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Auditors and regulatory work (1987–2013)

From reporting accountants' to skilled persons' reports in the UK

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Abstract

Purpose – The purpose of this paper is to investigate the jurisdictional expansion of audit into the area of UK financial regulation. The paper draws on the analytical framework of new audit spaces (Andon *et al.*, 2014, 2015), which built on the concept of regulatory space (Hancher and Moran, 1989), and characterises this new audit space as regulatory work.

Design/methodology/approach – Through an intensive reading of a variety of publicly available documentary sources, the paper investigates the role of auditors and accountants in the reporting accountants' and skilled persons' regimes in the UK under the Banking Act 1987 and the Financial Services and Markets Act 2000.

Findings – The paper identifies a new audit space characterised as regulatory work, which is made up of three distinct phases (and suggests the recent emergence of a fourth phase), and considers the extent to which these phases of regulatory work share common themes across new audit spaces identified by Andon *et al.* (2015) as independence, reporting, accreditation and mediating.

Originality/value – The paper identifies a further jurisdictional expansion of audit into a new audit space, characterised as regulatory work.

Keywords Financial regulation, Regulatory space, New audit spaces, Regulatory work, Reporting accountants' reports, Skilled persons' reports

Paper type Research paper

1. Introduction

The primary responsibility of company auditors under the UK Companies Act is to provide an affirmation to shareholders that in the auditor's opinion the accounts show a true and fair view of the state of a company's affairs and of its profit or loss. In the UK, in the case of banks and the financial services industry more generally, auditors are also involved in processes of supervision and regulation. For banks these provisions were first introduced under the Banking Act 1987 and continued in modified form under the Financial Services and Markets Act (FSMA) 2000.

Relatively little has been written about the emergence and growth of the reporting accountants' regime under the Bank of England and the Banking Act 1987 and its demise and replacement by the skilled persons' regime under the new Financial Services Authority (FSA) and FSMA 2000. This neglect of these two regulatory regimes may be regarded as somewhat surprising for at least two reasons. First, the change involved an expansion of the role of the accountancy and auditing profession. Second, such change might have been expected to arouse the interest of scholars examining the development of the profession and

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investigating new forms of statutory reporting. Indeed, we suggest that the development of these regimes, which has seen "private" actors taking on a public role, might have been expected to arouse the interest of scholars working on developments in regulation. Furthermore, and with the issue of scholarly neglect to the forefront, it is worth noting that the professional and regulatory developments under consideration did not take place in an obscure sector but in banking and financial services, an industry of significant importance at UK, European and international levels.

Dewing and Russell (2005) have however explored the changing nature of the role of auditors, reporting accountants and skilled persons as the separate regulatory regimes for each sector of the UK financial services industry were brought together under a single regulator, the FSA, and a single Act, FSMA 2000. In addition, Collins *et al.* (2012) analysed in more depth the origins, establishment and implementation of the extension of the auditors' role and the new role of reporting accountant in the UK system of banking regulation under the Bank of England and the Banking Act 1987. In particular they investigated the failure of Johnson Matthey Bankers (JMB), the subsequent review and recommendations that included the creation of the new role of reporting accountant and the extension of the auditors' role, and the implementation of the new arrangements by auditors and the Bank of England. Using Power's (1996, 2003) schema of controversy, closure and credibility they established that controversy and closure took place front stage in the public domain and was well documented whereas credibility, establishing the renormalization of practice, took place back stage in the private domain. Credibility required the establishment of new communicative relationships between senior partners and supervisors, and was examined by interviews with senior partners and supervisors. The private, back stage process was described but an issue Collins *et al.* (2012) did not address was the "output", that is, the content and extent of the reporting accountants' reports. This was because the reports themselves remained back stage. Individual reports were not published and indeed remained a private matter between the bank, the Bank of England and the auditors/reporting accountants. Thus, while Collins *et al.* (2012) demonstrated knowledge and awareness of the changing audit role, they did not deal with the content and extent of reporting accountants' reports and the development of the reporting accountants' regime. Neither did they deal with the demise of the reporting accountants' regime and the subsequent establishment and development of the skilled persons' regime.

Nevertheless, it is possible to study the evolution of the reporting accountants' and skilled persons' regimes so long as one is willing to "mine" information which is contained in a variety of documents and sources that signal the changing nature and character of financial regulation. The paper examines this evolution by investigating the role of auditors in financial regulation, from reporting accountants' reports under the Banking Act 1987 to skilled persons' reports under FSMA 2000, using documentary information gathered from a variety of sources. This includes the annual reports of the Bank of England under the Banking Act 1987 and the annual reports of the FSA under FSMA 2000. This documentation is supplemented by additional publications of the Bank of England and the FSA, such as discussion and consultation papers, responses and policy statements. Other relevant publications examined include reports of official inquiries and investigations, Parliamentary Select Committee reports, professional guidance statements and newspaper reports.

The main analytical framework employed to interrogate these materials is that of "new audit spaces" developed by Andon *et al.* (2014, 2015) which built on the concept of "regulatory space" originally developed by Hancher and Moran (1989). Drawing on the recent discussions of Power (2016) and Robson *et al.* (2017), and responding to their calls to study everyday, back stage processes and to investigate financial reporting and auditing as social and organisational practice, we characterise the new audit space created by the reporting accountants' and skilled persons' regimes as "regulatory work". Using a variety of documentary sources, and employing the analytical framework of new audit spaces, the paper examines the extension of the auditors' role and the new role of reporting accountant under the Banking Act 1987, and the subsequent role of skilled person under FSMA 2000. The paper covers a period of nearly 30 years from the failure and rescue of JMB in October 1984 which led to the Banking Act 1987, to the financial crisis of 2007–2008 which led to the demise of the FSA and its replacement from 1 April 2013 by two new regulators, the Prudential Regulation Authority (PRA) under the Bank of England and the independent Financial Conduct Authority under the Financial Services Act 2012.

The paper makes two main contributions: first, by intensive reading of limited and varied publicly available information, and using the analytical framework of new audit spaces, it explores further the relatively under-researched topic of auditor involvement in UK banking and financial supervision as a new audit space, characterised as regulatory work; and, second, it extends the recent uses of regulatory space and new audit spaces perspectives beyond the investigation of a single episode or event to the investigation of an extended period of about 30 years, and reveals the ebb and flow of the jurisdictional expansion and contraction of the new audit space by identifying three phases of regulatory work. The paper proceeds as follows: Section 2 provides an overview of the relevant research on regulatory space, new audit spaces and the characterisation of regulatory work; Section 3 identifies three contrasting phases of regulatory work, first, the use of the reporting accountants' regime under the Banking Act 1987, second, the replacement of the reporting accountants' regime by the skilled persons' regime under FSMA 2000 and, third, how the skilled persons' regime changed post-financial crisis. The final section is a discussion and conclusion.

2. Regulatory space, new audit spaces and regulatory work

The analytical framework to be employed in this study is that of new audit spaces, recently developed by Andon *et al.* (2014, 2015). This built on the earlier concept of regulatory space, originally developed by Hancher and Moran (1989). We therefore review the ways in which the frameworks, first, of regulatory space and then, more recently, of new audit spaces have been used in the accounting literature. It is also important to be able to characterise the nature of this new audit space of reporting accountants' and skilled persons' reports. We consider the discussions of Power (2016) on riskwork and Robson *et al.* (2017) on financial reporting and auditing as social and organisational practice, and suggest that the extended role of auditors in the new audit space of banking and financial regulation should be characterised as regulatory work.

A common context for studies of financial accounting and auditing is regulation. Hancher and Moran (1989, p. 271) argued that "Regulation is virtually a defining feature of any system of social organization […]" and that, regardless of the particular area under consideration, regulation consists of four elements, "[…] the design of general rules, the creation of institutions responsible for their implementation, the clarification of the exact meaning of a general rule in particular circumstances, and the enforcement of the rule in those circumstances". They went on to suggest that regulation is "[…] best understood through the analytical device of‘regulatory space' ". The concept of regulatory space is, as we shall, see increasingly used in accounting research beginning with Young (1994).

Unpacking the dimensions of regulatory space, Hancher and Moran (1989) drew attention to four key features. They argued, first, that this spatial conceptualisation conveys that regulatory space may be "occupied" and, second, that it might be unevenly sub-divided between actors. Third, in addition to the general concept of regulatory space, they suggested that there may be specific concepts shaped by particular issues and concerns within sectors, and by varied practices of exclusion and inclusion across sectors. Fourth, they suggested that the metaphor of regulatory space provides an image that is fecund as it lends itself to further elaboration which, for example, reminds us that a "regulatory arena" may be "furiously contested". Hancher and Moran (1989, p. 277) concluded their initial elaboration of this concept by suggesting that investigating regulatory space "[…] involves examining the outcomes of competitive struggles, the resources used in those struggles, and the distribution of those resources between the different involved institutions. In other words, the play of power is at the centre of this process".

