying for the reports, banks naturally sought to minimise their costs. The most effective way of minimising costs was for the auditors to undertake the reporting accountants' report. For banks, therefore, a vital issue was whether the auditors should also be appointed as the reporting accountants. Not to appoint the auditor as reporting accountant would lead to a greatly increased expense as considerable time would be spent by an independent reporting accountant, and by the bank's senior management assisting them, in familiarising themselves with the bank's complex internal control systems. As a senior accountant at a major bank [F1] put it:

Our interest in s.39 work is the benefit we get in terms of economics. We can end up spending a lot of money on these things ...

A related question concerned the scope of the reports. Since banks were paying for the reports, banks aimed, not unreasonably, to derive additional benefits for themselves. Therefore an important factor in the usefulness of s.39 reports to the BoE and to banks was defining carefully the scope of the report. This was normally achieved by a

trilateral meeting with representatives from the BoE, the bank and the auditors/reporting accountants, but with the BoE in charge. As the same senior accountant put it:

It served everyone's interest to have a fairly open dialogue, but clearly the BoE [staff] had a very clear view of what they wanted.

Thus, agreeing the exact scope of the report was crucial to all parties but the BoE as the supervisor had the final say in determining the scope.

A possible danger, if a bank was paying for a report which was undertaken by the auditors with whom the bank had a long-term relationship, was that the scope of the report and the rigour of the investigation might be compromised. It was important that, since the subject of the s.39 report was decided upon by the BoE, banks generally understood and acknowledged the reasons behind the choice of topic. That this was the case was confirmed by another senior accountant in a leading bank [F3] who commented that for s.39 reports:

They were always driven, in our experience, by the BoE. They decided as supervisor which s.39 reports, which areas they were going to look at, and generally we could understand the rationale for the subjects they chose. ... It was their agenda.

There were also the questions of confidentiality and conflicts of interest. Most banks, indeed most financial services firms, are audited by the Big Four professional accountancy practices. Virtually all interviewees considered that only the Big Four accountancy practices had sufficient expertise and resources to act as bank auditors and s.39 reporting accountants, certainly for larger firms. To appoint a Big Four accountancy practice, other than the auditors, as reporting accountants would inevitably raise issues of confidentiality and conflicts of interest. However, this did not get around the issue of an internal conflict of interest for a Big Four accountancy practice acting both as auditors

and as reporting accountants. The most significant safeguard was that the BoE reserved the right to approve the appointment of reporting accountants and, therefore, if it perceived a conflict of interest, or had any other reservations about the appointment of the auditors as reporting accountants, it could insist on an alternative.

Indeed, it was argued that the reporting accountants needed to be seen to be independent, not only by the BoE but also by banks commissioning the reports. A senior accountant [F1] emphasised:

We don't want tame accountants, we want independent accountants. We're paying good money, we want to get some value out of it. ... So what we don't want is somebody who will just sign a report for the sake of signing a report. It's not in our interest.

However, further safeguards existed, with the accountancy practices observing the guidance provided by the professional accountancy bodies and following auditing guidelines provided by the APC and APB. In practice, it was not necessarily the audit engagement partner or members of the audit team that would be involved in carrying out the s.39 report. Often, the report required specialist expertise, for example, credit risk, IT and treasury.

The independence of auditors acting as reporting accountants was summed up by a senior accountant at a large bank [F1] as follows:

So certainly from my experience our auditors are very, very independent in terms of s.39 reporting. We welcome that in the sense it serves our purposes.

At the time of the Banking Act 1987 the involvement of auditors as reporting accountants in the system of banking supervision, and the introduction of s.39 reports represented a 'culture shock' for the BoE. As the same senior accountant commented:

When this regime started, they [BoE] didn't know what they were in for. ... Another thing is they were coming from the BoE regime where

you went for a cup of coffee with - 'you're doing a good job, carry on' – whatever, to the s.39 which was quite a revolutionary step.

An important issue for s.39 reports was to clarify what could, and could not, be done and, in particular, to point out that guarantees could not be given to both management and the BoE. The same accountant believed that APC/APB guidelines were helpful in this respect:

What they're [the guidelines] at great pains to emphasise is that they're [reporting accountants] not going to give you cast iron guarantees either to management or to the regulator. All they can say is this is what they've done, and this is what their views are, and lay it out as to why they've come to that view. But ultimately the responsibility is to the regulator to make that judgement. This is just trying to inform the regulator.

Not surprisingly, the nature of s.39 reports changed over time. Following the Banking Act 1987, a senior accountant of a large bank characterised the BoE approach as going in for 'full scope' reviews, and it became necessary for auditors to ask the question – 'how does a reporting accountant differ from an auditor?' This interviewee [F2] commented:

And what you actually see when you look at s.39s is accountants being dragged into areas which in detail they're unfamiliar with. The whole approach seems to be for the BoE to press them towards greater depth in understanding of the business ... so that when you looked at some of the issues for auditors, they were about – what additional work will we have to do in order to complete this s.39 report as reporting accountant that we wouldn't do as auditor?

In the opinion of this interviewee there was a significant change in the way the BoE used s.39 reports pre-Barings and post-Barings. The impression pre-Barings was that of going through a 'routine'. At this time the BoE approach was to select particular topics, and then call for

a s.39 report investigating the adequacy of controls around the topic. Related to this was the overall economic environment for banking which was becoming more competitive. A possible danger was that traditional banking practices would be neglected as banks competed more vigorously for business. The BoE reacted by emphasising the need to maintain acceptable standards of control. The same banking interviewee put it succinctly as follows:

The BoE was responding by saying – you’re a bank. You think you are a business, but we think you’re a bank. And if you forget you’re a bank we’re going to remind you ...

The failure of Barings in 1995 triggered a reappraisal of banking supervision¹. This resulted in the development of a risk-based approach to supervision, known as the RATE model (Risk Assessment, Tools of Supervision and Evaluation)². The role of s.39 reports needed to be considered in the light of this more formal risk-based approach to supervision. According to this interviewee the cost effectiveness of s.39 reports was already being questioned:

There was some dissatisfaction up to 1995 about whether s.39s were delivering value for money - whether they were being just done for the sake of form under the Banking Act. And actually they were quite expensive to do and there was no need ... for the BoE to have regard to the cost of these things.

This was an important issue. As mentioned above, a key issue for banks in paying for s.39 reports was that it was a mutually beneficial arrangement of satisfying the supervisory requirements of the BoE whilst obtaining additional benefits for themselves. In response to the question as to the extent to which the s.39 reports revealed anything material that was not already known to bank executives, this same banking interviewee made the significant comment:

But I have to say in the round most s.39 reports were telling them [bank executives] what they already knew.

Thus, pre-Barings the then current approach to s.39 reports was becoming regarded as unsatisfactory by both the BoE and the banks. Post-Barings, with the new risk-based approach to supervision, there was more of an emphasis on ‘hot topics’ and the focus on ‘high level’ controls became greater. This interviewee believed that s.39 reports served a useful purpose in addressing these issues. This was mainly because the reports could focus on an identified risk and became a management tool. The interviewee noted that the s.39 reports process:

... became more effective as it became risk-based and thematic. It was most effective in a situation where you had an identified risk and the s.39 report was part of the way management dealt with that risk. So the s.39 report became integrated into the management process...

Although s.39 reports post-Barings were more useful, the question remains whether they were cost effective. Again this interviewee made the significant remark:

So if you could put the costs on one side and the output on the other, then probably it would be seen as expensive consultancy.

Of course, these comments were from a bank’s point of view. Clearly it was the case that the BoE, as supervisor, derived benefits from s.39 reports. However, since there was still no requirement on the BoE to consider costs, the cost-benefit of s.39 reports to banks and to the BoE was not evaluated³.

The normal time scale for completion of a s.39 report was 90 days from the date of commission. Just as scoping the report involved a trilateral meeting, so following delivery of the report ‘it was inevitably followed up by a trilateral meeting to follow up the findings’. This banking interviewee [F1] observed that over time the nature of the

report changed from an 'exceptions' report to a 'long form' report. Although this meant an increase in cost, the advantage was greater detail:

A long form report inevitably meant more effort and more cost on the banks. But it meant the bank, the BoE itself, had a lot more detail.

Depending on the findings, the s.39 report might not have required specific follow up but, where follow up was required, this might have involved, for example, the reporting accountants undertaking further specific work, or might involve the bank undertaking agreed action which would need to be reported to the BoE by the bank and/or reporting accountants.

Under the Banking Act 1987 and BoE guidelines, there were specific provisions recommending that a trilateral meeting should take place at least annually to discuss relevant matters arising from the statutory audit and from s.39 reports. In addition, bilateral meetings between the BoE and the auditors and/or reporting accountants could be held. The main problems with bilaterals were that the bank was not party to the discussions which might have had major implications for it and, at a more practical level, it might not be possible to resolve certain issues without obtaining further input from the bank. Thus, most interviewees favoured trilateral meetings, but recognised that bilaterals would take place. As a senior accountant [F1] explained about trilaterals:

... you get a well-rounded discussion. Otherwise either the auditor then has to go and talk to his client, or the regulator has to come and talk to the bank. So it seems to me best if we all get around a table – at least you deal with the issues.

However, this interviewee recognised that bilaterals would take place and commented:

*We have no difficulties if the regulator wants to talk to our auditors.
We have nothing to hide.*

However, another senior accountant observed that the nature of bilaterals changed post-Barings. Bilaterals were initially regarded as an exception rather than the rule, so that a bilateral meeting was regarded as a significant event with potentially serious implications. Post-Barings, the BoE introduced bilaterals as a matter of routine. As this banking interviewee [F2] explained:

Up to 1995 bilaterals had been with the permission of the organisation. There would have had to have been some sort of crisis to have a bilateral. You would have been on a hook for something if a bilateral had taken place. After 1995 the BoE introduced bilaterals as ordinary course of business. And if everything was going normally they would allow the auditors to tell you what had transpired and what the topics were. But certainly it was a change ...

Overall, bank interviewees felt the BoE was clearly ‘in charge’, and commented favourably about the role of reporting accountants in producing ‘controls’ reports as implemented and developed under s.39 of the Banking Act 1987. However, the process was controlled by the BoE, and banks had no choice other than to comply. The overall message from bank interviewees was the need to manage the process so as to satisfy BoE requirements, whilst minimising costs and maximising benefits to the bank. Key to this was that the auditors should also be the reporting accountants, and that the scope of s.39 reports should be carefully defined so as to meet the overriding requirements of the BoE, and the supplementary requirements of banks, in a form that was ‘deliverable’ by the auditors/reporting accountants.

Auditors

Partners in accountancy practices confirmed that s.39 reports were regularly used by the BoE as part of the supervisory process. As one partner [A6] put it:

It was an expectation every year that you would go through and do a s.39 report, follow that with a trilateral and then, following the trilateral, the scope would be determined for next year's reports, and that tended to happen year in, year out.

