The Report of the Review Group on Auditing

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Foreword

As Chair of the Review Group on Auditing, I wish to thank each and every member of the Group for their selfless contributions and for their diligent and admirably focused approach to the work. Following its establishment by Ms Mary Harney, T.D., Tánaiste and Minister for Enterprise, Trade and Employment, the Review Group had its first meeting in late February 2000 and concluded its business before the end of June 2000. It is a reflection of the members' dedication that they completed in four months an assignment that the Committee of Public Accounts estimated would take six.

The shape and chapter titles were decided at the very first meeting. To ensure rapid progress, the main work was initially considered through two working groups under the very able direction of the Review Group's Vice-Chairs, Ann Fitzgerald and Professor Niamh Brennan. These working groups dealt with the general themes of Self-Regulation and Auditor Independence respectively. As part of its *modus operandi,* all documentation was communicated electronically, in order to save time and improve efficiency.

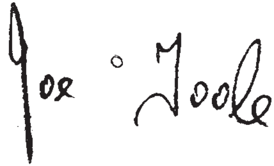
The members of the Review Group gave unstintingly of their time and knowledge, contributing both in writing and orally always constructively, and where necessary, robustly. This Report represents the outcome of many hours and days of consideration, discussion, argument and compromise.

The Review Group would wish me to thank in particular the staff from the Department of Enterprise, Trade and Employment who were the Secretariat to the Group. Paul Appleby, Geraldine Hurley, Mary Solan-Avison and Nuala Moloney provided substantial drafting, secretarial and co-ordinating support to the members of the Group, as well as liaising with third parties in carrying our work forward. Their crucial and central inputs as authors of a large number of high quality papers, were the catalysts to the progress which we were able to make in such a very short time-frame. Their extraordinary grasp of the subject combined with their ability to articulate quite diverse views in coherent text was fundamental to developing the Report.

The members of the Review Group also appreciate all those who took the trouble to make submissions to the Group. These assisted us enormously.

Thanks must also go to the professional accountancy bodies and their representatives. In addition to preparing submissions and occasional working papers to assist the Review Group's work, we also required the six recognised accountancy bodies to complete a detailed questionnaire on their activity in the regulation area which has been of great assistance to us. Many other bodies and individuals, too numerous to mention individually, also gave of their time to assist us, and our appreciation is extended to all of them.

For myself, all I can say is that it was a privilege to work with such a talented and committed group of people. I thank them for their co-operation at all times, and I conclude with the hope that our work will result in the legislative and other changes which we recommend should be implemented.



Senator Joe O'Toole
Chair
Review Group on Auditing
11 July 2000

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Chapter 1

Executive Summary

1. Executive Summary

1.1 Introduction

Following media reports in 1998 which suggested that bogus non-resident accounts were being used as a means of evading Deposit Income Retention Tax (DIRT), the Committee of Public Accounts (PAC) of Dáil Éireann made enquiries of the bank involved, AIB plc, and the Revenue Commissioners. This led to a Resolution of the Dáil requesting the PAC to inquire into the incidence of DIRT evasion across the Irish deposit-taking system. Special legislation was also enacted to facilitate the inquiry.

On behalf of the PAC, the Comptroller and Auditor General (C&AG) conducted, in co-operation with the financial institutions and State authorities involved, an extensive investigation of the available papers, and relevant persons were interviewed. The Comptroller's Report[1], published in July 1999, established that evasion of DIRT was pervasive and that the relevant State authorities were well aware of the problem.

In Autumn 1999, the PAC's Sub-Committee on Certain Revenue Matters held public hearings at which representatives of a number of financial institutions, State authorities and other relevant parties (including auditors of the relevant financial institutions) were examined on oath. The PAC's subsequent Report[2] in December 1999 recommended *inter alia* that the Department of Enterprise, Trade and Employment establish a Review Group to examine in detail a number of matters, including auditor independence, the auditing of financial institutions and the role of the external auditor in ensuring statutory compliance.

Having considered the PAC's recommendation, Ms Mary Harney, T.D., Tánaiste and Minister for Enterprise, Trade and Employment, decided to establish a Review Group on Auditing with twelve terms of reference. Aside from dealing with all of the issues suggested by the PAC, two of these terms of reference were new and dealt with self-regulation in the auditing profession.

In late December, the Department of Enterprise, Trade and Employment placed advertisements in the national media inviting submissions on the Review Group's terms of reference by 31 January, 2000. A copy of the advertisement, incorporating the terms of reference, is at **Appendix I** to this Report. Submissions were subsequently received from 37 different sources, and these formed the basis for the Review Group's initial consideration of its mandate.

The Tánaiste announced the composition of the Review Group on 17 February. Following its first meeting on 23 February, the Review Group worked intensively, and it successfully concluded its deliberations by the end of June 2000.

[1] Report by the Comptroller and Auditor General entitled "Investigation into the Administration of Deposit Interest Retention Tax and Related Matters during the period 1 January 1986 to 1 December 1998" (19 July, 1999), Pn. 7260.

[2] Parliamentary Inquiry into D.I.R.T. - First Report by the Committee of Public Accounts (15 December, 1999), Pn. 7963.

1.2 General Comment

Despite recent events, the Review Group believes that very many auditors and accountants continue to observe the highest professional standards, but for others, the present system of auditing regulation has not operated as a corrective counterweight to the pressures of the marketplace.

The Report of the Review Group points to the need for a process of renewal in auditing and accountancy in much the same way as other areas of professional life in Ireland are undergoing a process of change at present. In particular, the Review Group considers that the system of auditing regulation should operate to enhance the quality of audit and thereby to maintain public confidence in the value of the audit function. The Review Group believes that better lines of accountability need to be established:

- between the State and the recognised accountancy bodies which are delegated in law with the responsibility of supervising the auditing profession and
- between the accountancy bodies and the individual members of the profession in ensuring that members adhere to the standards which the law and professional duty requires of them.

In examining the auditor/client relationship, the Review Group was aware that many international bodies and jurisdictions, such as the EU and USA, are considering similar issues at present. The Review Group's view is that Ireland should be at the forefront of international best practice in establishing and implementing rules governing auditor independence while at the same time maintaining Ireland's competitive position as a small extremely open economy.

On a more general level, the Review Group was conscious of the increasing global dimension to auditing issues and the growing involvement of the EU in such matters in the context of the completion of a single financial services market.

In approaching its work, the Review Group assessed the extent to which existing regulatory structures, statutory provisions, professional and other rules required to be changed. In general, the Review Group concluded that additional measures were necessary to enhance the operation of the present system. It considers that a more demanding and effective system of regulation and accountability is needed for the future, if the value of the audit and the reputation of auditors and accountants in the public mind are to be strengthened.

1.3 Structure/Summary of the Report

The Report comprises sixteen chapters and is organised in three Parts. It contains 80 recommendations which are located in Chapters 7 to 16 inclusive. The following summarises our main findings and recommendations in relation to each of the terms of reference which are identified (a) to (l) in the following pages. This Executive Summary also includes the chapter or recommendation number, in order to facilitate access to the detailed discussion preceding the recommendation in the main body of the Report.

(a) "Whether self-regulation in the auditing profession is working effectively and consistently"

The Review Group considers the term "self-regulation" to be inappropriate, in that the relevant accountancy bodies are recognised and supervised by the Minister for Enterprise, Trade and Employment under the statutory powers laid down in sections 191 and 192 of the Companies Act, 1990. A more accurate term is "delegated self-regulation".

The Review Group has noted that there are differences in the manner in which the system of delegated self-regulation is operated across the six recognised accountancy bodies.[3] In addition, weaknesses have been identified in the following areas, some of which have been recognised by the bodies and have been, or are being, remedied:

- while the Review Group accepts that the monitoring of members' practices has helped to improve general standards in the profession, monitoring has not been effective in deterring a number of significant instances of corporate malpractice over a prolonged period;
- while the investigation, disciplinary and appeals structures within the recognised accountancy bodies for handling complaints of professional misconduct against their members are broadly similar, differences are apparent in the operation of these structures across the bodies;
- the sanctions imposed on members for professional misconduct are generally light and the maximum level of fine which may be imposed is inadequate;
- the practices of the recognised accountancy bodies in publicising the sanctions imposed on the members involved have varied substantially until recently.

The Review Group also concluded that legal constraints and insufficient State resources applied to oversight of the auditing profession have contributed to some extent to the lack of effectiveness of existing regulation. (**Chapters 5** and **6**).

[3] The six recognised accountancy bodies whose members may be authorised to practise as auditors in the State are the Institute of Chartered Accountants in Ireland, the Insitiute of Certified Public Accountants in Ireland, the Association of Chartered Certified Accountants, the institute of Incorporated Public Accountants, the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland.

(b) "Whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what form they should take"

The Review Group considers that the recognised accountancy bodies should continue to regulate their members within a reformed framework of supervision comprising some persuasive external influence. The Review Group recommends that this take the form of a statutory Oversight Board established as a distinct legal entity on a stand alone basis **(Recommendation 9.1)**. In parallel with the publication of the necessary draft legislation, the Oversight Board should be established on an interim basis **(Recommendation 9.2)**.

The Oversight Board should be independent **(Recommendation 9.3)**. It should comprise eight members broadly representative of the main stakeholders in the accounting area, no more than two of whom should be accountancy professionals **(Recommendation 9.5)**. Following consultations with the Department of Enterprise, Trade and Employment and the accountancy profession, the Oversight Board should decide its annual budget, which should be funded on a 60/40 basis by the profession and the State respectively **(Recommendation 9.8)**. The Oversight Board should determine within its budget the number of staff and the skills required to carry out its work effectively **(Recommendation 9.7)**.

The Oversight Board should assume the supervisory responsibilities currently exercised by the Minister for Enterprise, Trade and Employment. It should be given adequate statutory powers of approval, direction and intervention to satisfy itself on an ongoing basis that the structures, procedures and professional standards in the recognised accountancy bodies are operating to high standards **(Recommendations 7.2, 8.1** and **8.2)**.

Proper accountability structures should be established. Each recognised accountancy body should regularly prepare and submit to the Oversight Board a Business Plan of its regulatory activity, and it should annually report to the Oversight Board on its progress in meeting defined performance indicators **(**Part of **Recommendation 8.2)**.

The Oversight Board should similarly engage in regular business planning, and it should annually report progress in meeting its business objectives to the Minister for Enterprise, Trade and Employment and the Oireachtas. The Oversight Board should be required to make itself available for discussions with a relevant Committee of the Oireachtas **(Recommendation 9.11)**.

The Review Group considers that a Liaison Group should be established to ensure a good flow of communication between the Oversight Board and other regulators, such as the Central Bank/the proposed Single Financial Regulator, the Revenue Commissioners and the Office of the Director of Corporate Enforcement **(Recommendation 9.12).**

The recognised accountancy bodies should continue to manage investigation and disciplinary matters within an open and transparent framework, subject to the overall supervision of the Oversight Board **(Recommendation 10.1)**. This reformed system should include the following common features:

- each recognised accountancy body should prepare, in consultation with the Oversight Board, and make freely available to its members and the general public information on its investigation and disciplinary procedures **(Recommendation 10.2)**;
- when complaints are being considered by each recognised accountancy body, both the member and the complainant should be given the opportunity to attend and be heard at each stage of the hearing of the complaint **(Recommendation 10.4)**;
- the proceedings at Disciplinary and Appeal Committee levels should be heard in public **(Recommendation 10.3)**;
- a majority of independent persons, i.e., non-members of recognised accountancy bodies, should comprise the membership of the Investigation, Disciplinary and Appeal Committees **(Recommendation 10.5)**;
- notifications of decisions made in response to complaints should contain the reasons for the decisions made **(Recommendation 10.6)**;
- the Oversight Board should be invested in law with a right to intervene in relation to any decision of an accountancy body in a case involving the alleged misconduct of a member **(Recommendation 10.9)**;
- the level of fines should be substantially raised (if necessary with statutory backing), in order to apply more meaningful penalties against members breaching their duties of professional conduct **(Recommendation 10.11)**;
- following completion of the disciplinary process, the sanctions imposed on a member should generally be circulated for publication to appropriate national, local and professional publications **(Recommendation 10.12)**;
- the Oversight Board should have the right to determine if a public concern case should be investigated independent of the recognised accountancy bodies **(Recommendation 10.20)**.

The Review Group also proposes that the Minister for Enterprise, Trade and Employment should consider, following consultations with relevant parties, extending the remit of the Oversight Board in the investigation and disciplinary area to other professional accountancy bodies[4], with a view to ensuring a consistent application of standards across the entire accountancy profession **(Recommendation 10.18)**.

[4] Examples of professional accountancy bodies which are not recognised as auditing bodies under the Companies Acts are the Chartered Institute of Management Accountants and the Chartered Institute of Public Finance and Accountancy.

Having examined audit in the public sector, the Review Group believes that the Office of the C&AG and the Local Government Audit Service should prepare and publish explicit goals and performance indicators and that the quality of their audit service should be subject to regular peer review **(Recommendation 10.19)**.

The Review Group also considers that other complementary measures are required to improve public confidence in the value of auditing regulation, including:

- each of the recognised accountancy bodies should adopt a risk-based approach to the selection of members/member firms for monitoring visits, with those members in larger practices or having audit clients in higher risk categories (e.g., those operating in the financial area) receiving more frequent scrutiny **(Recommendation 11.9)**;
- in approving the monitoring plan of each recognised accountancy body, the Oversight Board should pay particular attention to the proposed monitoring arrangements of the "Big Five" firms, so as to ensure that the persons engaged in such monitoring have the calibre and experience required for effective review (Part of **Recommendation 8.2**);
- individual auditors, who are Ministerially authorised and are not supervised, should be regulated by the recognised accountancy bodies **(Recommendation 11.1)**;
- each recognised accountancy body should make publicly available on its website and in hard copy format an up-to-date list of its register of members, identifying inter alia the status of each member and the nature of the activity which each is authorised to undertake **(Recommendation 11.5)**;
- the Registrar of Companies should also display an up-to-date list of registered auditors on the Companies Registration Office website **(Recommendation 11.5)**;
- the Registrar of Companies should arrange that his Office institute a systematic checking of the annual returns of companies to ensure that the firm or person who signs the audit report attached to those returns is an auditor registered with his Office **(Recommendation 11.6)**;
- unqualified persons should be prohibited by law from holding themselves out as an auditor, regulated auditor or registered auditor **(Recommendation 11.2)**;
- the Companies Acts should require that the annual audit reports of unlimited companies (which are required to have an audit undertaken but which are exempt from filing accounts) and of other exempted companies (as defined in section 2(1) of the Companies (Amendment) Act, 1986) be promptly filed with the Registrar of Companies after the end of their financial year **(Recommendation 11.7)**.

(c) "The role of the external auditor in providing other services to the same institution"

(d) "The impact of other functions such as tax advice and consultancy on the external audit process"

(e) "The possible introduction of a maximum term of five years for an auditor to a financial institution"

The Review Group agrees with the PAC that the provision by an auditor of non-audit services to its client company can pose a threat to auditor independence. This threat to auditor independence is increasing as the scope and profitability of non-audit services expands both in absolute terms and in relation to audit services **(Chapter 12)**.

The Review Group also examined international developments in the area. It notes that while both the EU and the Securities and Exchange Commission (SEC) in the USA consider that existing auditor independence rules need to be strengthened, neither intends to introduce an absolute rule prohibiting audit firms from providing non-audit services to audit clients. In these circumstances, the Review Group considers that implementing rules significantly out of step with current international practices, such as recommending a complete prohibition on audit firms providing non-audit services to audit clients, would damage Ireland's competitive position as a small open economy, particularly in the financial services sector **(Chapter 12)**.

However, the Review Group concluded that additional safeguards in the Companies Acts and in the rules of the recognised accountancy bodies are necessary to protect the independence of auditors **(Recommendation 12.1)**. The Review Group recommends that Ireland adopt an approach to improving auditor independence in which the proposed Oversight Board plays a central role in ensuring that Ireland establishes and implements rules at the forefront of best international practice. Within this framework, the additional safeguards recommended by the Review Group are that:

- existing provisions in company law requiring the disclosure by a company of audit fees in its annual financial statements should be amended to require, in addition, the disclosure of the non-audit fees paid to its audit firm, and the nature of those services should also be analysed in adequate detail **(Recommendation 12.2)**;
- where the non-audit fees earned by the audit firm from a client company exceeds the audit fee, the Audit Committee of the company must explain in an annual report to shareholders why the non-audit services were obtained from the audit firm and confirm that it is satisfied that this does not compromise the independence of the auditor **(Recommendation 12.3)**;

- revised ceilings of 5% (in the case of listed and other public interest companies) and 10% (for all other companies), representing the maximum proportion of total audit and non-audit fee income contributed to the audit firm by any one client company or group of client companies, should be introduced to reduce the dependence of the audit firm on any one client **(Recommendation 12.4)**;
- within audit firms, procedures should be put in place to ensure that an audit engagement partner is aware of all other business relationships between the audit firm or associated firms and the client company that could affect the audit firm's responsibilities as auditors **(Recommendation 12.6)**;
- audit firms should be required to document how risks to auditor independence are dealt with **(Recommendation 12.7)**.

There was extensive discussion within the Review Group on whether specific non-audit services should be prohibited. Within the wide spectrum of non-audit services provided by auditors to client companies, the Review Group encountered the same difficulty as other international experts in precisely identifying services that compromise auditor independence in all circumstances. In concluding that audit firms should not audit their own work or be permitted to provide valuation services or internal audit services to audit clients (either directly or via associated firms), the Review Group recommends that an auditing standard, acceptable to the Oversight Board, be developed to implement this decision **(Recommendation 12.5)**.

The Review Group considers that the above recommendations should be mandatory for public limited companies, financial institutions and other public interest companies. Some of these recommendations should also apply to small and medium enterprises (SMEs) **(Chapter 12)**.

The Review Group recognises that ongoing developments may require changes to the approach to auditor independence recommended in this Report. In particular, the Review Group believes that after an implementation period of three years, the Oversight Board should conduct a review of these auditor independence safeguards taking account both of international developments and domestic experience in implementing the recommendations contained in this Report. More specifically, the Review Group recommends that the Oversight Board undertake a review of the impact of non-audit fees on auditor independence and make known its judgement as to whether or not any new rules are required **(Recommendation 12.9)**.

