Following the financial crisis, the role of financial regulation and audit is being questioned like never before. It is clear that in the UK, the role of auditors in financial regulation is likely to increase. How this will be achieved is still a matter for debate. This report provides a useful comparison of the role played by auditors in UK and Swiss banking supervision and highlights features of the Swiss system which are worthy of consideration in the UK.

The report finds that the differences are considerable, with auditors in Switzerland playing a significant direct role in banking supervision, compared to the situation in the UK, where auditors' involvement is very limited. In fact, the role of auditors in UK banking supervision significantly diminished following the Financial Services and Markets Act 2000, although it is likely that this will be reversed following the financial crisis.

The authors of the report welcome the decision by the FSA to increase the engagement between auditors and supervisors in UK banking supervision, but also highlight the problems of unrealistic expectations and a blurring of roles and responsibilities between auditors and supervisors. The authors recommend, based on the Swiss system of regulation, that the FSA (and in due course the new Prudential Regulation Authority) considers the following methods for increasing engagement with auditors: approval by the FSA of auditors as banking experts; on-site observation by the FSA of banking audit engagements; and involvement in the review of auditors' work by the FSA.

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The contrasting role of auditors in UK and Swiss banking supervision

by

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Foreword

Following the financial crisis, the role of financial regulation and audit is being questioned like never before. It is clear that in the UK, the role of auditors in financial regulation is likely to increase. How this will be achieved is still a matter for discussion. This report provides a useful comparison of the role of auditors in UK and Swiss banking supervision, and highlights features of the Swiss system which are worthy of consideration in the UK.

The report highlights that, whilst auditors in Switzerland play a significant direct role in banking supervision, in the UK, auditors’ involvement is very limited. The authors of the report welcome the decision by the FSA to increase the engagement between auditors and supervisors in UK banking supervision but also highlight the problems of unrealistic expectations and a blurring of roles and responsibilities between auditors and supervisors. The Swiss and previous UK systems highlight the need for a clear framework of roles and responsibilities. The authors recommend that the FSA (and in due course the new Prudential Regulation Authority) considers the following methods to increase engagement with auditors: approval by the FSA of auditors as banking experts; on site observation by the FSA of banking audit engagements; and post-hoc file reviews by the FSA of the auditors’ work.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER - see page 49). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the project will add to the debate about future prudential regulation and the role of auditors.

Michelle Crickett
Director of Research
December 2010
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Finally, the Research Committee and the researchers are grateful for the financial support of the Scottish Accountancy Trust for Education and Research, without which the research would not have been possible.
Executive summary

Background

The global financial crisis, and associated banking collapses and bailouts, has fundamentally called into question the efficacy of existing systems of banking supervision. Governments, banks, regulators and auditors have each been criticised for the roles they played in the run-up to the crisis.

In the UK the role of auditors in banking supervision is very limited with the supervisor, the Financial Services Authority (FSA), undertaking direct inspections of banks. In contrast, in Switzerland, auditors have a significant, direct role in banking supervision that dates back to the Banking Act 1934.

This report contrasts the role played by auditors in two alternative national models for banking supervision, that of the UK and Switzerland, in the context of debates and reforms following the financial crisis.

Research approach

The report draws on three projects, undertaken by the researchers and sponsored by the Scottish Accountancy Trust for Education and Research (SATER), on the role of auditors in both UK and Swiss banking supervision. In particular, it reports the main findings of the most recent project undertaken in 2009. This project involved interviews with Swiss banking audit partners and others on the implications of the global financial crisis for the Swiss dualistic approach to banking supervision and on recent institutional developments in Switzerland.

Research findings

The Swiss system provides a significant contrast with the UK where the more limited role for auditors in banking supervision under the Banking Act 1987 had significantly diminished following the Financial Services and Markets Act (FSMA) 2000. However, greater engagement by the FSA with auditors is being restored as part of the FSA’s response
The contrasting role of auditors in UK and Swiss banking supervision

to the financial crisis. Following its election in 2010, the new coalition government has announced its proposals to replace the FSA by a new Prudential Regulation Authority under the Bank of England and to establish a separate Consumer Protection and Markets Authority.

Recent reforms to the arrangements for Swiss banking supervision, including the establishment of the Financial Market Supervisory Authority (FINMA), were seen by banking audit partners as being more ‘continuity’ rather than ‘change’. This was similarly the case with the introduction of the Swiss Federal Audit Oversight Authority (SFAOA), although partners noted that it had been more of a challenge for their non-banking colleagues. While appreciating the need for oversight, partners expressed concern about the growth of formal documentation, arguing that some of the time spent on documentation would be better spent on undertaking more audit work. The earlier move to a risk-based approach to audit and the associated risk-based approach to supervision was welcomed by partners as reflecting developments in current practice.

The banking audit partners, not unnaturally, were pleased that the recent financial crisis was recognised by all parties as not being caused by audit failure. On the other hand, following the financial crisis, it was seen as inevitable that greater demands would be placed on them as auditors. An issue identified by partners as problematic was the difference between a ‘certification’ and a ‘view’, the latter case being when a benchmark against which to express an opinion was not available. Partners believed they were increasingly being asked by supervisors to express ‘views’ or to offer ‘predictions’. Arguably, this is linked to the problem that audit is essentially ‘backward-looking’, whereas supervision, at least in times of financial crisis, is essentially ‘forward-looking’. It is a reminder of the ongoing audit expectations gap between what auditors can deliver and what stakeholders expect.

Implications

As the FSA (and its successor body, the Prudential Regulation Authority) seeks to increase its engagement with auditors there are a number of features of the Swiss system worthy of further investigation as to their applicability in a UK context.
Approval by the FSA of auditors as banking experts

In Switzerland, in addition to audit firms having to be approved and registered by the SFAOA, the Swiss public oversight body, audit firms undertaking bank audits must also be licensed by FINMA, the Swiss banking regulator. In a UK context, the greater involvement of the FSA in the review and recognition of both audit firms and engagement partners able to undertake the audit of banks may provide a formal opportunity, as a minimum, to help improve knowledge of, and communication between, audit firms/partners and the FSA.

On-site observation by the FSA of banking audit engagements

In Switzerland, FINMA has the power to accompany audit firms during the period auditors are undertaking work at banks in an observational capacity. This provides a further opportunity for the supervisor to gain a deeper understanding of the process of audit, including its boundaries and limitations. Similar powers do not exist in the UK but may provide another opportunity for the supervisor both to liaise with auditors and understand the audit approach adopted by audit firms.

Involvement in review of auditors’ work by the FSA

In Switzerland, responsibility for the inspection of the work of banking auditors is undertaken by a specialist unit within FINMA. In contrast, file reviews of other public interest companies in Switzerland is undertaken by the SFAOA. This approach facilitates not only the acquisition of specialist banking audit knowledge by a dedicated team at the regulator, but also benchmarking of the audit approach/performance both between and within audit firms. In the UK the Audit Inspection Unit is responsible for undertaking the review of auditors’ work. The creation of a dedicated team within the FSA responsible for the file review of auditors’ work in financial services firms may also facilitate knowledge and benchmarking opportunities. As is the case in Switzerland, close liaison between the Audit Inspection Unit and the FSA would be required.
1. Background

The global financial crisis, and associated banking collapses and bailouts, has fundamentally called into question the efficacy of existing systems of banking supervision. Governments, banks, regulators and auditors have each been criticised for the roles they played in the run-up to the crisis. Post-crisis reforms are being implemented at national, European and international levels with the objective of putting systems in place such that future crises might be prevented.

The aim of this report is to contrast the role played by auditors in two alternative national models for banking supervision, that of the UK and Switzerland, in the context of debates and reforms following the financial crisis.