An interesting question was how the topics for a s.39 were chosen. These were categorised by another partner [A2] into three areas: 'institution specific', for example, entering a new business area; 'round robin' areas, such as high level controls, IT, etc; and these would be supplemented by 'themes'.

As with bankers, partners agreed that a key element of a s.39 report was to define the scope. One partner [A9] believed that there was a learning process on the part of supervisors in the BoE in correctly defining the scope. This partner identified two possibilities where inadequate scoping of the report could lead to problems. First, the supervisors omitted what was actually required:

We have had occasions where supervisors have reacted to a report and said that's not what we wanted. We've got the scope letter out and said, well what you just said you wanted isn't here.

Second, supervisors made the scope too general, making it difficult for the reporting accountants to establish what the real concerns of the supervisors were:

There was a tendency of some supervisors to put the auditors in to see if the auditors came to the same view as the supervisors, without telling us what their concern was in the first place.

This partner believed that supervisors eventually ‘got the message’ about the need to define the scope clearly. A partner in another accountancy practice noted that over time scopes for reports had become more standardised, although this perception was qualified by another partner from the same practice who commented that an exception would be where a particular issue had arisen and there was to be an ‘ad hoc’ s.39. In these circumstances discussions over the scope could become more intense.

A partner in another practice [A4] felt that reporting accountants in fact exercised significant influence over the scoping, and that often the BoE allowed them to take the initiative. As the partner explained:

What was supposed to happen was that the supervisor wrote a draft scope and sent it to the bank and the auditor. To speed the process up we used to offer to volunteer to draft it and it would go to the bank and the supervisor.

However, this partner acknowledged that it was essential to obtain agreement on the scope from all three parties which might involve a trilateral meeting. The scoping process was perhaps best described by another partner as ‘bouncing the draft around’ until agreement was reached between the BoE, the bank, and the reporting accountants.

With the scope agreed, the next important question was, who within the accountancy practice should be responsible for undertaking the s.39 report? Clearly the audit partner and audit team were well placed to undertake the task. Even if they were not directly responsible, they were able to make a significant contribution because of their in-depth knowledge of the bank. As one partner [A2] explained:

Typically we would leverage the knowledge of the audit partner about the organisation generally, and for cost effectiveness, and the rest of it as well, we would lever the knowledge that the audit team already had in terms of how various things worked.

Another partner [A1] commented that there was a 'great deal to be gained' from someone who was familiar with the client leading the work. However, this partner stated that it would also depend upon the scope of the report, for example, it was unlikely that a s.39 report investigating money laundering would be headed by one of the audit partners. Nevertheless, it was still likely that the audit partner would have some input into managing the engagement and the client relationship.

It may be thought that continuity of relationship between the audit partner and the leader of the s.39 team was of primary benefit to the bank and to the accountancy practice. However, one partner [A6] commented that this continuity of relationship was also seen as being of considerable value, at least historically, by supervisors at the BoE:

Historically, I think the banking supervisor at the BoE had a relationship with the audit partner and found that relationship very useful. And, therefore, unless you're dealing with something which is clearly outside the expertise, or is very specialist in nature, generally it was accepted practice that the audit partner should do it.

This relationship was built up over the years through regular bilateral and trilateral meetings. However, the introduction in the Banking Act 1987 of bank auditors no longer being bound by their normal duty of client confidentiality was a radical step for auditors. Views as to the usefulness of bilaterals were mixed. After initial reservations about bilateral meetings, some regarded them as having value. As one partner [A9] explained:

Actually we were very suspicious of it, candidly, when it came in but I actually think it was quite useful. It enabled a certain amount of sharing of impressions in an environment where you could do that. ... The good bilaterals were where you got the same impressions from the regulator coming back.

An important question was the extent to which bankers were content for auditors to discuss matters with the BoE in their absence. The same partner felt that bilaterals had to be seen in the context of the overall regulatory process. Most clients accepted the inevitable fact that the BoE would be meeting directly with their auditors, and that contributed to mutually 'comfortable' relationships. However, another partner from another practice [A2] emphasised an opposite opinion about the usefulness of bilateral meetings:

The bilateral – we'd stay behind, the institution got asked to leave the room and departed with great suspicion as to what was going to be talked about afterwards. ... In terms of the bilateral as an opportunity to discuss things when an institution was out of the room - not actually a useful forum in most cases.

A partner [A6] recognised the potential importance of a bilateral both to the auditor and the supervisor – for the auditor, '...the opportunity in a bilateral to be able to say things you might be uncomfortable in saying in front of your client clearly exists'; for the regulator, 'I presume it provides comfort to the regulator that they know you have the opportunity to say [something] orally directly in a bilateral'. The key issue for partners was that they felt there should be no barriers between themselves and their clients, so that any comments should be raised in trilaterals. Overall, the result was a wary approach by partners to bilaterals. As one partner [A2] commented frankly:

In my case the bilateral generally consisted of – 'have you got anything to add?' And me saying 'no'.

All partners recognised that when there was serious cause for concern, and there was no other alternative, it was important to have the power to speak directly to the regulator. Of those interviewed, only one senior partner had used this power, and had done so only once during his career.

An important question was the overall value of s.39 reports, and the associated bilateral and trilateral meetings, to the BoE and to banks. One partner [A11] had major reservations about the basis on which initial s.39 reports were commissioned, but this improved with experience:

There were a lot of people at the BoE who commissioned reports without knowing what they wanted, either the style of the report or the purpose of the report or the exact scope. And we were very critical and the BoE had taken this on board.

This partner believed that some of the bilaterals and trilaterals ‘really helped get the BoE staff on the right track’. One partner [A9] regarded most of the s.39 reports as ‘huge information gathering exercises by the regulator’. Other partners noted different approaches taken by different supervisors in response to s.39 reports in trilateral meetings. As one partner [A2] noted, a trilateral meeting was ‘...the point in the process that you inject people, and different people have different views’.

The other question was whether banks themselves obtained value from s.39 reports. Given that the banks were paying for the reports and all the apparent effort that went into scoping the reports, this might be expected. However, partners were less sure. One pointed out [A9] that the BoE used to ask banks whether they felt the s.39 reports were useful, and observed:

The banks always used to say ‘yes sir, yes sir’, but I was never really convinced that they felt like that. I think the problem is the banks probably felt if they wanted that kind of control review they could get it done more cheaply by their auditors without all the paraphernalia of writing big reports.

Another partner [A1] believed that most banks adopted a pragmatic approach such that their aim was to satisfy the BoE at least cost, and then seek, without much hope, of deriving further value:

My sense is that the client's objectives were first of all to minimise the intrusion and second to minimise the cost ... I think then having got to an appropriate scope and division of responsibilities they would then try and apply the challenge of looking for value. But my assessment is, speaking plainly, is that that was probably half hearted.

An interesting question was the extent to which work undertaken for audits and s.39 reports were related. The most insightful comment came from a partner [A2] who suggested that it was helpful to picture the relationship as 'some sort of Venn diagram'. This partner commented:

There's a base level of knowledge and understanding of an institution which is undoubtedly common to approaching the institution from a s.39 point of view and an audit point of view.

However, there would be matters relevant to audit that would not be relevant to a s.39 report, but this would also depend on the scope of a s.39 report. A key issue concerned the level of detail which might be required for a s.39 report, but which would not be necessary for an audit. This partner [A2] felt that undertaking s.39 reports was a valuable supplement to the audit because it would help give support to the audit judgement:

So you approach this by saying well actually from an audit we would say this is a well-run institution at the top and middle level ... If we drill down in one particular area to the base level, do we actually still feel it's well run? ... It does help you to build your sense of the overall integrity of the organisation.

A partner in another practice [A1] was of a different opinion, and believed there was little overlap between audits and s.39 reports. This partner viewed the two as fundamentally different:

On an audit you focus very much on what drives the financial results, and it is a comparatively narrow focus in the controls that you're looking at. When you're doing a s.39 report ... you're looking at the wider business risks, not the risks of material misstatement in the financial results, and from that perspective you look at a much wider set of processes and the scope is very different. I never experienced where the degree of overlap with what you do in the audit is particularly material.

Another partner [A6], who took an intermediate position, identified the key difference between audit and s.39 reports, even where issues might be in common, as the 'true and fair' requirement for audit:

I'm not sure that issues or exceptions raised in a reporting accountant's report, irrespective that they touch on areas that are covered by the audit, would necessarily cause a problem because of the scope and depth. The issues raised can still be squared with the fact that a set of financial statements show a true and fair view.

Notwithstanding problems over scoping s.39 reports and the differences in perceptions as to the effectiveness of reports, an issue of concern to partners was the regulators' understanding of the difference between an audit 'true and fair' opinion and that of a s.39 report where the opinion was more exceptions based to a pre-defined and tailored scope.

Regulators

Interviews with regulators confirmed and enhanced the impressions gained from the interviews at banks and accountancy

practices. A regulator [R5] with specific experience of the previous BoE supervisory regime was able to offer particularly helpful insights and the following section relies on this interviewee's comments. First, was the fact that s.39 reports were meant to give 'added value' to banks, whilst acknowledging the primacy purpose of the reports was BoE supervision. As this interviewee noted:

The whole idea was there should be, and the way we tried to approach it was that there should be, a benefit to the firm as well as to us ... So there had to be a collaborative process involved, but at the end of the day we always had the last word.

This interviewee, however, expressed 'misgivings' about the s.39 process since it could be argued that 'fundamentally it's a flawed structure'. This was because of the indirect nature of the contractual relationship whereby the bank pays for the report, which was undertaken by its auditor with whom it had a long-term relationship, rather than the BoE contracting directly with an independent reporting accountant. As this interviewee put it:

You are instructing a firm to instruct its accountants and pay them to dish the dirt on them ...

Not surprisingly, this was not raised as an issue by the interviewees at banks or accountancy practices. Interviewees at banks argued that the costs of using independent reporting accountants were prohibitive; audit partners argued that their practices were able to maintain professional independence. The BoE was able to require that a bank appointed a reporting accountant other than its auditor, which was done occasionally, but this interviewee commented:

It would be a fairly drastic thing if you were to do that.

In practice the BoE recognised the benefits of auditors undertaking s.39 reports on the basis that the auditors would have a greater knowledge of the bank and its management which should contribute

to a 'more productive report'. Nevertheless this interviewee emphasised that:

You always had to be on your guard for the relationship being too close.

This interviewee also confirmed the mixed experience about the usefulness of trilateral and bilateral meetings. As a regulator it was necessary to be 'quite subtle' in interpreting the signals, and 'body language' at meetings was another source of 'fruitful information' from both accountants and banks. One of the problems was that reports were usually written in a 'very carefully constructed language' and it was down to the regulator to ask questions and 'smoke' it out. This interviewee attributed this to the problem of the indirect contractual relationship:

Of course the report was addressed to the firm, the bank, not to us, and it was obviously not going to be put in a language that said 'This is absolutely appalling'.

This interviewee was also aware that another reason for this was because the reporting accountants were having 'to cover themselves':

They were obviously exposed to quite a serious risk if they produced a s.39 report that didn't draw attention to something that then became obvious to us ... So there was quite a lot riding on this for them.