The Review Group recognises that the mandatory rotation of auditors after a fixed number of years could improve the appearance of auditor independence. However, the Review Group concluded that the mandatory rotation of auditors could also impact negatively on the quality of an audit as, for example, a new audit firm would be less familiar with the audit client **(Chapter 12).**

On the related question of mandatory tendering, the Review Group is of the view that there must at all times be an open transparent process in the awarding of audit contracts. This should include consideration on an annual basis by the Audit Committee as to whether the audit contract should be put out to tender and the Committee should justify its recommendation to shareholders **(Recommendation 12.8).**

(f) "The determination of fees, bearing in mind shareholder interests"

(g) "The relationships between an external auditor and the management that appoints and remunerates him"

The Review Group considers that a central component of the framework for ensuring auditor independence is the development of suitable corporate governance structures within audit client companies. Having examined international developments, particularly in the USA, the Review Group proposes enhancing the role of audit committees within those structures **(Chapter 13).**

In summary, the Review Group has concluded that the primary relationship between the auditor and the client company should be with its Audit Committee which is in a better position than management to protect the interests of shareholders as well as the wider public interest. The Review Group accordingly recommends that:

- Boards of Directors be required by law to establish audit committees representative of independent non-executive directors **(Recommendation 13.1)**;
- audit committees have regular meetings every year **(Recommendation 13.2)**;
- audit committees have formal written charters, approved by the Board of Directors, that specify the scope of the Committee's responsibilities and how it carries out those responsibilities, including structures, processes and membership requirements **(Recommendation 13.3)**;
- shareholders approve the appointment of auditors and set their fees, based on a recommendation from the Audit Committee rather than from management as is currently often the case **(Recommendation 13.4).**

The Review Group recommends that in its Charter, the Audit Committee be responsible for:

- obtaining from the external audit firm a formal written statement of all current and relevant previous business and personal relationships between the audit firm and the company;
- actively engaging in a dialogue with the audit firm, so that all relationships that may impact on the objectivity and independence of the auditor are fully disclosed;
- approving the procedures for the appointment of the audit firm to provide any other services;
- assessing and clearing in advance all proposed contracts and business and personal relationships between the client company and the audit firm;
- monitoring the number of former employees of the audit firm currently employed in management positions in the company and assessing its impact on auditor independence;
- reviewing the audit firm's statement concerning its general policy on risks to independence;
- approving any contract with the audit firm, payment for which is to be made on a contingent basis – such contingent contracts should be rare **(Recommendation 13.5).**

Audit committees should meet with the external auditor regularly each year, both in the presence of management and without management being present. Such meetings must be held at the planning stage of the audit and on its completion **(Recommendation 13.6).**

On the subject of management letters from the external auditor, the Review Group recommends that management letters be made available to the Audit Committee and to the members of the Board of Directors, in advance of the approval of financial statements **(Recommendation 13.7).**

The Review Group considers that an effective internal audit function is central to a proper system of internal control within companies. It should be adequately resourced and be set up independently of management and the external auditor **(Recommendation 13.8).** Specifically, the Audit Committee should endorse the appointment of the internal auditor **(Recommendation 13.10).** It should also meet with the internal auditor regularly, at times without management being present **(Recommendation 13.9).** All internal audit reports and findings should automatically be made available to the external auditor **(Recommendation 13.11).**

In addition to reporting to the Board of Directors, the Review Group recommends that the Audit Committee prepare a separate report for presentation to shareholders in the company's annual report. This should outline its work during the year with company management and with the internal and external auditors and indicate any disagreements with respect to any issues in the company's financial statements **(Recommendation 13.12).**

The Review Group considers that these recommendations relating to audit committees should be mandatory for public limited companies, financial institutions and other public interest companies and should, in appropriate circumstances, be applied as best practice in the audit of SMEs **(Chapter 13).**

(h) "The statutory provisions on auditing in the Companies Acts and related codes"

(i) "The role of the external auditor in ensuring compliance with statutory provisions"

The Review Group has noted the low level of reporting to statutory bodies by external auditors and considers it likely that some auditors are failing to exercise their statutory obligations. However, the Review Group is clear that while there is a need to expand the role of external auditors in improving companies' compliance with statutory provisions, this duty remains the primary responsibility of the company's directors **(Chapter 14).**

Against this background, the Review Group recommends that:

- Directors of a company be required to report on an annual basis to the shareholders on the company's compliance with its obligations under company law, taxation law and other relevant statutory or regulatory requirements. The report should confirm that any instances of non-compliance have been reported to the relevant regulatory authority and that in all other respects, the company has complied with its obligations under company law, taxation law and other relevant statutory or regulatory requirements **(Recommendation 14.1)**;
- external auditors be required to report as to whether, in their opinion, the directors' report on the company's compliance with its obligations is reasonable (Part of **Recommendation 14.2**);
- in making their report, the auditors specifically address whether the directors have made appropriate disclosure concerning any circumstances of which the auditors are aware that give reasonable grounds to believe the company has not, or may not have, fulfilled its statutory obligations (Part of **Recommendation 14.2**);
- where the auditors consider that any such circumstances have not been so disclosed by the directors and the directors have not amended their report, the auditors include the relevant information in their report which should be appended to the annual financial statements (Part of **Recommendation 14.2**);

- where the directors have not issued their compliance report to the shareholders or the appropriate statutory body within a specific period, the auditors be required to report that failure to the Director of Corporate Enforcement **(Recommendation 14.3).** In the case of financial institutions, the auditors should report instead to the Central Bank or other relevant regulator **(Chapter 15)**.

The Review Group considers that **Recommendation 14.1** should apply to all companies and should be enshrined in legislation. In addition the Review Group considers that **Recommendations 14.2** and **14.3** should apply to all companies whose accounts are audited, including those no longer required to have a statutory audit, but who decide not to avail of the audit exemption **(Chapter 14).**

(j) "The possible role of the Central Bank in regard to management letters issued by external auditors to financial institutions"

(k) "The possible strengthening of audit standards relating to financial institutions"

(l) "The suitability of having joint auditors to financial institutions with one being appointed by the Central Bank"

The Review Group considers that there are areas of common interest between the Central Bank and the external auditor of financial institutions in ensuring that there are effective corporate governance and internal control systems in place. While the Review Group appreciates external auditors' concerns over breaches of their confidentiality rules to their clients, the Review Group considers that the present arrangements for external auditors' providing information to the Central Bank are insufficient **(Chapter 15).**

The Review Group therefore recommends that:

- the accountancy profession begin work as a matter of urgency on updating and strengthening auditing pronouncements relating to the audit of Irish financial institutions, in order to cover the issues identified in both the DIRT Inquiry Report and this Report **(Recommendation 15.1)**;
- external auditors of financial institutions provide an annual positive statement to the Central Bank on whether anything has come to their attention that gives rise to a legislative duty to report to the Central Bank **(Recommendation 15.2)**;
- there be increased liaison between the Central Bank and external auditors of financial institutions. To facilitate this, a protocol on the exchange of information, including audit working papers, should be agreed between the Central Bank and the accountancy profession and should be backed by statute if necessary **(Recommendations 15.3** and **15.5)**.

- the Central Bank have the power to obtain reports from external auditors or other reporting accountants on financial institutions' accounting and other records, their internal control systems and any other issues that, in the opinion of the Central Bank, are appropriate or necessary for regulatory purposes **(Recommendation 15.4)**;
- the Central Bank automatically receive management letters from the external auditors of financial institutions at the same time as the 'final' management letter (i.e., that incorporating the management response) is issued to the regulated entity **(Recommendation 15.6).**

The Review Group considers that all of these recommendations should be extended to other regulated financial sectors, such as insurance undertakings and credit unions. In implementing the recommendations, advance consultations should be held between the relevant Departments, regulators and the accountancy profession **(Chapter 15).**

Having noted that the Central Bank is already empowered to appoint an external auditor (or other "appropriate person") to a financial institution to assist the Bank's performance of its statutory functions, the Review Group has concluded that after implementation of the above recommendations, no further advantage would accrue from introducing a requirement to have joint auditors in financial institutions, one of which would be appointed by the Central Bank **(Recommendation 15.7).**

1.4 Conclusion

This Report seeks to define a new set of relationships:

- between the audit client company and the auditor,
- between the auditor and his or her professional body and
- between the accountancy profession as a whole and the State.

In framing its recommendations, the Review Group has been very conscious of the need to address comprehensively all of the issues set out in its terms of reference, in order to encourage better standards of corporate governance. The Review Group considers that its recommendations will if implemented place Ireland at the forefront of best international practice in the field of auditing. At the same time, the Review Group was also anxious to limit the regulatory burdens on business in a competitive marketplace. In particular, it did not wish to propose rules significantly out of step with current international practice. The Review Group believes that it has achieved in this Report a satisfactory balance between objectives of high standards and limited regulation.

The Review Group considers that in the light of the DIRT Inquiry Report and other events, priority should be given to implementing this Report. In particular, it recommends that the statutory and other associated changes relating to the auditing profession be implemented within twelve months of the publication of this Report **(Recommendation 16.1).**

Part I

BACKGROUND TO OUR WORK

Chapter 2

Establishment and Work of the Audit Review Group

2 Establishment and Work of the Audit Review Group

2.1 Preliminary Comment

The Review Group was asked to examine the following principal issues:

- self-regulation in the auditing profession;
- auditor independence;
- the auditing of financial institutions; and
- the role of the auditor in ensuring compliance with statutory provisions.

The present framework for the regulation of the audit function essentially comprises a series of legal requirements in company and financial services law, together with a set of professional standards issued by accountancy and other bodies to which each member or member firm is committed in undertaking his/her/its work. The disclosures suggesting breaches of inter alia tax, exchange control and company law, as well as apparent non-compliance with appropriate professional standards, have challenged the effectiveness of the present system, and our task is to recommend how best to improve it.

The Review Group is aware that work in this area is being undertaken at present in the EU and in the US, particularly in seeking to uphold the principle and practice of auditor independence. In the UK, the profession in consultation with Government has recently agreed a specific structure for the regulation of auditors and accountants. The Review Group considers the subject of international developments in greater detail in the next Chapter.

The Review Group's examination of the issues has led us to the conclusion that there is no one panacea which, when implemented, will hold good for all time. Business life today is very dynamic and competitive, and it will be necessary to ensure that the framework which is now considered to be relevant is regularly reviewed to meet changing market circumstances.

The challenge for Government and the accountancy profession as a whole is to develop and maintain a strong and adaptable framework of regulation and professional standards. This framework must be capable of empowering and requiring all of its participants – directors, preparers of financial statements, shareholders as well as auditors - to give priority to proper standards of corporate governance and to maintain the highest standards in the face of the commercial pressures of the marketplace.

In addition to protecting the interests of shareholders, auditors today continue to perform a public interest role, and many non-auditor members of the accountancy profession working in auditing firms regularly discharge assurance roles on behalf of their clients. It is important that people in business and in the wider community can continue to be confident that reliable and timely commercial information is a key output of the work which is undertaken by the accountancy profession on behalf of its clients in the public and private sectors.

2.2 Disclosures of Corporate Malpractice

The establishment of this Review Group has arisen directly from the Report of the Parliamentary Inquiry into Deposit Interest Retention Tax (DIRT) by a Sub-Committee of Dáil Éireann's Committee of Public Accountants (PAC). This Report is commonly known as the DIRT Inquiry Report. However, there have been many other disclosures of possible malpractice in the recent past which have called into question the standards applied to State and corporate governance, particularly over the last twenty years. Auditors and other members of the accountancy profession have been associated with a number of these disclosures.

The Tribunal of Inquiry (Dunnes Payments) under Mr Justice Brian McCracken, the Report of which was published in August 1997[5], also uncovered circumstances suggesting tax evasion, exchange control and company law breaches. This Report (commonly known as the McCracken Tribunal Report) dealt principally with payments made from one of Ireland's leading grocery chains, Dunnes Stores, to two senior politicians, Mr Charles Haughey, a former Minister and Taoiseach, and Mr Michael Lowry, T.D., a former Minister for Transport, Energy and Communications. The disclosures in the McCracken Tribunal directly led to:

- the establishment in September 1997 of a further tribunal of inquiry under Mr Justice Michael Moriarty (hereinafter referred to as the Moriarty Tribunal) which is investigating payments made to Mr Haughey, Mr Lowry and any other person holding public office. The proceedings of this Tribunal are still ongoing;
- the initiation, commencing in September 1997, by Ms Mary Harney, T.D., Tánaiste and Minister for Enterprise, Trade and Employment, of a series of investigations of companies using the powers available to her under section 19 of the Companies Act, 1990. Some of these investigations have concluded, and in one case (Ansbacher (Cayman) Ltd.), the company's activities are now being investigated by Inspectors appointed by the High Court in September 1999;
- the establishment in October 1997 by the Institute of Chartered Accountants in Ireland (ICAI) of a Committee of Inquiry chaired by retired Supreme Court Judge, Mr John Blayney. Its purpose is to investigate the professional conduct of a number of ICAI members who were interviewed by the McCracken Tribunal as part of its work. The Report of the Inquiry (commonly known as the Blayney Inquiry) is under appeal at present.

In addition, a further Tribunal of Inquiry into Certain Planning Matters and Payments was established in November 1997 under Mr Justice Feargus Flood to investigate possible corruption in the planning system in the Dublin area. The Flood Tribunal is currently examining the activities of certain politicians, officials and business persons over a period of more than ten years.

[5] Report of the Tribunal of Inquiry (Dunnes Payments) (25 August, 1997), Pn. 4199.

Other unrelated circumstances suggesting corporate malpractice are the subject of separate inquiries by High Court Inspectors into National Irish Bank Ltd. and National Irish Bank Financial Services Ltd. These were initiated in March and June 1998 at the request of the Tánaiste and Minister for Enterprise, Trade and Employment following media allegations of improper practices in the two companies.

2.3 Working Group on Company Law Compliance and Enforcement

The emerging concerns about corporate malpractice led the Tánaiste and Minister for Enterprise, Trade and Employment to establish in August 1998 a Working Group on Company Law Compliance and Enforcement which was chaired by Mr Michael McDowell, S.C., (now Attorney General). A key finding of the Working Group's Report finalised in November 1998 (hereinafter known as the McDowell No. 1 Report) was that:

> "*Those who are tempted to make serious breaches of company law have little reason to fear detection or prosecution. As far as enforcement is concerned, the sound of the enforcer's footsteps on the beat is simply never heard.*"[6]

The Government subsequently accepted the thrust of the Working Group's recommendations which included:

- the establishment of a properly resourced Office of the Director of Corporate Enforcement. It is intended that this Office will assume the company law investigation and enforcement functions which presently reside in the Department of Enterprise, Trade and Employment;
- the establishment of a statutory Company Law Review Group whose work will support a regular modernisation of Irish company law.

The Company Law Enforcement Bill that will, once enacted, give effect to these recommendations was published on 3 July 2000. Pending the enactment of this Bill, a Company Law Review Group (which had examined a number of company law matters in its First Report[7] in 1994) has been re-established by the Tánaiste and Minister for Enterprise, Trade and Employment as a standing committee. The Review Group on Auditing understands that the Company Law Review Group has been given the task of making recommendations to the Government on the basis of two-yearly work programmes. In its first work programme (2000-2001), the main focus of the Company Law Review Group's work is on the simplification of company law for small and medium-sized businesses. Other areas which the Company Law Review Group are addressing include the consolidation or restatement of company law in a single code and the possible regulation and licensing of insolvency practitioners in Ireland.

[6] Report of the Working Group on Company Law Compliance and Enforcement (30 November, 1998), Pn. 6697 (Paragraph 2.5).

[7] First Report of the Company Law Review Group (December 1994).

2.4 Implementation Advisory Group on a Single Regulatory Authority

In October 1998, the Government agreed in principle to the establishment of a single regulatory authority for the financial services sector, and it formed an Implementation Advisory Group (chaired by Mr Michael McDowell, S.C.) to progress the necessary work. The Advisory Group's Report in May 1999[8] recommended, inter alia, that the Single Regulatory Authority should be responsible:

- for all prudential supervision of financial services, including decisions concerning licensing and authorisation, and
- consumer issues related to the entities for which it is responsible.

The Advisory Group's Report is at present under consideration by the Ministers for Finance and for Enterprise, Trade and Employment.

2.5 Tribunal of Inquiry (Payments to Messrs Haughey and Lowry)

While the establishment of the Moriarty Tribunal pre-dated a number of subsequent developments, it is worth noting that two elements of its extensive terms of reference are relevant to company law, and one of these is directly relevant to the work of this Review Group, viz:

> *"....And further in particular, in the light of its findings and conclusions, to make whatever broad recommendations it considers necessary or expedient:*
>
> *....(l) for the reform of the disclosure, compliance, investigation and enforcement provisions of company law (including in particular those which relate to directors' duties).*
>
> *....(o) for the effective regulation of the conduct of their members by such professional accountancy and other bodies as are relevant to these terms of reference, for the purpose of achieving the highest degree of public confidence...."*

The Review Group understands that the Tánaiste and Minister for Enterprise, Trade and Employment intends to seek limited representation at the Tribunal in due course to address these aspects of its terms of reference, and clearly both the McDowell No. 1 Report and this Report by the Auditing Review Group will be relevant to her submission to the Tribunal.

[8] Report of the Implementation Advisory Group on the establishment of a Single Regulatory Authority for the Financial Services Sector (19 May, 1999), Pn. 7271.

All of this work has emerged from the allegations of corporate and other malpractice which have come into the public domain in recent years. These disclosures of possible malpractice have shocked the general public and undermined public confidence in the prevailing standards in Irish public and corporate life. While some of these developments are not directly relevant to our deliberations, they have nevertheless served as an influential background to our work.

2.6 DIRT Inquiry Report

As indicated earlier, the establishment of the Review Group on Auditing arose directly from the DIRT Inquiry Report published by the PAC. DIRT was introduced in 1986. Banks and other financial institutions were obliged to collect and remit to the Revenue Commissioners the appropriate amount of tax, taking account of the prevailing rate of tax applicable to the interest earned on the individual savings accounts of Irish residents. DIRT was not payable on accounts opened by non-Irish residents who had completed a statutory declaration ("non-resident accounts").

The DIRT Inquiry was set up following allegations in the media in 1998 that the proper amounts of DIRT were not being paid. In order to examine the internal papers of the banking institutions and State agencies concerned and to interview relevant persons in those organisations, the PAC used the provisions in two new Acts, namely:

- the Committees of the Houses of the Oireachtas (Compellability, Privileges and Immunities of Witnesses) Act, 1997 and
- the Comptroller and Auditor General and Committees of the Houses of the Oireachtas (Special Provisions) Act, 1998.

On foot of a resolution of Dáil Éireann made under the 1998 Act on 17 December, 1998, the Comptroller and Auditor General (C&AG) initially undertook an extensive investigation of the administration of DIRT and related matters covering the years 1986 to 1998 inclusive. The Comptroller issued his report in July 1999.

The Report of the C&AG suggested that evasion of DIRT tax was common and that this evasion was carried out principally by the use of bogus non-resident accounts. It also appeared from the Comptroller's Report that the State and relevant financial institutions concerned had some knowledge of the evasion problem but that no effective remedial action was implemented.

Based upon the information in the Comptroller's Report, the PAC's Sub-Committee on Certain Revenue Matters held public hearings in Autumn 1999 at which various witnesses from the principal financial institutions, State agencies and other relevant parties (including the auditors of the financial institutions concerned), were interviewed on oath. The PAC's DIRT Inquiry Report in December was critical to a greater or lesser extent of many of the institutions and agencies involved. It concluded inter alia that:

- "*the problem of DIRT evasion was an industry-wide phenomenon.*"[9]
- "*there were a number of serious defects and weaknesses in relation to the statutory external audit function, which contributed to the continuance of the bogus non-resident problem, and these require to be addressed urgently.*"[10];
- "*the Department* (of Finance) *did not fully inform Ministers during the relevant period (1986 to 1998) in relation to the problem of bogus non-resident accounts.*"[11]
- "*During the relevant period, Revenue's freedom of action in relation to deposit takers as taxpayers was restricted by law as compared to its powers vis a vis taxpayers generally.*"[12];
- "*Bogus non-resident accounts were breaches of Exchange Control and the Central Bank took no action.*"[13].

The following specific conclusions in the DIRT Inquiry Report are relevant to the statutory audit function:

(a) in 1992, the first draft of a detailed Long Form Report on ACCBank in preparation for its disposal by the State suggested a liability for arrears of DIRT of £17.5 million. (A Long Form Report is a detailed financial report, usually prepared by external accountants, on a business that is about to be sold or floated on the Stock Exchange). The DIRT Inquiry findings in relation to this issue included the following:

    (i) "*The decision by Ernst & Young, external auditors and tax advisors to ACCBank, to drop their own calculation of DIRT arrears – without due regard for the legal obligations of the Bank in relation to D.I.R.T. – to be without justification*"*:*

    (ii) It is "*impossible to reconcile the knowledge in the possession of Ernst & Young with the unqualified opinion given on the 1992 financial statements of ACCBank.*"*:*

    (iii) "*Ernst & Young acted improperly in not challenging the non-disclosure by ACCBank at the meeting with Revenue of 18 February 1993 at which they were present, even though they were in possession of the information.*"[14]

[9] Public Accounts Committee; DIRT Report, Volume 1, page 78
[10] Public Accounts Committee; DIRT Report, Volume 1, page 79
[11] Public Accounts Committee; DIRT Report, Volume 1, page 53;
[12] Public Accounts Committee; DIRT Report, Volume 1, page 54
[13] Public Accounts Committee; DIRT Report, Volume 1, page 56
[14] Public Accounts Committee; DIRT Report, Volume 1, page 176

(b) "*PricewaterhouseCoopers, AIB's External Auditors, were in error in relying on the findings of the Audit Committee of the AIB Board of Directors and the memorandum of Dr. de Buitléir of 12 March 1991*" (in relation to the alleged amnesty with the Revenue Commissioners involving the write-off of tax). They "*should have sought independent written confirmation to support the assertion of a deal*"[15]. ;

(c) in calculating its outstanding DIRT liability in 1998, "*NIB relied on a formula worked out with their tax advisors KPMG for their negotiations with Revenue which ignored any risk factor other than absence of documentation and which disregarded the findings of the 1994 Theme Audit*" (which would have suggested a higher liability)[16]. It should be stressed that the findings of the DIRT Inquiry Report contain no criticism of KPMG's statutory audit of NIB in 1998 or at any other time.