The contrast between the role played by auditors in UK and Swiss banking supervision is marked. In the UK the role of auditors in banking supervision is very limited with the supervisor, the Financial Services Authority (FSA), undertaking direct inspections of banks.¹

In contrast, in Switzerland, auditors have a significant, direct role in Swiss banking supervision that dates back to the Banking Act 1934. As Hüpkes explains:

“The external auditor is seen as the ‘extended arm’ of the supervisor...
The external auditors carry out regular direct supervisory tasks. At the same time the supervisor retains (indirect) oversight responsibility...
(Hüpkes, 2006, pp. 145-146)

The supervisor is the Swiss Financial Market Supervisory Authority (FINMA) which only infrequently undertakes direct supervisory tasks. Legally established under the Financial Market Supervision Act 2007, FINMA assumed overall responsibility for financial market regulation from predecessor bodies, including the Swiss Federal Banking Commission (SFBC), as from 1 January 2009. This report generally refers to the Swiss banking supervisor as FINMA, except where there is a specific need to refer to the SFBC.
The extent of the involvement of auditors in the Swiss dualistic system of banking regulation is unique among countries with a major financial services industry, including Switzerland’s main competitors, such as the US, France, Germany and the UK. This dual role, therefore, provides a particularly interesting focus for auditing research as it raises theoretical and practical issues, for instance, as regards auditor independence, and the role of non-state (private) actors in state (public) regulation.

This report draws on three projects, undertaken by the researchers and sponsored by the Scottish Accountancy Trust for Education and Research (SATER), on the role of auditors in both UK and Swiss banking supervision and, in particular, reports the main findings of interviews undertaken with Swiss banking audit partners carried out in July 2009.

The first of these projects, *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* (Dewing & Russell, 2005), researched *inter alia* the dual role of auditors of banks reporting to shareholders under the Companies Act 1985, and reporting as auditors and reporting accountants/skilled persons to the Bank of England under the Banking Act 1987 and to the FSA under the Financial Services and Markets Act (FSMA) 2000. Interviews for the research were conducted between April 2002 and November 2003 at a time soon after the newly established FSA had assumed its full powers as from 1 December 2001.

The second of these projects, *Auditors as regulatory actors: the role of auditors in banking regulation in Switzerland* (Dewing & Russell, forthcoming), researched the dual role of auditors in banks in Switzerland, which in contrast to the UK, involves the auditor acting as an extended arm of the supervisor undertaking supervisory tasks directly for the regulator. Interviews for the research were undertaken with Swiss banking audit partners and conducted between June and July 2006. The project investigated the long-standing Swiss dualistic approach to banking supervision in the wider context of debates in auditing and the changing nature of regulation.

The third of these projects, *The role of auditors in Swiss banking supervision: recent developments*, important findings of which are reported here (see chapter four), was designed to gather perceptions from
Swiss banking audit partners on recent institutional developments in Switzerland, including the establishment of FINMA and the Swiss Federal Audit Oversight Authority (SFAOA). This body was legally established under the Auditor Oversight Act 2005 and commenced operations on 1 September 2007 (SFAOA, 2008). The implications of the global financial crisis for the Swiss dualistic approach to banking supervision are also considered. Interviews for the project were conducted in July and September 2009.

This report provides an overview of the significant role of auditors in Swiss banking supervision, in contrast to the more limited role of auditors in UK banking supervision, and in the light of recent institutional developments in Switzerland and following the global financial crisis.

As the research projects have been sponsored by SATER, the report is written to be relevant primarily to members of the accountancy profession in the UK. It is hoped that the report will also be of interest to others involved in banking regulation in the UK, Switzerland and elsewhere, and help inform policy debates and practice developments following the financial crisis. Readers interested in academic debates in this area are referred to Dewing and Russell (forthcoming). This report proceeds as follows:

• Chapter two sets out the research approach, including a brief overview of the three SATER sponsored projects undertaken by the researchers;

• Chapter three discusses the role of auditors in UK banking supervision before and after the establishment of the FSA, and as undergoing change after the financial crisis. In particular, drawing on Dewing and Russell (2005), the role of auditors in banking supervision under the Bank of England’s regulatory regime is contrasted with that of the FSA’s. Changes to the role of auditors in UK banking supervision following the financial crisis are discussed by drawing on recent documentary sources;

• Chapter four sets out the role of auditors in Swiss banking supervision before the financial crisis, and discusses how recent institutional developments and the financial crisis have affected the role auditors
in Switzerland. In particular, the chapter draws on Hüpkes (2006) and Dewing and Russell (forthcoming) to discuss the role of auditors in Swiss banking supervision, and on interview and documentary evidence to discuss recent changes and developments following the financial crisis;

• Chapter five sets out recommendations and policy implications emerging from the research projects, together with suggestions for further research.
2. Research approach

The findings reported in this study are based on evidence gathered from three SATER supported research projects. The first project was primarily concerned with the role of auditors in UK financial services supervision, research interviews being conducted during 2002-03. The second and third projects investigated the role of auditors in Swiss banking supervision, research interviews being conducted before (in 2006) and after (in 2009) the global financial crisis.

UK project (Dewing and Russell, 2005)

The main aim of the UK project was to investigate the roles and responsibilities of auditors, reporting accountants and skilled persons in UK financial services supervision before and after the establishment of the FSA. The study was conducted in three stages. The first stage 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 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 (34 interviews), accountancy and auditing practices (11 interviews), and regulators (eight interviews). Selected findings from the study are reported in chapter three. The full report can be downloaded at: www.icas.org.uk/dewing
Swiss 2006 project (Dewing and Russell, forthcoming)

The aim of the 2006 project was to investigate the dual role of auditors in the Swiss system of banking supervision, whereby the auditor of a bank undertakes not only the statutory audit of the bank's financial statements but also undertakes direct supervision of the bank as an extended arm of the regulator. The Swiss system provides an interesting contrast to that of the UK since, although both jurisdictions have a major banking industry, the involvement of auditors in UK and Swiss banking supervision differs considerably.

Nine face-to-face interviews were conducted jointly by the researchers in June 2006 with 12 interviewees, which included six interviews with seven specialist banking audit partners. Three background interviews involving five interviewees were conducted with representatives from the SFBC and Basel Committee for Banking Supervision (BCBS). Semi-structured interviews were conducted in English and generally lasted for approximately one hour. In addition, due to the unexpected availability of one of the audit partners, one telephone interview was conducted in July 2006. Selected findings from the study are reported in chapter four.

Swiss 2009 project (chapter four of this report)

The 2009 project developed the 2006 project by gathering perceptions from Swiss banking audit partners and others on recent institutional developments in Switzerland, including the establishment of FINMA and SFAOA, and the implications of the global financial crisis for the Swiss dualistic approach to banking supervision.

The 2009 project was concerned with two main research questions:

- What is the impact of recent institutional developments in Switzerland, including the establishment of FINMA and SFAOA, on the role of auditors in banking supervision in Switzerland?
- To what extent is the role of auditors in Swiss banking supervision likely to change following the financial crisis?
Nine face-to-face interviews were conducted jointly by the researchers in July 2009 with 11 interviewees, which included five interviews with five specialist banking audit partners who had also been interviewed during the 2006 Swiss project. Four background interviews involving six interviewees were conducted with representatives from FINMA, SFAOA, Swiss Bankers Association and BCBS. A further background interview involving one interviewee was conducted by one of the researchers in September 2009 in Switzerland. Semi-structured interviews were conducted in English and generally lasted for approximately one hour. The main findings are reported in chapter four.

In the next two findings chapters the role of auditors in banking supervision in the UK and in Switzerland are discussed respectively.
3. Research findings - UK

This chapter begins by outlining the role of auditors in UK banking supervision pre-financial crisis, relying particularly on Dewing and Russell (2005)\textsuperscript{2}. The chapter then discusses recent investigations and reviews post-financial crisis undertaken by Parliamentary Committees, the government and FSA, and others, and identifies changes in the role of auditors in UK banking supervision.