There was a danger that the auditors/reporting accountants were in a 'pretty invidious position'.

This interviewee, however, acknowledged that matters improved as all parties gained greater experience of the s.39 process and of bilateral and trilateral meetings. Regulators became 'more proficient' at the way they would 'interpret the signals', and banks and reporting accountants became more comfortable with the arrangements. Bilateral meetings were initially seen especially by banks, but also by accountants, as 'a last resort', but over time these became 'more readily accepted', even by

the banks. Often the bilateral would immediately follow the trilateral and regulators were able to discuss matters directly with reporting accountants so as to confirm 'we'd got the right end of the stick'. In this interviewee's opinion:

I actually think that worked very well. And once the firms [the banks] got used to the idea and realised that it wasn't actually going to kick them where it hurts, they seemed to accept it as well.

Interestingly, this interviewee commented that the approach of accountancy practices was by no means uniform and each had a 'house style':

The style of their reports would be different. The freedom with which they would talk in meetings was also noticeably different. That would be down to some extent to the individual partner but also it would have something to do with the house style.

Overall, impressions gained from regulators broadly confirmed the impressions gained from the interviewees at banks and accountancy practices. One concern was about the 'fundamentally flawed' nature of the contractual relationship between the BoE, the bank and the auditors/reporting accountants, while recognising the practical need for a compromise because of the cost and expertise needed. Interviewees from the banks and accountancy practices, perhaps disingenuously, often believed that the s.39 process was more frank and open than was really the case.

Building societies, insurers and friendly societies

For building societies the equivalent of the Banking Act 1987 and the BoE as regulator was the Building Societies Act 1986 and the BSC respectively. There were, however, differences in the accounting and auditing requirements and supervisory approach in these areas and, in particular, there was no direct equivalent of s.39 reports. Instead,

under s.71 of the Building Societies Act 1986, the chief executive and directors of a building society provided an annual statement to the BSC as to whether the accounting records and systems of control, of inspection, and of report had complied with the requirements of the section. Under s.82, the auditors provided an annual report to the BSC giving their opinion as to whether the accounting records and systems of control, of inspection, and of report had complied with the requirements of s.71. Thus, under s.71 the report was furnished by the society; under s.82 the auditors reported on it.

For insurance companies, the equivalent act was the Insurance Companies Act 1982 and the equivalent supervisor was the Insurance Directorate of the DTI. As with building societies, there was a difference in accounting and auditing requirements compared with banks. Under s.21 of the Insurance Companies Act 1982 auditors were required to report on the returns made to the DTI Insurance Directorate and under s.21A to report matters of 'material significance' that came to their attention in the course of their work. Thus, there were no requirements for regulators to consider, or for auditors to report on, the adequacy of systems of control. However, there was a much greater role for actuaries in the supervision of life insurance companies, whereby an appointed actuary had to be satisfied at all times with the soundness of a company's financial position.

For friendly societies, the equivalent was the Friendly Societies Act 1992 and the FSC. Interestingly, for the role of auditors and accountants, the supervision of friendly societies combined elements both from the regulation of building societies and insurance companies. Thus, under s.79(1) of the Friendly Societies Act 1992 auditors were required to make an annual systems report to the FSC and, under s.79(8), to inform the FSC of any matters, in the interests of protecting policyholders without breaching any duty of confidentiality.

Thus, there was significantly less involvement by auditors and reporting accountants in the supervisory process for building societies, friendly societies and, especially, insurers, than for banks.

An important feature for the BSC, the DTI Insurance Directorate and the FSC was that each was dealing with a more homogenous group of firms than the BoE. Many of these firms were mutuals, run for the benefit of their members, rather than as limited companies making profits for shareholders. Thus, as a senior accountant in a small building society [F14] remarked, whether societies were small or large all had 'reasonably common business models'.

For building societies, the main difference between the s.39 regime for banks and the s.71/s.82 regime for building societies, was characterised by a senior risk manager of a medium sized building society [F17] as follows:

The fundamental difference was ... the old section 71/82 reports under the Building Societies Act were by exception, whereas the section 39/166 reports are full reports.

A risk manager of a large building society [F16] characterised the BSC's approach as 'hands off'. Others, including the chief executive of a medium-sized building society, characterised it as 'quite formal'. Key to the BSC's supervisory approach was an Annual Review Meeting where representatives of the BSC would meet with the board, including a separate meeting with non-executives, to discuss the results for the previous year, the current year, and the corporate plan. In addition, issues raised in the s.71/s.82 reports would be considered, as well as issues in the management letter from the auditors. An impression gained from the interviewees from the building societies, especially smaller ones, was one of 'nostalgia' for the days of the BSC where supervision was 'quite a gentlemanly affair' involving 'some sandwiches and a chat'.

For insurance companies contact with the DTI Insurance Directorate was limited in the extreme. A chief accountant of a large insurance company [F26] saw it mainly as submitting the annual return and getting no feedback:

The extent of their involvement was submitting an annual return. We had rare, very little contact. I don't even think we got any questions on it to be honest.

Another chief accountant [F25] recollected rather more involvement, which included meetings, but was rather dismissive of the overall process:

I was engaged in meetings with them – this was quite revolutionary at the time – and we'd actually sit face to face with the relevant people from the regulator and the Government Actuary's Department. I think they thought it was something like an inquisition.

The chief accountant of another large insurance company [F33] explained that these experiences could be accounted for by the fact that in his opinion the DTI Insurance Directorate was more bound by the legal framework and focused its attention on smaller companies:

Larger major companies probably had quite limited contact with the regulator because they were sufficiently comfortable – in terms of the status of the major groups and the capital backing that these major groups had. A lot of their time and attention was focused on the smaller companies ...

This bureaucratic approach of the DTI Insurance Directorate was confirmed by another chief accountant [F23] who commented:

It was very much you had people who had been dedicated to insurance regulation for some time and were very familiar with the industry but were perhaps used to the traditional way of monitoring and supervising.

The involvement of auditors in insurance regulation was considerably more limited than in the case of banks, or even building societies and friendly societies. A chief accountant [F33] described it as follows:

The auditors' prime role of course would be looking at the DTI returns and auditing the part of the DTI returns that would be audited by them, and that would be a natural follow-on from the annual accounts and audit – and that would be about it.

This picture of 'hands-off' regulation continued for friendly societies, even when an issue was potentially serious, such as expenses exceeding income. A chief executive [F34] commented:

The FSC tended to be relatively passive and I think they never really interfered much with the society's affairs.

However, unlike insurance companies, friendly societies had experience of reporting on systems of control to the FSC and of auditors signing off these reports, under s.68 and s.79 respectively of the Friendly Societies Act 1992. In the opinion of this chief executive, this gave friendly societies a considerable advantage compared with insurance companies in preparing for the new supervisory regime under FSMA 2000:

We had to do that prior to the systems of controls that were brought in for insurance companies. It was actually the same thing, so we've actually been broken in on this more than say the insurance companies. It was quite a painful breaking in period.

This was confirmed by a finance director of a friendly society [F32], who had previously worked as an auditor of, and a manager in, life offices:

The FSC had been very prescriptive in the controls and documentation that had to be in place so when we hit N2 we were far better prepared

than any other life office I'd been at either as an auditor or as an internal manager. Because of that very prescriptive, dogmatic approach where everything was documented we were in a very good position to do the risk analysis because I do find it very paper based. We were fortunate that the FSC had effectively prepared us for that.

Thus, this revealing comment indicates that although the FSC approach might be characterised as bureaucratic in the extreme, it was nevertheless regarded by these senior friendly society interviewees as an excellent preparation for the rigours of the FSA and N2.

Summary

The objective of this chapter was to obtain the perceptions of interviewees about the role of auditors and reporting accountants in the pre-FSMA 2000 supervisory regimes.

Auditors' and reporting accountants' contact with supervisors was at its greatest in banking with more limited, albeit regular, contact in both building societies and friendly societies through the requirement for annual systems reports. In insurance there was little, if any, contact between auditors and the DTI, where the role of the appointed actuary was more significant. Thus, the role of auditors and reporting accountants in the pre-FSMA 2000 supervisory regimes varied considerably.

The interview findings about reporting accountants' reports under s.39 Banking Act 1987 were mixed. At best s.39 reports offered a powerful mechanism for investigating issues and problems raised by regulators, thus providing them reassurance, with helpful spin-offs for firms and auditors, and with the associated bilateral and trilateral meetings providing a forum for fruitful dialogue between firms, regulators and auditors. At worst, the reports and associated meetings were an expensive ritual, where nothing was revealed that was not already known. Overall, there was little evidence of an expectations

gap between the role as set out by the BoE and firms' experiences. The dual role of auditors in reporting to shareholders under the Companies Act 1985 and to the regulator under both the previous financial services legislation and FSMA 2000 is considered in the next chapter.

ENDNOTES:

- ¹ The BoE's Review of Supervision conducted in association with Arthur Andersen is summarised in BoE (1997, pp. 6-10).
- ² RATE was the forerunner of the FSA's ARROW process (see Chapter 3, section 1).
- ³ The requirement to consider costs in relation to perceived benefits was introduced by FSMA 2000.

CHAPTER FIVE

INTERVIEW FINDINGS: FSMA 2000 SUPERVISORY REGIME

This chapter examines the post-FSMA 2000 regulatory framework and the dual role of auditors and reporting accountants/skilled persons (research questions (ii) and (iii)).

This chapter reports the results of interviews about the new supervisory regime established under FSMA 2000 as implemented by the FSA since 1 December 2001 (N2). The two most important features of the new regime are that it is an integrated regime with a single regulator that applies to all financial services firms, and that supervision is risk based. Thus, the approach to supervision of individual firms is determined to a large extent by the outcome of a risk assessment, with greater resources being targeted to those firms with a higher risk profile.

FSMA 2000 replaced s.39 Banking Act 1987 reporting accountants' reports, and their equivalent for other financial services sectors, by s.166 skilled persons' reports. Compared to s.39 reports, and their equivalent, the most important features of s.166 reports are that they widen the range of persons who may undertake such reports to include actuaries, lawyers or others with relevant skills, and they are a non-routine regulatory tool. In commissioning such a report, the FSA must have regard to cost and to the use of alternative tools.

Reports by skilled persons

Senior management

Section 39 reporting accountant reports were regularly used as routine information gathering exercises by the BoE without the need for the BoE seriously to consider the benefits or costs. Under the new supervisory regime the FSA has other means of obtaining information, which feeds into the FSA's risk-based assessment process. Section 166 skilled persons' reports are seen by the FSA as a 'last resort' or, at least, that the benefits of commissioning a s.166 report demonstrably outweigh the costs (see below).

During 2002-03 and 2003-04 only 59 reports have been commissioned across the whole population of financial services firms regulated by the FSA. The perception of s.166 as a significant risk mitigation tool, not lightly or routinely employed by the FSA, and its potential seriousness to a firm, means that firms subject to a skilled persons' report are unlikely either to admit it, or to discuss specific matters about it, during interviews. What follows, therefore, reflects general perceptions of interviewees in firms about the new s.166 skilled persons' reports.