The DIRT Inquiry Report[17], discusses the role of the external auditor and the issues which impact on the independence of external auditors. In the light of their findings and Inquiry, the PAC Sub-Committee recommended that a Review Group be established by the Department of Enterprise, Trade and Employment to examine and report within six months on the following issues:

- "*Whether accountancy firms appointed to undertake external audit should be involved in the provision of other services to the same financial institution;*
- *Whether the external audit function is compromised or undermined by the extent of modern-day intermingling of functions – audit, tax advice, consultancy, etc;*
- *How the issue of fees can be determined in such a way as to give primacy to the interests of shareholders and in a manner that respects the central importance of the audit process;*
- *What the Sub-Committee perceives as possible over dependence of the external auditor on a management that in practice appoints and remunerates the external auditor;*
- *If the balance of relationships between audit and other functions is reflected correctly in the statutory provisions of the Companies Acts and related codes;*
- *The role of the external auditor in ensuring compliance with Statutory provisions (e.g., the D.I.R.T. legislation) and whether the existing statutory audit requirements adequately address this issue;*
- *The Sub-Committee's view that the Central Bank should prescribe the scope of management letters issued by external auditors to financial institutions and that the Central Bank receive and discuss management letters with management and its external auditors on an annual basis;*

[15] Public Accounts Committee; DIRT Report, Volume 1, page 106
[16] Public Accounts Committee; DIRT Report, Volume 1, page 144
[17] Public Accounts Committee; DIRT Report, Volume 1, pages 62 to 73

- *The Sub-Committee's view that the specific audit standards pertaining to Financial institutions be strengthened;*
- *The suitability of having joint auditors to financial institutions one of which to be proposed and appointed by the Central Bank;*
- *The view of the Sub-Committee that there should be a maximum term of 5 years for any Auditor to a financial institution after which a new Audit Firm must be appointed.*"[18] .

Having considered the Report's recommendation, the Tánaiste and Minister for Enterprise, Trade and Employment decided to establish a Review Group on Auditing with terms of reference which addressed all of the above issues. In addition, she asked the Review Group to examine the following matters:

- whether self-regulation in the auditing profession is working effectively and consistently;
- whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what form should they take.

In late December 1999, the Department of Enterprise, Trade and Employment placed an advertisement in the national newspapers publishing the terms of reference of the Review Group and inviting submissions thereon from the public by 31 January, 2000. (A copy of that advertisement, including the Review Group's terms of reference, is included at **Appendix I** of this Report.) The Department also wrote individually to a large number of State, professional and other representative bodies whom it felt would have an interest in commenting on the Review Group's remit.

Some 37 individuals and bodies subsequently made submissions on the Review Group's terms of reference. A list of those parties who made formal submissions to the Review Group is attached at **Appendix II.** A number of other parties provided background information which was of assistance to the Review Group's work.

In determining the composition of the Review Group, the Tánaiste and Minister for Enterprise, Trade and Employment decided that membership should include a balance of State, professional and independent members. Having received nominations from a number of parties, the Tánaiste announced on 17 February, 2000 the membership of the Group. The list of members of the Review Group is attached at **Appendix III** of this Report.

[18] Public Accounts Committee; DIRT Report, Volume 1, page 195

2.7 Working Methodology of the Group

The Review Group held its first meeting on 23 February, 2000. It met on a very intensive basis until its work concluded. At each meeting, the members of the Review Group considered various papers that were provided to them – either by the Secretariat to the Review Group or by the members themselves. The submissions to the Review Group also formed the basis for many of the initial papers considered by the Review Group.

At its first meeting, the Review Group decided to establish two working groups, each of which would deal with distinct areas of the terms of reference. One working group (chaired by Ms Ann Fitzgerald) dealt with self-regulation issues, and the second working group (chaired by Professor Niamh Brennan) dealt with the remaining terms of reference, including in particular the issues of auditor independence and auditing of financial institutions. Each working group reported back at a plenary session of the Review Group, in order to ensure that all members of the Review Group were kept up to date with the progress of their collective deliberations. Towards the completion of the Review Group's work, the bulk of the deliberations proceeded in plenary session where final decisions were reached.

The Review Group prepared and circulated to six accountancy bodies a questionnaire on the regulation undertaken by them of their members. This proved to be of particular value to the Review Group's evaluation of the effectiveness of the accountancy bodies' regulatory activities.

The Review Group also took into account the supervisory arrangements and rules governing the audit profession which are in place or are proposed in various jurisdictions, particularly in the EU and USA. The Review Group considered these to be of most relevance to its work.

The work of the Review Group was greatly facilitated by the use of e-mail in the dispatch of documentation to members of the Review Group. This resulted in substantial time and cost saving and greatly contributed to the efficient manner in which the Review Group carried out its task.

Chapter 3

International Developments

3 International Developments

3.1 Introduction

With the increasing globalisation of the world economy, business and financial markets, there is a growing recognition of the need for and a trend towards greater international harmonisation of both accounting and auditing standards. Market forces and in particular access to the international capital markets are the driving forces behind this trend.

Variations between accounting and auditing standards and regulations applicable in different jurisdictions impose significant cost on multinational companies and create inefficiencies in the operation of the global market. Normally companies have to prepare financial accounts and have them audited in accordance with the national rules of the jurisdiction in which they are registered. Stock exchange rules may only accept accounts prepared in accordance with the national generally accepted accounting practices (GAAP) of that jurisdiction, though some EU Member States, such as Germany, do permit listed companies to prepare accounts on the basis of internationally accepted accounting standards (IASs or US GAAP).

On a practical level this can mean that:

- an Irish company wishing to list on a US stock exchange such as the NASDAQ may have to prepare two sets of audited accounts, one in accordance with national rules and one in accordance with US GAAP;
- companies may have to prepare a reconciliation of national GAAP accounts to comply with US GAAP;
- different companies use different accounting standards within one country (e.g. Germany) even when listed on the same stock exchange.

This situation imposes costs on companies and can cause confusion among shareholders, investors and other users of financial statements. It also undermines the reliability of audited accounts, as two sets of accounts prepared using different accounting standards may show different profits and losses.

In its deliberations the Review Group was conscious of the position of Ireland as a small extremely open economy. The necessity to be aware of international issues that influence the regulation of the accountancy and auditing profession and the setting of auditing standards in Ireland was recognised by the Review Group. The related international developments concerning accounting standards are also of relevance in this context. The most significant international influences can be identified as the:

- UK;
- European Union; and
- United States.

3.2 UK Influences

Given the similar company law frameworks and accounting regimes in the UK and Ireland, the accountancy bodies in Ireland are closely linked to the UK. The major recognised accountancy bodies are active with their UK counterparts in influencing the form and content of emerging accounting and auditing standards. Much of this work takes place, at present, in the Accounting Standards Board (ASB) and in the Auditing Practices Board (APB). The ICAI (Institute of Chartered Accountants in Ireland) is one of the six members of the Consultative Committee of Accountancy Bodies (CCAB).[19]

The auditing and accounting standards that apply in Ireland are generally those developed by the auditing and accounting standard setting bodies in the UK, although they are adapted at times to take account of particular Irish regulatory or legal requirements. Both the Government and the accountancy profession consider that Ireland benefits significantly from this link with internationally recognised auditing and accounting standards. However, the increasing globalisation of world trade and the move to international accounting and auditing standards will mean that in the future the influence of the UK on standard setting in Ireland will diminish somewhat.

Arising from the work of the UK Company Law Review Steering Group's proposals are currently under consideration in the UK to reform company law. These include proposals to change auditors' roles and their relationship with stakeholders.[20]

3.2.1 Reform of the Regulatory Structure in the UK

The self-regulatory structure of the auditing profession in the UK is currently being reformed to provide further reassurance that the public interest is being protected. An 'Accountancy Foundation' has recently been established to oversee the regulation of auditing in the UK. This non-statutory body will not replace the work of the UK accountancy bodies but will establish an improved framework within which the effectiveness of their existing powers should be enhanced. It is being funded entirely by the UK accountancy profession though these professional accountancy bodies are not represented on the Foundation itself. The Foundation is comprised entirely of users of financial statements. The UK Government undertook a widespread consultation on this issue in advance of reaching the decision to establish the Foundation. However, the new regulatory structure is based largely on the profession's proposals which were also the subject of extensive discussion and consultations with interested parties as well as within the accountancy profession.

[19] In the UK the following professional accountancy bodies are recognised audit supervisory bodies under the UK Companies Act 1989 and are members of the CCAB: the ACCA (Association of Chartered Certified Accountants), ICAEW (Institute of Chartered Accountants in England and Wales), the ICAI (Institute of Chartered Accountants in Ireland) and the ICAS (Institute of Chartered Accountants in Scotland). There are two other accountancy bodies which are also members of the CCAB but which are not recognised under the UK Companies Acts to supervise their members' audit work.

[20] Modern Company Law for a Competitive Economy, Developing the Framework: A Consultation Document from the UK Company Law Review Steering Group, pages 200 to 219.

The stated role of the Foundation is to safeguard the independence of the self-regulatory professional accountancy bodies and to ensure that the self-regulatory system is providing an effective way of representing the public interest in relation to the setting of standards, discipline and the other regulatory responsibilities of the various professional accountancy bodies that will fall within its remit. This Foundation will become the legal 'parent' of, make appointments and channel finance to, a new Review Board and three operational bodies. These operational bodies are:

- a reformed APB;
- a new Ethics Standards Board;
- a new Investigation and Discipline Board.

The Central Bank of Ireland is one of the nominating bodies to the Board of the Foundation.

3.2.1.1 Review Board

This Review Board will be made up of eight members only one of whom will be a practising accountant. Its role will be to assess the extent to which the public interest in professional auditing standards and in regulatory arrangements is being satisfied. The Review Board's remit is not confined to the three operational bodies of the Foundation as it also extends to the scrutiny of the continuing responsibilities of the professional accountancy bodies for monitoring the work and handling complaints in relation to accountants and auditors. In addition it will review the manner in which investigation and discipline cases are conducted by the professional accountancy bodies.

3.2.1.2 Auditing Practices Board (APB)

Currently the APB is a committee of the Consultative Committee of Accounting Bodies (CCAB). The APB was established in 1991 to develop and issue professional standards and guidance for auditors in the UK and in Ireland with which auditors must comply in the conduct of audits. It issues statements of auditing standards (SAS), based on principles rather than on detailed rules, bulletins and practice notes. Failure to follow a requirement issued by the APB can result in disciplinary action by the professional body to which the auditor belongs. The APB has authority to issue standards in its own name without the approval of the Council of the CCAB, after due process (which includes consultation) and members of CCAB have undertaken to adopt its standards for application to their members. APB's membership is determined by a selection panel consisting of the Presidents of the CCAB bodies, representatives of the Bank of England and the London Stock Exchange. Membership is comprised of eighteen voting members and may be extended by up to seven non-voting members. The

Department of Enterprise, Trade and Employment is a non-voting member. Irish auditing practitioners can be and regularly are members of the APB. The voting membership comprises both auditing practitioners and non-practitioners in equal numbers, though many of the non-audit practitioners are members of the accountancy bodies.

Under the new regulatory structure, the APB will continue its existing role but it will be established as a company owned by the Foundation. The proportion of non-practitioner members will be increased to 60%.

3.2.1.3 Ethics Standards Board

This new Board will build on the existing ethical guidance set by the individual professional bodies and develop the consistent application of such standards in professional practice, whether in accountancy firms, private industry or the public sector.

3.2.1.4 Investigation and Discipline Board

Currently the professional accountancy bodies have internal investigation and discipline committees which deal with cases of alleged misconduct that are put to them. It is not intended that this will change under the new framework. However, some professional bodies may refer public interest cases to a Joint Disciplinary Scheme or, in the case of the ICAI, to its Special Disciplinary Scheme. The Joint Disciplinary Scheme will be replaced by the new Investigation and Discipline Board while the ICAI will continue to operate its own arrangements.

3.2.2 Financial Reporting

In the area of accounting and financial reporting, the Financial Reporting Council (FRC) is responsible for the promotion of good financial reporting and for acting as the overarching and facilitating body for its two operational bodies, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP). The Irish Government attends the FRC as an observer. The ASB develops and sets accounting standards for companies. In Ireland the accounting standards in use are those of the ASB.

The FRRP was established in 1991. Its activities are focused on the annual accounts of public companies (PLCs) and large private companies (around 2,500 companies). The Review Panel reviews material departures from accounting standards where such a departure results in accounts not giving a true and fair view. The Review Panel adopts a reactive rather than a proactive approach in that it acts on matters drawn to its attention, but it can apply to the courts where a company is not prepared to adjust its accounts to take account of its findings. The FRRP is considered by many observers to have led to a significant improvement in the quality of financial reporting in the UK since its establishment.

3.3 EU Influences

3.3.1 EU Legislation in Relation to Statutory Audit

The following are the main pieces of EU legislation of relevance to auditing:

- Fourth Council Directive (78/660/EEC) requires certain companies to have their annual accounts audited by a qualified auditor. Member States may exempt small companies within certain thresholds from having their accounts audited;
- Seventh Council Directive (83/349/EEC) extends the audit requirement to all entities which draw up consolidated accounts;
- Eighth Council Directive (84/253/EEC) sets out the conditions on which Member States may approve auditors. The conditions include minimum professional qualifications and personal integrity and independence. It does not contain any specific guidance concerning the independence requirement.

3.3.2 Regulatory Systems in EU Member States[21]

A summary of the regulatory regime and the setting of auditing standards in some of the EU Member States, that reflect the different types of audit regimes in operation throughout the EU, is set out in the following paragraphs.

3.3.2.1 France

In France, company law only permits one type of auditor (Commissaire aux Comptes) to conduct statutory audits. All auditors are required to be members of the Compagne Nationale des Commissaries aux Comptes (CNCC), the professional body that also acts as the regulatory body of the French auditing profession under the supervision of the Ministry of Justice. The Conseil National of the CNCC adopts standards that have been prepared by the Comité de Normes Professionnelles which is made up mainly of auditors but can also include independent people with specialist knowledge.

The rights and powers of auditors, certain general principles for carrying out the audit and the content of the audit opinion are prescribed by French law.

3.3.2.2 Germany

The auditing profession is regulated by law and the overall objectives of the audit and the rights and powers of the auditor are specified in law. There are two categories of auditors, one of which is restricted to carrying out statutory audits of medium sized private limited companies. Auditing standards are issued by the Institute der Wirtschsftsprufer in Deutschland (IDW) which is a private association of which all auditors are members. All auditors are compulsory members of the Chamber of Auditors, a public body under the auspices of the Federal Ministry of Commerce, charged with discipline and control of the profession.

[21] This Section is based on two surveys undertaken on the situation of auditing in EU Member States. The first was published by the EU Commission in 1996 titled Final Report of a Study on The Role, Position and Liability of the Statutory Auditor within the EU (pages 13 to 23) and the second published in June 1998 by FEE titled Setting the Standards: Statutory Audit in Europe (pages 10 to 20).

3.3.2.3 Sweden

The auditing profession is regulated by law and Swedish company law requires statutory audit to be carried out in accordance with 'good auditing practice'. As in Germany, there are two types of auditors with one being limited in the range of companies he/she can audit. Both types of auditors are registered with the National Board of Trade which is the regulatory body for the auditing profession in Sweden. It has the power to issue regulations, monitor and discipline members. Auditing standards are issued by Foreningend Auktoriserage Revisorer, one of the professional bodies.

3.3.3 Recent EU Developments

Financial reporting and auditing regimes differ significantly between Member States, making it difficult for investors and other users to make meaningful comparisons of financial statements audited in different Member States. This can in turn act as a brake on cross-border investment and so handicap the effective workings of the Single Market and the single currency area (Euro zone).

The 1996 EU Green Paper on 'The Role, Position and the Liability of the Statutory Auditor within the EU'[22] acknowledged both the need for and the lack of harmonisation of the auditing profession in the EU.

The need for greater harmonisation in the auditing profession is required in the context of:

- the completion of the Single Market;
- free movement of services and freedom of establishment;
- improving companies access to more integrated EU capital markets;
- improving European companies access to international capital markets.

The EU recognises the difficulty associated with disrupting properly functioning national systems that are embedded in national traditions, and consequently the benefits of greater harmonisation has to be weighed up against the cost. Differences between Member States can relate to the techniques of auditing, differing professional structures, different environments of corporate governance, company law and accounting standards.[23]

Following from the widespread consultation on the above mentioned Green Paper, a Communication on the Future Direction of Statutory Auditing in the EU was adopted during May 1998 by the European Commission[24]. There is support among Member States, the European auditing profession and users of audit reports in favour of action at EU level in the auditing field. This Communication recognises:

[22] OJ C 321 28/10/96
[23] FEE ' Continuous Quality Assurance, Statutory Audit in Europe, April 1998, page 7
[24] OJ C 143 8/05/98

- "*that the regulatory framework that surrounds the statutory audit at EU level is incomplete*";
- the absence of a common view at EU level on the role, the position and liability of the statutory audit has a negative impact "*on audit quality, and on the confidence that is placed in audited accounts as well as on the freedom to establish and freedom to provide services in the audit profession*"[25].

This Communication does not propose to legislate in the area of regulation of the auditing profession, and it endorses the principle of monitored self-regulation.

An essential feature of the work programme set out in the Communication is the co-operation and involvement of Member States, the auditing profession and users. The Committee on Auditing, established following this Communication, comprises experts from and representatives of Member States as well as representatives of the European auditing profession.

To date this Committee which meets twice yearly has dealt with, amongst other things, the following issues:

- a Recommendation will be adopted in the near future on Quality Assurance for the Statutory Audit: Minimum Requirements;
- Debating and comparing national audit standards and International Standards on Auditing (ISA);
- initial discussions on statutory auditors' independence. It is the intention that this will lead to a Recommendation.

The European accountancy professional body, the Fédération de Experts Comptables Européens (FEE), undertakes a significant amount of background work for the Committee on Auditing. For example they have prepared papers on the issues under consideration by the Committee, such as those concerning quality assurance, auditing standards and independence and objectivity that feed into the discussions that take place within the Committee. Ultimately the Committee of Auditing reports into the Accounting Contact Committee at which level political decisions are taken.

The importance attached at EU level to such issues is further demonstrated in the conclusions of the recent European Council meeting in Lisbon. The European Council called for a speeding up of the completion of the internal market for financial services and specifically mentioned in this context the need for further actions to enhance the comparability of companies' financial statements[26].

[25] OJ C 143 8/05/98 page 2, para 1.2
[26] Presidency Conclusions from the Lisbon European Council (23/24 March 2000)

3.4 Increasing Globalisation of Standards

In the move towards the globalisation of accounting and auditing standards, the EU looks to work being undertaken by international standard setters rather than seeking to develop its own additional set of standards. There has been significant progress on this issue in relation to accounting standards where the Commission has just published a Communication[27]. In this Communication the Commission indicates its intention to present a formal proposal before the end of this year to oblige listed companies to use International Accounting Standards (IASs) set by the International Accountancy Standards Committee (IASC)[28] rather than national standards. If the Commission proposal is accepted by Member States, it will mean that from 2005 onwards Irish listed companies will be required to use IAS accounting standards rather than UK ASB accounting standards when preparing their accounts.