Banking supervision in the UK: pre-financial crisis

Banking Act 1987

In discussing the role of auditors in UK banking supervision pre-financial crisis it is important to distinguish the periods before and after the establishment of the FSA, the new single financial services regulator which assumed its full powers on 1 December 2001. Prior to the unified regulatory approach of the FSA under FSMA 2000, regulation was conducted under separate Acts for each sector of the financial services industry.

For banking, the Bank of England was responsible for the supervision of banks under the Banking Act 1987 (see Dewing and Russell, 2005, pp.16-22). This Act placed additional responsibilities on statutory auditors of banks over and above those contained in the Companies Act 1985. For instance, under section 39, the Bank of England had powers to call for two kinds of reports on a bank by ‘reporting accountants’, normally the auditors, on certain matters: first, on a bank’s accounting and other records and internal controls systems (‘controls reports’); and, second, on a bank’s financial returns used for statistical or monitoring purposes (‘returns reports’). These reports were of a ‘routine’ nature and would normally be undertaken by the bank’s auditors. Under section 47, auditors or reporting accountants were obliged to communicate directly with the Bank of England on any matter that was relevant to
the performance of the Bank of England’s duties without breaching client confidentiality provided that the communication was made in ‘good faith’. These reports were non-routine and of an ‘exceptional’ or ‘ad-hoc’ nature.

In addition, auditors and reporting accountants were obliged to participate in bilateral meetings with the Bank of England, and trilateral meetings with the Bank of England and the bank. The meetings could be ‘informal’, for example, to discuss the scope of section 39 reports, or ‘formal’, for example, to discuss matters arising from the statutory audit or from section 39 reports. Normally, at least one bilateral and one trilateral meeting was held each year. The Bank of England 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 Bank of England 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 bank without the consent of the Bank of England.

Thus, under the Banking Act 1987, the Bank of England made considerable use of auditors and reporting accountants. Regular reporting accountants’ reports (section 39 reports) on systems and controls were commissioned by the Bank of England. In addition, bilateral and trilateral meetings involving the bank, Bank of England and the auditors were common.

FSMA 2000

FSMA 2000 unified the regulation of the financial services industry under one regulator, the FSA (see Dewing and Russell, 2005, pp.33-42). The FSA introduced a new risk-based approach to supervision, applied across all financial sectors, to enable it to focus resources on those firms categorised by the FSA as of relatively higher risk and larger potential impact.

It is interesting to note that FSMA 2000, and the FSA in its formal guidance on supervision, attach a lower importance to the involvement of external auditors in the supervisory process, particularly as regards banks. For example, there are no comparable provisions to those under section 39
of the Banking Act 1987 for reporting accountants to report formally on a regular basis to the FSA on the adequacy of a bank’s system of controls or returns. Similarly, no comparable provisions exist for regular bilateral and/or trilateral meetings with the FSA to discuss matters of interest or concern, as was effectively the case for banks under the section 39 regime.

However, under FSMA 2000 and similar to provisions contained in the Banking Act 1987, auditors have a statutory duty to report matters to the FSA if the auditor reasonably believes that the information or opinion is relevant to any functions of the FSA. Such communication would not breach any duty of confidentiality, so long as the auditor was acting in ‘good faith’.

Under section 166 FSMA 2000, the FSA has the power to commission a skilled person’s report (see Dewing and Russell, 2005, pp.44-48). The skilled person may be an accountant, lawyer, or actuary, or any other person with relevant business, technical or technological skills. These reports are designed to be exceptional in nature and therefore are not comparable to the regular reporting regime contained in section 39, Banking Act 1987. Once completed, the skilled person’s report is initially submitted to the bank. The bank 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 bank to discuss the findings of the report.

There are 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 Bank of England, 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 including cost, 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 bank, not the FSA, and the interaction between a bank, a skilled person and the FSA continues, although not necessarily as previously structured, with formal annual bilateral and trilateral meetings.

As regards appointment as external auditor (see Dewing and Russell, 2005, pp.42-44), the FSA does not maintain a list of audit firms licensed to undertake the audit of banks and other financial institutions but guidance is provided in the FSA Handbook, Supervision. In summary, the auditor must be eligible to be appointed under company legislation but it is the bank’s responsibility to ‘take reasonable steps’ to ensure, both, that the auditor has the required skill, resources and experience to perform the audit, and that the auditor is independent of the bank (paras. 3.4.2 and 3.5.2, respectively). The auditor is required \textit{inter alia} to co-operate with the FSA, for example, by attending meetings with and supplying information to the FSA, and to take reasonable steps to guard against any conflict of interest (paras. 3.8.2 and 3.8.6, respectively). The FSA may also seek information about an auditor’s qualifications, skills, experience and independence in order to assess the ability of an auditor to undertake an audit (paras. 3.4.7-8).

**Banking supervision in the UK: post-financial crisis**

The global financial crisis has led to a number of reviews of the arrangements for financial services supervision. Reviews have been undertaken at national, European and international levels leading to reforms of both micro-prudential and macro-prudential supervision (see Dewing and Russell, forthcoming). The focus of this section is to discuss recent investigations and reviews undertaken by Parliamentary Committees, the government and FSA, and others, and to identify changes in the role of auditors in UK banking supervision following the financial crisis.
Parliamentary Committees

Parliamentary Committees enquiring into the banking crisis have included chapters relating to the role of auditors (Treasury Committee, 2009a, chapter six; Select Committee on Economic Affairs 2009, chapter eight). The Committees found no evidence that auditors had failed to perform their statutory duties, including judgements about going concern:

*We have received very little evidence that auditors failed to fulfil their duties as currently stipulated.* (Treasury Committee, 2009a, para. 221)

*We have seen no evidence that bank auditors failed in their statutory duties to make a going concern judgement on their clients.* (Select Committee on Economic Affairs, 2009, para. 211)

Both Committees noted it is the case that auditors accumulate considerable information during the course of carrying out the statutory audit and expressed concern at the reduction in contact between auditors and supervisors. In forthright terms the Committees encouraged the FSA to have greater engagement with auditors:

*The FSA’s piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge on a confidential basis...* (Treasury Committee, 2009a, para. 221)

*It is regrettable that supervisors no longer meet auditors regularly. The auditors could provide useful information and the banks would not object. We recommend that the FSA should take the initiative to resume regular meetings with bank auditors, even where there are no obvious problems in the banks.* (Select Committee on Economic Affairs, 2009, para. 215)
The Treasury Committee also looked at more general issues related to the role of auditors. The Committee made recommendations concerning auditor independence, going concern and the desirability of improving the understandability of financial reports (Treasury Committee, 2009a, paras. 237, 243, 247). An interesting issue pursued by the Treasury Committee, and which was raised in their report on Northern Rock, was the question of whether auditors should give further assurance to shareholders in respect of the risk management processes of a company (Treasury Committee, 2008, para. 299; 2009a, para. 223). The Committee however concluded:

_We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion._ (Treasury Committee, 2009a, para. 225)

**Government and FSA responses**

In its response to the Treasury Committee, the government confirmed the Committee’s view that the banking crisis was not because of audit failure:

_The government believes that there is very little evidence from the banking crisis that auditors have failed in their duties... _(Treasury Committee, 2009b, p. 14)

As regards more general issues raised by the Committee on independence, going concern and improving the understandability of financial reports and which are relevant to all companies, the government noted that these issues were under active consideration by the Financial Reporting Council (FRC) (see Auditing Practices Board (APB), 2009; FRC, 2009a,b respectively).
As regards questioning the usefulness of audit and the possible extension of auditors’ duties to report to investors on risk management processes in companies, the government continued:

...any extension of the role of audit would raise a range of complex legal and practical issues. The government welcomes debate about these issues, but it is not clear that there is currently any consensus around the need for a fundamental review of the audit process, so soon after the Companies Act 2006 and the Company Law Review. (Treasury Committee, 2009b, pp. 14-15)

The government also pointed out that risk management was being considered by the Walker Review (2009) of the corporate governance of banks and other financial institutions (see below).