In accounting Young (1994) was one of the early writers who used the concept of regulatory space to examine the process of enacting change in accounting recognition practices. As a result of an invitation to revisit her earlier paper, Young (2017) commented that employing the lens of regulatory space, crucially, had enabled her to consider the agenda for US accounting standard setting as not only involving the operation of the FASB as the standard setter but also included examining the roles of other actors engaging with change inside and outside the regulatory boundary.

Other accounting researchers have also made use of the concept of regulatory space, examples include Nicholls (2010), Canning and O'Dwyer (2013), Malsch and Gendron (2011), MacDonald and Richardson (2004), Hazgui and Gendron (2015) and Artiach *et al.* (2016). Nicholls (2010), for example, analysed the regulatory space within which reporting and disclosure practices for the new Community Interest Companies in the UK were negotiated. Internationally, Canning and O'Dwyer (2013) mobilised the concept of regulatory space to investigate the establishment of the Irish Auditing and Accounting Supervisory Authority. Malsch and Gendron (2011) employed the concept to investigate the creation of the Canadian Public Accountability Board as a substantive change in the profession's regulatory space. MacDonald and Richardson (2004) similarly employed the concept of regulatory space in a historical study of the formation of the Public Accountants Council of Ontario. Hazgui and Gendron (2015) also drew on the notions of regulatory space to better understand the development of independent audit oversight in France. Artiach *et al.* (2016) employed the concept of regulatory space to investigate legitimacy building activity by the Australian Charities and Not-for-profit Commission. Thus, Nicholls (2010) and Young (1994) were primarily dealing with the emergence and development of practices, whereas Canning and O'Dwyer (2013), Hazgui and Gendron (2015), Malsch and Gendron (2011), MacDonald and Richardson (2004) and Artiach *et al.* (2016) were primarily dealing with the emergence and development of institutions. Apart from Hazgui and Gendron (2015), who undertook a longitudinal study, most studies generally employed the concept of regulatory space to examine a single episode, such as the establishment of a new regulatory body or the introduction of new financial reporting and disclosure practice. Following in the footsteps of these authors, our initial interest will be in the enrolment of accountants and auditors as private actors in the regulatory space of banking and financial services regulation. However, it is important to understand what is new about the work that auditors and accountants are being called on to perform.

Andon *et al.* (2014) introduced the related concept of "new audit spaces" to explore the jurisdictional expansion of auditing in considering the role of "salary cap auditors" in the National Rugby League in Australia, and in the Canadian Football League in Canada (Andon and Free, 2012, 2014). Their motivation was to acknowledge the increase in auditing and assurance of information published in a variety of new spaces and to respond to calls to undertake more detailed empirical work on the extension of audit-type practices into new spaces. Subsequently, in a special issue on "Contemporary Professional Work: Accounting and Beyond" in this journal, Andon *et al.* (2015) undertook a wider review of the emergence of new audit spaces. They identified new audit spaces as including efficiency and value for money auditing (Radcliffe, 1998, 1999), performance auditing (Gendron *et al.*, 2007), sustainability assurance (O'Dwyer, 2011; O'Dwyer *et al.*, 2011), salary cap auditing (Andon and Free, 2012, 2014), e-commerce assurance (Barrett and Gendron, 2006; Gendron and Barrett, 2004), and rankings and ratings (Jeacle and Carter, 2011) (see summary Andon *et al.*, 2015, p. 1408).

Basing their analysis of new audit spaces around four themes – independence, reporting, accreditation and institutionalised cultural capital, and reorientations in the mediating roles of auditing – Andon *et al.* (2015, pp. 1407-1416) found the Big Four accountancy firms experienced a mixture of success and failure in engaging in new audit spaces. Areas identified as "success" for the Big Four included efficiency and value for money auditing (Radcliffe, 1998, 1999). Areas identified as "failure" included salary cap auditing (Andon and Free, 2012, 2014; Andon *et al.*, 2014), Trip Advisor (Jeacle and Carter, 2011), BAFTA voting (Jeacle, 2014), collectibles certification (Jamal and Sunder, 2011), WebTrust Seal (Barrett and Gendron, 2006; Gendron and Barrett, 2004). Sustainability assurance (O'Dwyer, 2011; O'Dwyer *et al.*, 2011) was identified as "mixed" with both Big Four and non-financial auditors successfully undertaking sustainability audits. A particularly interesting finding was the traditional view, that independence is fundamental to financial audit, is not necessarily valued in new audit spaces (Andon *et al.*, 2015, p. 1410). In a paper introducing the special issue Carter *et al.* (2015) noted this important "bifurcation" in the experience of the Big Four that acknowledged the success of the Big Four "behemoth" but also highlighted their potential vulnerability (p. 1206). Both the Andon *et al.* (2014, 2015) papers made use of theoretical perspectives derived from Bourdieu (see Malsch *et al.*, 2011). They concluded that success or failure of the Big Four in entering new audit spaces depended on the extent to which the capitals and habitus of the Big Four, and the capitals and habitus of new audit spaces, were aligned. This was also linked to the ability of the Big Four to acquire the relevant expertise from other fields of knowledge and/or the ability of other fields of knowledge to appropriate audit and assurance ideals. The enrolment of auditors and accountants in banking and financial services regulation can therefore be viewed as part of the jurisdictional expansion of auditing into a new audit space. We characterise this new audit space as "regulatory work" for reasons discussed next.

Introducing the topic of "riskwork", Power (2016) noted that the study of risk and risk management tended to focus on well documented and publicised accidents, failures and disasters, and that the "normal, non-post disaster, work of organisational actors has received much less attention" (p. 2). Power advocated more attention should be paid to "everyday processes" (p. 2) which is aligned with increasing interest in "bottom-up", "back stage" or "back-office studies" (pp. 3, 4, 8). Power stated that riskwork "[…] makes no presumptions of coherent practice and directs attention to the actions and routines through which organisational actors make sense of risk, of themselves and their roles, and collectively try to enact institutional scripts" (p. 8). Power noted this is consistent with the "turn to work" in research in organisation and management theory as discussed, for example, by Phillips and Lawrence (2012), who identified 15 "new" forms of work, including boundary work, identity work and institutional work, and by Lawrence *et al.* (2013), who reviewed the evolution and growing importance of institutional work in organisation studies. Accounting scholars have employed the insights of institutional work to study, for example, the role of hybridised professional groups in the emergence and diffusion of enterprise risk management (Hayne and Free, 2014), the nature of domain change as accounting expertise is reconstituted in new social media (Suddaby *et al.*, 2015) and the response of the accounting profession to regulatory change following the introduction of an independent oversight body (Canning and O'Dwyer, 2016).

Robson *et al.* (2017) also identified an emerging agenda of research having a common emphasis on the theme of work. While the social and organisational approach to research in management accounting and control is of long standing, in financial accounting and auditing it is relatively new and in contrast to the well-established finance/capital markets approach to research in financial accounting. Robson *et al.* initiated a call for papers for a workshop on "Financial Reporting as a Social and Organisational Practice" (FRASOP) (later expanded to include auditing) to be held in 2011. This was christened FRASOP1, and was followed by two further workshops. Three of the FRASOP1 papers were recently published in a special section of *Accounting, Organizations and Society*, respectively Kettunen (2017), Barker and Schulte (2017) and Huikku *et al.* (2017). In particular, Kettunen made use of the concept of institutional work in a study of the interlingual translation of International Financial Reporting Standards from English into Finnish. Linking the riskwork approach of Power (2016) and the FRASOP approach of Robson *et al.* (2017), suggests that the extended role of auditors in banking and financial regulation in producing reporting accountants' report and subsequent skilled persons' reports for regulators is a new audit space that can usefully be characterised as "regulatory work".

As previously stated, reporting accountants' reports and skilled persons' reports are not published. However, it is possible to use information that can be gathered from a variety of publicly available documentary sources such as the annual reports of the Bank of England under the Banking Act 1987 and the annual reports of the FSA under FSMA 2000. This can be supplemented by additional publications of the Bank of England and the FSA, such as discussion and consultation papers, responses, and policy statements. Other relevant publications include reports of official inquiries and investigations, Parliamentary Select Committee reports, professional guidance statements and newspaper reports. By bringing these documentary findings together and subjecting them to detailed scrutiny, it is possible to trace the long term jurisdictional expansion and contraction of this new audit space of banking and financial regulation and identify three contrasting phases of regulatory work.