These perceptions have been set within the context of the almost universal comment by senior management of the importance attached by chief executives to maintaining a satisfactory relationship with the FSA. A senior accountant from a bank [F11] explained:

There is a corporate culture, and there has been under this chief executive and the previous two, that you must keep the regulators on side.

The way to achieve this, at least for large firms, was to adopt a proactive approach to liaison with FSA regulators. Another senior accountant at this bank [F12] commented:

I think we are very good at keeping in touch with what we're doing, running things by them, etc. So we're very proactive in our relationship with them, and maybe that's why we don't feel they've visited us that often.

Financial services firms tended to regard s.166 skilled persons' reports essentially as an important reserve power for the FSA to be used in the context of a risk mitigation programme where an evaluation of the benefits/costs justified its use. A senior accountant from a bank [F9] commenting on s.166 put it as follows:

I think in principle I don't have a huge problem with that. ... In principle it seems an appropriate thing for them to reserve the right to do. ... It's healthy that they get the right experts to look at the right areas.

The reaction from other financial services firms, such as building societies and insurers, which were not previously subject to s.39 reporting accountants' reports, was in a similar vein although rather more circumspect. The concern was to have an influence over the scope so that the skilled persons' report was useful to the firm as well as to the FSA. A senior risk manager at a building society [F17] commented:

Am I concerned about getting a s.166 report? Not overly, but if I do have to have one ... I'll make sure I get some value out of it by making sure they look into the issue properly. So that's why it's important I get an input into the scoping letter rather than just using it as pure external audit. It all comes back to the need for risk-based rather than rules-based supervision.

A senior accountant at an insurer [F33] was even more cautious as regards reasons for, and costs of, a s.166 skilled persons' report, and was concerned to make quite sure that the FSA was acting within guidelines stated in its Handbook:

I think were one to be in that situation, to look closely at what the FSA Handbook says ... that one would want to be comfortable that the FSA were acting reasonably, and that this wasn't just an easy way out for them to say we'll have a skilled persons' review for this, that and the next thing.

A senior accountant at an insurer [F22] expressed a similar opinion that, since the firm was paying for the skilled persons' report, it was important the firm got value from it, but recognised that, even if the firm had reservations, it was important to co-operate so as to achieve the primary objective, that is, maintaining a satisfactory relationship with the FSA. It is worth quoting the remarks of this interviewee in full on this topic as, in many respects, they encapsulate firms' views not only of s.166 skilled persons' reports but also firms' attitudes towards the FSA supervisory regime in general:

I think from the FSA's point of view it's useful, and I think we would understand its use so long as it's not abused. I think, hopefully, if they see a major issue, it would be something we could understand their view of, and then, in that case, if there were to be a skilled persons' review – which of course we'd have to pay for – that, hopefully, would be of value to us as well, and not merely an expensive way of obtaining confirmation. ... Better to have a little bit of pain and take it like a man than to actually make a stink and damage the relationship.

Where there was more disagreement among firms was over who would be the appropriate skilled person to appoint to undertake s.166 reports. Setting aside the issue of independence, this ranged from the emphatic view that the Big Four accountancy practices still had all the necessary skills, to the view that emphatically they did not! The former argument was most clearly articulated by a senior accountant from a bank [F1]:

Arguably they have the skills-base to do most things. If there's something very specialised then they can buy it in. Just thinking out loud, I can't imagine anything they'd want to commission under a s.166 with which our auditors or reporting accountants wouldn't be able to cope.

This interviewee initially qualified this view and observed that, since a number of the Big Four were disposing of their consulting arms, this might not continue to be the case. However, this interviewee came back to the point that whatever occurred within the bank, however complex, was still subject to audit and, therefore, the auditor had to have the expertise. This interviewee illustrated the argument as follows:

Don't forget, the auditor has to audit it. ... In our trading businesses we use complex models for valuations. ... Because we use models to value our products and therefore I want to use those for financial reporting, the auditor needs to satisfy himself that the models work. And so he can't hide behind the fact that they're complex models, therefore he can't audit them. He's got to find some way of auditing them. If he can do an audit, he can do a s.166.

The other end of the spectrum was represented by the views of a finance director of a bank [F10] who thought a s.166 skilled person's report would require specialised skills not possessed by auditors:

I suspect that the skilled person is in areas where the external auditors do not have the skills to be able to do the job. And that could be IT, it could be treasury. Not all external auditors have the skills to be able to do reviews into treasury, or even all the IT skills, particularly the ones getting rid of their consultancy arms.

Not surprisingly, insurers anticipated that, for them, the most likely skilled persons to be appointed would be actuaries to look at, for example, reserving levels. However, this was also connected with the role of appointed and external actuaries.

Assuming that auditors had the requisite skills and that there were no independence issues, the main reason for firms favouring auditors undertaking s.166 skilled persons' reports was the same as for s.39 reporting accountants' reports: cost. This was emphasised by a senior accountant with a bank [F3] who noted that:

There's also a real cost issue. Inevitably they have a detailed knowledge of your business so when they come in to do something generally they should be able to do it more quickly and cost-effectively than someone coming in with no knowledge.

Another issue, regarded as particularly important by this firm and the interviewee, was the issue of confidentiality. The more outsiders that were given access to the detailed workings of the firm, the more it was possible for sensitive information to leak out. This was put forcibly as follows:

My natural inclination has always been to use the auditors where possible. Not because the auditors are in our pocket or heavily influenced, rather than influential, but because whoever comes in to these positions has to get some fairly detailed and intimate knowledge of the organisation, which can be sensitive. ... And, therefore, the fewer people that know the intimate details of our business, the better. That's always been our historical view ...

This is a key issue which should not be underestimated. However, this opinion was qualified by the view that times were changing and that, post-Enron, the role of auditors in undertaking non-audit work, including s.166 skilled persons' reports, would need to be reviewed.

Auditors

Partners in accountancy practices recognised that there was a fundamental change between the 'old' s.39 reporting accountants' and the 'new' s.166 skilled persons' reporting regimes. This was not so much

because s.166 reports involved skilled persons rather than accountants but because s.166 reports were non-routine and were commissioned on a benefit/cost basis as part of a risk mitigation programme. As a partner [A9] commented:

The new reporting accountant regime or skilled person regime, as the FSA keeps reminding us, it might not be using accountants – that's still way up in the air. There have been a few reports. We really don't know where they're coming from.

An important issue for this partner was that this very flexibility would give rise to problems. In comparison to s.39 reports, where guidelines for reporting accountants were developed by the APC (see APC, 1987; 1989), s.166 reports were 'free form', where there was no prescribed format. This partner suggested to the FSA that some form of guidance was necessary in order to avoid an extended debate over the scope and form of opinion for each s.166 report:

We've said to them – well, we really need to develop some guidance because if you have something which is completely free form you'll spend six months discussing the scope and form of the opinion, before which time the problem's either gone away or become fatal!

The reason for appointing a skilled person to report was that the FSA wanted an opinion, which inevitably made the skilled person open to litigation. As this partner described it:

Being a regulator, they'll almost always start by wanting an opinion, and if we're going to give an opinion you've got to come up with what type of opinion you can give. ... And we're not going to start issuing blanket opinions – 'internal control is adequate'. That's a ticket to lawsuits. ... This is not risk free work by any means.

Another partner [A11] also saw professional liability as a major issue, potentially preventing the FSA making the best use of skilled

persons' reports, especially in the light of the recent experience of the demise of Andersen:

It seems to me fundamental that if a body like the FSA is going to have professional firms [accountancy practices] to be able to co-operate fully, be frank in their opinions, and be open, then they need to be doing that within the constraint of a limitation of liability. I'm not talking about a small number ...

The APB issued the previous guidelines for s.39 reports. For skilled persons' reports, guidance has been issued by the ICAEW. Although it has been issued by the ICAEW rather than the APB, as one partner [A9] stated, this was not a primary concern. The key was that guidance had been issued:

Personally as a practitioner, I don't care whether it's got ICAEW on it or APB. I want a body out there that issues professional guidance.

If a partner in an accountancy practice was concerned about having professional guidance, clearly an issue for other skilled persons undertaking s.166 reports was the extent to which their professional bodies also provided guidance to members.

So far as the role and nature of skilled persons' reports were concerned, partners noted that, compared with s.39 reports, very few s.166 reports had so far been commissioned, but also commented that in any case the number of s.39 reports had declined in the years immediately prior to N2. One partner [A8] saw s.166 reports as a 'raising of the game' as compared to s.39 reports. This partner believed that the FSA would use skilled persons' reports sparingly, partly because of the need to justify the benefits *versus* costs of using s.166 as a risk mitigation tool, and partly because of the need to send appropriate messages about London as a financial services centre:

They've had to think in a softer way and say to the industry we're not about to send storm troopers in all over the financial services

businesses in London in a way which causes people to say this just isn't a good place to do business, and people scream about the cost.

Another partner [A11] envisaged three main uses for skilled persons' reports. The first would be to address a 'short term' problem where the FSA was looking for timely assurance on a particular issue. An example was given about whether management had adequate systems in place for monitoring solvency. The second would be linked to a possible enforcement or disciplinary action. An important aspect in this case would, potentially, be the need to conduct such a report to criminal justice standards. The third, and more typical, would be closely linked to the outcome of the FSA's risk-based assessment of a firm where a skilled person's report would be identified as an appropriate risk mitigation tool. This partner stated: 'We are seeing fewer of these than we expected'. However, another partner [A9] commented: 'We're expecting probably to see overall the same sort of level [as for s.39 reports] but spread across the whole of the financial services industry – so rather less for banks, more insurance ones'.

An important issue for accountancy practices was the extent to which the audit partner/team would be involved in s.166 reports compared with s.39 reports. The view was that skilled persons' reports would arise because of specific concerns and, therefore, the scope would be more precisely defined and focused. This made it less likely that the audit partner/team would be involved. A partner [A9] commented:

Going forward, because the use of s.166 implies some sort of concern, we believe we should have a fresh pair of eyes on it, and so we'll put another partner on it. We've always had an independent partner review of all our s.39 reports anyway. But now we're thinking for s.166s, we're planning they'll be led by an independent partner in most instances. ... Partners' judgements are the ones that really matter on a s.166.

However, this was not to say that that the audit partner/team were not involved in discussions. As previously emphasised, the benefit/cost equation will still tend to favour the firm's auditor conducting a s.166 report, but with an independent team. As another partner [A11] commented with reference to a recent s.166 commission:

We identified an independent team and they did it - obviously discussing with the audit team in terms of getting an assessment of the individuals they were going to deal with, and the risks. ... So we got the benefit of the audit team's experience in agreeing the scope and in the background, but we used separate staff ...