As regards closer involvement between auditors and the FSA, in its response to the Treasury Committee, the FSA recognised that contact had declined but that a major change had been instituted:

We now have a far more intense relationship with auditors than in the past. We have increased our engagement with auditors and investors to emphasise their role in the oversight of firms... our supervisors of high-impact firms are now required to meet the auditors of high-impact firms at least annually... This has required us to become more involved with the scrutiny of specific accounting practices and judgements. (Treasury Committee, 2009b, p. 28)

The FSA pointed out that more general contact with auditors also occurred to consider potential risks in industry sectors, such as high-level bilateral meetings with audit firm partners, technical bilateral meetings with audit firm directors and roundtable meetings with the Big 6 firms to discuss key financial reporting and audit issues (Treasury Committee, 2009b, p. 29).

The Turner Review (FSA, 2009a), the associated Discussion Paper (FSA, 2009b) and the subsequent Feedback Paper (FSA, 2009c) offer further insights on why the FSA perceived the need to increase its contact with
auditors. For example, the FSA stated that intensive analysis of bank balance sheets to inform decisions on bank recapitalisations:

...revealed significant differences used in the marks used by different banks to value similar trading book assets and significant differences in the allocation of assets between trading and banking books. (FSA, 2009a, p. 89)

Thus an important ‘future role’ for the FSA should involve ‘monitoring accounting judgments’ (FSA, 2009a, p. 89).

Subsequent feedback indicated strong support for the FSA’s intention to engage in an ‘intensive dialogue’ between banks and their auditors, but also warned about the ‘potential blurring of responsibilities of directors, auditors and the FSA’ (FSA, 2009c, para. 4.10.2). In particular, there was concern that the FSA should not become an ‘interpretive body’ on accounting issues, and also that ‘uniformity’ was not necessarily a useful goal as underlying economic circumstances may differ between firms (FSA, 2009c, para. 4.10.2). The FSA accepted the need:

...to be mindful of the respective roles of and responsibilities of directors of UK banks and their auditors... The FSA also appreciates the need to be careful not to become an ‘interpretive body’ on accounting issues. In addition uniformity in valuation is not necessarily the desired goal... (FSA, 2009c, Response p. 38)

The FSA pointed out that auditors have an important role in ‘independently assessing’ valuation assumptions and techniques used by directors and therefore it was ‘essential’ to include auditors in the dialogue and not to rely only on the directors. The FSA stated its intention:

...to become more involved in comparing, contrasting and challenging differences in valuation assumptions and judgments in relation to comparable assets. (FSA, 2009c, Response p. 39)
An area of concern raised by the FSA (2009b, see para. 5.46 and Box 5.3) concerned the institutional framework for global audit firms. The FSA pointed out that such firms are now a ‘lynchpin’ in the provision of reliable financial information about international banks. However, there were two gaps in the oversight of international audit firms: first, while the major audit firms operate globally, audit regulation is undertaken at national level; and second, there is no regulation of the provision of non-audit services. A complicating factor was that accountancy firms are primarily networks of nationally based partnerships without a unified global management and financial structure. The FSA suggested a strengthening of the global supervisory architecture for all significant activities of the major accountancy firms, possibly via the International Forum of Independent Audit Regulators.

Subsequent feedback (FSA, 2009c, paras. 4.13.1-4) recognised the increased need for global oversight of audit firms, although noting it would take time to achieve and questioning whether it was an urgent priority for the FSA. In the UK there are ethical standards published by the APB as to the nature and quantity of work that can be undertaken by auditors for audit clients, and the Institute of Chartered Accountants in England and Wales (ICAEW) has developed a Code on audit firm governance on behalf of the FRC (ICAEW, 2010). The FSA however restated its view that serious consideration needs to be given to the global regulatory architecture for major accountancy firms (FSA, 2009c, Response, p. 45).

Corporate governance of banks

The government also instituted a review of the corporate governance of banks and other financial institutions under the Chairmanship of Sir David Walker (Walker Review, 2009). An interesting response to an earlier consultation paper report, and noted in the Review, was that: ‘Some concern was also expressed at the very limited discussion of audit, in particular internal audit...’ (para. 6.1) In an echo of the previous Parliamentary Committee reports and government and FSA responses, the Review provided further confirmation that audit was not seen as a
significant issue in the financial crisis. The lack of discussion of audit in the Review:

...in fact reflected the judgement that the principal failures that afflicted problem banks did not principally arise under the rubric of ‘audit’. (para. 6.1)

In an important chapter on the ‘Governance of Risk’, the Review distinguished between:

...the management and control of known financial risks and the identification and monitoring of current risks, including new risks, in a potentially fast-changing market environment... (para. 6.8)

The Review noted that the two areas of risk are often covered by the audit committee. However, the Review argued that the oversight of financial accounts, and the adoption of appropriate accounting policies, internal control, compliance and other matters, is essentially ‘backward-looking’ (para. 6.8); whereas the oversight of current risk and approving and monitoring limits on exposures and concentrations and determining overall risk tolerance and risk appetite is largely ‘forward-looking’ (para. 6.9). The Review argued that:

...a clear differentiation is needed to (sic) in ensuring that appropriate and separate attention is given to backward and forward-looking risk functions. (para. 6.9)

The Review concluded that, as the ‘oversight burden’ for audit committees had greatly increased by enhanced statutory, accounting and other standards surrounding the financial statements, together with the need to review and report on the effectiveness of internal controls, risk committees should be established separate from audit committees (para. 6.11). The result is to institute a ‘clear differentiation’ (para. 6.9) between backward-looking and forward-looking risks, with the audit committee remaining responsible for the former, and a separately constituted risk committee responsible for the latter. The Review reported results that
showed approximately half of the financial institutions listed in the FTSE 100 had a risk committee (Annex 9).

As regards risk governance, the Review inter alia recommended:

• The board of a FTSE 100 bank or life insurance company should establish a board risk committee separately from the audit committee... (Recommendation 23)

• In support of board-level risk governance, a bank or other financial institution should be served by a Chief Risk Officer (CRO) who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units... The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board... (Recommendation 24)

• The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts... (Recommendation 27)

The Review suggested that the risk report be included in the annual financial statements and should seek to meet the following key principles: ‘Strategic Focus’; ‘Forward-looking’; and ‘Risk Management Practices’ (Annex 10).

In recommending the creation of a board risk committee, the Walker Review (2009) follows the well-established British corporate governance tradition of dealing with problem areas, such as audit, nomination and remuneration, by establishing a board committee of non-executive directors to have oversight of the topic, and that a separate report on the topic be included in the annual financial statements. The recommendation of the creation of a Chief Risk Officer as a new company official with additional independence safeguards is an interesting and important corporate governance innovation. The characterisation of the audit committee as dealing with ‘backward-looking’ risks and the risk committee as dealing with ‘forward-looking’ risks is considered below (see chapter five).
Developments in 2010

The new coalition government has published proposals for the restructuring of the financial regulatory system in a consultation paper *A new approach to financial regulation: judgement, focus and stability* (Osborne, 2010; HM Treasury, 2010). Under these proposals a new Financial Policy Committee (FPC), responsible for macro-prudential regulation, will be established under the Bank of England. Also, the FSA would cease to exist in its present form and will be replaced by a new Prudential Regulation Authority under the Bank of England, and a separate Consumer Protection and Markets Authority will be established.