As part of the general move towards globalisation of accounting and auditing standards most, if not all, national standard setters in Europe look towards International Standards on Auditing (ISAs) when developing their own standards. ISAs are published by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). IFAC is an organisation of national professional accountancy organisations that represent accountants employed in public practice, business and industry, the public sector and education, as well as some specialised groups that interface frequently with the profession. Currently, it has 143 member bodies in 104 countries, representing 2 million accountants.

International Standards on Auditing (ISAs) outline basic responsibilities for auditors, help them cope with increased and changing demands on financial statements for information, and provide guidance in specialised areas.

While the EU Committee of Auditing has undertaken a comparison between national auditing standards and ISAs there is, as of yet, no clear consensus in the Committee as to whether the IAPC is the appropriate forum to develop international auditing standards that could be endorsed by the EU. The Commission is not convinced that IFAC's or IAPC's constitution is adequate to ensure that ISAs properly reflect the public interest. There is also some debate over whether ISAs are yet sufficiently rigorous.

Proposals are currently being discussed to restructure IFAC to enable it strengthen its standard setting capabilities in relation to auditing as well as its quality review process and its role in relation to the protection of the public interest.

[27] Communication from the Commission to the Council and the European Parliament COM (2000) 359 13/06/2000: EU Financial Reporting Strategy: The Way Forward

[28] The IASC was set up by the accountancy profession in 1973. The IASC's principal function is to issue standards, known as International Accounting Standards (IASs).

While there is therefore more uncertainty on the current acceptability to the EU of international auditing standards as prepared by IFAC, as compared to international accounting standards prepared by IASC, it is likely that, in the medium term, the EU will begin to move along the same lines in relation to auditing standards as it is currently doing in relation to accounting standards. This may ultimately mean the auditing standards that apply in Ireland may no longer be those of the APB.

3.5 United States

The influence of the US on international standards arises from the importance of the US capital markets on a global level as a means of raising finance. The US and in particular the Securities and Exchange Commission (SEC) has a significant influence over international accounting bodies and in developments in financial reporting within the EU and the UK. The SEC has statutory authority to establish financial accounting and reporting standards for Publicly Listed Companies under the Securities Exchange Act of 1934.

The approach of the US, and in particular the SEC, to standard setting is much different to that adopted in the UK or the EU. In the US the SEC adopts a much more detailed rule based approach clearly setting down what is not permitted rather than setting general principles that rely to a certain extent on the professional judgement of individual auditors. The view of the standard setters in the UK, other EU Member States and the EU Commission is that such detailed rules are impractical as they are too inflexible to take account of all the various circumstances that arise during an audit.

The difference in the two approaches means that the international debate surrounding the move towards international standard setting can be slow, complex and at times political.

Currently the US SEC rules apply to all partners of a particular accountancy firm, and many of these have implications for international accountancy firms. For example the Irish Big Five[29] accountancy firms have to keep track of the investment portfolios of partners to ensure that they do not impinge on the SEC investments rules that do not permit partners to hold investments with client companies.

The SEC was initially established to enforce the securities laws, to promote stability in the markets and to protect investors. SEC relies on private sector organisations to carry out this function as long as it is satisfied that the private sector continues to fulfil its responsibilities in the public interest.

[29] KPMG, Arthur Andersen, PricewaterhouseCoopers, Deloitte & Touche and Ernst & Young

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organisation in the private sector for establishing standards of financial accounting and reporting. These standards govern the preparation of financial reports. They are officially recognised as authoritative by the SEC and the US professional body, the American Institute of Certified Public Accountants (AICPA). FASB's objectives include establishing and improving standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

The SEC oversees various processes and activities conducted through the AICPA. These include:

- the Auditing Standards Board (ASB), which establishes generally accepted auditing standards;
- the Accounting Standards Executive Committee (AcSEC), which provides guidance on audit standards through issuing statements of position and practice bulletins;
- the SEC Practice Section (SECPS), which seeks to improve the quality of audit practice by member accountancy firms that audit the financial statements of public companies.

In addition there is a Public Oversight Board, an independent private sector body, that monitors and reports on the self-regulatory programmes and activities of AICPA.

The SEC also works closely with domestic and international private sector accounting and auditing standards setting bodies such as IFAC.

3.6 Conclusion

The above analysis indicates that there is diversity on an international level in the manner in which accounting and auditing standards and other regulatory activity are implemented and supervised in the public interest. Increasing globalisation of international business and capital markets is giving rise to moves towards greater harmonisation of both auditing and accounting standards, and consequently the diversity in this field is and will continue to diminish over the coming number of years. In developing its recommendations, the Review Group has taken on board the evolving international situation and recognised that Ireland should not develop standards, or a regulatory regime, that would be significantly out of step with emerging international developments that are moving towards greater uniformity in this area. To do so would place Ireland at a competitive disadvantage.

Part II

CURRENT REGULATORY CONTROLS

Chapter 4

Current Framework for Regulating the Auditing Profession

4 Current Framework for Regulating the Auditing Profession

4.1 Introduction

The first part of the Review Group's terms of reference requires it to examine:

- "*whether self-regulation in the auditing profession is working effectively and consistently and*
- *whether new or revised structures and arrangements are necessary to improve confidence and if so, what form they should take.*"

Before the Review Group can specifically address these matters, it will start by outlining the arrangements which already exist for regulating the auditing profession.

This Part of the Report will cover this ground and will deal with the issue in the first indent above. It contains three Chapters which will proceed as follows:

- this Chapter will outline the present framework for regulation in Ireland;
- the next Chapter, Chapter 5, will review the use of the instruments of regulation; and
- Chapter 6 contains an assessment by the Review Group of the extent to which these arrangements are working effectively and consistently.

We deal in subsequent Parts of the Report with the rest of our terms of reference.

4.2 What is an Audit?

At the outset, it is useful to describe what an audit actually involves.

4.2.1 Purpose of the Audit

As a general introduction to the topic of auditing regulation, the Review Group recalls that the purpose of the audit is to provide an independent, professional and informed opinion of the validity of a particular set of financial statements. These may relate to Government Departments and agencies, companies or other forms of corporate entity. The audit is therefore a form of objective assurance that the financial statements fairly reflect the financial position of the company or other entity at a point in time.

4.2.2 Objective of the Audit of Financial Statements

In describing the objective and general principles governing the auditing of financial statements, the APB has stated that:

> "*The objective of an audit of financial statements is to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view … and have been prepared in accordance with relevant accounting or other requirements*".[30]

The APB goes on to state:

> "*In undertaking an audit of financial statements auditors should:*
>
> (a) *carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs, to determine with reasonable confidence whether the financial statements are free of material misstatement;*
>
> (b) *evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and*
>
> (c) *issue a report containing a clear expression of their opinion on the financial statements*"[31]

4.2.3 Related Services

Auditors may also provide assurance on other financial and non-financial information. The APB has commented that:

> "*As well as financial statements, audit and related service engagements may involve other financial information, or non-financial information such as*
>
> - *the adequacy of internal control systems*
> - *compliance with statutory, regulatory or contractual requirements*
> - *economy, efficiency and effectiveness in the use of resources ('value-for-money' auditing), and*
> - *environmental practices.*"[32]

[30] Paragraph 1, SAS 100, Objective and general principles governing an audit of financial statements (March 1995).
[31] Paragraph 2, SAS 100, Objective and general principles governing an audit of financial statements (March 1995).
[32] Paragraph 2, The Scope and Authority of APB Pronouncements, (May 1993).

4.2.4 Scope of the Audit

Preparation of financial statements involves consideration of inherent uncertainties that exist at the date they are prepared and those responsible must exercise judgement in making accounting estimates and selecting appropriate accounting policies. Hence the view given by financial statements cannot be characterised as either 'absolute' or correct; and when auditors report on financial statements, they provide a level of assurance which is reasonable in that context, but equally, cannot be absolute.

The Review Group believes that it is useful, in the interests of clarity, to reiterate the respective roles of those involved in the presentation of financial statements for a company, viz:

- notwithstanding the valuable role discharged by the auditor in the Companies Acts, it is the company that is legally required under section 202 of the Companies Act, 1990 to ensure that proper books of account are kept, such that they give a true and fair view of the state of affairs of the company. Any company director failing *inter alia* to take all reasonable steps to secure compliance by the company with the requirements of the section is guilty of an offence;
- the duty of the auditor under section 194 of the 1990 Act is limited to reporting to the shareholders his/her opinion as to whether proper books of account have been kept. In all but minor cases, the auditor is obliged to serve notice of his/her opinion of inadequate books of account on the company, and following any failure of the directors to take the necessary steps to correct the position, to notify the Registrar of Companies of that opinion in writing;
- auditors do not examine all transactions of a company or other entity in planning his/her work, the auditor is expected to seek to obtain sufficient evidence to satisfy him/her that the financial statements are free from material misstatement, whether caused by error, fraud or other irregularities. However, the auditor is not expected to guarantee that the accounts are absolutely accurate in all respects. Section 193(6) of the Companies Act, 1990 only imposes the general duty that the auditor carry out the audit with professional integrity. In order to fulfil this function, an auditor normally examines the financial management system within a client company, as well as a representative sample of the transactions which a company will undertake in any financial year. The size of the sample examined by the auditor during the course of an audit will depend on his/her view of the strength, or otherwise, of the financial management system.

Although these factors reflect inherent limitations in the audit process, the Review Group believes that a properly conducted audit carried out by a suitably qualified professional should be in a position to uncover any material defects in the financial statements of a company. Accordingly, the Review Group does not consider that any major change in the existing delineation of responsibilities between the company, its directors and its auditors is needed at this time. However, the Review Group does propose later on in this Report to extend the reporting obligations of auditors in circumstances suggesting statutory non-compliance or other concerns.

4.3 Regulation of Auditing

4.3.1 Scope of Regulation

Similar to the conduct of an audit, a system of auditor regulation, whether carried out as at present by the recognised accountancy bodies or otherwise, will not review in detail each and every audit undertaken by an auditor or accountancy firm undertaking audits. Thus, it will not be able to guarantee that all auditors and auditing firms are properly discharging their duties at all times but should satisfy a reasonable expectation of users of financial statements that proper standards have been consistently applied.

4.3.2 Levels of Regulation

It is important that the task of auditing is performed by competent and professional persons and that appropriate supervisory arrangements are in place to ensure high standards in auditing. Auditors issued with a practising certificate by a recognised accountancy body are entitled by law to undertake a statutory audit. There are also a small number of individually recognised auditors authorised by the Minister.

The regulatory framework applying to the auditing profession in Ireland operates at two main levels:

- the regulation of those accountancy bodies recognised as being qualified to regulate their auditing members;
- the regulation of auditors, whether they are individuals or firms.

The Review Group will discuss each of these levels in more detail later in this Chapter.

4.4 Nature of Regulation – Statutory, Executive and Professional Authority

Each level of regulation shares the following dimensions:

- the regulation of auditing at both levels is directly controlled to a limited extent by statute;
- the regulation of both levels is also indirectly controlled by executive authority;
- in the case of the regulation and activity delegated to the recognised accountancy bodies, executive authority over the bodies is exercised by the Minister for Enterprise, Trade and Employment. Any Ministerial decision will normally be supported by statutory power to be found in the Companies Acts, 1963-1999;
- in the case of the regulation of auditors, executive authority is exercised by the recognised accountancy bodies. Any decision by a body derives from its constitution with which the member has agreed to abide on becoming a member.

There is also a large measure of regulation based on professional standards and practices. The accountancy bodies regularly update their professional practices and procedures in the light of national and international developments. Many of the recognised accountancy bodies put considerable resources into monitoring and encouraging compliance by their members.

In considering the general area of auditing, it is important to be aware that:

- there are other accountancy bodies whose members do not practise as auditors but who may be employed by auditing firms. These bodies are not subject to statutory or Ministerial supervision, because they are not recognised to issue audit practising certificates and so operate outside the remit of the statutory controls on auditing in the Companies Acts;
- there are also a small number of individually authorised auditors who are not subject to direct supervision by any of the accountancy bodies; and
- there are specific sectoral requirements on auditors defined in other legislation, such as the Central Bank Acts, which impose different and sometimes more onerous requirements on auditors than those set out in company law.

4.5 Regulation of Accountancy Bodies

The Review Group started the review of the regulatory framework by focusing initially on the regulation of the recognised accountancy bodies, before moving on to describe the supervisory arrangements for auditors.

The dimensions of the regulation of recognised and unrecognised accountancy bodies may be fairly represented as follows:

Figure 4.1: Dimensions of the Regulation of Accountancy Bodies

4.6 Recognition under the Companies Act, 1990

The requirements for recognition of accountancy bodies in section 191(1) of the Companies Act, 1990 are that the Minister be satisfied:

- that the standards relating to training, qualifications and repute are not less than those specified in Articles 3 to 6, 8 and 19 of Council Directive No. 84/253/EEC of 19 April, 1984; and
- as to the standards an accountancy body applies to its members in the areas of ethics, codes of conduct and practice, independence, professional integrity, technical standards, disciplinary procedures.

The standard terms and conditions applied to a recognised body under section 192 of the Companies Act, 1990 are that:

- the Minister may use any of the powers contained in section 192 of the Companies Act, 1990 during the currency of the recognition;
- the body shall furnish to the Minister a copy of any proposed alterations to its Charter, Rules, Bye-Laws, Regulations or similar Instruments;
- the body shall submit an annual report to the Minister giving details of the number of complaints received and the number and outcome of cases dealt with by its Investigation, Disciplinary and Appeals Committees pertaining to members practising as auditors in the State;
- the body shall furnish to the Minister, on request, information regarding the holding of examinations, appointment of examiners, etc.

The process of Ministerial recognition of accountancy bodies under the Companies Acts derives from the importance of the audit in company law. Most forms of non-audit service provided by members of the recognised accountancy bodies are also provided by members of the unrecognised accountancy bodies. The absence of Ministerial recognition of the latter bodies under the Companies Acts makes no judgement on the quality of services provided by their members vis-à-vis the same services provided by the recognised bodies.

4.7 Executive Dimension of the Regulation of Recognised Accountancy Bodies

Under the following provisions of the Companies Act, 1990, the Minister may:

- impose, amend or delete terms or conditions from the recognition of a body (section 192(1) and (2));
- revoke or suspend for a specified period a body's recognition (section 192(3));
- require the submission for approval by a body of a code prescribing standards of professional conduct (section 192(4)(a)).

It should also be noted that under the Institute of Chartered Accountants in Ireland (Charter Amendment) Act, 1966, the Government is required to authorise changes to the Bye-Laws of the ICAI, before they can come into effect. The Minister for Enterprise, Trade and Employment sponsors the necessary Memorandum for the Government when this arises.

4.8 Professional Dimension of the Regulation of Accountancy Bodies

Beyond the framework approach adopted in legislation, there is no statutory or Ministerial regulation of accounting and auditing standards. As we have seen in Chapter 3, these particular matters are essentially determined at an international level by professional organisations of appropriate expertise. The major recognised accountancy bodies in Ireland participate in the discussions to prepare and revise accounting and auditing standards in line with market developments and best international practice, viz:

- ACCA, ICAEW, ICAI and ICAS are all involved with UK standard setting and are members of FEE and IFAC. They monitor international developments. However, the development of guidance on application of auditing standards in Ireland is undertaken primarily by ICAI and ICPAI;
- ICPAI participates in the promulgation of standards through its membership of CCAB-I and a number of joint committees with ICAI. It is also an active member of FEE and IFAC;
- IIPA is the only recognised accountancy body without specific links to standard setting arrangements. It applied for membership of CCAB-I and sought a nomination to join FEE but was refused.

The table at **Appendix IV** summarises the position.

While there is no independent professional regulation of the recognised accountancy bodies as such, the proposed strengthening of the functions and resource base of IFAC is an indication of moves in this direction. The regulatory work of the participating accountancy bodies and the standards of the profession in general will also be influenced by the work of the new Accountancy Foundation in the UK as a professional regulatory organisation.

The deliberations of the EU Committee on Auditing and increased activity at FEE are also indicators of moves towards greater professional supervision and influence on the activities of accountancy bodies.

Other professional influences include those in the legal domain. From time to time, the Courts determine matters in disciplinary cases in other professions which can set a new standard for the handling by professional bodies of their regulatory functions. Similarly, interpretations of the provisions of the European Convention on Human Rights have in the past caused certain recognised accountancy bodies to adjust their investigation and disciplinary procedures, so that they remain legally acceptable. The Competition Authority has also sought changes in the rules of at least one of the recognised accountancy bodies to ensure that they do not unduly hinder competition in the market.

Some of the bodies also engage outside expertise as required, in order to help maintain quality processes and standards. These may be by way of formal reviews, either on an ongoing or occasional basis. For instance, the Association of Chartered Certified Accountants (ACCA) employs a Lay Observer (a non-accountant and non-member) of legal standing who regularly monitors the performance by the body of its disciplinary processes. From time to time, the ICAI engages the Joint Monitoring Unit (in which it participates with the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS)) to assist it in its monitoring work or in the investigation of any complex cases of alleged misconduct.

The Institute of Certified Public Accountants in Ireland (ICPAI) has obtained ISO 9002 designation and is subject to regular external audit in respect of all its quality processes.

We now move on to describe the dimensions of auditor regulation.

4.9 Regulation of Auditors

The framework for regulating auditors also comprises a mix of statutory, executive and professional dimensions, although the emphasis here is more on professional regulation than was the case in respect of the supervision of the recognised accountancy bodies. This is because of the status of the recognised accountancy bodies under the Companies Acts and the role of delegated regulation which they discharge under law on behalf of Government in the public interest.

In summary, the dimensions of the regulation of auditors and non-auditors may be represented as follows:

Figure 4.2: Dimensions of Regulatory Controls on Auditors and Non-Auditors

4.10 Principal Statutory Provisions under the Companies Acts

4.10.1 Qualification for Appointment as Auditor

Section 187 (as amended) of the Companies Act, 1990 essentially provides that a person shall not be qualified to be an auditor of a company or a public auditor, unless the person:

- holds a valid audit practising certificate from a recognised accountancy body; or
- was individually authorised by the Minister prior to 3 February, 1983, or
- has obtained a qualification outside the State which the Minister is satisfied is of a standard not less than that required for audit under the Companies Acts.

In addition, the person must be appropriately registered with the Registrar of Companies who is required to maintain such a register under section 198 of the 1990 Act.

The above and a number of other requirements set out in section 187 of the 1990 Act are specifically not applied to the C&AG under subsection (8).

4.10.2 Prohibitions on Appointment

Even if qualified as an auditor, a person is prohibited from appointment as auditor to a particular company if *inter alia* the person:

- is an officer or servant of the company; or
- has been an officer or servant of the company within the accounting period which falls to be audited; or
- is a parent, spouse, brother, sister or child of an officer of the company; or
- is a person who is a partner of or in the employment of an officer of the company; or
- would be disqualified from auditing a subsidiary or holding company of the company to be audited or a subsidiary of the company's holding company.

It is an offence for any person to act as auditor while not qualified to do so.

4.10.3 Appointment/Removal of Auditor

Section 160 of the Companies Act, 1963 establishes the circumstances under which an auditor may be appointed to, or removed from, a company. In general, the members at a general meeting of the company make this decision. However, the company's directors may appoint the auditor prior to the holding of the first annual general meeting (AGM) or where a casual vacancy in the office arises, and the Minister may do so where no auditors are appointed or re-appointed at an AGM.

4.10.4 Resignation of Auditors

Section 185 of the Companies Act, 1990 provides that where an auditor resigns from the office of auditor to a company, he/she shall send to the Registrar of Companies a copy of the notice of resignation to the company. That notice is required to contain either:

- a statement to the effect that there are no circumstances surrounding the resignation which the auditor considers should be brought to the attention of the company's members or creditors; or
- a statement of any such circumstances.

It is an offence for any auditor to fail to comply with these provisions.