It is not necessarily the case that the FSA would ideally prefer an independent skilled person but reluctantly settles for the auditors because of the cost to the firm. By reference to a recent assignment another partner [A7] illustrated the reasons why the FSA might actually prefer the accountancy practice to produce a s.166 report:

We want you to do it because you are the auditors. Because this is a complex, international, multinational organisation, you, the audit firm [accountancy practice], understand the business. We don't want another firm [accountancy practice] having to get up that learning curve. We want this done quickly, efficiently, cost effectively...

An interesting question, since the advent of N2, has been the extent to which auditors have regular contact with regulators. For banks, the framework of undertaking annual s.39 reports and the associated trilateral and bilateral meetings no longer exists, and it is not clear how it will be replaced. As one partner [A9] put it:

That's gone! So at the moment it's very unclear what the communication forum will be between the supervisor and the auditor. ... some of the contact which probably built up over time between auditor and supervisor, there's now no obvious mechanism for maintaining it ... but I think we're, sort of, watch this space.

This partner felt there was a ‘commonality of interest’ between auditor and regulator, but it required a framework for it to occur because of client confidentiality rules. Another partner [A11] confirmed this lack of contact between auditor and regulator:

You’re right – these are not occurring. It’s not less regular, they’re just not occurring. I think there’s been a swing away, and it’s swung too far away, from using the auditor ...

This partner noted that the BoE was ‘in the vanguard’ of using auditors, but felt there was a swing by the FSA away from using auditors because ‘auditors are of slightly bad taste at the moment’! However, this partner believed that the pendulum would swing back and that contact between auditors and regulators would be re-established. This partner also believed that auditors and the FSA had interests in common:

We, the auditors and the FSA ... we have similarly overlapping positions in this area and to ignore the co-operation we can offer each other would be quite inappropriate.

These partners were primarily responsible for banking clients. However, another partner [A10] primarily responsible for insurance clients, had a very different experience of contact with the FSA since N2. Before N2 there was virtually no contact between auditors and the DTI Insurance Directorate as part of the ongoing supervisory process. Thus, the partner’s view from an insurance perspective as compared to a banking perspective could hardly be more different:

As of N2 the regulator has been embarking extensively on a round of bilateral or trilateral meetings as part of their general supervisory process. They’re starting on the large ones - and I think on all of our large ones we’ve had bilateral or trilateral meetings with the regulator on them. In virtually all instances that would have been the first occasion that that’s happened ...

This partner was of the view that for insurance companies the new system of regulation initiated by the FSA represented a 'step change' and was a 'distinctly different' kind of regulation to that of the DTI Insurance Directorate. This partner identified possible reasons for the dramatic increase in the involvement of auditors in the supervisory process as follows. First, it was because the FSA had identified the insurance sector as its 'highest priority' and about which it had the 'greatest number of concerns', since it believed that the quality of controls and risk management of insurers was on a much less developed scale than banks. Also, the recent experience with Independent Insurance and Equitable Life tended to reinforce this. Second, the FSA's aim was to make supervision common across all financial services sectors by 2004, so that a 'big push' was necessary to achieve this. Third, because of the previous style of regulation, the FSA 'does not know much' about insurance companies as compared to banks.

Thus, this partner characterised contacts between auditors and the FSA as part of a 'learning process', especially since a number of insurance company regulators came from a banking background:

... a lot of what's going on is fact finding, understanding, getting a feel, getting more detail. Therefore, we're a reasonably sensible point of call to get some flavour of that. ...

Overall, the impression gained from interviewing partners about contact between regulators and auditors was that contact for partners responsible for insurers had increased significantly, and that contact for partners responsible for banks had diminished. This reduction for banks may in part be explained by the undertaking of 'quasi' or 'shadow' s.166 reports, an issue also raised by some interviewees from financial services firms. Typically, such a report would be undertaken by the internal audit department of the bank. The advantage of this from the FSA's point of view was that there was no need formally to consider the benefits or costs of commissioning a full s.166 report.

From a bank's point of view, the advantage was that it could satisfy FSA requirements without the need to employ, often at considerable expense, a skilled person. One partner [A6] supported the view that one of the reasons for the diminished contact with auditors might be because work, formerly conducted under s.39, was now being undertaken by internal audit departments:

A lot of the work you might have given to an external auditor under the s.39 regime has gone to internal audit and that diminishes the need for dialogue with the external auditors as well.

Another partner [A1] believed that this was often the preferred route for regulators as this obviated the need to consider the benefits or costs of a s.166 skilled persons' report:

It's certainly our experience of internal audit providing reports to the regulator is that they welcome it. They prefer to do it than have to seek a report from external skilled persons. So yes the regulator will say, 'we would like you to commission internal audit to report on ...' That happens all the time.

Another partner [A6] confirmed that 'there is no question it happens'. It did not seem that partners objected to a loss of work. Partners were well aware of the need for assessing the benefits and costs of using regulatory tools and recognised that internal audit might be cost effective:

I think the burden of regulation continues and, therefore, cost effective regulation will continue to be a driver. So reliance on internal audit, where appropriate, I think will continue to be the first choice. But clearly you cannot rely on internal audit for everything in all organisations.

However, if regulators too readily demanded 'quasi' or 'shadow' s.166 reports to be undertaken by internal audit departments, there was a possible danger of reverting back to the routine associated with

s.39 reports with the costs of this regulatory tool remaining hidden in firms.

Regulators

Apart from the substitution of ‘skilled person’ for ‘reporting accountant’, the initial impression was that s.166 FSMA 2000 was quite similar to s.39 of Banking Act 1987. However, the decision to employ s.166 must be considered in the light of the FSA’s statutory regulatory objectives and principles of regulation as set out in s.2(2) and s.2(3) respectively, and as interpreted by the FSA in its Principles of Regulation and in conformity with the new risk-based approach as described by the FSA in *A New Regulator for a New Millennium* (FSA, 2000a) and subsequent publications. This was emphasised by a regulator [R4]:

The skilled persons’ regime ... is new in a sense although it represents elements of the pre-N2 regimes of some of the previous regulators. It’s probably fair to say ... the legislative framework looks very similar to s.39 of the Banking Act. The way we intend to use skilled persons will be quite different from the way banking regulators used reporting accountants.

The key FSA principles were, first, economy and efficiency – ‘when addressing a specific risk the FSA will aim to choose the options which are most efficient and economic’; and, second, ‘proportionality’ – ‘the restrictions imposed on firms and markets should be in proportion to the expected benefits ... One of the main techniques which the FSA will use is analysis of the costs and benefits ...’ (FSA, 2000a, para 18).

As with s.39 reports, costs of s.166 reports are borne by the firm. It was, therefore, in the interests of the financial services industry, not only for banks, who had experienced the s.39 regime, but also for all

other financial services firms to lobby against the regular use of s.166 reports. As a regulator [R3] noted:

... The industry as a whole, both those who were familiar with a similar regime, like banks, and those who are not familiar with the regime, which is the rest of the financial sector, made long and loud noises about the potential cost of this.

The FSA's policy on the use of skilled persons is set in the context of the principles of economy and efficiency and of proportionality and is given in the FSA *Handbook* (SUP, 5.3). The policy is set out in considerable detail but, in summary, the concerns of firms have been allayed in two main ways: first, s.166 reports will not be used as a matter of routine; and, second, their use will be in the context of the FSA's risk-based approach. Thus, the FSA undertakes a risk assessment of a firm, and identified risks are assessed against the risk of the FSA failing to meet its statutory objectives. The outcome of the risk assessment is communicated to the firm, together with a risk mitigation programme. The FSA has a number of risk mitigation tools at its disposal, one of which is the appointment of a skilled person under s.166. This was described by a regulator [R3] as follows:

What we're trying to get to now is that we have identified a specific risk to our statutory objectives, which is how all of this is now framed, which we need to mitigate. And one of the ways we might want to mitigate that would be to get a skilled persons' report.

Another regulator was at pains to emphasise that other options would be considered, for example, whether the risk could be mitigated by the FSA undertaking the work itself and using its own resources, whether the issue could be addressed by making use of existing material such as internal audit reports, or whether the FSA could rely on the firm to provide the information. Thus, using s.166 was seen by this regulator [R4] as a 'last resort':

The commissioning of a report from a skilled person is essentially the last resort if we can't get the information in any other way.

Another regulator [R6] felt that while there was an element of truth in this view of a skilled persons' report as a last resort, the issue was more a question of making sure the benefits outweighed the costs of using s.166 as a risk mitigation tool:

In some ways that's true. I'd say more it's seen as an expensive tool so you have to justify the cost of using it. So the question is – could you get the same level of comfort on a regulatory tool that was cheaper?

This regulator commented that the decision to require a skilled persons' report was also related to the FSA's overall risk assessment of the firm. The firm would need to be rated at least medium/high to justify its use as noted by the same regulator:

You've got to have rated it at least medium/high depending a bit on the size of the firm – there is that sort of trade-off. It's got to be something that's fairly high risk before it justifies a skilled person's report.

The obvious difference between s.39 and s.166 reports is that the former were undertaken specifically by reporting accountants, the latter are undertaken by skilled persons – a wider group that might include other professionals, such as actuaries and lawyers, or technical specialists in, for example, IT, treasury, risk and compliance. Regulators stressed that, as in other areas of supervision, the past practice of previous regimes should not automatically continue. There should not be a 'presumption' that the auditors should be appointed as skilled persons. Rather, the emphasis should be on choosing those having the most appropriate skills set, whilst recognising that education might be required to change habitual thinking as regulator [R4] stated:

The key thing we're focusing on is the skills which are needed to deliver the particular report that we're interested in. The regulatory product, if you will, is the report ... So there is an education job to do for us with our staff, focusing on that product and who's the right person to deliver it.

Although regulators prescribe what the skilled persons' reports should cover, as with s.39 reports the contractual relationship is between the firm and the skilled person. Regulators must approve the nominated skilled person, and may refuse approval on grounds, for example, of conflicts of interest or of insufficient expertise. However, it was recognised that withholding approval would be exceptional, and it was accepted that in most instances firms would still be likely to nominate their auditors by 'default' for 'efficiency reasons'.

The audit of financial services firms is dominated by the Big Four accountancy practices. This dilemma was recognised by another regulator [R7] who noted that the supervision manual states that the FSA may draw up a short list for a firm to choose from (*SUP 5.4.6*). The problem then became who should the FSA select for the short list? As with firms, the FSA's fallback position would in effect be the Big Four accountancy practices. As this regulator commented 'they're the people we know most about'. However, another regulator [R6] identified cases where auditors had been appointed as skilled persons, but also noted cases where this had not happened.

The FSA's supervision manual makes it clear that auditors are required to co-operate with the FSA in the discharge of its functions under the Act, which may include attending such meetings as the FSA requests and supplying any information that the FSA may reasonably require. As regards skilled persons, similar requirements are imposed by contract. The FSA supervision manual requires that firms must, in the contract with the skilled person, require and permit the skilled person, during and after appointment, to co-operate with the FSA in the discharge of its functions under the Act.