Debate about how public confidence might be restored in the role of auditors has increased with: the publication of an ICAEW Financial Services Faculty report *Audit of banks: lessons from the crisis*; a joint FSA/FRC discussion paper *Enhancing the auditor’s contribution to prudential regulation* (ICAEW Financial Services Faculty, 2010; FSA/FRC, 2010); and a House of Lords Economics Affairs Committee inquiry *Auditors: market concentration and their role* (Select Committee of Economic Affairs, 2010). In addition, the FRC has announced it has launched a project to examine the lessons learned from the financial crisis as they impact corporate reporting, accounting and auditing of non-financial services companies (FRC, 2010; Haddrill, 2010).

UK practice may also be affected by recent developments in Europe. The European Commission (EC) initiated a restructuring of the financial regulatory architecture as summarised in the communication *Regulating financial services for sustainable growth* (EC, 2010a), which was recently endorsed (EU Council, 2010). In addition, the EC has started a debate on the governance of financial services firms with the issuance of a green paper *Corporate governance in financial institutions and remuneration polices* (EC, 2010b), and a green paper on auditing, entitled *Audit policy: lessons from the crisis* (EC, 2010c).

Overall, although the initial findings of UK Parliamentary Committees and the government response indicated that the banking crisis was not because of audit failure, there has been further discussion about the ways in which auditors and regulators could more effectively...
The contrasting role of auditors in UK and Swiss banking supervision

As the debates moved on into 2010, with a new coalition government in London and a new European Commission in Brussels, the role of auditors in the supervision of banks and other financial firms, and more generally, is receiving detailed attention. At the time of writing, the outcome of these discussions is unknown. It is, however, clear that the general thrust of current UK and European auditing and financial regulatory reforms will result in greater interaction between auditors and regulators, especially for large, complex financial firms.

Summary

Under the Banking Act 1987, the Bank of England routinely used auditors/reporting accountants as an aid to supervision and held regular bilateral and trilateral meetings. In contrast, under FSMA 2000, contact with the FSA declined from being routine and annual to exceptional because the FSA predominantly uses its own front-line supervisors to form its risk-assessment. It is arguably the case that as a result of this change the FSA missed out on a significant opportunity to enhance its understanding of banks. Dewing and Russell (2005) in undertaking interviews with banking partners in audit firms found concern that the commonalty of interest with the supervisor and the potential co-operation between auditors and the FSA was being ignored.

Following the financial crisis, a series of investigations and reviews were undertaken. Importantly, these concluded there was no evidence that auditors had failed to fulfil their statutory duties. On the other hand, these reports recommended that the FSA should make greater use of auditors’ knowledge, and the FSA confirmed that it was increasing its engagement with auditors, including a requirement for supervisors to meet the auditors of high-impact firms at least annually.

What is not clear is the nature and extent of the new FSA engagement with auditors as compared to the situation between auditors and the Bank of England under the Banking Act 1987. Under the 1987 Act contact routinely occurred through consideration of section 39 reporting accountants’ reports which took place within a framework of detailed and regularly updated guidance notes provided by the Bank of England and
Auditing Practices Board. Whereas before the focus of discussions was on systems and controls, statements by the FSA indicate that discussions with auditors are likely to revolve around accounting practices and judgements concerning the classification and valuation of financial assets. The recommendation of the Walker Review (2009) of the creation of a board risk committee separate from the audit committee for FTSE 100 financial institutions, and the appointment of a Chief Risk Officer with independence safeguards, also has implications for increased dialogue between auditors and regulators.

That there could be minimal to no dialogue between auditors and regulators is inconceivable in the Swiss system. This is because in Switzerland auditors have a dual role where, under banking law, they also act as an arm of the banking regulator. Recent developments in the Swiss system and banking audit partners’ views on these developments and on the financial crisis are discussed next.
4. Research findings - Switzerland

This chapter first outlines the role of auditors in Swiss banking supervision and recent developments drawing on Hüpkes (2006) and Dewing & Russell (forthcoming). The second part of this chapter discusses perceptions of Swiss banking audit partners on recent developments and on the implications of the financial crisis for the future role of auditors in Swiss banking supervision.

Banking supervision in Switzerland: recent developments

The origin of the Swiss dualistic system of banking supervision is the Banking Act 1934 which established the SFBC and gave external auditors a role in regulating banks. Although subject to reform and development (Faith, 1982), the Swiss system still operates in essentially the same way whereby external auditors undertake direct supervisory tasks on behalf of the regulator. It has been characterised as a ‘two-tiered’ system (Gugler, 2005) or ‘dualistic’ or ‘indirect’ system (Hüpkes, 2006). Thus, in addition to the normal statutory audit and reporting to shareholders carried out under Swiss company law, further audits and reporting to supervisors are carried out under Swiss banking law. Additional arrangements apply to the supervision of the two large Swiss banks, Credit Suisse and UBS, which involve FINMA undertaking direct supervisory activity.

A major review of Swiss financial market regulation commenced in 1998. Commissions were successively set up to review the structure of financial markets regulation, the reform of bank audit and the legal requirements needed for a new integrated supervision body (Zufferey, Nobel and Zimmerli Commissions respectively). The outcome was the decision to create a single financial markets regulator FINMA which was legally established under the Financial Market Supervision Act in June 2007. FINMA took up its duties on 1 January 2009.

Reforms to bank audit did not require new legislation and during this period a number of reforms were put in place (for further detail see Hüpkes 2006; Dewing and Russell, forthcoming). Crucial to the reforms
was the issuance of two Circulars on Audit (SFBC, 2005a) and Audit Reports (SFBC, 2005b) which became effective from 1 January 2006. These were instituted under the SFBC and have been retained by FINMA. The Circulars relate to the 'financial' and 'regulatory' audits which are carried out under Swiss banking law. The Circulars specify in detail the nature and subject matter of the financial audit and the regulatory audit, and associated with each audit there is a report that is filed by the auditors with FINMA.

The Audit Circular (SFBC, 2005a) states that audits are to be conducted using a risk-based approach. Audits commence with a risk analysis whereby the auditors draw up a risk profile of the bank. On the basis of this profile the key audit risks are identified, and then the audit strategy for each element of the financial and regulatory audits is determined. In the event of the auditors discovering breaches of legal requirements or other irregularities, the auditors must set an adequate deadline for correcting them. When the deadline has expired the audit firm must perform a follow-up audit to confirm the bank rectified the situation. Serious irregularities must be immediately reported to FINMA.

The Audit Reports Circular (SFBC, 2005b) sets out matters on which the auditors are required to report, which are extensive. For the financial audit these include: notices of reservations with their set deadlines; confirmations, statements, analysis and commentary on the financial statements; audit opinions on organisation and internal control, valuation of assets and off-balance sheet items, budgeting and planning, and treatment of the previous year’s financial audit by the bank. For the regulatory audit these include: a variety of confirmations and opinions on compliance with banking regulations, the financial figures reported to FINMA, internal controls and risk management. For both audit reports additional information is included, for example, ‘key figures’ relating to the detailed analysis of the balance sheet and income statement, large exposures, organisation charts.

In other jurisdictions, such as the UK, the financial information would normally be provided by the bank and not generally subject to independent audit, with the FSA itself responsible for analysing and forming an opinion on the data. In this context it is interesting
to note that the UK Treasury Committee (2009b, para. 229) observed that regulatory returns of the insurance sector were reported on by the auditors, and queried whether re-introduction of a review of key bank regulatory returns by auditors would be useful.