4.10.5 Auditors' Report

Section 193 of the Companies Act, 1990 specifies that:

- the auditors shall make a report to the members on the company's accounts and on every balance sheet and profit and loss account and on all group accounts (subsection (1));
- the auditors' report shall be read at the AGM and be open for inspection by any member (subsection (2));
- the auditors have a right of access to the company's records and a right to demand from its officers all information and explanations necessary for the performance of their duties (subsection (3));
- the auditors' report shall state *inter alia* whether they have obtained all the information and explanations necessary for the purposes of the audit and whether, in their opinion, proper books of account have been kept by the company (subsection (4));
- the auditors shall be entitled to attend any general meeting of the company, to receive all notices of, and communications relating to, such a meeting and to be heard on any part of the business of the meeting which concerns them as auditors (subsection (5));
- auditors have a general duty to carry out their work with professional integrity (subsection (6)).

Under section 15 of the Companies (Amendment) Act, 1986, the auditors of a company (other than an unlimited company) are also required to state in their report if, in their opinion, the information in the directors' report is consistent with the company's accounts.

It is a general requirement in the Companies Acts, e.g., section 128(1) of the Companies Act, 1963 (as amended), that the auditors' report must accompany the annual return filed by a company with the Registrar of Companies.

4.10.6 Keeping of Books of Account

Section 202 of the 1990 Act places the legal onus for the keeping of proper books of account on the company, and under subsection (10), directors are required to take all reasonable steps to secure compliance by the company with the requirements of the section. Such books must *inter alia*:

- correctly record and explain the company's transactions (subsection (1));
- enable the company's financial position to be determined with reasonable accuracy at any time (subsection (1));
- enable its directors to ensure that its accounts comply with the Companies Acts (subsection (1));

- enable its accounts to be readily and properly audited (subsection (1));
- be kept on a continuous and consistent basis (subsection (2));
- meet certain specified requirements as to their form and content, e.g., that a record of services provided and related invoices is maintained (subsection (3)); and
- give a true and fair view of the company's state of affairs (subsection (4)).

4.10.7 Inadequate Books of Account

Where auditors form the view that the company is failing, or has failed, to keep proper books of account as required by section 202 of the 1990 Act, section 194 requires them to serve a notice on the company to that effect. If sufficient steps are not taken by the directors to remedy the situation within seven days, the auditors are then required to notify the Registrar of Companies to that effect. It is an offence for any auditor not to make the required notifications, unless the contraventions are minor.

4.10.8 Other Provisions on Auditors and Company Accounts

The principal statutory sources for the general requirements relating to auditors and for the more detailed technical provisions relating to the format and content of accounts are set out in **Appendix V** of this Report.

4.10.9 The Standard of Care owed by Auditors

There is no statutory definition in Irish law of the standard of care which an auditor should apply to his/her task. Instead, the Courts have generally accepted the following descriptions from UK case law of the standard of care which an auditor should apply to his/her task, viz:

> "*It is the duty of an auditor to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.*"[33]

[33] In Re Kingston Cotton Mills Co. (No. 2) [1896] 2 Ch. 279 at pp. 288-289.

Although this case was heard over one hundred years ago, the enunciated principles remain the foundation on which subsequent case law has been built. Over sixty years later, Lord Denning expressed the duty of an auditor in similar terms:

> "*His vital task is to take care that errors are not made, be they errors of computation or of omission or commission, or downright untruths. To perform this task properly he must come to it with an inquiring mind – not suspicious of dishonesty, I agree – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.*"[34]

More modern cases have also suggested that in addition to complying with statutory requirements, auditors have a duty to maintain close adherence with their professional guidelines and standards. The courts have recognised that these may evolve and change over time and that the courts are bound to take account of these developments when assessing the standard of care required of auditors.[35]

4.11 Ministerial Regulation of Auditors

Because the system of auditor regulation is largely delegated by law to recognised accountancy bodies, the primary role of the Minister for Enterprise, Trade and Employment with respect to auditors is one of enforcing the statutory provisions governing the members of the profession. This matter is covered in detail in the following Chapter.

4.11.1 Position of Individually Authorised Auditors

However, there is one area where the Minister has a residual direct responsibility for regulating auditors. This is with respect to individually authorised auditors who may be either company or public auditors. Insofar as individually authorised company auditors are concerned, the then Minister for Industry and Commerce was permitted under section 162 of the Companies Act, 1963 to authorise individual persons to be company auditors on certain conditions. This power was withdrawn from the Minister in section 6 of the Companies (Amendment) Act, 1982, and this withdrawal became effective on 3 February, 1983. However, this Act and the subsequent section 187(1)(a)(iv) of the Companies Act, 1990 included appropriate "grandfather rights" enabling those persons who were individually authorised as company auditors prior to 3 February, 1983 to continue to act as auditors to companies.

[34] Fomento (Sterling Area) Ltd v Selsdon Fountain Co [1958] 1 All ER 11

[35] From Courtney, "The Law of Private Companies" (Butterworths, 1994, page 563).

In section 182 of the 1990 Act, a public auditor is acknowledged to be a person entitled to audit the accounts of co-operative and friendly societies covered by provisions in the Industrial and Provident Societies Acts, 1893 to 1978 and the Friendly Societies Acts, 1896 to 1977 respectively. However, a public auditor is not entitled to audit the accounts of a limited company. The amendments according "grandfather rights" in the 1982 and 1990 Companies Acts also apply to public auditors authorised prior to 3 February, 1983.

4.11.2 Mutual Recognition Directive 89/48/EEC

Despite the withdrawal of the right of individual authorisation by the Minister in the 1982 Act, this power had to be re-introduced on foot of Directive 89/48/EEC of 21 December, 1988 which provides for the mutual recognition by EU Member States of certain higher education qualifications. Thus, an auditor recognised in one Member State had to be capable of being recognised to provide services as an auditor in another Member State. However, the Directive permits the Member State in which a person wishes to achieve authorisation to impose tests to ensure that he/she is fully conversant with local taxation and company law. This power was transposed into Irish law under section 187(1)(a)(vi) of the Companies Act, 1990, and requests for authorisation under the Companies Acts are addressed to the Minister for Enterprise, Trade and Employment. However, no such persons have been authorised to date under this provision. The Review Group understands that any persons who have enquired about the matter have been encouraged by the Department to become a member of a recognised accountancy body.

4.11.3 Register of Qualified Auditors

The Registrar of Companies is also required to maintain a register of qualified auditors under section 198 of the Companies Act, 1990. This register includes both those persons authorised by the recognised accountancy bodies to undertake audit work and those previously authorised by the Minister. Paragraph 7(1)(b) of the Companies Act, 1990 (Auditors) Regulations, 1992 construes sections 199 and 200 of the Companies Act, 1990 as requiring all individually authorised company and public auditors to re-register annually with the Registrar of Companies his/her continuing authorisation.

4.12 Professional Regulation

4.12.1 The Role of the Recognised Accountancy Bodies

Each recognised accountancy body is responsible *inter alia* for:

- the education, training and development of its students and members, including continuing professional education;
- the issue of audit practising certificates to those of its members who meet the necessary qualification criteria to be auditors;
- monitoring the work of its members who are practising auditors;
- the investigation of complaints concerning, and the disciplining of, members.

As indicated earlier, a number of the recognised accountancy bodies contributed to the process of determining the content of accounting and auditing standards developed internationally and implemented in Ireland.

4.12.2 Constitution and Funding of the Recognised Accountancy Bodies

Each body has its own constitution (e.g., its Memorandum and Articles of Association), Bye-Laws/Regulations and ethical code or guidelines, which are issued from time to time to its members. The Bye-Laws and Regulations deal with the conditions for admission to membership, registration, fees and subscriptions, meetings of the body and voting criteria, the management of the body, examination procedures and disciplinary matters. While each recognised accountancy body delegates particular functions to specified committees from time to time, the principal committee is its Council which determines policy and the strategic direction of the body. Members are elected to the Council from amongst the membership of the body, and the auditing members of the body do not receive any preferential treatment in the governing of the body over the body's non-auditing members.

The recognised accountancy bodies rely substantially on members' fees and subscriptions for their income. Each member of the recognised accountancy body pays an annual fee, and different fees and subscriptions are paid by student, non-auditing and auditing members. In the case of some bodies, the cost of monitoring the auditing members forms part of the higher fee paid by them. In other cases, the cost of monitoring is borne by the auditing members separate from the annual fee.

Issues such as professional conduct, independence, integrity and objectivity, confidentiality and conflicts of interest are some of the issues addressed in the ethical codes or guidelines. Members agree to abide by the body's Bye-Laws and Regulations and its ethical code or guidelines and, where appropriate, to have professional indemnity insurance, to undertake continuing professional education and to undergo practice review or monitoring visits by the body.

4.12.3 Educational Standards

Each recognised accountancy body evaluates students' knowledge through its examination processes. Reflecting the provisions of the Eighth Directive, core subjects which underlie the work of accountants and auditors include financial accounting, cost and management accounting, taxation and auditing. Support subjects include business and company law, IT, economics, mathematics, statistics and management. Students' depth of knowledge of theory and technique must be such as to enable them apply the knowledge gained in their profession whether they work in public practice, industry or in commerce or in the public service.

In order to obtain an audit practising certificate, an accountant is generally required to complete a minimum of three years' practical experience in the course of their training in *inter alia* the auditing of annual accounts, consolidated accounts or similar financial statements. At least two-thirds of such practical training must be completed under the supervision of a qualified auditor. In addition, some bodies require that members obtain a period of relevant post-qualification experience before being eligible for the status of a registered auditor.

4.12.4 Monitoring/Quality Review

Each recognised accountancy body has in place a system of review which covers, at a minimum, either all its practising members or those registered for audit. The review is either individual member or firm focused depending on the professional body's method of granting audit registration. The review conducted by the professional bodies generally consists of:

- an internal assessment of information provided in a requested format on an annual basis by their firms or members;
- an inspection visit to the firm or member.

While the approach of each recognised accountancy body differs, the general procedure for an inspection visit is:

- a specific pre-visit questionnaire for completion to provide up to date information on the operation of the practice;
- a discussion with the individual member or partners in the firm under review to ascertain the exact nature of the work undertaken by the firm;
- a review of the procedures of the individual member/firm with regard to 'whole firm' aspects, such as resources, competence, ethics, confidentiality and independence;
- a selection of files for review. Each professional body will have procedures in place for ensuring an appropriate number and mix of client files selected. The inspector will look at the selected files, in order to check whether the audit work supporting the opinion given has been carried out in accordance with the rules and regulations of the body, with auditing standards and with any relevant legislation;
- at the close of the visit, the inspector will discuss the findings with the individuals under review and provide details of what will be included in the final report to the firm.

A report will follow summarising the visit and selection process and record any areas of non-compliance with the body's rules and regulations, with auditing standards and with any relevant legislation.

The information provided by the recognised accountancy bodies suggest that the larger bodies apply a risk-based selection method for their monitoring work. In the case of the ICAI for instance, it introduced in 1999 a new Quality Review system. Quality Review involves:

- an annual assessment of an extensive 28 page annual return;
- a requirement for each firm to conduct an annual audit compliance review to ascertain the strength of internal quality control procedures, and
- an inspection visit to the firm based on risk. This method of selection for a monitoring visit was only introduced in 1999.

The Review Group understands that the other recognised accountancy bodies use a mix of risk-based and random methods of selection to determine what auditors should receive visits. However, they have systems in place to ensure that all members are visited at least once every five/six years.

4.12.5 Investigation, Discipline and Appeals

Each body operates its own complaints and disciplinary procedures, and a member generally becomes liable to disciplinary action, if he/she/it has been found guilty of misconduct. Generally, the complaints and disciplinary procedures have the following elements:

- **mediation/initial assessment:** the first stage involves the body in mediating between the complainant and the member to establish if some mutually acceptable solution is possible. This work is often undertaken by the executives of the body;
- **investigation:** if the complaint cannot be resolved or otherwise disposed of, an Investigation Committee of the body determines if there is a *prima facie* case of misconduct;
- **discipline:** if the Investigation Committee finds a *prima facie* case of misconduct, this will then be forwarded to the Disciplinary Committee to hear the case and determine what level of sanction is appropriate, e.g., a reprimand, fine, expulsion from membership;
- **appeal:** the member has a subsequent right of appeal to an Appeal Committee which may vary the decision made;
- **judicial review:** it is always open to the member to seek to overturn the decision of the body by undertaking judicial review proceedings via the High Court.

The decisions at investigation, disciplinary and appeals levels are usually made by various committees, comprising the member's peers and some non-members of the accountancy profession. In cases of public interest, a formal Committee of Inquiry or a Special Investigator can be appointed to inquire into the matter.

The sanctions which may be imposed on a member range from admonishment, fine and suspension up to expulsion in the most serious cases. Except for ACCA which can apply a Stg£50,000 fine, the maximum level of fine imposed is usually IR£10,000. Costs will also usually be added.

4.12.6 Auditing Standards

As already outlined in Chapter 3, the Auditing Practices Board (APB) is at present responsible for the development and issuing of auditing standards and guidance for the UK and Ireland. The APB comprises auditing practitioners and non-practitioners in equal numbers, together with a number of non-voting observer members, e.g., the representatives of the Department of Trade and Industry in the UK and of the Department of Enterprise, Trade and Employment. Views of Irish practitioners are represented on the Board through a voting member nominated by the ICAI. The Standards that are set are equally applicable to the UK and Ireland, although separate reference is made, where appropriate, to the legal framework in Ireland. In addition when necessary, separate versions of guidance notes of their application in Ireland are produced by the ICAI to take account of the differences in law and business practice between the two countries. These are then adopted by the CCAB-I and approved for issue by the APB.

4.12.7 Accounting Standards

Chapter 3 has already indicated that the Accounting Standards used in Ireland are those developed by the Accounting Standards Board (ASB). Essentially, these Standards are developed in line with UK company law and are recognised there for the purposes of accountancy requirements of the Act.

There is no equivalent recognition in Irish company law of these Standards. The main accountancy bodies here do have the right, either through the Consultative Committee of Accountancy Bodies – Ireland (CCAB-I) or individually, to comment on "Discussion Drafts" of proposed Financial Reporting Standards (FRSs) and to influence them at that stage of preparation.

4.12.8 Ethical Standards

Each of the recognised accountancy bodies has a code of professional ethics which lays down what professional standards are expected of its members. This code usually comprises rules of professional conduct, the breach of which renders the member liable to disciplinary action. Heavy emphasis is placed in the rules on the need to act with integrity, independence and with due care, skill and attention to the needs of the client in particular.

In addition, the code of professional ethics usually contains a guide to assist members in handling circumstances which could potentially give rise to a breach of professional conduct. Listed safeguards include strong independent procedures and controls and recommended actions and restrictions in certain cases. In later Chapters, we indicate if and where the ethical guidelines of the recognised accountancy bodies deal with specific issues such as safeguarding auditor independence.

4.13 Concluding Comment

While the recognised accountancy bodies have more detailed rules of professional behaviour for their auditing members, they nevertheless demand similar standards of professional behaviour from all staff employed in auditing firms. Similarly, a number of the unrecognised accountancy bodies have structures and professional standards similar to those outlined above for their members.

Having outlined above the framework for regulation of both the recognised accountancy bodies and auditors, the following Chapter proceeds to discuss how this framework has been applied in practice.

CHAPTER 5

Outputs of Regulation

5 Outputs of Regulation

5.1 Introduction

This Chapter will describe the outputs of regulation, namely how the statutory, executive and professional dimensions of regulation have been applied in practice. The Review Group starts the review of this area by establishing:

- who is regulated;
- what regulatory/compliance activity has taken place; and
- what resources are invested in regulation.

In addressing each issue, the Review Group deals in turn with the regulation of the recognised accountancy bodies and auditors. The Review Group also briefly outlines the international links of the regulated accountancy bodies.

The Review Group's work in this area was greatly assisted by a questionnaire which was prepared by the Review Group and completed by each of the recognised accountancy bodies. In addition, some separate statistics were independently provided during the course of the Review Group's work.

5.2 Who is Regulated?

5.2.1 Recognised Accountancy Bodies

As noted in Chapter 4 statutory auditors must necessarily be members of a recognised accountancy body. Six accountancy bodies are currently recognised by the Minister to register auditors under section 191, viz:

- the Institute of Chartered Accountants in Ireland (ICAI);
- the Institute of Certified Public Accountants in Ireland (ICPAI);
- the Association of Chartered Certified Accountants (ACCA);
- the Institute of Incorporated Public Accountants Ltd (IIPA)[36];
- the Institute of Chartered Accountants in England and Wales (ICAEW);
- the Institute of Chartered Accountants of Scotland (ICAS).

5.2.2 Numbers of Registered Auditors

Appendix VI provides information on the number of members in the recognised accountancy bodies based in Ireland. In summary, this indicates that the four principal bodies (ICAI, ICPAI, ACCA and IIPA) have some 4,600 members in practice in the State. Of this number, some 3,200 firms and individuals resident in the State are registered by the bodies to sign audit reports. The number of ICAEW and ICAS auditors resident in the State is not significant.

[36] Judicial review proceedings are outstanding against a decision by the then Minister for Commerce, Science and Technology in 1996 to recognise the IIPA under section 191 of the 1990 Act. The ICAI, the ICPAI, the ACCA and a non-recognised body, the Chartered Institute of Management Accountants (CIMA) initiated these proceedings in 1996.

Appendix VI shows that most members of the accountancy bodies are not auditors/engaged in auditing work. The largest number of auditors/members engaged in auditing work are members of the ICAI.

In addition, there are significant numbers of members of the six recognised accountancy bodies resident elsewhere who are permitted to audit Irish registered companies. Approximately 19,000 may do so (about 17,000 of whom are ICAEW and ICAS members), but it is likely that only a small number would undertake a significant amount of Irish audit business.

In addition to these numbers, there are a small number of auditors who were individually authorised by the then Minister prior to 3 February, 1983 and who remain registered with the Registrar of Companies. At present, there are about 10 public and 40 company auditors. One auditor resigned last year, and their numbers are gradually declining. For instance, there were 149 authorised in 1980, and this number had reduced to 132 by 1983. In 1995, the number stood at 59.

5.3 Regulatory Activity by Minister

5.3.1 Recognised Accountancy Bodies

In the wake of the McCracken Tribunal Report and various investigations of companies which have been initiated under Part II of the Companies Act, 1990, the Review Group understands that the Tánaiste and Minister for Enterprise, Trade and Employment has taken a number of initiatives in the supervisory area, viz:

- in 1997, the Minister decided under section 192 of the 1990 Act to attach a condition to the recognition of the accountancy bodies requiring them to give unrestricted access to an observer from her Department at any Committees of Inquiry established to examine matters of public interest affecting their members. A Departmental observer attended the proceedings of the ICAI's Committee of Inquiry under the chairmanship of the former Supreme Court Judge, Mr John Blayney, which has completed its investigation of the conduct of a number of ICAI's members arising from the revelations in the McCracken Report. The Minister declined the opportunity to observe the proceedings of a second public interest case initiated by the ICAI in 1999;
- in various public statements following the McCracken Report, the Minister has encouraged the recognised accountancy bodies to develop more transparent disciplinary arrangements for their members. A number of the recognised bodies responded positively to these suggestions and have amended their Bye-Laws, so as to provide greater transparency to the disciplinary process.
  In accordance with the terms of recognition of the recognised accountancy bodies, the amendment to their Bye-Laws were submitted to and approved by the Minister and the Government as appropriate;

- in 1997, the Department requested each recognised accountancy body to notify any breaches of the Companies Acts which come to their attention in the disciplining of their members. To date, the few notifications made have tended to be for breaches of section 187 of the 1990 Act (acting as auditor without being qualified to do so);
- in 1998, the Department required each of the recognised bodies to submit more detailed information on their activity in the areas of monitoring, investigation and disciplinary arrangements. The key features of this additional information was published in the Department's Companies Report, 1998[37]. Each of the recognised accountancy bodies is meeting the requirement to produce its annual report within a period of about four months of the end of the preceding calendar year;
- in recent years, the Minister has received an increasing number of representations from persons dissatisfied with the hearing by certain recognised bodies of complaints of professional misconduct made against their members. In a number of recent cases, the Department has had cause to investigate complaints from persons dissatisfied with the disciplinary process undertaken by the recognised accountancy bodies. This has entailed seeking reports from the bodies concerned. The Department has also recently accepted invitations from the recognised accountancy bodies to observe the conduct of some disciplinary hearings;
- in 1999, the Department sought access to the investigation papers of two cases by two separate recognised accountancy bodies, where the decisions to dismiss the complaints appeared to be questionable.