For banks, although not for other financial services firms, bilateral and trilateral meetings involving auditors took place on an annual basis. However, in keeping with the FSA's regulatory objectives and principles of regulation and its risk-based approach, this annual round of meetings no longer takes place. As a regulator [R3] explained:

It's changed in the sense there's no standard expectation. We do encourage regulators to talk to auditors. But there is no expectation that that will be done annually, or every couple of years, or bilaterally, or trilaterally, or whatever.

In addition, it was pointed out that since the number of firms supervised by the FSA was now so large, it simply was 'not practical' to make meetings with auditors part of the FSA's 'standard procedure'. Nevertheless, it was seen as 'likely' that regulators of high impact firms would seek meetings with auditors. It was further argued that the issue of meetings with auditors illustrated the FSA's new risk-based approach to supervision, the aim of which was to develop a 'tailored relationship' with firms.

Whilst a major thrust of FSA policy has been to develop individual supervisory relationships with firms, based primarily on the FSA's risk assessment of a firm, it has to be done in the context of an integrated supervisory regime that applies to all financial services firms. As another regulator [R5] pointed out:

The fact is, we are all operating under a common regime, under common internal procedures and processes guidance, consciously using the same tools and the same methodologies, having the same risk-assessment processes.

The creation of the FSA as a single regulator highlighted 'significant differences' between the regulation of insurance and other sectors in respect of types of risk, such that insurance regulation was in need of a 'major overhaul' resulting in the 'Tiner Project'¹. A comparison

between previous regimes for banking and insurance was made and consistency required insurance regulation to be more closely aligned to that for banking. As this regulator explained:

There is a deliberate and publicly announced intention to bring insurance supervision and the way insurance firms conduct themselves ... more up to banking levels. ... The consistency of our risk assessment and the use of tools that we make under risk mitigation programmes will be measured, not only against other insurance firms, but against banks.

Banks have long been familiar with regular meetings with the BoE, reporting accountants' reports, and bilateral and trilateral meetings. Under the FSA's risk-based assessment process, banks are likely to experience a considerable reduction of such involvement. However, insurance firms that never have experienced such hands on involvement, are likely to experience an increase. The same regulator saw this as a 'cultural issue' for insurance companies:

Culturally there's a difference. Culturally, insurance firms have not been used to this kind of thing and they need to be brought into developing a closer relationship with their supervisor is in their interest as well.

This regulator saw a skilled person's report as an example of a cultural factor, but recognised that cultural change does not happen 'overnight'. Similarly, this regulator also commented on the lack of involvement of auditors in the previous supervisory regime for insurance companies compared with banks, but anticipated that involvement would increase:

I would see that we will be developing closer relationships with the auditors of insurance firms. ... I think supervision is missing out on some opportunities as a result.

However, the previous regime of insurance regulation gave a prominent place to the role of the appointed actuary. Thus, as this regulator put it, there seemed to be a view that:

Provided the actuaries are happy, you're happy. If the actuaries are not happy, you're not happy. ... If the appointed actuary is happy with something, then it's not really a matter for the auditors to worry about.

This regulator saw this as a 'false logic' and no longer sustainable under the FSA's Principles of Good Regulation. The FSA is conducting a review of the future role of the appointed actuary in insurance regulation, which may result in closer monitoring by the auditor, together with an emphasis on the role of senior management, including non-executive directors, being responsible for a firm's activities and for ensuring its business complies with regulatory requirements in accordance with the second of the FSA's Principles of Good Regulation (see section 6.2.2).

Dual role of auditors and reporting accountants/skilled persons

Under the Companies Act 1985 auditors have a duty to report to shareholders. Under the previous financial services legislation, auditors could be appointed as reporting accountants. Auditors and reporting accountants had a right and duty to report to the regulator if any matter came to their attention that would cause the regulator to consider withdrawing authorisation of the firm, and the reporting accountant could be required to attend bilateral and trilateral meetings with the regulator. Similar provisions as to the right and duty to report to the regulator for auditors (and actuaries) are included in FSMA 2000. Section 166 FSMA 2000 includes provisions for the appointment of a skilled person to undertake a report. Thus, accountants acting as

auditors and skilled persons (or reporting accountants under previous legislation) have a dual role in reporting to shareholders under the Companies Act 1985 and to the FSA as supervisor, under FSMA 2000.

Interviewees were asked to consider whether this gave rise to threats to auditor independence, or a confusion of responsibilities or conflicts between the role of auditors reporting ‘publicly’ to shareholders and ‘privately’ to regulators. Most interviewees, whether from regulators, accountancy practices, or financial services firms, either did not see this dual role as a significant problem, or believed that there were sufficient checks and balances in place to act as safeguards, or argued that the dual role could be justified on a benefit *versus* cost basis.

The dual role was recognised, but the reason for not seeing it as a significant problem was a view that the interests of auditors and regulators were closely aligned. This tended to be the view of regulators. In considering the background to the original s.39 provisions, a regulator [R5] commented as follows:

This was all predicated on the assumption, that I think was a very fair one to make, ... of a common interest between auditors and supervisors, albeit with, of course, the difference – the auditors are there to protect the interests of shareholders, and the supervisors are there to protect the interest of depositors.

Another regulator [R6] stressed the issue of independence – shareholders expected that auditors were independent of management, and so did regulators who were commissioning a s.166 report:

What I'm expecting there, actually, is a fairly independent view anyway of the management, and that's the same really when they're reporting on behalf of shareholders. The independent view from management – that's what you actually want!

This regulator made the important point that undertaking a s.166 report did not compromise auditors' independence. Rather, it was if the amount of consultancy work in general undertaken by auditors, compared to audit work, became 'out of kilter' that could threaten independence, whether to shareholders or to the FSA. Interestingly, this regulator was also inclined to categorise s.166 as consultancy work. Thus the basic question was – are auditors independent of management? As this regulator commented:

I think we ... have concerns about independence, generally, if the amount of consultancy work, and I would include skilled persons in consultancy work, and the amount of audit fee, becomes out of kilter. ... What you do want to avoid is them actually doing too much consultancy work, that really they are more worried about losing that. And actually what they then lose is their independence from management, whether it's on behalf of shareholders or on behalf of the FSA.

Another regulator also drew attention to areas of specific and self-evident concern about auditor independence, for example, where a skilled persons' report was to investigate an issue which the FSA believed should have been covered during the audit, or about which the accountancy practice had previously given consultancy advice. A final possibility was where the FSA believed the accountancy practice did not have sufficient expertise to undertake the assignment.

The view that the dual role was not a problem was also the view of auditors. Although it might be regarded as self-serving, it was genuinely believed by audit partners that it was not a problem, who argued that sufficient checks and balances were in place to remove any doubt about their independence. A partner [A9] argued as follows:

When you look at the objectives of the statutory audit and the objectives of the regulator, there isn't really any inherent conflict. The auditor is supposed to give an independent view to the shareholders

of the financial position of the institution. As reporting accountant you're giving an independent view of the control environment, and there is so much overlap between those two that I don't see that as a conflict.

This partner identified two areas where regulators might have understandable concerns. First, regulators might believe that the general duty of client confidentiality might 'get in the way' and make auditors less than open and frank in dealings with the FSA. However, as this partner pointed out, there are 'legal protocols' in place which gives the auditor relief of this duty in dealings with the FSA, and is built in by contract for s.166 skilled persons' reports. Second, regulators may believe auditors are 'too close to the client' and 'won't take a stand' against the client in front of the regulator. This partner pointed out that the accountancy practice's view was that partners should be prepared to maintain that degree of independence from the client, and that this policy would be enforced. The partner emphasised:

... that if the supervisor feels that an individual partner is not taking a sufficiently robust line then I would personally prefer the supervisor to tell me, and I'll do something about it.

As regards the issue of reporting publicly to shareholders and privately to the regulator, another partner observed that auditors' options to report concerns publicly, under the Companies Act 1985, were in fact quite limited and amounted to either qualifying the audit opinion in some way, or to resigning as auditor. The only channel that has been provided for 'whistle-blowing' is for auditors to report their concerns to the FSA under FSMA 2000, and it was the responsibility of the FSA to decide what action to take. Auditors would need to consider whether the whistle-blowing would affect their opinion on the financial statements, which concerned not so much the accounts but what should be properly disclosed.

Interviewees from firms saw very little conflict between the dual role of auditors and reporting accountants/skilled persons, and tended to view the issue from a benefit *versus* cost perspective. A senior accountant [F10] illustrated the situation describing the problem in terms of a Venn diagram:

I think if you did it diagrammatically you'd have two circles, the audit for the shareholders and the regulators, and actually most of the circles would be over each other. There would be a little bit ... where maybe they don't overlap. So I would say, my answer would be, in most cases, it's complementary. But there are areas, I'd want to make sure, where they don't complement, they work against each other – but very, very small.

On this basis this senior accountant was reluctant to countenance a separation of the roles, or of banning auditors from undertaking non-audit services, arguing that the increased cost of regulation was borne, first, in a narrow sense by shareholders and, second, in a wider sense by making the UK financial services market less competitive. As regards shareholders this interviewee commented:

What I would say is I can't see the logic of increasing the costs for shareholders. Because let's get something straight – nobody is recompensing the shareholders or the company for the cost of this regulation, and it's the shareholders that are effectively bearing the cost – not the saver, not the borrower. ... Now what does it add to the shareholder? It adds a bit of security I agree but you have to be sensible about making sure that you use the appropriate people who are going to give you a value report without it being massively expensive.

This interviewee argued that in practice there were sufficient safeguards, especially post-Enron, as firms, executive and non-executive directors, audit committees and auditors themselves were far more

conscious of possible conflicts of interest and threats to independence. The main concern was that regulation did not lead to ‘strangulation’, such that financial services in the UK did not become uncompetitive as compared to Europe:

... it's got to be a balance between regulation and strangulation. Because the more you regulate, the more you increase the cost base, the more you're likely to find people in Europe doing something in the UK that, effectively, we can't do.

Another senior accountant [F9] recognised the possible conflict of interest and threats to independence, but argued that the quality of advice also needed to be taken into account in considering the benefit and cost balance. In this respect the advice of an experienced audit partner, who had an in-depth understanding of the firm, could prove to be invaluable not least to the regulator:

We used to have a fairly regular lunch with the audit partner, who was probably in his fifties at that stage, and I really used to look forward to that meeting because we'd be quietly talking over lunch and he'd just throw in this question, very quietly, very politely, but it was right to heart of a key issue that the organisation had to address, whether it was a problem with a senior individual or whether it was a business issue. You could see that he was very much in touch with the organisation ... So a skilled auditor who has that ability, I think, is of more value to the FSA in the context of the Enrons of this world, than somebody who is completely from outside.

For this interviewee, the key issue was the integrity of the auditing profession. Thus, it would be ‘healthier’ for the regulator who would get more ‘value’ by having someone with knowledge of the firm because that’s where the ‘real’ issues would surface. This interviewee’s opinion was:

If you believe in the integrity of auditors, they are much better placed to observe and pick up those things than somebody who has come in and never met the organisation before ...