3. From reporting accountants' reports under the Banking Act 1987 to skilled persons' reports under FSMA 2000[1]

The first part of this section focuses on the origin and structure of the reporting accountants' regime under the Banking Act 1987 before moving on to discuss subsequent refinements to the regime following the collapse of BCCI in 1992 and Barings in 1995, and the eventual transfer of banking regulation from the Bank of England to the FSA in 1998. The role of auditors and reporting accountants in this new audit space is then described and discussed by drawing on information primarily taken from annual reports of the Bank of England and the FSA. This is characterised as regulatory Work I.

The second part of this section focuses on how the nature of this regulatory and new audit space changed in 2000 when regulation of the UK financial services industry was brought together under a single Act, FSMA 2000, and a single regulator, the FSA. Skilled persons' reports, designed to be applicable to all financial services firms (not just banks), and to allow the FSA to appoint a wider range of professionals (not just accountants and auditors), were an innovation under FSMA 2000. The FSA initiated a policy debate about how it would use its new powers, which resulted in a significant change to the nature of regulatory work under the skilled persons' regime as compared to the reporting accountants' regime. This is described and discussed drawing primarily on submissions to the FSA consultation, FSA annual reports and FSA enforcement actions. This is characterised as regulatory Work II. Further significant changes to the regulatory work undertaken by skilled persons following the financial crisis of 2007–2008 are discussed, drawing in particular on the reports of Parliamentary Select Committees, and is characterised as regulatory Work III.

3.1 Beginnings – reporting accountants' reports

Banking regulation, as established by the Banking Act 1979 following the secondary banking crisis of the 1970s, was destabilised by a further crisis, namely the collapse and rescue of JMB in October 1984 by the Bank of England. The government set up a committee chaired by Robin Leigh-Pemberton, the then Governor of the Bank of England, to establish lessons to be learned from the JMB affair (Leigh-Pemberton Report, 1985). The committee's terms of reference were crucial in structuring the debate. The main issue was stated as: "The

Committee shall consider the present supervisory system and whether any early changes in supervisory procedures are called for in the light of the problems which have arisen at Johnson Matthey Bankers” (p. 26). The terms of reference also identified a number of issues “to which particular attention should be given”, of which the most relevant for this paper was “the relationship between auditors and supervisors” (p. 26). An important decision of the committee which further structured the debate was that it did not believe the system of supervision then in place was “fundamentally flawed”, so it did not examine the possibility of changing to a different system (para. 2.2). This implied that if the Bank of England did not carry out detailed inspections of “banks” books’ then it needed to be able “to rely on the assistance and co-operation of the professional firms who do carry out this task: the bank’s auditors” (para. 2.3). The recommendations of the Leigh-Pemberton Report were implemented in the Banking Act 1987. Thus, auditors were “invited” to become actors in the expanded regulatory space of UK banking supervision. This is in contrast to Hancher and Moran’s (1989) original portrayal of competitive struggles among actors to enter and occupy regulatory space. On the other hand, this did not necessarily rule out competition among accountancy firms to be appointed bank auditors and reporting accountants or, as will be seen, questioning the role of the accountants and auditors in the event of further banking failures or changes in financial regulation.

A key provision of the 1987 Act allowed the Bank of England to require banks to provide it with reporting accountants’ reports. Under section 39 of the 1987 Act, the Bank of England could call for two kinds of reporting accountants’ reports: first, on a bank’s accounting and other records and internal control systems (“controls reports”); and, second, on a bank’s financial returns used for statistical or prudential monitoring purposes (“returns reports”). Reporting accountants’ reports were normally conducted by the auditors. In addition, under section 47, auditors or reporting accountants could communicate directly with the Bank of England on any matter of which they became aware that was relevant to the performance of the Bank of England’s duties. Reports under section 39 were regarded as “routine reports” whereas reports under section 47 were regarded as “non-routine” and of an exceptional or ad hoc nature. Auditors and reporting accountants were also obliged to participate in bilateral meetings with the Bank of England and in trilateral meetings with the bank and the Bank of England. Further, Section 47(1) stated that auditors and reporting accountants would not be in breach of a duty of confidentiality in communicating directly with the Bank of England on any matter relevant to the performance of its duties provided communications were made in good faith. Similarly, Sections 83(1) and (2) permitted the Bank of England to disclose information to auditors and reporting accountants if it enabled the Bank of England to discharge its functions or it would otherwise be in the interest of depositors.

Thus, the Banking Act 1987 established the jurisdictional expansion of audit. The reporting accountants’ regime, consisting of reporting accountants’ reports to the Bank of England and bilateral and trilateral meetings with the bank and the Bank of England, created a new audit space (Andon *et al.*, 2014) that can be characterised as regulatory work. Auditors of banks now had a dual role – a “private” or “non-state” role in reporting their audit opinion to shareholders under the Companies Acts, and a “public” or “state” role in reporting to the Bank of England as the banking regulator under the Banking Act 1987.

3.1.1 Refinements. This new audit space underwent further changes as a result of two subsequent major banking failures. The first failure was the Bank of Credit and Commerce International (BCCI) in 1992, which led to an Inquiry conducted by Lord Justice Bingham (Bingham Report, 1992). The second was the collapse of Barings in 1995, which led to a report by the Board of Banking Supervision (Barings Report, 1995). The specific changes were relatively minor and were designed to clarify the role of the auditor and reporting accountant and encourage the adoption of a more flexible basis in commissioning reporting accountants’ reports (Bingham Report, 1992, paras. 3.39-3.50; Barings Report, 1995, paras. 14.52-14.55).

What proved to be the most important overall recommendation impacting on the regulatory work of the reporting accountants' regime came from the Barings Report. The Report noted:

> At the present time supervisors in the Bank are not subject to an independent quality assurance group review of their supervision of banks in their section. We would commend such a practice to the Bank, believing it would assist in the continuous improvement of supervisory practices and procedures and challenge important decisions made. (Barings Report, 1995, para. 14.59)

The Bank of England engaged a team of management consultants from Arthur Andersen to undertake a review of banking supervision. Key recommendations of the Andersen Report (1996) were that the Bank of England should develop a more systematic approach to the assessment of risk (paras. 38-52) and to improve the effectiveness of supervisory tools, including Section 39 reports (paras. 63-83). Henceforth, the intention was that the number and scope of Section 39 reports would be determined by reference to the findings of the Bank of England's risk assessments, which was likely to result in fewer, more focused reports (Bank of England, 1997).

It turned out that a risk-based approach to regulation was not taken forward under Bank of England auspices but under a new regulator. This involved a major reorganisation of regulatory space. In an important policy announcement shortly after the election of the new Labour government in May 1997, Gordon Brown, the Chancellor of the Exchequer, stated that banking supervision would be transferred from the Bank of England to the Securities and Investment Board, later renamed the FSA. The FSA would also become the single regulator of the financial services industry by bringing together the regulation of banking, securities and insurance under "one roof" (HM Treasury, 1997). Whereas the Banking Act 1987 and the reporting accountants' regime and its subsequent refinements were responses to the individual crises at JMB, BCCI and Barings, Brown's policy announcement may be regarded not so much as a response to any individual crisis. Rather, it may be seen as an innovation in response to changes in global capital markets which increasingly saw the emergence of integrated financial groups with involvements across a variety of financial sectors.

In its "launch document" the FSA stated it would develop a set of principles that would apply to the supervision of all firms across the financial services industry (FSA, 1997). Key to this would be the adoption of a risk-based approach to regulation:

> The FSA will adopt a flexible and differentiated risk-based approach to setting standards and to supervision reflecting the nature of the business activities concerned, the extent of risk within particular firms and markets, the quality of firms' management controls and the relative sophistication of the users involved. (FSA, 1997, Appendix 1, para. 3)

The first step to this end, taken under the Bank of England Act 1998, was to transfer responsibility for the regulation of banking from the Bank of England to the FSA with effect from 1 June 1998. Banking supervision was still conducted under the Banking Act 1987 which remained the statutory basis for banking supervision until 1 December 2001 when FSMA 2000 came into full effect and the reporting accountants' regime was replaced with the skilled persons' regime (discussed in Section 3.2). The FSA argued that one of the advantages of a risk-based approach was the targeting of section 39 reports to areas of greatest risk, and hence the costs of the reports would be more directly related to risk (FSA, 1998, paras. 6, 8). Arguably, this revision of the approach to the commissioning of section 39 reports, originally begun under the Bank of England and carried forward by the FSA, implied that the regulatory work of reporting accountants' reports could also be characterised as an early form of riskwork (Power, 2016).