Important features of the Audit and Audit Reports Circulars include that FINMA can review the risk analysis/audit strategy form and suggest changes before the audit has commenced:

_The SFBC may request this form before the beginning of the audit and may suggest amendments or demand additional audit activities._ (SFBC, 2005a, margin note 60)

Audit partners interviewed, however, commented that this was rarely exercised. In their dual role, if the auditors find the bank is failing to comply with FINMA requirements for authorisation, they are empowered to require the bank to rectify the matter:

_If the audit firm identifies breaches of legal provisions or other irregularities, it sets an adequate deadline for correcting them… Once this deadline has expired, the audit firm performs a follow-up audit…_ (SFBC, 2005a, margin note 76)

The board is formally required in meetings attended by the lead auditor to consider the auditors’ reports before the reports are submitted to FINMA:

_The Board of Directors must discuss the regulatory and financial audit reports, and minutes must be taken of their discussion._ (SFBC, 2005b, margin note 12)

Another recent development in Switzerland is the establishment of the SFAOA which commenced operations on 1 September 2007. The SFAOA is responsible for the registration and public oversight of all individuals and firms wishing to provide statutory audit in Switzerland. The impetus for its creation was two fold: first, the desire
to modernise company law relating to auditors; and, second, to take account of international developments in audit regulation, such as the implementation of the US Sarbanes-Oxley Act and the EU Eighth Directive on statutory audit (SFAOA, 2008).

As regards the process of inspection, it covers checking ‘registration conditions’, ‘processes relating to independence’, and the existence of an appropriate and functioning internal quality control system (‘firm reviews’). In addition working papers from individual audit engagements are reviewed to confirm that the audit firm has followed appropriate quality assurance criteria (‘file reviews’) (SFAOA, 2008, p. 17).

As discussed below FINMA for a number of years has licensed audit firms able to undertake bank audits and has undertaken file reviews of the working papers of bank auditors. In order to avoid duplication of effort following the establishment of the SFAOA, ‘joint inspections’ in banking are now conducted whereby the SFAOA undertakes the firm level review and FINMA continues to undertake file level reviews. The SFAOA states that: ‘This cooperation worked very well in practice...’ (SFAOA, 2009, p. 25).

Banking supervision in Switzerland: banking audit partners’ views on recent developments

The interviews with banking audit partners for the first Swiss project were undertaken in June/July 2006 and in June 2009 for the second Swiss project. During this time the Audit Circulars formalising the risk-based approach to financial and regulatory audit and supervision were introduced from 1 June 2006. The SFAOA commenced operations from 1 September 2007. The SFBC continued to be the banking supervisor until responsibility passed to FINMA which commenced operations on 1 January 2009. The period saw the reforms, planned long before the credit crunch, being implemented during the greatest global financial crisis since the great depression. Interview findings for the first project undertaken in 2006 are reported in Dewing and Russell (forthcoming). This section reports important findings from the second interview project in 2009. The objectives of these interviews with banking audit partners were to gather their perceptions on recent institutional developments in
Switzerland, especially FINMA and SFAOA, and on recent developments/proposed reforms to the role of auditors in Swiss banking supervision as a result of the financial crisis.

Financial Market Supervisory Authority (FINMA)

So far as banking audit partners were concerned, there were no major changes in the move to FINMA. One partner explained, ‘I’ve not seen big differences’ and pointed out ‘because anyway, it’s a continuation of the existing system we had in banking’. As another partner put it, ‘It’s rather a consolidation of supervision … but for banking audit there is no big change out of this’. This was reinforced by the fact that key Circulars issued by the SFBC had been adopted by FINMA. As one partner explained about the Circulars, ‘…they have new names now but their content is exactly the same’. In addition, the individuals with whom partners had contact at the SFBC remained the same for FINMA. Another partner confirmed, ‘I have not seen much difference because they are still the same people who are dealing with banking supervision’. On the other hand one partner, although agreeing there had not been major changes, felt there was a change towards a more forceful style of engagement with auditors by FINMA:

*I mean for my day to day work I would not say that there are drastic changes... They are more pushy on questions, follow up on things, asking more questions in writing, where we have to reply etc – so there is a kind of maybe more aggressive...*

Overall, partners emphasised continuity rather than change in the move from the SFBC to FINMA.

Swiss Federal Audit Oversight Authority (SFAOA)

The other major change more generally for audit firms has been the establishment of SFAOA which commenced operations on 1 September 2007. The SFBC was responsible for licensing audit firms able to undertake bank audits but, under the new system, the procedure is
that SFAOA grants the basic licence to firms and individuals authorised to undertake audits and FINMA continues to grant special licences to audit firms and lead auditors authorised to undertake bank audits. The legislation permits SFAOA and FINMA to coordinate their activities to avoid duplication of effort. Thus, the ‘firm’ review is the responsibility of SFAOA, and the ‘file’ review of individual bank audits is undertaken by FINMA.

Banking audit partners commented that the new licensing system had not been a major issue for them as they were used to the licensing procedures of SFBC. However, they reported that at the level of the audit firm and for non-banking colleagues, the process of obtaining the basic licence had been onerous. Interestingly, one partner referred to the process as an ‘audit’, ‘...it’s a really a very detailed audit and it requires from us a lot of resources to respond to their needs’.

As regards independence another partner commented that a firm with a FINMA licence may in fact be less concerned about independence issues because only a small number of firms are licensed to undertake bank audits. Therefore, the matter could be referred to FINMA and, ‘...then it will be up to the regulator to decide whether it’s a real stumbling block, or if you can have some Chinese rules or whatever within your process’.

As regards oversight more generally, a concern of partners was the increased need for the comprehensive documentation of audit work. This was not so much the requirement to write things down per se, but that the time spent writing up the audit might have been more usefully spent doing more audit work. As one partner put it:

And from time to time we really say... ‘Oh, I have to document all of that’. You spend a day doing that and the end of the day you have a nice thing, well documented for somebody checking. But what is the real audit work that we have done?

Another partner echoed this view:

Yes. It’s very much about documentation nowadays and personally I find it a pity how it is going; you lose time for doing your audit work,
your proper audit work, and then spend a lot of time documenting a lot of findings. I mean, five years ago you could write ‘okay’. And now you have to write ‘because...’ Before you can say ‘okay’ you have to write quite a sermon why it is okay.

Risk-based audit and risk-based regulation

Fundamental to the Swiss system of banking supervision are the risk-based financial and regulatory audits and the associated long-form reports. Primary responsibility for identifying the key audit risks and determining the audit strategy lies with the auditors. These are performed according to relevant accounting and auditing standards. FINMA can specify additional audit areas which are performed according to FINMA’s instructions (SFBC, 2005a, margin notes 47-49). Information provided by the auditors is thus a major input into FINMA’s risk-rating system and its risk-based supervisory approach.

The risk assessment for the financial and regulatory audits, and development of an appropriate audit strategy, is the responsibility of the auditors and FINMA is not involved unless there are exceptional circumstances. As one partner explained:

...for the audit and the delivery of the work and the risk assessment, they rely on us. And if they... they have a very different perception probably they will discuss it with us. But I think they really rely on us for that area.

Another partner detailed the audit firm’s contribution to the process:

On the one hand we are providing them [FINMA] as a result of our work with two very large audit reports, it’s the audit report on financial audit and regulatory audit. We then in addition have to provide them with the sending of these two reports with a questionnaire and this questionnaire asks you an awful lot of questions, qualitative, quantitative questions and based on these they establish their rating system. But that’s one input factor.
On the other hand, partners have no detailed knowledge of how the information supplied to FINMA is incorporated and processed by FINMA’s risk rating system. As this partner stated:

*My understanding is they have also their own studies and statistics they are running with relevant key performance indicators, their own means, liquidity or whatever relevant factors they take into consideration. We do not know about the systems, we just know that is taken into consideration, our questionnaire.*

FINMA’s rating system places banks into supervisory classes – the higher the ratings, the more intense the supervision, and the greater the involvement of the auditors. As one partner described it:

*...for normal [ie small and medium sized] banks, if they have high ratings, then there are more trilateral meetings, probably also more bilateral meetings, then they [FINMA] intensify the contacts and the meetings, that’s for sure. And they might then also then ask the bank for direct information, for a special report. So that’s how that works.*

Another partner confirmed this intensification of involvement with FINMA ranging from just a ‘scanning’ of the audit report for banks on a low rating. The next level would be a ‘reading’ of the report by FINMA, following which ‘they would call us for a discussion’. If the auditors had had to ‘post an irregularity and give a deadline’ then FINMA would ‘request us and the bank to come to Bern [that is, FINMA] to discuss it’. Beyond this, ‘on the topside’, there would be ‘more frequent meetings’. This partner commented that:

*I had banks where they had to provide FINMA with quarterly update reports, where they meet more often with the bank, where they might ask them to take additional steps, meaning it could be higher ratios, or whatever, if the risk would be assessed as being extremely high.*
Crisis/post-crisis developments

The global financial crisis has affected all major financial centres regardless of the individual institutional arrangements at the national level for banking supervision. Switzerland was no exception.