It is perhaps here that a discussion of the dual role for auditors and reporting accountants/skilled persons should rest. It is not so much whether the interests of shareholders and regulators are closely aligned, or whether there are sufficient checks and balances in place, or whether the dual role can be justified on a benefits/cost basis. The fundamental issue is the actual and perceived integrity of the profession.

Summary

The objectives of this chapter have been to provide empirical evidence regarding, firstly, the post-FSMA 2000 situation for the role of auditors and skilled persons and, secondly, the nature of the dual role of auditors and reporting accountants/skilled persons.

As regards bilateral and trilateral meetings with the regulator, experience was mixed. Contact appeared to be much reduced for banks but much increased for insurers. This appears to be in accordance with the FSA's stated policy of focusing resources on areas where it perceives risks to its objectives to be greatest.

As regards the new s.166 skilled persons' reports, the FSA policy on their use is set out in considerable detail in the rules and guidance contained in the FSA Handbook. Reports are specially commissioned as part of a risk mitigation programme which represents a sea change away from the routine nature of s.39 reporting accountants' reports. The main differences from s.39 reports are that the range of persons who may undertake such reports is widened, that reports are regarded as a non-routine regulatory tool and that, in commissioning them, the FSA must have regard to the cost and benefit, and the use of alternative regulatory tools. Thus, firms' potential concerns are allayed in two ways - s.166 reports will not be used as a matter of routine and their use

will be in the context of the FSA's risk-based approach. Interviewees viewed favourably the ability to appoint a wider range of professional persons and the fact that they were not intended to be used as a matter of routine. However, there was a general belief that, except where there were good reasons to the contrary, skilled persons' reports would continue to be conducted by the auditors who were generally perceived as able to undertake the work effectively and, certainly for the Big Four accountancy practices, as possessing all the requisite skills. Overall, there was little evidence of an expectations gap emerging between the role as set out by the FSA and firms' experiences. However, it should be acknowledged that this is in the context of the relatively few s.166 reports that have been commissioned thus far.

As regards the dual role of auditors in reporting to shareholders under the Companies Act 1985 and to the regulator under both the previous financial services legislation and FSMA 2000, this was not seen as a major problem by regulators, auditors or financial services firms. This was because the interests of shareholders and regulators were perceived to be aligned, or that there were sufficient checks and balances, or that the dual role could be justified on benefit and cost grounds. However, whatever safeguards for independence are established, the actual and perceived integrity of the profession is fundamental.

Thus, the overall picture to emerge is one in which the requirements of the key interested parties are not compromised by the dual role. Indeed, it can be argued that the knowledge reporting accountants/skilled persons are able to leverage about firms where they are also acting as auditors at least reduces the time necessary to understand firms and hence the cost and, at best, enhances the quality of the reports.

ENDNOTE:

¹ FSA (2002b, p.3), see also previous Progress Reports (FSA, 2000b; 2002a).

CHAPTER SIX

CONCLUSIONS AND IMPLICATIONS

The aim of the study was to investigate the role of auditors and reporting accountants/skilled persons in the system of UK financial services supervision. In particular, the study investigated the dual role of auditors in the financial services industry reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons under FSMA 2000 and previous legislation, in particular, the Banking Act 1987. The findings of the study are based on interviews with individuals occupying senior positions including: chief executives; finance directors and chief accountants; and senior partners. It is a measure of the topicality and importance of the subject that the researchers were able to obtain access to high-level individuals in the financial services community.

Themes and implications

Reporting accountants' reports - from innovation to ritual to reform

The introduction of s.39 reporting accountants' reports in the Banking Act 1987, and the associated bilateral and trilateral meetings, gave the BoE extra powers for the detailed and expert investigation of accounting and other records and internal control systems. As auditors, banks and the BoE gained experience of understanding and using reporting accountants' reports, three phases of development can be identified up to their replacement by skilled persons' reports.

The first phase involved coming to grips with the major innovation that s.39 reports involved: identifying the scope; undertaking the report; giving an opinion; and, discussing the findings. Of these, defining the

scope was crucial, as it set the agenda for the report. Setting the scope involved a process of discussion and negotiation so that the scope met the requirements of the BoE, whilst providing benefits to the firm at a reasonable cost to the firm, and on which the auditors could deliver an opinion. There was a learning process whereby the scope of s.39 reports became more focused, and of mutual benefit to the firm and the BoE, and the role of the auditor/reporting accountant became more clearly defined, partly through professional pronouncements, and the parties became more comfortable with bilateral and trilateral meetings.

As the number of s.39 reports increased and as the process developed into an annual cycle, there was a danger that an element of routine would creep in. What started as a significant innovation was in danger of becoming a taken-for-granted ritual. This might have been the case had not the Barings scandal intervened. Following the failure of Barings in 1995, the BoE undertook a reappraisal of its supervisory methods which led to the introduction of a risk-based approach to supervision known as RATE. This was a significant reform which would be taken further by the FSA. The new risk-based approach reinvigorated the s.39 process, but by then the new Labour government in 1997 was contemplating a wholesale reconstruction of financial services supervision.

Risk-based approach to supervision

The FSA, as the new single regulator of financial services firms, developed a risk-based approach to supervision known as ARROW. The FSMA 2000 changed reporting accountants' reports to skilled persons' reports. Skilled persons' reports were only one of the risk mitigation tools available to the FSA. Unlike reporting accountants' reports, the FSA did not use skilled persons' reports as a matter of routine, and their use had to be justified on a cost-benefit basis. The

change in supervisory regimes post-FSMA 2000 profoundly affected both the relationship between the supervisor and firms, and also that between the supervisor and firms' auditors.

As regards auditors of banks, contact with the supervisor declined, from being routine and annual, to exceptional. Much of the decline was due to the FSA's risk-based approach to supervision. The change from s.39 reporting accountants' reports to s.166 skilled persons' reports also played a part. Thus, in contrast to the BoE, which routinely used auditors/reporting accountants as an aid to supervision, the FSA predominantly uses its own front-line supervisors to form its risk-assessment. For building societies and friendly societies the requirement for firms and firms' auditors to make an annual report to the relevant supervisors was discontinued. Interestingly, following its risk-based approach, at the sectoral level the FSA has identified insurance as being of relatively higher risk than other sectors and has allocated its supervisory resource accordingly. In insurance, pre-FSMA 2000 there was little, if any, contact between the auditor and supervisor. Post-FSMA 2000 a number of meetings took place, but such meetings were generally perceived by auditors to be part of the FSA's learning process rather than anything more substantive.

Overall, the FSA's risk-based supervisory approach led to a reduced role for auditors in supervision, especially as regards banking. Auditors have unparalleled third party knowledge of firms and arguably the FSA is missing out on a significant opportunity to enhance its understanding. Indeed, a number of auditors recognised a commonality of interest with the supervisor and expressed concern that such potential co-operation was being ignored. In this context it is interesting to note that internationally, and in contrast to the UK situation, the BCBS is advocating *inter alia* regular bilateral meetings between auditors and supervisors as an aid to the supervisory process (see section 6.3.1 below).

Skilled persons' reports - good relationship with the supervisor paramount

The FSA is the new, single, powerful regulator of the financial services industry. In terms of managing the supervisory process firms gave the highest priority to maintaining a good relationship with the FSA. Firms welcomed the fact that s.166 reports were not intended to be used as a matter of routine, and the non-routine nature implied the need for, and ability to, appoint from a wider range of professional persons. There was a general expectation that, except where there were good reasons to the contrary, skilled persons' reports would continue to be conducted by the auditors who were generally perceived, certainly for the Big Four accountancy practices, as possessing all the requisite skills to conduct a s.166 report. Because maintaining a good relationship with the FSA was regarded as paramount, and the fact that s.166 reports were potentially more serious, firms were less likely than for s.39 reports to argue about the scope, or to press for a scope that provided benefits to the firm. An additional possibility for maintaining a good relationship where a s.39 report might have previously been commissioned from the auditors was that the firm might readily offer that an equivalent piece of work be undertaken by its internal audit department to which the FSA might agree, to avoid the process of justifying a full s.166 report. Thus, although maintaining a good relationship with the FSA was of overriding importance to firms, there was a degree of flexibility in how this might be achieved.

Dual role of auditors and the audit expectations gap

In the post-Enron climate all parties in the financial services sector have been acutely conscious of the need to establish clear safeguards for auditor competence and independence. The dual role of auditors reporting to shareholders under the Companies Act 1985, and to the regulator under FSMA 2000 and previous legislation was not seen

as a major problem by regulators, auditors or senior management of financial services firms. This was because the interests of shareholders and regulators were perceived to be aligned, or that there were sufficient checks and balances, or that the dual role could be justified on cost *versus* benefit grounds. Hence, for these parties there were few concerns about auditor independence. However, whatever safeguards for independence were established, the actual and perceived integrity of the profession was fundamental. Interestingly, the undertaking of a skilled person's report by a firm's auditors was against the general trend post-Enron of a decline in auditors undertaking non-audit services in order to safeguard independence but the FSA can require an alternative if it is not satisfied about the appointment of the auditors as skilled persons.

In considering auditor independence it is important not to neglect consideration of auditor competence. In financial services it can be argued that both the reduction of consultancy work undertaken by auditors for audit clients post-Enron, and the reduction by auditors in reporting to, and meeting with, regulators post-FSMA 2000, may lead to a reduction of auditors' overall knowledge of their clients. The measures taken to strengthen auditor independence, coupled with the adoption of a risk-based approach to supervision may have the unintended consequence of depriving auditors of sources of information previously used to inform their audit of financial services firms. Bearing in mind their whistle-blowing responsibilities, and the consequences of audit failure, auditors may need to insist, and their audit clients learn to accept, that greater resources should be devoted to the statutory audit of financial services firms than heretofore.

Developments during the course of the research

A number of recent developments in financial services have had implications for this research, in particular, the supervision of life

insurance firms, including the Penrose Report (2004) into Equitable Life and the FSA's continuing review of insurance regulation. In addition, there have been a number of more general developments including: the EU's FSAP; the continuing fallout from the collapse of Enron; and the DTI's proposals for the restriction of liability for directors and auditors.

Equitable Life

The research was undertaken during the period of Lord Penrose's Inquiry into Equitable Life, although the Report appeared after the interviews for the study had been completed (Penrose Report, 2004). The Report is in seven parts: annuity guarantees; the Society's approach to bonus allocation; the Society's financial position; governance and audit; policyholders' reasonable expectations; regulation of Equitable Life; and, conclusions and lessons.

The terms of reference of the Inquiry were as follows (para. 1, p. i):

To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration of life assurance business; and to give a report thereon to Treasury Ministers.

It is not the purpose of this study to consider the Report's findings in detail. However, it is helpful to highlight issues in so far as they relate to the role of auditors in the supervision of life insurance. Lord Penrose's conclusions on these issues as discussed in chapter 19 of the Report (pp. 683-727) are as follows. As regards audit (chapter 19, paras. 138-148, pp. 708-709) the following terms of reference should be noted (para. 138, p. 708):

So far as it is material, it is not within the terms of reference to form or express any views on the performance by the auditors of their contractual or professional duties.