3.1.2 Regulatory work I – reporting accountants' reports 1987–2001. The Bank of England, and then the FSA, made considerable use of auditors in regulating banks. The level of regulatory work disclosed indicates the development of a thriving reporting accountants' "industry" involving private actors working closely with the public regulator. The numbers of reports authorised under the Banking Act 1987, and the related meetings, are shown in Tables I and II, respectively.

From 1991/1992 when the first figures were published, it can be seen that the volume of regulatory work carried out by auditors was considerable. Several hundred reports were commissioned annually, and the number of meetings annually regularly exceeded one thousand. However, this regulatory work was carried out back stage and little is known about the nature and content of the reports and meetings. Such knowledge as there is has to be gleaned from successive Annual Reports by the Bank of England under the 1987 Act.

In its 1987/1988 Annual Report, the first under the 1987 Act, the Bank of England (1988, p. 29) explained: "The past year has seen the completion of a major policy initiative designed to enlist the assistance of the accountancy profession in the process of bank supervision". This was the reporting accountants' regime and the Bank of England stated that it would place "considerable reliance" on the reports received (p. 31). It expected that UK incorporated banks would normally appoint their auditors as the reporting accountants. It also provided auditors with an indication

Table I.
Number of section 39 reports

Bank of England	Overseas branches	Standard	Special	Total section 39 reports commissioned
1991/1992	414	310	4	728
1992/1993	414	263	4	681
1993/1994	244	374	2	620
1994/1995	260	339	11	610
1995/1996	268	364	15	647
1996–1997	332	332	25	689
Financial services authority	Returns reports	Controls reports	Special reports	Total section 39 reports commissioned
1997	257	248	13	518
1998	145	174	10	329
1999	152	149	11	312
2000	143	104	4	251

Notes: The numbers of reports commissioned under the Banking Act 1987 were only published from 1991/1992. This Table has been constructed as follows: from 1991–1992 to 1996–1997 from information published by the Bank of England in the Annual Reports under the Banking Act 1987; and from 1997 to 2000 from information published in FSA (2001a, p. 24)

Source: Bank of England and FSA, Annual Reports under the Banking Act 1987

Table II.
Number of prudential interviews and trilateral meetings

Bank of England	Prudential meetings	Trilateral meetings	Total meetings
1991/1992	772	356	1,128
1992/1993	735	320	1,055
1993/1994	684	357	1,041
1994/1995	670	357	1,027
1995/1996	652	347	999
1996/1997	671	390	1,061

Notes: The numbers of prudential and trilateral meetings held by the Bank of England were only published from 1991/1992. The FSA did not provide this information

Source: Bank of England, Annual Reports under the Banking Act 1987 of the knowledge and skills required to undertake the work of reporting accountants (p. 31). Auditors would need to be familiar with the Bank of England’s supervisory approach and practice, have experience of undertaking work of a similar nature, have appropriate professional skills and resources, be readily available to meet bank officials, and have a continuing relationship with their client to enable them to report to the Bank of England, either directly or via the client, on an ad hoc basis.

In the 1988/1989 Annual Report the Bank of England provided comments on its newly emerging links with the accounting profession (Bank of England, 1989). It emphasised that the arrangements “break new ground” and that it had “co-operated fully” in the development of the accounting profession’s Auditing Guideline (p. 18). The Bank was here referring to the APC (1989) recently produced guideline on the audit of UK banks. The Bank was also positive about the first round of section 39 reports and associated meetings and increased links to the accounting profession stating: “The Bank”s supervision has benefited from the insights and analysis provided by the reports and from closer contacts forged with the accounting profession’ (p. 18). Interestingly, the nature of the auditors’ regulatory work had already changed. As the Bank of England noted, it was neither “practicable or desirable” to have full reviews on an annual basis and that a “rolling programme” was started, in many cases beginning with reviews of a bank’s “high-level” controls by which the board and senior management exercised control over day-to-day operations (p. 18).

The 1989/1990 Annual Report (Bank of England, 1990, p. 19) reported on the first full year of operation of the new arrangements, observing that reports had been made on “most” authorised institutions, although the number of reports was not given, and acknowledging that “digesting the volume of reports received by the Bank of England in a short space of time was not easy[2]”. However, the indication was that the reports were useful: “The limited experience so far suggests the exercise has considerable potential supervisory benefit, and this has been acknowledged by many banks despite the burden on their resources”. Banks remained concerned about the cost and possible duplication of requirements, although the Bank of England and the major accounting firms believed any overlap was limited. An important finding was that the work of the reporting accountants tended to support the work undertaken by the Bank of England: “The reports in the main confirmed the Bank of England”s own assessments of institutions’ systems rather than bringing to light major, previously undetected weaknesses’. The reports also served two further important purposes: first, “in convincing management of the need for change” and, second, “in encouraging many banks to take action in anticipation of the report”. Reports on prudential returns revealed “many cases of inaccurate reporting” but in nearly all cases the errors were minor and had “no material effect” on the Bank of England’s supervisory view. The Bank stated banks’ management should be “more aware of the importance of ensuring accurate reporting”, warning that a “marked improvement in standards in the future is expected”. Thus, the regulatory work of auditors in turn influenced the institutional work of banks.

The 1990/1991 Annual Report (Bank of England, 1991, p. 24) was the first to make reference to the actual volume of regulatory work, stating that over 3,000 interviews, meetings and visits[3] were conducted during the year. This was similar to the previous three years, of which approximately one-third were described as “routine”, and approximately two thirds were described as “non-routine” to discuss “specific issues”. Perhaps surprisingly no further details about the nature, topics and outcomes of these meetings were provided by the Bank of England. On the other hand the Bank of England provided more details about the work of review visits. These consisted of its staff and seconded bankers and accountants and typically lasted 2–3 days. In total 117 reviews were conducted, of which 56 covered the whole range of activities, 28 targeted loan book quality and 33 operating and control systems. From these Annual Reports it is clear that the regulatory work of auditors in the new audit space was becoming extensive but the limited disclosures of the Bank of England ensured it remained largely unknown and back stage.

Nevertheless, the 1991/1992 Annual Report (Bank of England, 1992, p. 26) was the first to report the specific numbers of bilateral and trilateral meetings and of section 39 reports. As such, it provided an opportunity for the Bank of England to provide a commentary on the nature, topics and outcomes of the meetings and reports. However this was not done and the regulatory work of auditors remained back stage. In fact, as the reporting accountants' regime bedded down, subsequent Annual Reports, apart from providing details about the number of meetings and reports, added little to what had been already stated in the earlier Annual Reports. Another opportunity to provide more information came when responsibility for banking supervision moved to the FSA. However, even less information about the reporting accountants' regime, other than numbers of reports commissioned, was provided by the FSA after taking over banking supervision from the Bank of England.

In summary, following the collapse and rescue of JMB by the Bank of England, the government undertook a reorganisation of regulatory space that resulted in auditors becoming actors in the enlarged regulatory space of UK banking supervision. This represented a significant jurisdictional expansion of audit and a new audit space that can be characterised as regulatory work emerged. From the limited information that is publicly available it is clear that a considerable amount of regulatory work took place back stage. This intensive audit and reporting activity during which several hundred reports were commissioned annually and the number of meetings annually exceeded one thousand on a regular basis is categorised as regulatory work I.

Over the period there were two important though not fundamental changes. Following the recommendations of the Andersen Report (1996), more emphasis was placed on the Bank of England's prior risk assessment which was expected to result in fewer, more focussed reports. The second change was that in 1998 responsibility for banking supervision moved from the Bank of England to a new regulatory actor, the FSA, but the reporting accountants' regime remained in place until 2001. At this point there was a radical reconstitution of regulatory space as the FSA took on responsibility for the whole range of financial supervision, of which banking was only one part. For auditors the scope and nature of the regulatory work changed significantly. The reporting accountants' regime needed to evolve to reflect the wider responsibilities of the FSA.

3.2 Innovation – skilled persons' reports

The new Labour policy (HM Treasury, 1997) of bringing the regulation of banking, insurance and securities under one regulator, the FSA, and one Act, FSMA 2000, led to a reconsideration of the role of reporting accountants' reports. The reporting accountants' regime as developed under the Banking Act 1987 was not carried over in its entirety into FSMA 2000. Rather, as regulatory space was redrawn, under section 166 FSMA 2000 provision was made for the FSA to call for skilled persons' reports. This explicitly enabled a wider range of professionals, such as actuaries, lawyers, IT specialists, as well as accountants and auditors, to be appointed to conduct reports. One aspect of the redrawn space did not change. This was the ability of auditors to communicate directly with the regulator. Under section 342 FSMA 2000, auditors (and actuaries) were able to communicate directly with the FSA on any matter of which they became aware relevant to the performance of the FSA's duties, and they were not in breach of any duty of confidentiality provided communications were made in good faith. Thus, although under FSMA 2000 there was no "parallel system" of audit, auditors of financial services firms still retained a dual role – the private or non-state role to report to shareholders under the Companies Acts and the public or state role to report to the FSA under FSMA 2000.