Having examined the matters in detail, the Department advised one body that its handling of the complaints seemed to have been "seriously deficient". In October 1999, the recognised accountancy body in question undertook to reopen its investigations, and no final outcome to its proceedings is yet available. Arising from the experience of this case, the Department subsequently specified that the body's procedures be changed to improve the independence and transparency of its investigation and disciplinary proceedings and to enhance the standing of the complainant in the process.

In the second case, the Department advised the recognised accountancy body in question that it was unsatisfactory that an admitted disclosure to a third party by one of its members of information given by a prospective client did not involve a breach of the body's ethical code. The body in question has agreed to amend its Rules of Professional Conduct to ensure no repetition of the circumstances of this case.

[37] Chapter 9, Companies Report, 1998 (Department of Enterprise, Trade and Employment), Pn. 7977.

The Review Group understands that a number of other complaints from members of the public against recognised accountancy bodies are awaiting examination in the Department.

5.3.2 Auditors

As Chapter 4 indicates, the 'public interest' obligations of auditors under the Companies Acts are limited. Perhaps the most important such obligation is that the Registrar of Companies be informed under section 194 of the Companies Act, 1990 of a failure by company directors to keep proper books of account. The following indicates the number of such notifications to the Registrar in each of the last five years:

Table 5.1: Notifications by Auditors under Section 194, Companies Act, 1990

Year	Number
1995	12
1996	4
1997	13
1998	8
1999	11

Insofar as prosecutions are concerned, the Review Group has been informed that in the period 1995 to 1998, the Minister for Enterprise, Trade and Employment successfully prosecuted six persons for acting as auditor without being qualified to do so, contrary to section 187 of the Companies Act, 1990. Typically, these convictions attracted a small fine ranging from £100 to £500 in each case. The Probation of Offenders Act was applied in one case. The usual source of complaint relating to such cases is one of the recognised accountancy bodies, although other sources have included the Registrar of Friendly Societies and the Companies Registration Office.

As the flow of information to the Department suggesting possible breaches of the Companies Acts has increased, the Review Group has been advised that the Minister's use of her powers of prosecution has been widening and intensifying. Sixteen convictions of companies and officers were obtained in 1999 for breaches of auditing and other Companies Acts offences, and over twenty have been successfully prosecuted so far this year. For the first time, successful prosecutions have been undertaken in the recent past against:

- companies and their directors for failing to keep a proper register of members, contrary to section 116 of the Companies Act, 1963;
- companies and their directors for failing to comply with a Ministerial direction to hold an AGM, contrary to section 131 of the 1963 Act;
- companies and their directors for misusing the word "Limited", contrary to section 381 of the 1963 Act;

- persons acting as an auditor of a company while also directors, contrary to section 187 of the 1990 Act and
- companies and their directors for failing to keep proper books of account, contrary to section 202 of the 1990 Act.

These convictions typically attract a small fine for the company and/or its directors of about £250 on average. The source of these complaints is generally members of the public who are concerned about the activities of the companies and directors concerned.

However, the prosecutions for section 202 breaches have been the result of a systematic examination of the register of notifications from auditors of inadequate books of account under section 194 of the Companies Act, 1990. On successful prosecution of cases deriving from such notifications, the Department of Enterprise, Trade and Employment has introduced a practice of formally conveying its appreciation to the auditor concerned and copying its letter to the auditor's recognised accountancy body.

The Review Group understands that a series of further prosecutions are in the pipeline and that some of these derive from the results of the Minister's own company investigations in recent years. The Minister is also examining at present a number of possible breaches by auditors of section 194 of the 1990 Act, and legal advice on these cases is awaited.

5.3.3 Monitoring of Individually Authorised Auditors

The Review Group was advised by the Department of Enterprise, Trade and Employment that no arrangements were in place to monitor the work of individual auditors who had been authorised by the then Minister prior to 3 February, 1983. While it understands that there have been no complaints to the Department about their work or performance in the collective Departmental memory (some 14 years), the Review Group was nevertheless concerned at the lack of ongoing supervision of these persons. The Review Group will return to this issue later in its Report.

5.4 Regulatory Activity by Recognised Accountancy Bodies

5.4.1 Monitoring/Quality Review Visits of Auditors

The six accountancy bodies recognised by the Department use different criteria and terminology to describe their activities. These differences in approach has caused difficulty for the Review Group in preparing comparable performance measurements and in evaluating the effectiveness of regulation activity carried out by the accountancy bodies. The tables in this chapter have accordingly been the subject of extensive consultations with the bodies, in order to ensure close comparability across the six recognised accountancy bodies.

The following Table 5.2 provides information on the number of, and reason for, monitoring/quality review visits undertaken by each body of its auditing members during 1999.

Table 5.2: Number/Cause of Monitoring/Quality Review Visits of Auditors, 1999

Visit Numbers for 1999	ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Routine Visits	29	63	90	1	–	21
On foot of a complaint	7	1	–	–	–	–
Other (including follow-up)	5	17	50	–	–	1
Total	**41**[38]	**81**	**140**	**1**	**–**	**22**

While there is no fixed visit cycle for any firm, the ICAI has imposed a visit ceiling to ensure that should a firm not trigger a risk indicator, it will still receive a visit. The visit ceilings in relation to audit are:

- a Big Five firm: full visit every four years and an interim visit every two years;
- firms with PLC clients: full visit every four years;
- firms with public interest clients: full visit every five years;
- firms with smaller company audits: full visit every ten years.

The Review Group has been informed by ICPAI, ACCA and IIPA that each of its members in Ireland receives a monitoring visit every four or five years on average.

[38] The Review Group notes the explanation from the ICAI that its figure of 41 visits for 1999 is exceptionally low, due to two primary factors:

- the introduction in 1999 of its new Quality Review system which involved a substantial commitment in staff training, etc;
- the introduction of new monitoring requirements of its members under the Investment Intermediaries Act.

According to the ICAI, a more representative number of annual visits to registered audit firms would be about 200 covering some 300 Responsible Individuals, i.e., members eligible and wishing to sign audit reports.

5.4.2 Complaints

The figures of complaints reported by the recognised accountancy bodies relating to members practising as auditors within the State for the year 1999 are as follows:

Table 5.3: Throughput of Complaints against Auditors in 1999

Complaint Numbers	ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Complaints on hands at the start of 1999	27	2	2	–	–	–
New complaints received during the year	88	24	–	–	–	–
Complaints concluded during the year	(74)	(16)	(2)	–	–	–
Complaints on hands at year-end	41	10	–	–	–	–

Complaints against accountants can emanate from many different arenas. These complaints can come from clients, the general public, the press, the professional bodies and the Department of Enterprise, Trade and Employment. It is the experience of ICPAI that over 50% of complaints are generated by the Institute's own monitoring processes. However, this figure includes cases where members did not comply with their requirements under mandatory CPE (continuing professional education) guidelines, which have been in operation for nine years.

The Review Group understands that all of the bodies do not apply the same practices in relation to what constitutes a complaint. Some act on written complaints only, while others may initiate investigations of members if, for instance, press coverage so warrants.

The following Table 5.4 indicates at what level within each recognised body the complaints concerning members practising as auditors in the State were determined in 1999:

Table 5.4: Manner of Resolution of Complaints against Auditors in 1999

Number of Complaints/ Determinations	ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Number of complaints concluded without recourse to the Investigation Committee	44	4	–	–	–	–
Number of complaints concluded by the Investigation Committee	6	12	1	–	–	–
Number of complaints concluded by the Disciplinary Committee	17	–	1	–	–	–
Number of Complaints concluded by the Appeals Committee	1	–	–	–	–	–
Complaints withdrawn/ dropped due to bankruptcy	6	–	–	–	–	–
Total	**74**	**16**	**2**	**–**	**–**	**–**

Where sanctions were imposed by the Investigation, Disciplinary and Appeals Committees of the recognised accountancy bodies, the following has been reported by the bodies as the nature of sanctions imposed on their auditing members in 1999:

Table 5.5: Nature of Sanctions Imposed on Auditors in 1999						
Number/Nature of Sanctions	**ICAI**	**ICPAI**	**ACCA**	**ICAEW**	**ICAS**	**IIPA**
Reprimand	1	–	–	–	–	–
Reprimand and Costs	–	1	–	–	–	–
Reprimand, Fine and Costs	–	2	–	–	–	–
Censure	6	–	–	–	–	–
Admonishment	5	–	–	–	–	–
Admonishment and Costs	–	4	–	–	–	–
Admonishment, Fine and Costs	–	1	1	–	–	–
Suspension	2	–	–	–	–	–
Severe Reprimand, Fine and Costs	–	–	1	–	–	–
Others (not specified)	4	–	–	–	–	–
Total	**18**	**8**	**2**	**–**	**–**	**–**

The information provided to the Review Group indicates that the ICAI named in its professional publication, "Accountancy Ireland", two of the persons against whom sanctions were imposed. In addition, we understand that it is ICPAI policy to publish exclusions and suspensions in the national and local press, as well as withdrawals of audit registration and also any breaches of the Investment Intermediaries Act, 1995. We understand that ACCA policy is to issue press releases in all disciplinary cases. They did so in the above two cases in which its members were sanctioned.

Various reasons have been cited by the recognised bodies for the imposition of sanctions on their members practising as auditors in the State in 1999. While the determinations in a number of cases involved more than one reason, the basis for each decision was as follows:

Table 5.6: Basis for the Determinations made against Auditors in 1999

Basis for Determinations (Numbers)	ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Failure to respond to correspondence on a timely basis	7	–	–	–	–	–
Failure to report to a regulator on a timely basis	1	–	–	–	–	–
Carrying out audit work in breach of section 187 of the Companies Act, 1990	1	–	–	–	–	–
Breach of Professional Indemnity Insurance Regulations	2	–	–	–	–	–
Failure to satisfy a judgement debt	2	–	–	–	–	–
Failure to pay fines/ costs imposed by the Disciplinary/Appeals Committees	2	–	–	–	–	–
Failure to comply with an order of the Appeals Committee	1	–	–	–	–	–
Failure to disclose commissions	1	–	–	–	–	–
Poor auditing standards	1	–	–	–	–	–
Breach of Code of Professional Conduct	–	3	–	–	–	–
Failure to comply with mandatory Continuing Professional Education requirements	–	4	–	–	–	–
Breach of practising regulations	–	1	1	–	–	–
No practising certificate	–	–	1	–	–	–
Total	**18**	**8**	**2**	**–**	**–**	**–**

5.5 Staffing Resources Applied to Auditing Regulation

5.5.1 Department of Enterprise, Trade and Employment

The Company Law Administration section of the Department of Enterprise, Trade and Employment is responsible for the regulation of the auditing profession. Auditing is only one element of its sphere of activity which includes:

- company law investigations;
- company law enforcement;
- administration of other Ministerial duties under company law, e.g., determining if the name of a recently registered company should be required to be changed, because it is too like that of an existing registered company;
- overseeing the auditing profession and monitoring international auditing developments;
- policy and legislation in relation to co-operatives (credit unions, etc.) and certain collective investment schemes; and
- supervision of the Companies Registration Office and the Registry of Friendly Societies.

The normal staffing complement of the section comprises on average about eight full-time staff equivalents, all of whom are general service staff. About one full-time staff equivalent is generally deployed on auditing-related work.

5.5.2 Recognised Accounting Bodies

Appendix VII provides information on the staffing resources assigned by each of the six recognised accountancy bodies to monitoring, investigations and disciplinary work. In summary, about twenty full-time staff are deployed in the State on monitoring and quality review work. The bulk of this resource is directed to the firms and individuals registered to undertake audits in the State. A smaller number of additional persons support the investigation, disciplinary and appeals activity in each body.

5.6 Conclusion

Having outlined the activity undertaken in regulating the auditing profession, the following Chapter sets out the views of the Review Group on the merits and shortcomings of the present arrangements.

CHAPTER 6

Consistency and Effectiveness of Self-Regulation

6 Consistency and Effectiveness of Self-Regulation

6.1 Introduction

The purpose of this Chapter is to address the issue of:

- "*whether self-regulation in the auditing profession is working effectively and consistently*".

The Review Group deals with this subject under a number of headings, viz:

- monitoring/quality review;
- investigation of complaints;
- disciplinary and appeals structures and procedures;
- the sanctions applied;
- publication of sanctions;
- public concern cases; and
- national and international links.

In addition, the Review Group felt the need to comment on a number of other matters that are generally relevant to the area:

- compliance with statutory obligations;
- register of qualified auditors;
- management policy in the Companies Registration Office (CRO); and
- the resources applied in the Department of Enterprise, Trade and Employment in supervising the auditing profession.

The Chapter concludes with an overall assessment of regulation by the recognised accountancy bodies.

6.2 Monitoring/Quality Review

The Review Group holds the view that the independent monitoring of auditors is an important part of regulation, in that it serves to ensure that audit work is generally of an appropriate professional standard. The Review Group is broadly satisfied that the process of monitoring undertaken by each of the recognised accountancy bodies is appropriate. The Review Group accepts that these arrangements are designed to ensure a consistency of auditing practices **within** each recognised accountancy body.

As indicated in Chapter 4, the ICAI has recently introduced a new system of quality review. This new system of quality assurance has a tighter focus on the regulated work of audit and investment business. It is also a risk-based system. Monitoring is now focusing more on accountancy firms which have a large audit client base and which are auditing clients in the higher risk category, and this will be a primary factor in determining the incidence of monitoring visits. The Review Group understands that both

ACCA and ICPAI also operate a risk-based system of review. This type of system is, the Review Group believes, a useful innovation which should improve the quality of regulation of auditing members within the relevant recognised accountancy bodies.

The Review Group acknowledges that this system of quality review is more suitable to the size and diversity of auditing practices which are members of the ICAI and that such a system may not need to be replicated in the case of all of the other recognised accountancy bodies. In many cases, their members' audit clients would be in the SME sector. However, the Review Group believes that there is merit in all of the other bodies adopting some elements of this approach, particularly where their members act as auditors of credit unions, investment intermediaries or similar public interest entities.

As overall regulator of the auditing profession, the Department of Enterprise, Trade and Employment has properly taken a more active role of late in supervising the auditing profession. However, it has never undertaken a detailed independent examination of the monitoring activities of each of the recognised accountancy bodies. In the absence of such a detailed examination, the Review Group is unable to express any definitive opinion on the consistency and effectiveness of the monitoring undertaken **across** the recognised accountancy bodies.

However, it would be remiss of the Group not to offer some tentative observations in the general monitoring area, viz:

- the incidence of possible corporate malpractice being uncovered by the DIRT Inquiry and in tribunals of inquiry, company investigations, etc. seems not only to have shocked the public at large but the recognised professional accountancy bodies as well;
- while the monitoring activities of the bodies undoubtedly help to perform a valuable role in encouraging best practice in the auditing profession, they do not appear to have been effective in deterring a number of significant instances of corporate malpractice over a prolonged period;
- the capacity, in relative terms, of a lightly resourced accountancy body to conduct a thorough review of a large accountancy practice in particular, given the latter's substantial resources, diverse activities, specialist skills and high standing within the profession must be open to serious question.

The Review Group accordingly feels that while it cannot make any detailed evaluation of the consistency and effectiveness of the monitoring activities of the recognised accountancy bodies, weaknesses in the system are nevertheless apparent from the remaining discussion in this Chapter. Accordingly, a stronger independent oversight role must be discharged in the future, in order to provide public assurance that appropriate standards of monitoring are consistently applied by all the recognised accountancy bodies. Part III of the Report discusses how this might be achieved.

6.3 Investigation of Complaints

As indicated in Chapter 5, there appears to be differences between each of the recognised accountancy bodies in relation to:

- what constitutes a complaint;
- how pro-active/reactive the body is when information comes to its attention;
- the numbers of complaints received relative to the size of the body;
- the proportion of complaints dealt with at executive level vis-à-vis at Investigation Committee, etc.

The Review Group has also noted the recent interventions by the Department of Enterprise, Trade and Employment in two cases of complaint and the positive outcome in each case. In particular, the Review Group wants to guard against any characterisation that the process of complaining to a recognised accountancy body would be seen as knocking on a door that is firmly closed against the complainant.

It appears therefore that there are grounds for concluding that practice and procedure across the recognised accountancy bodies is not consistent and requires improvement in certain respects.

6.4 Disciplinary and Appeals Structures and Procedures

These structures are broadly similar across the six recognised accountancy bodies. In certain instances, however, the process of determining a complaint against a member of a recognised accountancy body seems not to have inspired confidence that the structures are not only independent but are seen to operate in an independent fashion.

With the exception of the ACCA, the disciplinary and appeals process of the recognised accountancy bodies has not been open and transparent up to recently. Some welcome changes have been made in the last two years to the Bye-Laws of ICAI and ICPAI to improve the situation, and the Review Group wishes to see appropriate changes implemented by all of the bodies in the near future.

The Review Group considers that there is scope for improving the manner in which these structures operate.

6.5 Sanctions Applied

In the absence of a detailed knowledge of the cases which have been the subject of sanction, the Review Group does not consider it proper that it should comment on the extent to which the sanctions in individual cases have been appropriate. However, it observes from Table 5.5 in Chapter 5 that only a minority of cases seem to attract a financial penalty or a more serious sanction, e.g., suspension or exclusion from membership.

This could suggest a number of possible conclusions:

- that the sanctions are appropriate to the findings and that the findings indicate that in general, transgressions, where they occur, are minor;
- that the sanctions imposed are light relative to the indicated findings;
- that the sanctions imposed are light, because the system of regulation is not effective in exposing cases, particularly the more serious cases, of professional misconduct.

The Review Group is not in a position to properly judge which of these scenarios is the correct one, but the Review Group would wish the conclusion to be that outlined in the first indent above. In that regard, the Review Group believes that improvements are necessary to the system of regulation to ensure that this is the case. The Group is also of the view that the maximum level of financial penalty which is capable of being imposed is insufficient.

6.6 Publication of Sanctions

The publication of sanctions is decided on a case by case basis by the Disciplinary and Appeals Committees of the various recognised accountancy bodies. Such Committees all include non-accountant representation, sometimes in the majority. The Review Group notes that it is the general practice of the recognised accountancy bodies to publish the results of their disciplinary and appeals hearings in their own professional publications. Disciplinary and Appeals Committees often see exposure to peers as a relevant and sufficient form of publication. In some cases however, the member's name and address is withheld even from the professional publication.

In the case of some recognised bodies, it is the general policy and practice of their Disciplinary Committees to publicise the results of their hearings, including naming the members concerned. This is now an emerging practice among a greater number of the recognised bodies in recent years. Until recently, the Committees of many of the recognised bodies only contemplated wider publication in the more serious cases of professional misconduct.

The Review Group would like to see publication being used more frequently than heretofore by all of the recognised accountancy bodies. The Review Group regards the withholding of members' names as fundamentally misguided and leaves the body wide open to the accusation that it is only acting to protect its errant members rather than acting in support of the public interest. If the members of the recognised accountancy bodies act unprofessionally, the persons and the nature of their misconduct should, as a matter of general practice, be publicly identified. The threat of publicity will also act as a powerful deterrent against professional misconduct in the future.

6.7 Public Concern Cases

The role played by accountants and accountancy firms in high profile controversies has led to investigations by the ICAI of three public concern cases in recent years, viz:

- the Blayney Inquiry which was started in October 1997 arising from the findings in the McCracken Tribunal Report;
- the Powerscreen Inquiry which commenced in September 1999; and
- the DIRT Report Inquiry which was recently launched in June 2000.