In this context the conclusions in full in so far as they relate to the role of auditors are (para. 145, pp. 708–709):

- i. There has been a comprehensive failure by industry and by standard-setting bodies over a long period of time to formulate and put into effect accounting standards for the preparation and presentation of financial statements relating to long-term business that reflect the realistic financial position of life offices.*
- ii. Without adequate accounting standards relating to liabilities, including contingent liabilities, audit has been inhibited from effective reporting on life offices' financial statements as a whole.*
- iii. In particular, failure to provide adequate accounting standards for disclosure and valuation of future terminal bonus payments has resulted in published financial statements that failed adequately to reflect the realistic financial position of companies reported on.*

It is significant to note that these conclusions are criticisms of the insurance industry and the accounting-standard setting process rather than auditors *per se*.

Chapter 19 goes on to identify eleven key conclusions arising from the report (para. 240, pp. 726–727). As regards supervision, the report identifies: ‘... an over-reliance on the appointed actuary...’ (conclusion 7); ‘The regulatory returns and measures of solvency applied by the regulators did not keep pace with developments in the industry ...’ (conclusion 8); ‘... There was, (however), no consistent or persistent attempt [by regulators] to establish how PRE [policyholders’

reasonable expectations] should affect the acknowledged liabilities of the Society' (conclusion 9); 'The regulators also failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of a future surplus. ...' (conclusion 10); and, 'There was a general failure on the part of the regulators and GAD [Government Actuary's Department] to follow up issues that arose in the course of their regulation of the Society, and to mount effective challenge of the management' (conclusion 11). The conclusions go on to state (p. 727):

It is also significant to note that at all material times the appointed actuary of the Society was able to claim that the Society's valuation practices were consistent with applicable professional standards, and that the auditors are able to claim that the discharge of their duties met all applicable auditing standards.

Thus, in spite of the shortcomings revealed by the report, the appointed actuary and the auditors are able to claim they acted properly. As the report goes on to point out in lessons for the future (chapter 20), the crucial issue was in fact the 'interaction of audit and actuarial verification' (para. 45, p. 738). The report questions whether there should be legislation requiring a joint opinion of an auditor and an independent actuary for which they would be jointly and severally liable, but recommends that the more limited proposals of the FSA (see below) should be implemented and tried in practice (para. 49, p. 739).

In response to the report, the Financial Secretary to the Treasury, Ruth Kelly, has announced a 'programme of work to build on Lord Penrose's findings' (HM Treasury, 2004). Thus, reviews are to be undertaken *inter alia* into: the corporate governance arrangements applicable to mutual life offices (to be led by Paul Myners); the actuarial profession (to be led by Sir Derek Morris); and accounting for with-

profits business by life insurers (to be led by the Accounting Standards Board). In addition, the Parliamentary Ombudsman, Ann Abraham, has announced her intention to conduct a further investigation into the prudential regulation of Equitable Life (Parliamentary Commission for Administration, 2004).

Insurance – the role of actuaries

As part of an overall concern about the insurance sector the FSA is introducing changes to the regulation of insurers in general (see, for example, FSA, 2002b) and changes to the roles of actuaries and auditors in the supervision of insurers in particular (see, for example: FSA 2002c, 2004b). An interesting aspect of FSMA 2000 is that the Act deals with the role of actuaries and auditors in the same way. It is becoming apparent that the actuarial and accountancy professions will in future need to work more closely together in the financial reporting, audit and supervision of insurers.

In this respect, the recently announced concerns at Standard Life are of considerable interest. The FSA (2004c) statement reports that: ‘Since the company first notified the regulator of the significant divergence in its calculation of liabilities and subsequently the higher level of reserving need against the likely cost of guarantees, both parties have worked together to address the issues raised’. The FSA statement continues by announcing that:

The FSA will now commission a review by independent experts, under Section 166 of the Financial Services and Markets Act 2000, into the origins and implications of the divergence between the most recent calculation of the aggregate value of liabilities on outstanding policies using asset shares and earlier calculations.

This may indicate a rise in the use of s.166 skilled persons’ reports on insurers and is a clear demonstration of the need for greater co-

operation between the accountancy and actuarial professions. It will be interesting to observe how such a relationship might develop following the Penrose Report's criticisms of the actuarial profession, and the three subsequent reviews announced by the Financial Secretary to the Treasury.

Areas for further research

Role of auditors and reporting accountants in other jurisdictions

The study also considered European and international arrangements for the role of auditors and reporting accountants in financial services supervision (research question (iv)). These arrangements were explored with representatives from the EC and European financial services trade associations, and a review of policy pronouncements from the EC and BCBS. An important finding of this aspect of the study was that a dual role directly comparable to that of the UK does not exist at EU level. It would be interesting to consider, therefore, how the arrangements for the involvement of auditors in financial services supervision differ between jurisdictions. It was beyond the scope of this study to undertake such a review but it is important to highlight certain significant findings.

At EU level the most significant development affecting financial services in recent years is the creation of the FSAP (EC, 1999). The FSAP sets out three strategic objectives which have the aim of creating (pp. 22–30): a single EU wholesale market; open and secure retail markets; and state-of-the-art prudential rules and supervision. As regards the latter objective, the EU does not advocate the establishment of single unified national supervisors in member states along the lines of the FSA in the UK. Instead, the EU considers this to be an area where rules on subsidiarity should apply, thereby permitting member states to develop their own supervisory structures¹. Arrangements must,

however, conform to the requirements of the various EU banking and insurance Directives, including rules on the supervision of financial services conglomerates.

Under EU accounting and auditing Directives, auditors have common obligations and responsibilities for the statutory audit of all companies including financial services firms. In addition, under EU banking and insurance Directives auditors have a duty to report to supervisors where they become aware of concerns regarding the financial situation of a firm.

Thus, at EU level important areas for further research include: the extent of progress towards a single financial services market; the efficacy of prudential supervisory arrangements across member states; and, the extent of involvement of auditors in supervision.

At an international level, a significant development is that the BCBS, in conjunction with the International Auditing Practices Committee (IAPC) has issued a Practice Statement to provide guidance on how the relationship between bank auditors and supervisors might be strengthened (BCBS, 2002). The Practice Statement highlights that communications and reports by the auditor to a bank are potentially of value to the supervisor in undertaking its supervisory responsibilities. Similarly, information originating from the supervisor may be of use to the auditor in undertaking the statutory audit of a bank (paras. 48 and 49 respectively). The Practice Statement acknowledges that all communications must not breach applicable national regulations, including those governing confidentiality (para. 51). In addition, it highlights the usefulness for both auditors and supervisors of periodic bilateral meetings. Such meetings are considered one mechanism by which both parties' contributions to the supervisory process can be made more 'efficient and effective' (para. 55).

An area worthy of further research would be to examine the extent to which supervisory processes and statutory audits internationally may become more efficient and effective following increased bilateral

contact between supervisors and auditors in banking, and in other financial services sectors.

Auditor independence post-Enron

During the research study, accountancy practices and the accountancy profession, financial services firms, the UK government and the EU were in the process of coming to terms with post-Enron developments, notably the US Sarbanes-Oxley Act and its implications. In terms of the study, the most important consequence was that financial services firms were reviewing the role of auditors undertaking consultancy work, and auditors were reviewing procedures to safeguard against possible and perceived threats to independence. For financial services firms with a US listing, this meant that auditors were no longer allowed to undertake consultancy work, and even firms without a US listing were considering adopting, or had in fact adopted, such a policy. Section 166 skilled persons' reports are commissioned by the FSA and if undertaken by the auditors, arguably, should not be categorised as 'consultancy'. Indeed, if the FSA perceives a conflict of interest, it has the power to require others to be appointed. Thus, a consequence post-Enron is the decline in auditors undertaking consultancy or non-audit services and an increased perception of auditor independence.

An area for further research would be to consider how independence concerns have affected the role of auditors in financial services supervision. With the Big Four accountancy practices' domination of financial services audits such research would need to consider not only the issues of independence and competence but also the consequences of such a restriction of choice and associated competition concerns.

Risk and liability for auditors and directors of financial services firms

The problems at Equitable Life and Independent Insurance in the UK, and the failure of Enron and others in the US followed by the demise of Andersen, one of the former Big Five accountancy practices, have also increased audit partners' awareness of risk and the consequences of making incorrect judgements. Since auditors are no longer able significantly to benefit from the additional remuneration associated with consultancy work, partners are increasingly reviewing the rewards and risks of undertaking audit work and s.166 reports. Perhaps unsurprisingly, the call has been for an increase in audit fees and/or a reduction in auditor liability. In addition, directors, especially non-executive directors, are increasingly aware of the rewards and risks associated with greater responsibilities as a result of changes to the Combined Code of corporate governance following Higgs (2003) and Smith (2003). These problems for auditors and non-executive directors are seen as particularly acute in financial services firms as a result of litigation in connection with Equitable Life. The UK government has taken note of these concerns and has issued a consultation document on director and auditor liability (DTI, 2003b)². It can be argued that unless progress is made on limiting liability it may become harder, or even impossible, to secure the appointment of auditors and non-executive directors to financial services firms without a substantial increase in their remuneration.

The specific role and responsibilities of auditors and directors, both executive and non-executive, in the financial services industry is an important area where further research is needed, particularly following the publication of the Penrose Report and the current litigation and potential liabilities surrounding Equitable Life.

Summary

This research study was conducted on a particularly interesting topic at a particularly interesting time. Thus, the study spanned the period from its first executive chairman, Sir Howard Davies, when the FSA assumed its full powers as the single regulator of the financial services industry with effect from 1 December 2001, to 22 September 2003, where the role was split between the newly appointed chairman, Callum McCarthy, and newly appointed chief executive, John Tiner. Dickson (2003) notes that the change coincides with a natural evolution in the FSA's remit from one of 'policy development and reform' to that of 'policy implementation'.

From the findings of this study, it is helpful to highlight two areas of future development which may be of particular relevance for the financial services industry and the accountancy profession. The first concerns the future role of skilled persons' reports. So far the FSA has been sparing in the use of its powers under s.166 FSMA 2000, and most such reports appear to have been conducted by the Big Four accountancy practices. It will be interesting to discover whether the FSA intends to extend the use of this risk mitigation tool, and whether the Big Four will continue their dominance in conducting such reports. The second concerns the future regulation of insurers and the role of actuaries, especially following criticisms in the Penrose Report. With the FSA under its risk-based approach devoting increased resources to the supervision of insurers, the extent of involvement of both actuaries and auditors is a topic of considerable interest.

ENDNOTES:

- ¹ A review of the institutional arrangements for the supervision of financial services across the EU is contained in European Central Bank (ECB) (2003).
- ² At the time of writing final proposals from government were awaited. However, the Office of Fair Trading (OFT) in its assessment of the implications for competition of a cap on auditors' liability concluded that 'It is likely that allowing audit caps would be competitively neutral overall. Arguments that allowing caps would be pro-competitive are not compelling.' (OFT, 2004).

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