In response to a comment by the chief executive of the UK FRC, ‘So far at least, auditing has had a good crisis’, Swiss banking audit partners agreed with this assessment. Indeed, one partner commented that the crisis was not limited to a specific bank or audit firm and the crisis had not been foreseen by anyone:

So here in that sense, yes, it’s a good crisis for auditors because it’s not specific to a company, it’s generic... If only one company went then it would be another story, because the auditor in place would have been criticised, of course. But here everybody is in the same situation. The bank has not seen it, the regulator has not seen it, the auditor has not seen it.

Audit partners confirmed there had been no calls in Switzerland to change fundamentally the dualistic system of banking supervision.

In response to the issue that auditors as the third party having the greatest knowledge of the banks and perhaps ought to have drawn attention to the issues, partners referred to the audit expectations gap. One argued, ‘You will never fill that gap’. For this partner, this had to do with the distinction between a ‘view’ and a ‘certification’ commenting:

If you want to certify something you need a benchmark, it’s in line with the benchmark. If we have to express a view then it’s a view.

Referring to the case of Swissair this partner commented that six months or one year before one view might have been, ‘This company will go bust in one year’, whereas another view might have been, ‘It’s a wonderful strategy and it’s going to work’. This is the risk as taken by the entrepreneur. The partner concluded, ‘The entrepreneur can...
have a judgement and you cannot certify a judgement. It’s a view, it’s a judgement’.

Another partner referred to the expectation gap that can exist between the auditors and supervisors, making two points: first, that regulators (and others) need to understand that the audit strategy is risk-based; and second that audit is, essentially, about the past not the future. One of the aims of the revision of the SFBC Audit Circulars was to clarify that the audit strategy is risk-based, and that the nature of the audit work undertaken depended on the levels of risk revealed by the risk analysis. The aim of the Circulars was to clarify this aspect of the financial and regulatory audit and for this partner, ‘...it’s where we have tried now to manage the expectations from the regulators’. However, if the auditors did not detect anything but later something was found amiss, then supervisors became concerned about the risk assessment, ‘...then they say, your risk assessment was wrong, you know, in hindsight’. This partner thought it was likely FINMA would seek to become more involved with the risk analysis and audit strategy, even to the extent of providing an additional report:

*And I already had discussions with FINMA where they say we have to discuss the risk assessment more often and we have maybe even to issue a separate risk-assessment report so that they see how we think.*

This partner also stated that in all the discussions and debates, it was important not to forget that audit is, essentially, about the past whereas supervision involves looking forward. The partner identified this as the current expectation gap between the auditor and the regulator, with the regulator pressing for predictions the auditor could not provide:

*We are always giving a statement of the past, the FINMA is always forward-looking. And sometimes we say it’s this and this and this, and I can hear them asking questions but they are asking questions about the future and then I always have to say, well, I cannot predict the future. But they want me to predict the future. But that’s the expectation gap we have at the moment with the regulator.*
As regards post-credit crunch developments, this partner believed there would be increased requests for ‘audit’ and reported receiving more requests ‘asking for comfort’, for example from FINMA and the Swiss National Bank. Following concerns about bankers’ salaries and incentives, this partner anticipated having to issue a ‘compensation report’. As this partner noted, ‘...the difficult thing is that they’re asking more from us without giving us the standard against which we have to audit something’.

Finally, it should not be forgotten that the banks are the auditors’ clients and that audit partners have to manage the relationship between themselves, FINMA and the bank. One partner gave a particularly informative description of the issues explaining that, with perhaps a degree of understatement, in certain circumstances this could indeed be ‘tricky’. The partner commented as follows:

...it’s more the aspect sometimes that the FINMA are in their informal way telling me what they want and then I have to find the right way to put that through to the client. But if I have to say which way... well, at the end FINMA says to me what I have to do, so that is certainly the stronger view. I try then to apply it in a way that it also satisfies the client, but not of course weakening the views of FINMA. What is a little bit tricky is more the informal part, the formal part of the report has an agreed procedure but the informal part that FINMA also expects me to call them if I see anything of a development, and that’s maybe the tricky part.

Summary

The Swiss ‘dualistic system’ of banking supervision whereby auditors undertake both statutory audits and report to shareholders under company law, and undertake financial and regulatory audits, including direct supervisory tasks, and report to the supervisor under banking law, is the most comprehensive example of the involvement of auditors in banking supervision of a major financial services centre. An important recent development is the formal adoption of a risk-
based approach to audit and banking supervision. The risk profile and associated audit strategy drawn up by the auditors for the financial and regulatory audit and the reports to FINMA form the basis of FINMA’s risk-based approach to the supervision of the bank. The Swiss system provides a significant contrast with the UK where the more limited role for auditors in UK banking supervision under the Banking Act 1987 had significantly diminished following FSMA 2000, although greater engagement by the FSA with auditors is being restored as part of the FSA’s response to the financial crisis.

The move from SFBC to FINMA was seen by banking audit partners as being more ‘continuity’ rather than ‘change’. This was similarly the case with the introduction of the SFAOA, although partners noted that it had been more of a challenge for their non-banking colleagues. While appreciating the need for oversight, partners expressed concern about the growth of formal documentation, arguing that some of the time spent on documentation would be better spent on undertaking more audit work. The earlier move to a risk-based approach to audit and the associated risk-based approach to supervision was welcomed by partners as reflecting developments in current practice.

The banking audit partners, not unnaturally, were pleased that the recent financial crisis was recognised by all parties as not being caused by audit failure. On the other hand, following the financial crisis, it was seen as inevitable that greater demands would be placed on them as auditors. An issue identified by partners as problematic was the difference between a ‘certification’ and a ‘view’, the latter case being when a benchmark against which to express an opinion was not available. Partners believed they were increasingly being asked by supervisors to express ‘views’ or to offer ‘predictions’. Arguably, this is linked to the problem that audit is essentially ‘backward-looking’, whereas supervision, at least in times of financial crisis, is essentially ‘forward-looking’. It is a reminder of the ongoing audit expectations gap between what auditors can deliver and what stakeholders expect.
5. Policy implications

In the light of the recent financial crisis, this chapter draws together a number of themes and implications from the findings of these research projects on the role of auditors in UK and Swiss banking supervision which are of relevance to auditing practice, and makes suggestions for further research. Readers interested in a related academic discussion of the findings from the Swiss research are referred to Dewing and Russell (forthcoming).

Themes

Increased dialogue

In the inevitable process of blame allocation that follows financial collapse and failure, the question typically asked is, ‘where were the auditors?’ Subsequent investigations often reveal audit failure associated with elements of the audit expectations gap, for example, lack of auditor independence, poor auditor performance. An interesting aspect of the investigations into the reasons for the recent financial crisis is that both in the UK and Switzerland the auditors have not been blamed. In the UK, the FSA as supervisor was actually criticised for not sufficiently engaging with the auditors who, as a result of their work on the statutory audit, have an in-depth knowledge and understanding of the bank and from which supervisors could derive benefit. Dewing and Russell (2005, p. 107) noted, prophetically as it turned out, that the FSA was potentially losing out on valuable information held by auditors:

*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 collaboration was being ignored.*
Therefore, the decision by the FSA to initiate a more ‘intense’ relationship between auditors and supervisors in UK banking supervision, including the requirement for supervisors of high-impact firms to meet the auditors at least annually, is potentially helpful. This represents a partial return to the previous UK system that prevailed between auditors and the Bank of England under the Banking Act 1987, and brings the relationship between auditors and FSA closer to that between auditors and FINMA in Switzerland.