Following a consultation paper, the FSA issued a policy statement about how it intended to use its section 166 powers (FSA, 2001a, b). As regards concerns over costs and other practical issues, the FSA accepted the need for a rigorous justification for the use of skilled persons' reports and stated that appointments would be made on a case-by-case basis. The FSA was unable to forecast how many reports would be commissioned but confirmed it would publish information on the cost and use of reports and that reports would not be used for routine monitoring or as a substitute for employing permanent FSA staff. There would normally be consultation with firms over the person to be appointed and over the scope of the report but the FSA stated there may be circumstances where it retained the right to nominate the person and to determine the scope. The FSA would consult with professions about guidance that could be given over the nature, scoping, planning, format of opinion, resulting meetings, etc[4]. As regards the extent to which, with the cessation of Section 39 reports, the FSA would use alternative methods to obtain assurance about internal controls and systems the policy statement was less clear. However, implicit in a risk-based approach to regulation and the detailed development of the FSA's new operating framework was that supervisors would have a more analytical approach to risk assessment and prioritisation, and a more structured approach to the use of a wider range of regulatory tools and responses.

Thus, assurance about internal controls and systems could be obtained by the FSA in other ways, for example, by requesting reports from internal audit departments rather than from reporting accountants and auditors, but with the possibility of commissioning a report by a skilled person in reserve[5]. The result was both to extend the range of regulatory work that could be commissioned and to widen the group of regulatory actors able to undertake such work.

3.2.1 Debate. Under section 166 of FSMA 2000 "Reports by skilled persons", the FSA had the power to appoint a person to provide the FSA "with a report on any matter about which the Authority has required or could require the provision of information or the production of documents under section 165[6]". The question of interest for accountancy firms and the accountancy profession was the extent to which the nature of the tasks undertaken, and the level of enrolment achieved under the reporting accountants' regime, would continue under the skilled persons' regime. The FSA issued a Consultation Paper setting out its policy on its use of the skilled persons' powers, and inviting comments (FSA, 2001a). The majority of the responses to the consultation were made publicly available by the FSA and provided an interesting commentary on the advantages and disadvantages of the reporting accountants' regime, as well as providing views on the implementation of the skilled persons' regime. The number of responses is shown in Table III.

A detailed analysis of the responses is outside the scope of this paper but a summary of the key points, especially those made by the accountancy profession, is provided[7]. The accountancy profession argued there was a general belief that the reporting accountants' regime had served a useful purpose, especially since the adoption of a more flexible, risk-based approach post-Barings. As Arthur Andersen stated, "We believe the current S39 regime for banks has worked well, particularly in recent years where reports have become more risk focussed". The main concern expressed by the accountancy profession was that

Accountancy profession	5
Firms	13
Trade and other professional bodies and associations	13
Individuals	2
Total	33

Source: FSA (2001b, pp. 9-10)

Table III. Responses to CP 91 – Reports by skilled persons

the cessation of routine section 39 reports would result in a reduction in the quality of accounting and internal control systems and regulatory reporting. KPMG commented, "The section 39 regime has, we believe, provided significant deterrent against weak systems and controls within banks and we are concerned that a reduction in the use of these reports may lead to a deterioration in the effectiveness of controls and the accuracy of reporting by the industry". It was argued there was a danger of a progressive decline and loss of independent and in-depth knowledge and expertise that had been accumulated about banks' internal controls and systems. Arthur Andersen emphasised "[…] the need to try and retain this knowledge as far as possible in the new regime to ease the burden on all parties".

Related to this, it was not clear how the infrastructure of formal and informal supporting practices that had evolved over the years, such as the Notices and Guidance notes issued by the Bank of England and the Auditing Practices Committee, and the experience of undertaking reports, particularly as regards appropriate scoping and planning, would be replaced. PricewaterhouseCoopers (PwC) commented that the advantages were a "more or less consistent approach between different professional firms and a recognisably standard form of report" and, importantly, that "the opinion can be rendered in accordance with professional standards". The disadvantage was the reporting framework was "rigid" and not sufficiently "flexible" to cover all possible situations. PwC argued that comparable supporting guidance should be also provided for the delivery of the new section 166 reports and the evolution of the new skilled persons' regime, particularly to assist the legal and actuarial professions which had "less exposure" to this form of reporting.

It was important to remember that the statutory audit would not necessarily reveal "all potentially significant control weaknesses", which was noted by the ICAEW (2001) who pointed out this was "one of the main conclusions" of the investigation of the failure of JMB, and which led to the introduction of the reporting accountants' regime in the first place. In the absence of section 39 reports, the ICAEW questioned how these weaknesses would be picked up. The ICAEW was "content" that the new section 166 reports should be produced on a risk-related basis, but was "concerned" if there was to be a substantial reduction in reports without an indication from the FSA of "alternative methods of […] obtaining appropriate assurance".

As might be anticipated, the ICAEW and the audit firms argued they were still well placed to undertake section 166 reports because of their knowledge of the client and range of expertise at their disposal, "Where external systems assurance is required, the most cost-effective professional firm able to provide that assurance would generally be the auditors. […] an alternate firm would […] impose unwarranted additional costs" (ICAEW, 2001).

Concerns expressed by financial services firms and trade bodies were mainly to do with practical issues of the skilled persons' regime, for example: the need for a rigorous justification for the use of skilled persons' reports; that measures would be in place to control the costs incurred by skilled persons; that firms would have an input into the choice of appointee as skilled person and to the scoping of the report; and that further guidance would be given on the nature and the scoping and planning of reports, on the format and content of reports, and on meetings and actions following submission of reports. Smaller financial services firms in particular were concerned with the potential costs.

Overall, there were concerns by the audit firms and the profession about a reduction in the amount of audit and assurance work on internal control systems and by the financial services industry about a costly expansion of other regulatory work. Not surprisingly, the profession sought to maintain a prominent place in redrawn regulatory space by arguing that knowledge of the client, and the range of expertise at their disposal, made auditors ideally placed to undertake the new skilled persons' reports.

3.2.2 Regulatory work II – skilled persons' reports 2001–2013. As with reporting accountants' reports, skilled persons' reports were confidential and only limited information was revealed. As with the Bank of England, the main source of evidence is the FSA's Annual Reports which provide summary details about the number, cost and topics of skilled persons' reports. The number and costs of skilled persons' reports over the lifetime of the FSA are shown in Table IV.

It can immediately be seen there were very few skilled persons' reports as compared to the number of reporting accountants' reports. Although it is noticeable that the number of skilled persons' reports increased significantly following the financial crisis, reaching 111 in 2012/13, they were still substantially below the number of reporting accountants' reports. Even after a risk-based approach to banking supervision was introduced there were still 251 section 39 reports issued in 2000 during the last year of the reporting accountants' regime (see Table I). It should also be remembered that all UK financial services firms, not just banks, may be the subject of a report by a skilled person, making the reduction even greater. Bearing in mind the market capitalisation of larger financial services firms, the costs of skilled persons' reports do not appear to be unduly excessive and the cost of some reports are modest indeed. No details of the persons undertaking the reports are made public but even if all of the reports were undertaken by auditors the figures demonstrate a major reduction of auditors as private actors in financial services regulation under FSMA 2000 as compared to the Banking Act 1987.

Also of interest is the subject matter of the reports, summaries of which are given in the FSA's Annual Reports, and are shown below.

Examples of the subject matter of skilled persons' reports:

- 2001/2002: adequacy of compliance functions; adequacy of money laundering arrangements; review of treasury models; adequacy of systems and controls; review of unauthorised blocking of customer direct debits.
- 2002/2003: compliance functions; money laundering arrangements; treasury models; systems and controls; financial resourcing; actuarial function; past business reviews; procedures for monitoring solvency; adequacy of regulatory returns.
- 2003/2004: corporate governance arrangements; systems and controls; account opening procedures and customer documentation; past business reviews, including selling practices, treatment of customers and of complaints; financial resourcing; internal audit; procedures for monitoring solvency; adequacy of regulatory returns.
- 2004/2005: retail sales practices; controls to prevent money laundering; insurers' reserving against future losses; accuracy of regulatory financial reporting; high-level systems and controls; effectiveness of risk management function.