As these investigations are either still ongoing or (as in the case of the Blayney Inquiry) the outcome is under appeal, the Review Group feels that it is in no position to comment on the effectiveness of these inquiries. The Review Group regards it as important that public concern cases are dealt with quickly, and the proposals in Chapter 10 for statutory underpinning of the investigation and disciplinary processes of the recognised accountancy bodies should support this objective.

6.8 National and International Links

In Chapter 4, the Review Group noted that not all of the recognised accountancy bodies have the same access to national and international developments in the general accountancy area. While the capacity of each body to involve itself is clearly dependent on its willingness and ability to contribute to such work, the Review Group believes as a matter of principle that each recognised accountancy body should be afforded the opportunity to participate in the process of developing best practice in the general accountancy field.

6.9 Compliance with Statutory Obligations

The Review Group was surprised to learn that under section 194 of the Companies Act, 1990, an average of less than ten statutory notifications per year are made by auditors advising the Registrar of Companies that proper books of account are not being kept by individual companies and their directors. Having regard to the tens of thousands of company audits which are conducted annually and the ongoing disclosures of corporate malpractice, the Review Group regards this notification figure as a substantial understatement of the actual position. This suggests:

- that some auditors are not complying with their statutory obligations because of their unwillingness to damage the commercial relationship with their clients, or
- that some auditors may be genuinely unaware of their statutory obligations.

The Review Group seeks to eliminate the latter possibility by proposing in Chapter 14 that all of the recognised professional bodies require their members on a regular basis to attend courses on continuing professional development and generally to ensure that their members are kept up-to-date with their statutory obligations.

6.10 Register of Qualified Auditors

The Review Group was made aware that the register of qualified auditors which is kept in the CRO under section 198 of the Companies Act, 1990 may not be as valuable a resource as it should be in enabling a check to be made on the standing of particular members of the auditing profession. Clearly, the accuracy of the register relies in the first instance on each of the recognised accountancy bodies forwarding on a regular basis an up-to-date list of qualified auditors, as they are required to do under section 200 of the 1990 Act. After that, the onus is on the Registrar of Companies to make the register as accessible as possible. In this context, the Review Group considers that the register should be made available on the CRO Website.

6.11 Management Policy in the CRO

The Review Group is aware that years of under-investment by the State in staffing and technology in the CRO contributed both to a substantial backlog in the registration of annual returns and other statutory documentation and to the poor record of compliance by companies and their directors with respect to the timely filing of such documents. In response to a substantial increase in resources in recent years, major progress is now being made both on reducing the backlog and on boosting compliance rates.

However, the Review Group understands that the volume of documentation now being processed by the CRO on a daily basis is such that only a small amount of checking can be done to ensure the accuracy and consistency of individual documents before being made available for public inspection. The Review Group accepts that it is a matter of primary importance that statutory documentation should not only be filed but be made available promptly by the CRO to the general public.

With respect to audit reports attached to the annual returns of companies, the Review Group considers that cross-checking must take place to confirm that the person who signs the audit report is a qualified person by reference to the register of auditors. The present situation is not satisfactory in that the filing of audit reports at the CRO is one of the main opportunities for identifying possible persons acting in breach of section 187 of the Companies Act, 1990. This is further discussed in Chapter 11.

6.12 Supervision of the Recognised Accountancy Bodies

The Review Group considers that the level of staffing resources presently available in the Department of Enterprise, Trade and Employment to supervise the auditing profession must be significantly increased in the future. While the interventions of the Minister and her staff have positively influenced compliance standards in the general company law area, the present level of resources is insufficient to undertake the expanded role which the Review Group envisages to be necessary for the effective regulation of the recognised accountancy bodies in the future.

6.13 Effectiveness of Regulation – General Comment

The above analysis suggests that there are weaknesses in the regulation of the auditing profession at present. Part III of the Review Group's Report, which follows, identifies what needs to be done to improve the standard of regulation, and the Review Group is anxious that a more rigorous system of regulation and oversight should be introduced. The Group's proposals seek to develop a better structure of accountability within the profession, including introducing a system of performance measurement against which the standard of regulation can be measured.

The Review Group recognises that the whole area of measuring the effectiveness of regulation in a wide range of economic and other areas is undergoing significant development at present. There is now a greater demand for effectiveness which puts regulators' work under increasing scrutiny. As a result, more effort is being applied by regulators to build visible frameworks through which they can demonstrate their effectiveness.

The replies to the questionnaire which was circulated by the Review Group to the recognised accountancy bodies during the course of the Group's work indicate that none of the bodies has a comprehensive explicit framework to underpin their assertions that their regulation activities are effective. The situation can be summarised as follows:

- none of the recognised bodies have tailored definitions of objectives and desired outcomes for the purposes of evaluating effectiveness. One body (ICAS) acknowledged that this would probably be required under the new regime in the UK;
- all of the recognised bodies regard their regulations and standards as the criteria to be used to determine effectiveness;
- the principal measures of effectiveness cited were:
- the extent of compliance with regulations (as determined by monitoring visits);
- the level of complaints; and
- the efficiency of dealing with complaints.

The Review Group considers that:

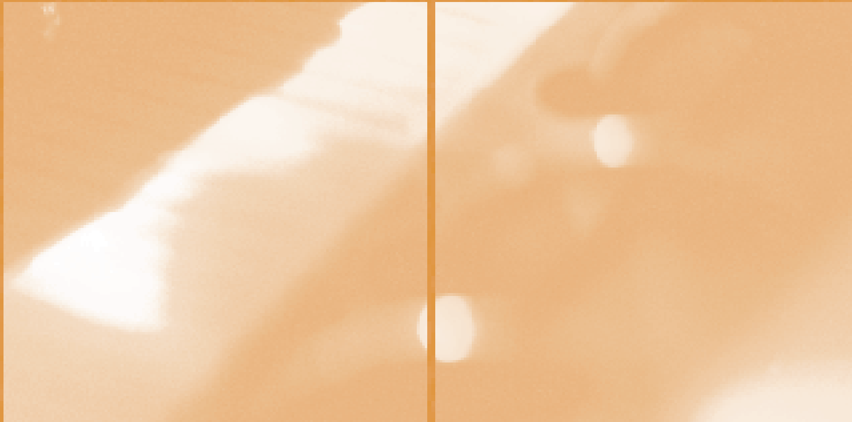
- it is unusual for the statements of objectives contained in mission statements or in legislation to be sufficient for the development of an effectiveness measurement framework. Some decomposition of objectives into a format which facilitate the assessment of achievement is usually required;
- it is acknowledged that the criteria for determining effectiveness are implicit in the objectives. There is a current trend to make these criteria explicit. Some of the criteria have already been identified, i.e., consistency, transparency, timeliness, independence, quality, etc;

- if the standards of the recognised accountancy bodies are to be used as effectiveness criteria in the future, this needs to be borne in mind when the standards are being produced. The present standards cover a wide ground ranging from ethical standards and codes of conduct concerned with the qualities of the auditor and his relationship with his client to the auditing standards dealing with the quality of the audit process. The danger is that standards may be focused more on the quality of the performance of the audit process (efficiency) rather than with the outcome of the process (effectiveness). The specific standards associated with effectiveness need to be identified.

The Review Group proceeds in the following Chapter to identify what it regards as the key goals and criteria of regulation in the context of the auditing profession. The Review Group also discusses at a later stage the need to develop explicit performance measurements for regulation of the sector.

Part III

STRENGTHENING THE PRESENT SYSTEM/STRUCTURE



CHAPTER 7

Regulating the Audit Profession

7 Regulating the Audit Profession

7.1 Introduction

This Chapter reviews the options for an effective and equitable system of regulating the auditing profession. In advance of reaching a conclusion on this issue, the Review Group firstly considered some basic principles such as the reasons for Government intervention in the form of regulation in the market place, and the purpose of an audit, in order to understand why there is a need to regulate the audit profession.

7.2 Purpose of Government Regulation

The limited liability company is an important business entity in a modern economy. Under this structure, entrepreneurs can conduct business with a limited risk to their personal assets in the event that the business proves unsuccessful and does not generate sufficient funds to meet all its liabilities. The limited liability structure represents a major concession by society generally to entrepreneurs, because it enables them to take risks that they might not otherwise be prepared to accept. The reason society is prepared to convey this concession is because it facilitates greater economic activity, which in turn increases the wealth of society generally.

However, the operation of limited liability companies carries an increased risk of default for anybody dealing with such companies, because once the resources of the company itself are exhausted, there is no further recourse for any debts owed. Thus, society does not allow unfettered use of the so-called "corporate veil" and prescribes rules under which those wishing to avail of it must operate. In Ireland's case, these rules are set out in the Companies Acts and elsewhere and are designed to ensure that the owners of companies behave in a responsible manner and do not attempt to take advantage of the privileged position which limited liability status affords them. In addition, there are other areas where the operation of companies is regulated in the interests of society as a whole.

The primary purpose of regulation in any economic sector is to provide, for reasons of public interest, a counterweight to free market forces and to counteract market failure. If allowed to operate unchecked, these forces may merely serve to benefit individuals in society to the disadvantage of society as a whole. Thus, we have regulation:

- of companies and other entities by the Department of Enterprise, Trade and Employment and its agencies/Offices (such as the Companies Registration Office, the Competition Authority and the Office of the Director of Consumer Affairs) to ensure *inter alia* that the marketplace for various goods and services operates efficiently in the interests of consumers and that company law generally is respected. The new Office of the Director of Corporate Enforcement will also play an important role in this regard;

- of financial institutions by the Central Bank, by the Department of Enterprise, Trade and Employment and by certain of its Offices to protect consumer interests and to ensure *inter alia* that those institutions are managed prudently to reduce the risk of loss of society's funds;
- of persons (both corporate and individual) by the Courts to ensure *inter alia* that society's accepted standards of behaviour as detailed in law are upheld;
- of certain professions by the professional bodies concerned to ensure *inter alia* that the conduct of their members complies with a high standard of professional practice.

These rules are a critical part of the business environment providing, for a wide range of parties, such as suppliers, customers and banks, the confidence to trade or engage in economic transactions with limited companies. Reliable, independent auditing of the financial statements of limited companies is a core principle underpinning this overall regulatory framework and is often the baseline from which regulatory authorities and other State agencies conduct their functions.

It is vital to the maintenance of a competitive marketplace that the organisations concerned and their supervisory authorities, usually Government, keep abreast of marketplace or societal developments, so that their role remains relevant and proportionate to the needs of society. Often this involves regular incremental changes in the regulatory role, such as the decision in the Companies (Amendment) (No. 2) Act, 1999 to remove small companies from the requirement of statutory audit. Sometimes, this may involve more substantial change, such as the termination of a particular regulatory function or the establishment of a new regulator. This process of review and renewal is an ongoing one, and some of the regulators identified in an earlier paragraph are currently involved in a similar process of change.

The review and renewal of the external auditing function and of auditing regulation should be seen in this context. It is the case that the present review is more fundamental than any other in recent years, but it is a necessary one having regard to the recent disclosures of corporate malpractice that impinge on the auditing profession.

7.3 Stake-Holders in the Audit of Company Financial Statements

In the light of the public assurance role which auditors perform, the Review Group considers it worthwhile to identify some of the persons who use the audit as an independent verification of the state of affairs of audited entities, viz:

- **shareholders and directors:** company owners and directors benefit to the extent that they receive an independent validation of the financial status of the company. These are the persons who have a primary interest in the company's well-being and to whom the auditor owes a particular duty of care;
- investors operating on financial markets extensively use audited financial statements to assess risks and make investment decisions;
- **other fund providers:** the audit assists banks and other financial institutions to assess the financial standing of a company and to properly evaluate the level of credit risk in making funds available;
- **trading partners:** customers and suppliers need to know if a company is experiencing financial problems, so that they can make informed decisions as to whether they will continue to supply the company and expose themselves to the possible risk of financial loss;
- employees have a major stake in any business and refer to audited financial statements to provide information as to how well or otherwise their employer is performing, so that they can negotiate appropriate remuneration for their work or avoid financial loss;
- in regulated sectors such as financial institutions and insurance undertakings, regulators acting for stakeholders such as depositors and policyholders make extensive use of audited financial statements of regulated entities and may also obtain further reports from auditors on relevant matters;
- Government in various forms avails of the audited financial statements to help establish companies' tax liability or assess if individual companies merit grant assistance for specific projects;
- the auditing profession, as the recipient of audit fees, also has a stake in ensuring that the audit function continues to enjoy a high level of public confidence and support.

In summary therefore, reports by auditors on financial statements are widely used for decision-making in our economic lives. Reliable and respected financial reporting and audit are fundamental elements in supporting the reputation of Irish business, in avoiding financial losses, in encouraging trade and ensuring the efficient operation of the Irish financial markets and more generally, in enhancing the attractiveness of Ireland as a location of business development.

7.4 Purpose of Auditor Regulation

While any practical system of auditor regulation will of necessity be selective in its focus, the Review Group considers that it is nevertheless possible to visualise the essential elements of a proper system of auditor regulation on which its success or failure will be judged.

It is vital that the duties of auditors and of the regulators of audit activity are exercised in accordance with appropriate legal and professional standards, in order to provide and maintain a credible form of public assurance in the auditing function. Unless the system of auditor regulation is strong enough to demand and enforce such standards, then the whole *raison d'être* for auditing as a function of independent public assurance would be undermined.

Recommendation 7.1

In the opinion of the Review Group, the objective of the system of auditing regulation should be to monitor and protect the quality of the external audit function and thereby to maintain public confidence in the value of the external audit function.

All three dimensions of the audit regulation framework (statutory, executive and professional), as described in Chapters 4 and 5, must work together to achieve the objective of audit regulation. The Review Group believes that the success or otherwise of the system of regulation in discharging this mandate will be judged by reference to the following core concepts:

- the concept of effectiveness, whereby audit work of unsatisfactory quality is discovered as such, appropriate remedial action is taken and corrective measures are put in place to prevent it occurring again;
- the concept of equity, whereby solutions to problems and determinations are made based on fairness to all parties, both in developing a realistic regulatory role and in resolving the claims of the different interests involved (e.g., auditor and client, accountancy body and complainant and the regulators and the auditing profession).

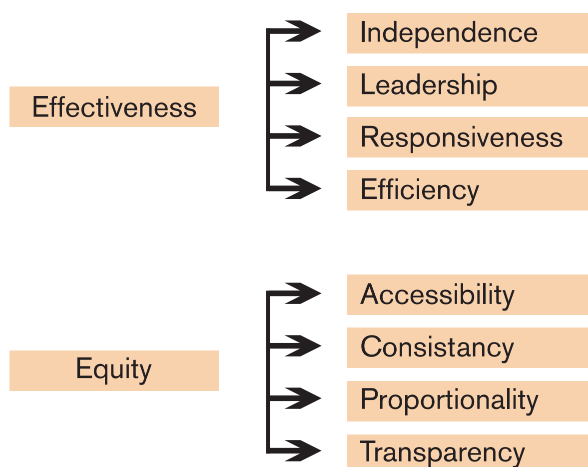
Within these core concepts, the Review Group identified a number of specific qualities which should be exhibited by the system of auditing regulation in meeting the mission statement defined in Recommendation 7.1 above. These qualities are summarised in Figure 7.1 below. The Review Group recognises that there is considerable scope for debate on this point, but it concluded that the system of audit regulation should display the following particular characteristics:

Effectiveness Criteria

These are:

- independence, in standing apart from the client company when professional requirements dictate such a decision by an auditor, in the interests of the integrity of the audit process. This quality is also relevant to the treatment of complaints made against members and member firms of the recognised accounting bodies;
- leadership, in contributing to national and international developments in the general auditing field and in effecting necessary changes in the profession at home;
- responsiveness, in being open to change in a world which itself is changing rapidly, in order to ensure that the outputs remain relevant to the demands of our external environment;
- efficiency, in ensuring that the work of individual auditors and of the associated regulatory structures is undertaken completely and quickly, consistent with the requirements of professional conduct.

Figure 7.1: Desirable Attributes of Audit Regulation



Equity Criteria

These are:

- accessibility, in terms of affording a reasonable opportunity for non-accountants (e.g., complainants about accounting/auditing standards) to be heard. This quality is very relevant to the whole disciplinary area which is discussed later;
- consistency, in terms of ensuring that similar standards and practices are established and implemented not only for all auditors within the same recognised accountancy body but for all auditors across each of the bodies;
- proportionality, in selecting solutions to individual issues and policy matters which reasonably address the problems at issue;
- transparency, in terms of providing regular information to clients of the regulatory system and to the public at large on developments and issues in the profession, so as to improve and sustain public confidence in auditing and in its system of regulation.

7.5 Main Options for Regulation

The Review Group identified a number of possible options for the regulation of auditing. These are:

- State Supervision of Delegated Regulation, i.e. the existing system, whereby the Department of Enterprise, Trade and Employment would discharge the task of supervising the regulatory practices of the recognised accountancy bodies. Alternatively, another State entity, whether existing or specially established for this purpose, could take over the role of the Department in relation to the supervision of the operation of the delegated regulatory framework;
- Self-Regulation, i.e. the auditing and accounting profession would exercise control over its own supervisory arrangements, subject only to the requirements of law and legal practice;
- Direct State Regulation, i.e. the Department of Enterprise, Trade and Employment or another State entity would be given the role of supervising directly the conduct of auditors and the auditing profession. This would involve it assuming some of the present functions of the individual accountancy bodies, such as the monitoring of members' activity and the determination of complaints against members;
- Independent Supervision of Delegated Regulation, i.e. the present supervisory role discharged by the State would be largely transferred to an independent entity controlled neither by the State nor the accountancy profession.

Given the background to its establishment, the Review Group concluded that the existing arrangements did not provide an adequate level of public assurance that a satisfactory level of standards was being achieved. The Review Group went on to consider what enhancements would be required to rectify this situation in a manner that addresses the weaknesses of the existing system while guarding against the risk of introducing an unduly burdensome and bureaucratic system in its place. Against this background, the Review Group ruled out the possibility of self-regulation by the profession on its own and maintaining the *status quo* as options for the future.

Similarly, the Review Group recognised that, in Ireland as in other jurisdictions, auditing as a professional activity will continue to be primarily promoted by the relevant accounting bodies and agreed that, with the added protection of enhanced supervision by another entity, the continued regulatory role assigned to these bodies should form the basis for the new system. Thus, the option of direct supervision by a State entity was not considered suitable and the focus of the Group's work was, therefore, on the nature of the new supervising entity and the level of supervision to be exercised by it.

Bearing in mind the desired attributes for effective and fair audit regulation, the Review Group concluded that the new arrangements would require to:

- be predominantly independent of the auditing profession but be accessible, consistent and transparent in the performance of its work, while building on the existing infrastructure for supervision and discipline of auditors and their firms;
- display leadership in co-ordinating the work of the various recognised bodies and interfacing with the international players in audit regulation to maintain and further enhance the existing high standards and reputation of auditors in Ireland;
- be responsive to the needs of stakeholders in particular those who heretofore have not been adequately catered for. This suggests the need for an external body with authority to intervene in appropriate circumstances in the monitoring, investigation and disciplinary areas and act on its own account. The effectiveness of such a body also suggests that like other regulators, its activities need to be supported by statute, so that it can implement (and enforce if necessary) its decisions. Without strong statutory backing, the Review Group believes that such a body would not have the required authority to act as an effective regulator of the auditing profession.

Recommendation 7.2

The task of supervising the framework for audit regulation operated by the accounting bodies should be transferred from the Department of Enterprise, Trade and Employment to a statutory Oversight Board which would have enhanced powers to enable it to deliver a more effective and equitable system of regulation than applies under the current arrangements.

The Review Group's views on the role and functions, location and structure of the proposed Oversight Body are set out later in this Report.