**Increased expectations**

The increased engagement with auditors by regulators may be welcomed but, after the financial crisis, supervisors may have unrealistic expectations of what auditors can deliver in terms of assurance, and it may lead to a blurring of the roles and responsibilities of auditors and supervisors. This embraces a number of topics. Issues raised by Swiss audit partners included: that they were being asked to go beyond the well-established role of certification against a benchmark, and to provide authoritative views or predictions; that audit is essentially backward-looking and supervision, at least in times of financial crisis, is forward-looking; and that the time devoted to formal documentation might more usefully be spent on undertaking further audit work. The danger is the growth of a gap between what supervisors expect and what auditors can deliver.

A traditional solution to this problem, at least from the accountancy and auditing profession’s point of view, is the education of users and stakeholders so as to provide them with a greater understanding of the audit and reporting process. A more general dialogue between supervisors and the accountancy and auditing profession may help in this respect, as may the increased recruitment of accountants and auditors by banking supervisors. The Swiss system, with FINMA audit circulars, and the previous UK system under the Banking Act 1987 with Bank of England and associated professional guidance, point to the importance of having a clear framework setting out guidelines within which dialogue and engagement takes place, and which assists auditors and supervisors,
as well as other stakeholders, to understand auditors’ and supervisors’ respective roles and responsibilities.

Implications for the UK

As the FSA seeks to increase its engagement with auditors, there are number of features of the Swiss system of banking supervision that may be relevant to the UK. However, institutional structures and legal arrangements differ between Switzerland and the UK. Therefore, what follows should not necessarily be read as recommendations for change but rather as interesting and important features of the Swiss system that are worthy of further investigation as to their applicability in a UK context. There are three main issues for the FSA (and in due course the new Prudential Regulation Authority as its successor body):

Approval by the FSA of auditors as banking experts

In Switzerland, in addition to audit firms having to be approved and registered by the SFAOA, the Swiss public oversight body, audit firms undertaking bank audits must also be licensed by FINMA, the Swiss banking regulator. In addition, the individual ‘lead auditor’ assigned to particular bank audits must also obtain prior recognition by FINMA as a banking expert (for further details see Hüpkes, 2006, p. 149). In the UK, it is primarily the responsibility of the bank itself to ensure the auditor has the qualifications, skills, experience and independence to undertake the audit. The greater involvement of the FSA in the review and recognition of both audit firms and engagement partners able to undertake the audit of banks may provide a formal opportunity, as a minimum, to help improve knowledge of, and communication between, audit firms/partners and the FSA, and may also help identify audit firms/partners about which the FSA may have concerns.
On-site observation by the FSA of banking audit engagements

In Switzerland, FINMA has the power to accompany audit firms during the period auditors are undertaking work at banks in an observational capacity (see Hüpkes, 2006, p. 153). This provides a further opportunity for the supervisor to gain a deeper understanding of the process of audit, including its boundaries and limitations. Similar powers do not exist in the UK but may provide another opportunity for the supervisor both to liaise with auditors and understand the audit approach adopted by audit firms.

Involvement in review of auditors’ work by the FSA

In Switzerland, responsibility for the inspection of the work of banking auditors is undertaken by a specialist unit within FINMA. In contrast, file reviews of other public interest companies in Switzerland is undertaken by the SFAOA. This approach facilitates not only the acquisition of specialist banking audit knowledge by a dedicated team at the regulator, but also benchmarking of the audit approach/performance both between and within audit firms. In the UK the Audit Inspection Unit is responsible for undertaking the review of auditors’ work. The creation of a dedicated team within the FSA responsible for the file review of auditors’ work in financial services firms may also facilitate knowledge and benchmarking opportunities as discussed above. As is the case in Switzerland, close liaison between the Audit Inspection Unit and the FSA would be required.

Further research – audit and risk

Interesting questions for further research into the role of auditors in banking supervision following the financial crisis concern the relationship between audit, risk and risk governance.

One interesting question is the extent to which the risks identified by auditors as part of a risk-based statutory audit are linked to the risks identified by supervisors as part of risk-based supervision. In the UK,
where there is limited involvement by auditors in banking supervision, the process is currently decoupled. Thus, it is possible that auditors and supervisors might perceive similar categories of risks in different ways and/or be concerned about different categories of risk, such that the approach of auditors and supervisors to risk may be different. In Switzerland, however, the process is much more closely linked as the risk analysis and associated audit strategy for the financial and regulatory audits is undertaken by the auditors and the results communicated to and used by supervisors. Thus, it is possible that auditors’ risk categories and perceptions colour the views of supervisors, such that the approach of auditors and supervisors to risk may be similar. A comparative study between the UK and Switzerland (and potentially other jurisdictions), of the extent to which auditors and supervisors differ in their approach to the analysis of risk, and the consequences of any similarities or differences in perceptions of risk, would provide increased mutual understanding of approaches to risk by auditors and supervisors.

Important recommendations from the Walker Review (2009) in the UK of corporate governance of banks and other financial institutions were that for financial groups in the FTSE 100 a risk committee should be established separate from the audit committee. Also, for banks and other financial institutions a Chief Risk Officer should be appointed with additional safeguards to ensure independence, and a separate risk report should be included in the annual reports and accounts. A UK study of how risk issues are partitioned between audit committees and risk committees, and the roles of external auditors, internal auditors and risk officers in the assessment and reporting of risks in banks would be informative. A comparative study of approaches to audit and risk governance by UK and Swiss financial institutions (and potentially other jurisdictions), might reveal interesting contrasts.
The contrasting role of auditors in UK and Swiss banking supervision

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Endnotes

1. The new coalition government has announced its proposals to replace the FSA by a new Prudential Regulation Authority under the Bank of England and to establish a separate Consumer Protection and Markets Authority (Osborne, 2010; HM Treasury, 2010).

2. The regulatory framework under the Banking Act 1987 and FSMA 2000 are described in chapters two and three respectively of Dewing and Russell (2005). Interview findings from auditors, firms and regulators as regards the dual role of auditors, reporting accountants and skilled persons under the two regimes are given in chapters four and five respectively.
About the authors

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Nigel Macdonald
Chairman of SATER
December 2010
Following the financial crisis, the role of financial regulation and audit is being questioned like never before. It is clear that in the UK, the role of auditors in financial regulation is likely to increase. How this will be achieved is still a matter for debate. This report provides a useful comparison of the role played by auditors in UK and Swiss banking supervision and highlights features of the Swiss system which are worthy of consideration in the UK.

The report finds that the differences are considerable, with auditors in Switzerland playing a significant direct role in banking supervision, compared to the situation in the UK, where auditors’ involvement is very limited. In fact, the role of auditors in UK banking supervision significantly diminished following the Financial Services and Markets Act 2000, although it is likely that this will be reversed following the financial crisis.

The authors of the report welcome the decision by the FSA to increase the engagement between auditors and supervisors in UK banking supervision, but also highlight the problems of unrealistic expectations and a blurring of roles and responsibilities between auditors and supervisors. The authors recommend, based on the Swiss system of regulation, that the FSA (and in due course the new Prudential Regulation Authority) considers the following methods for increasing engagement with auditors: approval by the FSA of auditors as banking experts; on-site observation by the FSA of banking audit engagements; and involvement in the review of auditors’ work by the FSA.

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