Financial services authority	Reports commissioned	Estimated costs per report	Estimated total cost
2001/2002	7	£42,000–£2.7m	£4m
2002/2003	31	£13,000–£4m	£10.75m
2003/2004	28	£17,000–£2m	£7.05m
2004/2005	19	£42,500–£1.15m	£6.5m
2005/2006	17	£400–£976,000	£3.7m
2006/2007	18	£2,000–£750,000	£3.8m
2007/2008	29	£2,000–£1.1m	£5.8m
2008/2009	56	£3,000–£2.4m	£12.8m
2009/2010	88	£3,000–£4.4m	£24.7m
2010/2011	95	£1,795–£4.0m	£32.2m
2011/2012	111	£2,975–£3m	£31.2m
2012/2013	113	£6,475–£40m	£176.4m

Source: FSA Annual Reports

Table IV. Number and costs of section 166 skilled persons' reports

- 2005/2006: client money handling; collateral management; management of an appointed representatives network; corporate governance arrangements; transaction reporting; past sales of retail financial products; controls to prevent market abuse.
- 2006/2007: controls to prevent money laundering; controls over trading; systems for the prevention of fraud; client money calculations; management of operational risk; corporate governance; reviews of past mortgage business.
- 2007/2008: treating customers fairly; corporate governance and senior management arrangements; adequacy of systems and controls; oversight and control arrangements in the finance function; capital adequacy; controls to prevent money laundering; controls over data security; controls over trading; accuracy of regulatory reporting.
- 2008/2009: corporate governance and senior management arrangements; adequacy of systems and controls (including compliance risk, risk management and data security); treating customers fairly (including sales practices and suitability of advice); review of past business; prudential controls (including accuracy of regulatory reporting); capital adequacy; market abuse.
- 2009/2010: review of past business and quality of advice; adequacy of systems and controls (including compliance and risk management); corporate governance and senior management arrangements; capital requirements; treating customers fairly; review of loan books and arrears handling; assurance on regulatory returns.
- 2010/11: review of past business and quality of advice; adequacy of systems and controls (including compliance and risk management); corporate governance and senior management arrangements; capital requirements; treating customers fairly; review of loan books and arrears handling; client money and client asset arrangements; assurance on regulatory returns.
- 2011/12: review of past business and quality of advice; adequacy of systems and controls (including compliance and risk management); corporate governance and senior management arrangements; assurance on regulatory returns, including liquidity risk; client money and client asset arrangements; effectiveness of control functions.
- 2012/13: review of past business and quality of advice; adequacy of systems and controls (including compliance and risk management); corporate governance and senior management arrangements; financial crime including market abuse controls; client money and client asset arrangements; effectiveness of control functions.

Source: FSA Annual Reports.

It can be seen that systems and controls continued as an important theme of skilled persons' reports, but following the financial crisis higher level themes, such as corporate governance and senior management arrangements, and specific issues, such as reviews of past business, accuracy of regulatory returns, became more significant.

Other than general disclosures in the FSA's Annual Reports, there is very little further information provided about section 166 reports in which, for example, a firm is named as being the subject of a report by a skilled person, or the topic and outcome of such a report is given in more detail. An exception occurred when the FSA made a public announcement of a report by a skilled person into Standard Life (FSA, 2004a). The statement explained that Standard Life had notified the FSA about a "significant divergence in its calculation of liabilities and subsequently the higher level of reserving needed against the likely cost of guarantees", and the company and the FSA had worked together to address the issues. Further, the FSA stated it:

> […] 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. (FSA, 2004a)

An example discussing the topic and outcome of a report by a skilled person, although not naming the firm, was given in an FSA Briefing on delivering reforms in the insurance sector. The issue concerned was corporate governance and the FSA presented it as "case study" of improvements that had been achieved:

> We used our powers under section 166 of FSMA to review the high level controls of the Board of a life insurance company. This highlighted deficiencies in the firm's corporate governance structure and resulted in agreement from the firm's Board and senior management to strengthen the composition of the Board by appointing independent non-executive directors to improve the Board's effectiveness and the balance between executive and non-executive directors. (FSA, 2005a, para. 4.24)

Another source of evidence offering insights into the skilled persons' regime is linked to enforcement actions. In its Annual Report 2003–2004, the FSA mentioned an action against Lloyds TSB for mis-selling Scottish Widows Extra Income and Growth Plan and referred to the commissioning of a review by a skilled person into the bank's handling of complaints after redress letters were sent out (FSA, 2004b, pp. 123-124). The FSA imposed a financial penalty of £1.9 million on Lloyds TSB. Further details are contained in the FSA's Final Notice (FSA, 2003a). The skilled person assisted in conducting a "past business review" which indicated a significant level of unsuitable sales and the matter was referred to the FSA's Enforcement Division (FSA, 2003a, paras. 5.4-5.6). Other Final Notices from the FSA's Enforcement Division making early reference to the use of skilled persons' reports, include St James's Place[8] (FSA, 2003b, c, d), Capita Trust (FSA, 2004c), Abbey National (FSA, 2005b) and Braemar Financial Planning (FSA, 2006). The firms were subject to financial penalties of £750,000, £300,000, £800,000 and £182,000, respectively. As with Lloyds TSB, the skilled persons were generally appointed to conduct a review of sales and complaints handling procedures, and their findings and recommendations were part of the evidence used by the FSA in deciding on the enforcement action and the penalty to be imposed.

Thus, the skilled persons' regime was of less importance to the regulatory process as compared to the reporting accountants' regime and the nature and volume of the regulatory work was significantly different. By piecing together information from different sources the skilled persons' regime was used in a more varied and, when linked to enforcement actions, in an, arguably, more threatening way. This is categorised regulatory work II. However, the financial crisis led to further questioning of the role of auditors and the use of skilled persons' reports resulting in a further transformation of regulatory work.

3.2.3 Regulatory work III – skilled persons' reports and the financial crisis. Following the financial crisis of 2007–2008, there was renewed interest in the general relationship between auditors of banks and other financial services firms and the FSA, including the FSA's use of skilled persons' reports. The topic moved front stage, in as much that it attracted the attention of Parliamentary Select Committees including the House of Commons, Treasury Committee (2009a) and the House of Lords, Economic Affairs Committee (2009, 2011), that considered it as part of their wider investigations into the causes and consequences of the financial crisis. A much fuller public discussion took place which, together with a less secretive approach by the FSA, led to a greater knowledge and understanding of the regulatory work undertaken by auditors and skilled persons post-financial crisis.

In evidence to the committees the accountancy profession took the opportunity to emphasise the general decline in contact between auditors and the FSA under FSMA 2000 as compared to the situation with the Bank of England under the Banking Act 1987. The limited use made by the FSA of section 166 skilled persons' reports, as compared to the extensive use made by the Bank of England of section 39 reporting accountants' reports, was commented on in written and oral evidence. For example, in written evidence to the Treasury Committee, the ICAEW contrasted the cost of the ad hoc section 166 approach as compared with the efficiency of the section 39 approach, stating for the former, "[…] because the assignments are bespoke, not timed to coincide with year end audit, and are used infrequently, they tend to be relatively costly," and for the latter, "Although the nature of this work might vary from year to year, the fact that there was often consistency across banks, as well as the fact that it could be built into the year end audit planning process for all bank audits, allowed greater efficiency" (Treasury Committee, 2009a, Written Evidence, p. 282). In oral evidence Brendan Nelson, Vice-Chair of KPMG, interestingly characterised the work conducted by auditors under section 166 as "detective" in contrast to the section 39 regime which was characterised as "preventative". Nelson argued that the aim of the previous regime was "[…] to ensure that they [the banks] constantly maintained the requirements in terms of records, controls and so on as imposed on them by the regulator", whereas under the current regime "The only role we now have is as and when we are required to go in and do a review under section 166, but that tends to be after the event" (Treasury Committee, 2009a, Oral Evidence, p. 159).

The clear implication of the evidence of ICAEW and Nelson was that the substantial decline in the volume of "preventative" regulatory work that took place under the reporting accountants' regime, and the small amount of "detective" work that took place after the event under the skilled persons' regime, meant the FSA had less knowledge and understanding of the firms it was supervising. Indeed, in so far as regulatory work undertaken for section 39 reports enhanced audit work undertaken for the statutory audit, and that work undertaken for the statutory audit enhanced the section 39 work, it could be argued that, similarly, auditors had less knowledge and understanding of the banks they were auditing.

The Treasury Committee invited the audit profession to suggest specific areas where the role of auditors might be strengthened in the audit of banks. The ICAEW Financial Services Faculty identified a number of areas including the previous controls reports under section 39 and argued that the FSA could "make greater and more regular use of their existing powers under section 166 to obtain more information about the operation and application of controls or compliance with regulations" (Treasury Committee, 2009a, Written Evidence, p. 451).

Overall, the Treasury Committee in its report commented that the "piecemeal approach" by the FSA to obtaining information from auditors represented a "wasted opportunity" to improve banking supervision, and invited the FSA to respond to ICAEW suggestions of how the relationship might be improved, including making more use of its powers to commission section 166 reports (Treasury Committee, 2009a, para. 231). As regards the greater use of section 166 reports, the FSA responded, first, by stating that such reports were used to obtain an independent view on a particular concern and were used in a risk-based way and, second, by clarifying that the skilled person was not necessarily the external auditor, remarking that supervisors "increasingly prefer an independent assessment", and pointing out that it was in fact making increasing use of section 166 reports – from 29 cases in 2007–2008 to 56 cases in 2008–2009 (Treasury Committee, 2009b, p. 28). Although this represented a doubling of reports, when compared to the previous number of section 39 reports (see Exhibit 1), and in the context of the vastly increased number of firms supervised by the FSA and the financial crisis, the number of reports remained surprisingly small.

The Economic Affairs Committee (2009) covered similar ground to the Treasury Committee and revisited the issue as part of its wider investigation of concentration in the audit market (Economic Affairs Committee, 2011). Perhaps the most helpful description of how the FSA viewed its use of section 166 was given in oral evidence to the Economic Affairs Committee (2009). Lord Turner, chairman of the FSA, defended the limited use of section 166 reports on the basis that the FSA had its own in-house capability to deal with normal risk assessment, and that to use auditors to undertake the task on a routine basis would increase costs considerably without necessarily coming to different conclusions. Turner argued that using the auditors was most appropriate for a "detailed in-depth analysis" and stated the section 166 report was used when:

> […] we do a deep dive on an institution where we have particular issues that we are worried about. […] When we have to do very deep dives on particular issues and indeed want to be able to have somebody else looking at it in addition to ourselves, we use them. […] We would probably prefer to use them for very specific things rather than make them an ongoing general part of the process. (Economic Affairs Committee, 2009, Oral Evidence, p. 179)

In the second Economic Affairs Committee investigation Sally Dewar, the FSA's Managing Director Risk, confirmed that a "deep dive" could be done externally through a section 166 report or internally by the FSA. For the former she stated these had previously been done "but not to the extent we do now" and for the latter "we have very much enhanced the discipline internally to enable us to have the skills to do it within the FSA" (Economic Affairs Committee, 2011, Oral Evidence, pp. 286-287). In written evidence the FSA clarified that it had developed expertise in-house referring to the new Supervisory Enhancement Programme developed post-Northern Rock[9]:

> This in-house expertise was designed to reduce the need for regular reporting by auditors on supervisory matters related to individual firms. […] In line with our supervisory philosophy of that time, we made less use of third parties (i.e. use of section 166 reports) and placed more reliance on what firms told us. […] we now recognise that this approach was wrong. Following the crisis, we have committed to making greater use of our powers under section 166. We now form our own judgements on firms' judgements. (Economic Affairs Committee, 2011, Oral Evidence, p. 194)

Separate confirmation of the increase in section 166 reports was provided by another senior FSA official, John Pain, the FSA's Managing Director Supervision, who in a speech "The FSA's approach to intensive supervision" stated:

> Our "finger prints" have been increasingly felt where we have actively encouraged a change in management or board members. Where we have identified weak or ineffective management or governance. To do this we have increasingly used our section 166 powers, to appoint independent skilled person reviews, to bring issues to the table. (FSA, 2010)

A controversial question was the extent to which section 166 reports were undertaken by the Big Four accountancy firms. Lord Myners, former Financial Services Secretary to HM Treasury, in giving evidence to the Economic Affairs Committee on auditors' market concentration, commented that he had asked the FSA what percentage of the reports were conducted by the Big Four and stated "[…] it's an extraordinarily high number. In some years 100% of the reports had been commissioned from the Big Four in terms of fees paid […]". This led Myners to wonder whether "one of the reasons why the auditing profession has not been subject to more scrutiny is because part of the scrutiny exercise has been in the hands of the auditing profession" (Economic Affairs Committee, 2011, Oral Evidence, p. 351).

The perception of Big Four dominance of skilled persons' reports was addressed. As part of the move to the new regulatory regime following the financial crisis the FSA established Panels of firms able to undertake various categories of skilled persons' reports. The Panels of firms would operate from 1 April 2013 and the firms extended well beyond the Big Four. As the *Financial Times* reported "City accountancy and law firms are jostling for the opportunity to earn bumper fees by winning a coveted place on the UK financial regulator's first panel of external experts called upon to undertake investigations at banks" (*Financial Times*, 2012). The FSA established Panels of firms authorised as competent to undertake skilled persons' reports in each of eight areas and the membership of the Panels was published[10]. However, it should be pointed out that a number of firms (such as the Big Four accountancy firms) were members of every Panel and during 2013–2014 only eleven firms (including all the Big Four accountancy firms) were used for 33 reports.

Following the financial crisis more information about skilled persons' reports appeared in the press. For example, in an article "Accountants profit as the FSA gets tough with banks", *The Times* (2009) reported that leading accountancy firms had received "up to five times the number of requests to conduct skilled persons" reports this year'. The *Financial Times* (2010), in an article "External experts help the FSA probe banks", reported that the FSA had engaged accountancy firms to conduct supervisory reviews of struggling UK banks and mentioned that PwC, Ernst & Young and BDO Stoy Hayward had been engaged to review RBS, HBOS and Bradford & Bingley, respectively. In another article "Probes ordered by FSA surge", the *Financial Times* (2011) reported that the FSA had commissioned a record number of skilled persons' reports during 2011.

The FSA itself was less secretive about its approach to and use of skilled persons' reports. In 2012–2013, the last year of its life, the FSA decided to disclose more information about skilled persons' reports by publishing on a quarterly basis the number of reports commissioned by type of firm (see Table V).

It is important to note the Economic Affairs Committee (2009, 2011) reports were not necessarily seeking an increase in section 166 reports as such, but rather to increase the dialogue between auditors and supervisors. As will be seen, the committee identified what might be called an "auditor-regulator gap". The first report concluded that it was "regrettable" that auditors and supervisors did not meet regularly and recommended that the FSA should initiate regular meetings with auditors "even where there are no obvious problems in the banks" (Economic Affairs Committee, 2009, para. 278). The second report took a stronger line and regarded the lack of meetings between auditors and supervisors during a period of financial crisis as a "dereliction of duty" by both auditors and regulators (Economic Affairs Committee, 2011, para. 201). In response to the first report the FSA and the Financial Reporting Council (FRC) jointly undertook a consultation about enhancing the auditor's contribution to prudential regulation (FSA/FRC, 2010, 2011). This led to the FSA

Table V.
Number of skilled persons' reports commissioned 2012–2013

	Q1	Q2	Q3	Q4	Total
Firm business type					
Personal investment	2	4	4	1	11
Investment management	4	4	0	1	9
Securities and futures	4	4	2	4	14
Banks (including building societies)	7	21	8	16	52
Insurance companies	2	3	3	9	17
General insurance brokers	2	1	2	0	5
Home finance business/mortgage	0	0	0	0	0
Professional firms	0	0	0	0	0
Credit Union	1	0	0	0	1
Others	1	1	2	0	4
	23	38	21	31	113

Source: FSA

establishing a new Code of Practice for the relationship between the external auditor and the supervisor (FSA, 2011). While the new Code of Practice was welcomed, in the light of the "regrettable backsliding" during the period 1997–2007 the committee believed the nature of the relationship should be established on a statutory basis (Economic Affairs Committee, 2011, para. 202).

Following the financial crisis the nature and volume of the regulatory work undertaken changed once again. This was partly because of the FSA's increased need to commission skilled persons' reports to investigate failing banks, and partly because of the need to respond to the detailed and critical public scrutiny of the FSA by the Parliamentary Select Committees. In addition, following the prompting of the committees to restore the dialogue between auditors and supervisors, the FSA and the FRC worked together to produce a Code of Practice to govern the relationship between the external auditor and the supervisor. Overall, this final phase, following the financial crisis and before the FSA was replaced by the PRA and the Financial Conduct Authority, is categorised as regulatory work III.

4. Discussion and conclusion

The paper has traced the little known story of the involvement of auditors in two UK regulatory reporting regimes for banking and financial services from 1987 to 2013 under the Bank of England and the Banking Act 1987 and then under the FSA and FSMA 2000.

Using the analytical framework of new audit spaces (Andon *et al.*, 2014) the new audit space of reporting accountants' and skilled persons' reports, characterised as regulatory work, was analysed in three phases. The first phase began with the establishment of the reporting accountants' regime under the Banking Act 1987. This was characterised as regulatory work I which, while remaining back stage, involved intensive engagement by auditors in producing annual reporting accountants' reports and attending and bilateral trilateral meetings with the supervisors. The second phase began in 2000 when regulation of the UK financial services industry was brought together under a single Act, FSMA 2000, and a single regulator, the FSA. The nature of the audit space changed significantly with the introduction of the skilled persons' regime. Skilled persons' reports, designed to be applicable to all financial services firms (not just banks) and to allow the FSA to appoint a wider range of professionals (not just accountants and auditors), were an innovation under FSMA 2000. This was characterised as regulatory work II where, although remaining back stage, the nature of the regulatory work changed and was considerably reduced, and the role of auditors was more limited and contested. The third phase occurred after 2007–2008 when further important changes were made to the skilled persons' regime following the financial crisis. This was characterised as regulatory work III where the number of skilled persons' reports increased from its previous low level and, with less secrecy and more publicity about the skilled persons' reports being commissioned, became more front stage with the processes for appointing skilled persons becoming more transparent.

The current study takes forward the findings of Collins *et al.* (2012) which had a different focus and was more limited in scope. The earlier paper dealt in more depth with a single event and its outcome, namely, the failure of JMB and the subsequent review and recommendations that led to the emergence of the new role of reporting accountant and extended the auditors' role in banking supervision. Power's (2003) schema of controversy, closure and credibility was used as a helpful descriptive framework to analyse a single event involving the renormalisation of practice following a crisis. Although also looking at the origins of the role of the reporting accountants and auditors in banking supervision, the current paper is more extended in scope. It goes beyond JMB and its aftermath, and looks at further refinements and developments in the auditors' role over a 30-year period. By using the analytical framework of new audit spaces, it sets the role of auditors in banking supervision in the wider and more comparative context of the jurisdictional expansion auditing into various new audit spaces. In particular, by the intensive reading of sources, it revealed the extensive and varied nature of the activities undertaken by reporting accountants and skilled persons, and uncovered the changing nature of the new audit space over time by identifying three distinct phases of regulatory work undertaken.

Following this analysis of the evolving new audit space of regulatory work, it is helpful to consider the extent to which it shares common themes across new audit spaces as identified by Andon *et al.* (2015). In their review of new audit spaces, Andon *et al.* (2015, pp. 1404-1416) identified four themes – independence, reporting, accreditation and institutionalised cultural capital, and reorientations in the mediating roles of auditing.

The first theme was independence. As Andon *et al.* commented, "The long standing view deeply held by the profession, researchers and regulators, is that auditor independence is fundamental" (p. 1407). Applying the principle of independence to the reporting accountants' and skilled persons' regimes, it could be argued that the closeness of auditors to their clients should preclude them from undertaking reports on clients separately commissioned for their own purposes by the Bank of England and the FSA. However, this was clearly not the initial view taken by the Leigh-Pemberton Committee or the Bank of England, and later the FSA, for reporting accountants' reports. However, for skilled persons' reports, especially following the financial crisis, the FSA indicated an increased preference for independence. These findings provide further support for Andon *et al.*'s view that "independence as conventionally conceived may not always be as prized as one might think when audit practices are translated into new fields" (p. 1410).

The second theme was reporting. All the new audit and assurance services reviewed by Andon *et al.* resulted in audit and assurance reports that were made publicly available. However, in the new audit space of reporting accountants' reports and skilled persons' reports, while it was publicly known that a bank's auditors were undertaking reports privately commissioned by the Bank of England and the FSA and having private, face-to-face, meetings with the Bank of England and FSA, there was no question of the findings of the reports or results of the meetings being made public. An interesting question that does not appear to have been debated for the reporting accountants' regime, and indeed for the skilled persons' regime, is the extent to which the findings should also be made available to other stakeholders, such as investors and depositors, who might be expected to have a legitimate interest in such additional audit and assurance information.

The third theme was the creation of special accreditation processes linked to the development of new audit spaces to ensure inclusion for those accredited and exclusion for those lacking accreditation. The reporting accountants' and skilled persons' regimes did not establish separate accreditation processes, other than that the person had to be nominated or approved by the Bank of England and the FSA, and who was normally the auditor. In fact, it was only after the financial crisis that lists of firms authorised to undertake particular categories of skilled persons' work were made public.

The fourth theme was a reorientation of the mediating roles of auditing, which includes certification, normative opinions, and quasi-judicial investigations. It can be argued this was the most powerful innovation of the reporting accountants' and skilled persons' regimes. Crucially, beginning with the reporting accountants' regime, communications between auditors and the Bank of England were no longer ruled out by confidentiality considerations. The Bank was able to obtain additional information not only through its powers of commissioning reports but also by requiring auditors and reporting accountants to attend face-to-face bilateral and trilateral meetings. Furthermore, under Section 47 of the Banking Act 1987, auditors and reporting accountants were required to communicate directly with the Bank of England (and vice versa under Section 83) on any relevant matter without informing the bank. Across the new audit space, by a combination of reports, meetings and communications, the Bank of England was able to communicate with an auditor as a mediator between itself and a bank across a spectrum of certifications, normative opinions and quasi-judicial investigations as required. While the ability of auditors and the FSA was retained under FSMA 2000, the implementation of the skilled persons' regime saw a drastic reduction in the number of skilled persons' reports as compared to the number of reporting accountants' reports commissioned previously. While auditors may have "lost" in the occupation of the revised audit and assurance space with the move from the reporting accountants' regime to the skilled persons' regime, there was some consolation in knowing that there was not a corresponding "gain" by other private actors. For the skilled persons' regime, two main impacts under the Andon *et al.* theme of the reorientation of the mediating role of auditing are indicated, first, the disclosure of the subject matter of skilled persons' reports summarising high-level topics covering a wide range of issues and, second, the quasi-judicial nature of the investigations where there is evidence that skilled persons' reports were used to support FSA enforcement actions.

Finally, the great diminution in the number of skilled persons' reports even after the financial crisis as compared to the number of reporting accountants' reports previously, not to mention bilateral and trilateral meetings, resulted in the identification of a significant "auditor-regulator gap" by the Parliamentary Select Committees. In response to their recommendations, the FSA established a new Code of Practice for the relationship between the external auditor and the supervisor which was adopted by the FSA's successor bodies, the PRA and the Financial Conduct Authority (FSA, 2011; PRA, 2013; FCA, 2013). In an interesting recent development, following a Consultation (PRA, 2015) the PRA has issued Supervisory and Policy Statements whereby auditors of major UK banks and building societies will be required as part of the statutory audit cycle to produce "written reports" in answer to questions posed by the PRA (PRA, 2016a, b). It can be argued that the issuance of the Code and Statement represents yet another reorganisation of regulatory and audit space and marks the emergence of regulatory work IV, bearing a distinct "back to the future" similarity to that of the former reporting accountants' regime.

Notes

1. Parts of this section rely on Dewing and Russell (2005) and Collins *et al.* (2012).
2. The numbers of reports commissioned by the Bank of England were only published from 1991/1992 (see Table I).
3. Although not specifically stated, it must be presumed that the routine and non-routine meetings, and the review visits, were linked directly or indirectly to the reporting accountants' regime.
4. The FSA subsequently assisted the Institute of Chartered Accountants in England and Wales (ICAEW) in producing guidance (ICAEW, 2003).
5. In addition, as a result of the FSA's 'Integrated Regulatory Reporting' (IRR) initiative following the financial crisis, the FSA decided to make use of its powers under section 166 to commission a report by a skilled person to provide specific assurance on regulatory returns, known as a section 166 Return Assurance Report (s.166 RAR), which were introduced with effect from 2008 (FSA, 2007).
6. Under section 165, the FSA had the power to require a firm to produce specified information or documents, or information or documents of a specified description.
7. The evidence that follows was made available to the authors by the FSA.
8. Final Notices were issued to St James's Place UK plc, St James's Place International plc and St James's Place Unit Trust Group Ltd.

9. Northern Rock was the first significant UK bank to fail during the financial crisis and was rescued by the Bank of England in September 2007 (Treasury Committee, 2008).

10. The areas were known as lots and as at 1 April 2013 the number of firms in the skilled persons' panel for each Lot were as follows: Lot 3: client assets (16 firms); Lot 4: governance, controls and risk management Frameworks (23 firms); Lot 5: conduct of business (25 firms); Lot 6: data and it infrastructure (21 firms); Lot 7: financial crime (20 firms); Lot 8: prudential – deposit takers and recognised clearing houses (18 firms); Lot 9: prudential – insurance (15 firms); Lot 10: prudential – investment firms, intermediaries and recognised investment exchanges (14 firms).

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