CHAPTER 8

Role and Functions of the Statutory Oversight Board

8 Role and Functions of the Statutory Oversight Board

8.1 Considerations of the Group

This Chapter sets out the deliberations and recommendations of the Review Group concerning the functions that should be assigned to the proposed Oversight Board. Some of the functions considered by the Review Group would involve the transfer of existing responsibilities from Government Departments, most notably the Department of Enterprise, Trade and Employment. In addition, the Review Group considers that there is a need for the Oversight Board to undertake additional functions to strengthen the self-regulatory system of the accountancy profession in Ireland.

The Review Group has already noted that "self-regulation" is a misnomer in that the Companies Acts (and some other legislation) delegates to certain recognised accountancy bodies supervisory responsibility over the activities of their members and member firms[39]. It follows that the bodies should be accountable for the exercise of those delegated functions and that their performance should be brought to public attention on a more regular basis than has been the case in the past. Such transparency would assist both in encouraging good performance and in creating public assurance that proper professional and ethical standards were being applied and enforced (where necessary) on a consistent basis.

In the light of the findings in the DIRT Inquiry Report and other developments in recent years, there was general agreement within the Review Group on the need for improved supervision of the accountancy profession. The Review Group considered that improvements were necessary at two levels - in the supervision by the recognised bodies of their members and in the regulation of the bodies themselves. We have earlier identified the principles and qualities which should constitute the future supervision of the profession.

The Review Group also accepted that it was important that the future supervisory structure should exercise an influential role in the development of the profession. A renewed commitment to high standards and to effective sanctions for breaches of those standards would be widely welcomed by members of the profession and by the business community in general. The exercise of a strong leadership role would be likely in the longer term to reap dividends in the form of extra business for the profession, as both domestic and international investors came to be assured that high quality standards in the accountancy sphere were practised in Ireland.

[39] Unless the context otherwise requires, the term "member" includes both individual members and member firms throughout this Report.

Having regard to these considerations, the Review Group decided that establishing on a statutory basis an Oversight Board with a strong independent role could best satisfy the ongoing requirement for high standards. This would involve taking over the main statutory functions for the regulation of the auditing profession which are primarily exercised by the Minister for Enterprise, Trade and Employment at present. However, the Review Group would also see the Oversight Board discharging an expanded role in certain of these areas, as well as taking on a number of additional functions. The Review Group's thinking on the role and functions of the Oversight Board is outlined in detail in the following paragraphs. The Review Group will set out its recommendations on the structure and composition of the proposed Oversight Board in Chapter 9.

While the Review Group sees the Oversight Board exercising a number of tasks, the main focus of the Oversight Board's activity must relate to discharging the mission statement which the Review Group has set out in the preceding Chapter.

Recommendation 8.1

The Oversight Board should be given sufficient statutory powers:

- **to encourage adherence to high professional standards in the profession;**
- **to undertake effective supervision of the accountancy bodies in the discharge of their delegated regulatory functions;**
- **to intervene where accountancy bodies are not carrying out their delegated regulatory functions to a sufficiently high standard.**

8.2 Outline of Functions of Oversight Board

The Review Group believes that in order to discharge the above role effectively, the Oversight Board should be empowered to undertake the following tasks.

8.2.1 Recognition of Accountancy Bodies

The present function of recognising accountancy bodies under the Companies Acts is discharged by the Minister for Enterprise, Trade and Employment and confers on the recognised body the right to issue audit practising certificates to its members. As such, it is an important duty which will influence the quality of future external auditors in Ireland. The Oversight Board, which will have a dedicated and experienced professional staff, should be responsible in law for determining what bodies exercise this role. Part of this remit would involve assessing in detail any applications for recognition which may be received from unrecognised bodies. Accordingly, the Oversight Board would become the competent authority for discharging the recognition role under the Companies Acts and EU Directives.

8.2.2 Approval of Changes to each Recognised Accountancy Body's Constitution

Similarly, it is a statutory duty of the Minister for Enterprise, Trade and Employment (and in one case of the Government) to approve changes to the constitution of each accountancy body subsequent to its initial recognition. The important matters covered in such applications for approval include the accountability of the members to the body for its ethical and other professional standards, the procedures employed by the body in investigating complaints against the members, the sanctions which may ultimately be imposed against a member found to be in breach of professional standards and the extent and the manner in which such breaches are publicised in the public interest. These matters are considered by the Review Group to be central to the functions of an Oversight Board and it is appropriate that they be transferred from Government to the Oversight Board for consideration.

8.2.3 Professional/Ethical Standards

The Review Group decided that the Oversight Board should exercise an important influence in standard setting within the profession. It agreed that it would take on the statutory functions presently discharged by the Minister for Enterprise, Trade and Employment in determining and approving the ethical standards of the profession. Specifically, any changes to an accountancy body's Ethical Code or Rules of Professional Guidance should be subject to the approval (with or without amendment) of the Oversight Board, before they can be implemented. In addition, the Oversight Board should have the legal power to require changes to an accountancy body's Ethical Code or Professional Rules, following consultations with the relevant body, in order to deal with omissions which may become evident in the light of practical experience. A more detailed discussion on the issue of Professional/Ethical standards follows later in Chapter 12.

8.2.4 Auditing Standards and Practice

The Review Group recognised that auditing standards are, and would increasingly be, formulated at an international level with Irish participation in the process. While these standards are generic in character, their implementation requires to be tailored to the requirements of each jurisdiction, including for example the legal frameworks which exist in each and the structure and state of development of each economy.

As already outlined, there is substantial common ground in the area of auditing standards and practice between the UK and Ireland. While auditing standards issued by the Auditing Practices Board (APB) and some Practice Notes are applied uniformly in the UK and Ireland, some of the recognised accountancy bodies in Ireland occasionally consider it necessary to prepare and issue supplementary guidance to their members.

Sometimes, a particular need arises for Ireland to take a lead role in the development of a Practice Note to meet local conditions. Examples include the Prompt Payment of Accounts Act, 1997 which differs from its UK equivalent and the auditing of credit unions which are relatively well developed in Ireland compared with Britain.

A point to note is that occasionally, guidance issued by one recognised accountancy body to its members in Ireland will differ from that prepared and issued by another body. While it is unlikely that such differences are material, it is nevertheless unsatisfactory that there is not a single Practice Note for each Irish situation.

The Review Group considers it essential that the Oversight Board should firstly play an active role, in partnership with Government and each of the recognised accountancy bodies, in contributing to the development of auditing standards at both UK and international level. It should keep in close touch with international developments, whether at APB, EU and IFAC and participate in these and any other relevant forum. While the manner of its involvement (e.g., acting as technical adviser to Government, lead participation or representation via one of the recognised bodies) may vary from case to case, the Review Group believes that it should have a significant role in determining how best to reflect Ireland's concerns in these fora.

Secondly, the Oversight Board should be involved in determining how agreed auditing standards should be applied to best reflect the existing statutory, economic and professional regime in Ireland. In this context, we see the Oversight Board encouraging, in consultation with the APB, the prompt production of a single set of Irish Practice/Guidance Notes when required by local statutory or other developments. While the Oversight Board would have the role in developing and approving these Practice Notes and Bulletins, the Review Group does not envisage any change to the prevailing situation that these are implemented by the profession on a non-statutory basis. The Review Group is aware that some recommendations in this Report, in particular in Chapter 12 relating to auditor independence, may have implications for how auditing standards are developed and applied in Ireland. Some of these recommendations may give rise to a need for Ireland to develop its own standards in areas not covered by the APB. In this context, the Oversight Board will have a role, in partnership with the accountancy bodies, in ensuring that such standards are developed.

In undertaking the role which has been defined here, the Review Group wishes to emphasise that it does not see the Oversight Board supplanting the technical resources which already exist in the accountancy bodies. On the contrary, it sees the technical resources of the Oversight Board as being small in number, although highly experienced. The Review Group believes that the technical expertise developed within each of the individual bodies will inform, support and strengthen the overall role in Irish auditing standards which will be discharged by the Oversight Board.

8.2.5 Accounting Standards

The development of accounting and auditing standards are linked at national, EU or international levels. It would seem to follow logically that the Oversight Board should play a similar role in the area of accounting standards. The Review Group wishes to reiterate here that it sees the Oversight Board continuing to rely on the technical resources already available in the accountancy bodies in discharging its overall role in this context.

8.2.6 Departures from Accepted Accounting Practices

The Review Group separately considered where the distinct role of examining departures from accepted accounting standards by a public limited company or other entity should reside. The Review Group agreed that this particular function should be discharged by a Financial Reporting Review Panel, as was recommended in the First Company Law Review Group Report[40], and that its remit be primarily directed at public and large private companies. The Review Group also agreed that the work of such a Panel would require statutory backing, including the power to seek a High Court order to enforce changes to a company's accounts if necessary.

Having regard to the investigation and enforcement activity of such a Panel, the Review Group accepted that a case could be made for the location of these particular functions in the Office of the Director of Corporate Enforcement. However, the Review Group decided that the role could best be discharged under the Oversight Board, because:

- it would have a greater familiarity with the accounting standards area having regard to its remit;
- there is a natural affinity/link between the preparation of accounts to recognised standards and the auditing of those accounts, and divorcing them would not promote efficient compliance;
- it would be in a better position to select suitable members of such a Panel in consultation with the recognised bodies and other relevant interests.

While the instruments which should be made available to the Panel include Court action in which the Office of the Director of Corporate Enforcement would have greater experience, this would very much be a last resort. Accordingly, there was no particular advantage in the Enforcement Office being involved in the process, as the other instruments available to the Panel, including public exposure of its views, was likely to be a much more influential factor in encouraging a company to change its interpretation of accounting standards.

[40] Company Law Review Group, First Report, December 1994, paragraph 4.39.

8.2.7 Monitoring (Quality Review)

Having contributed to establishing the appropriate professional standards that should apply in the auditing area, the Review Group believes that the Oversight Board should likewise have a role in ensuring that these standards are applied in practice. The Group does not however see any particular merit in the Oversight Board taking over the monitoring role of members in practice which is currently undertaken by each of the recognised bodies. The Review Group does however propose that each of the recognised bodies should be required to submit to the Oversight Board its annual plan for monitoring the compliance by its auditing members (taking account of risk, size and other factors) with statutory, auditing and ethical standards. The Group believes that the Oversight Board should have the power to approve the plan (with or without amendment following consultations with the body in question) in each case.

The Review Group is also of the view that the substantial market presence and specialist expertise of the Big Five accountancy firms pose special challenges for any supervising body. In order to achieve effective monitoring, it would seem to be necessary for the monitoring staff to be persons of equivalent experience and expertise. This points to a need for peer review by persons from other large firms or at least a mixed team of monitoring staff drawn from the relevant accountancy bodies and from other firms of equivalent standing. In order to ensure effective supervision of such firms in the public interest, it would therefore seem desirable that in approving the monitoring plan of each recognised accountancy body, the Oversight Board should pay particular attention to the proposed monitoring arrangements of Big Five firms, so as to ensure that it is satisfied that the persons engaged in such monitoring have the calibre and experience required to ensure effective review.

The Review Group believes that the Oversight Board should, where it considers it appropriate, have power to undertake or require to have undertaken a review of an auditing firm on an occasional basis, in order to confirm that each body is discharging its role of practice review on a proper and consistent basis in compliance with its delegated responsibility.

8.2.8 Investigation, Discipline and Appeals

This particular area received considerable attention from the Review Group, and the role which is envisaged for the Oversight Board is outlined in detail in Chapter 10.

8.2.9 Accountancy Body Review

Given the role to be undertaken by the proposed Oversight Board, the Review Group believes that it is important that the Oversight Board should have sufficient legal powers for the proper exercise of its remit. Thus, the present powers of the Minister for Enterprise, Trade and Employment enabling her to amend, suspend or withdraw recognition from a recognised body should be transferred to the Oversight Board.

However, as the sanctions of suspension or withdrawal of recognition from a body would have severe implications for the professional work of its members in the auditing field, the Review Group considers that other less serious forms of sanction should be capable of being imposed on a body without damaging the immediate work of all of its members. Accordingly, the Oversight Board should also possess the options of private admonishment, public censure and financial penalties up to £100,000, in addition to costs. The exercise of such powers would of course be without prejudice to the right of any accountancy body to challenge by way of judicial review any sanction which the Oversight Board planned to apply and with which it disagreed.

8.2.10 Accountability of the Recognised Bodies to the Oversight Board

In the same way as each member of a recognised accountancy body is accountable to a recognised accountancy body for his/her/its performance, so each recognised accountancy body should be accountable to the Oversight Board for the manner in which the recognised body discharges its role. This will require the Oversight Board to have similar legal powers of access to documentation and to explanations from each of the recognised bodies in respect of its exercise of its delegated supervisory duties.

The Review Group also believes that each recognised body should be required to prepare and submit an annual report to the Oversight Board within four months of the end of each calendar year containing such information as the Oversight Board shall specify in advance. A similar requirement is already imposed on each recognised body by the Minister for Enterprise, Trade and Employment.

8.2.11 Supervision of Individual Auditors

The Review Group considers that the position of individually authorised auditors whose work is not subject to any ongoing monitoring should be regularised. The Group's recommendations in this area are outlined in Chapter 11.

8.2.12 Co-operation with other National Authorities

In considering this issue, the Review Group distinguished between the need for the Oversight Board to be as transparent as possible in its activity with the need to provide strong safeguards against the unnecessary disclosure of commercially sensitive information. The Review Group considers that the Oversight Board should be as open as possible in the interest of generating public and professional confidence in its work.

However, the Group also recognises that the Oversight Board needs to be able to receive and handle information in confidence if it was to undertake its functions properly. Domestic and EU law provides such disclosure "gateways", permitting the sharing of information between regulators on a confidential basis in the public interest, and the Review

Group considers that the Oversight Board should be legally permitted to convey to and receive information from specified national and international authorities, viz:

- the recognised accountancy bodies, and if the limit of the Board is extended, the unrecognised accountancy bodies (see Chapter 11);
- accountancy profession regulators in other jurisdictions;
- the Minister for Enterprise, Trade and Employment;
- the proposed Office of the Director of Corporate Enforcement;
- the Irish Takeover Panel;
- the Irish Stock Exchange;
- the Minister for Finance;
- the Central Bank of Ireland;
- the proposed Single Financial Regulator;
- the Revenue Commissioners;
- the Comptroller and Auditor General;
- the Director of Public Prosecutions;
- the Garda Síochána;
- any other person performing an investigative role under statute, e.g., persons appointed under Part II (Company Investigations) of the Companies Act, 1990 or a tribunal of inquiry;
- the new Review Board being established in the UK under the auspices of the Accountancy Foundation.

This form of information-sharing capability is increasingly a part of the legal landscape, so as to enable other regulators to be advised on a timely basis of information which is relevant to the proper performance of their statutory functions. A domestic example is the extended provisions recently inserted by section 53 of the Companies (Amendment) (No. 2) Act, 1999 in section 21 of the Companies Act, 1990 relating to confidential company investigations.

Internationally, the European Parliament and Council Directive No. 95/26/EC ("the post-BCCI Directive") was developed in the wake of the BCCI banking scandal to enable the EU's banking, insurance and collective investment regulators to share information with their counterparts, with other forms of financial regulators and with company law authorities in other jurisdictions. Chapter 15 will consider in greater detail the application of this Directive in Ireland.

The Review Group considers it important that information flow is a two-way street. Thus, as far as is legally possible and subject to appropriate safeguards, all of the authorities listed above should be empowered to share information on a timely basis with the Oversight Board, where this is relevant to its role of upholding the standards of accounting and auditing in Ireland and of safeguarding the reputation of the profession in general.

8.2.13 Advisory Role

In the context of the discussion on auditing standards above, the Review Group has already proposed that the Oversight Board should be a focus for the development and articulation of advice to Government on the development of auditing and accounting policy at EU level. It would of course remain open to each accountancy body to continue to make its own representations on particular issues to Government.

The Review Group also believes that the Board should discharge a similar role with respect to the formulation of obligations which Government proposes to apply on auditors and accountants generally. This could arise in the drafting of domestic legislation, where the Review Group believes that the Oversight Board could exercise a valuable role in helping Departments to design appropriate regulatory provisions involving the use of members of the accounting profession.

A similar role could be discharged by the Oversight Board in the development of non-statutory requirements where a Department or Office might wish to require that particular information be validated by a professional accountant or auditor before being submitted for clearance. The absence of such a visible institution has, the Review Group believes, sometimes led to the imposition on auditors and accountants of poorly designed or unworkable requirements in the past.

In this advisory role, the Oversight Board may come to exercise a similar level of influence on the accountancy bodies themselves. In dealing with prospective Government or other initiatives, it will often be important to generate a constructive response to emerging proposals. Accordingly, the Oversight Board is likely to act in a facilitating role in engaging with the profession in the development of proposals by way of response to Government.

8.2.14 Development of Performance Indicators for the Accountancy Bodies

The Review Group recognises that performance indicators are an emerging discipline on Government and other regulatory activity where achievements cannot be readily assessed in the normal marketplace through, for example, profit and loss figures. In order to help evaluate the effectiveness of their regulation activities, there would be merit in the Oversight Board developing such performance indicators, in consultation with each of the bodies concerned. The Group envisages that these indicators would form part of the business plan and annual report of each recognised body, so as to permit ongoing evaluation of the body's compliance with its targets.

In the same way as each recognised body will be required to develop and apply indicators of performance to its activity, the Review Group considers that a similar discipline should be imposed on the Oversight Board itself. This point is discussed further in the following Chapter.

Recommendation 8.2

The Oversight Board should have statutory responsibility for:

- the recognition of accountancy bodies, including the amendment of the conditions of recognition;
- the approval of each body's constitution and amendments thereto;
- the approval of, and requiring changes to, each body's Ethical Code and Professional Rules;
- working with the accountancy bodies and other parties on the development of auditing and accounting standards and practice, including in particular the approval of Auditing Practice Notes and Bulletins;
- making arrangements for examining the validity of material departures from accepted accounting standards and practice by public limited companies;
- supervision of the performance of each recognised body in the area of monitoring (quality review), including the approval of the body's annual monitoring plan and the power to undertake an independent review of an auditing practice;
- supervision of the investigation, discipline and appeals arrangements within each body, including the power to obtain access to documentation and to explanations from each of the recognised bodies in respect of its exercise of its delegated supervisory duties;
- sanctioning each accountancy body where supervisory failures occur, e.g., by way of private admonishment, public censure and/or financial penalties up to £100,000 in addition to costs;
- arranging for the supervision of individually authorised auditors by the recognised accountancy bodies;
- the transmission and receipt of confidential information to/from specified scheduled authorities as far as is legally possible and subject to appropriate safeguards;
- acting as a specialist source of advice to Government and other parties on auditing and accounting matters;
- the approval of regulatory/business plans, the development of performance indicators and determining and evaluating the content of the annual report which each of the recognised bodies should be required to submit to the Board.

CHAPTER 9

Structure, Funding and Location of the Functions of the Oversight Board

9 Structure, Funding and Location of the Functions of the Oversight Board

9.1 Introduction

In addressing firstly the question of the location of the functions of the Oversight Board, the Review Group believes that there are a number of particular qualities, which the Oversight Board should possess, viz:

- independence – the Oversight Board should not only be independent but be seen to be independent, in order to provide assurance to the accountancy profession, the Government and the general public that it will pursue its supervisory mandate in the public interest;
- leadership – the Oversight Board should be a strong advocate in promoting best practice in accounting and auditing in Ireland and abroad and should, in close co-operation with the accountancy bodies, lead change in the profession (where appropriate) and in improving the public perception of its professional standards;
- responsiveness – while the Oversight Board will need to be responsive to the requirements of the profession and Government in discharging its duties, it will be as important that it anticipates and/or responds promptly to national and international change in the accounting and auditing environment.

Having established this identity for the Oversight Board, the Review Group considered where its functions should be properly located. The main options considered by the Group for the location of some or all of the functions were:

- in the Department of Enterprise, Trade and Employment;
- in the proposed Office of the Director of Corporate Enforcement;
- in the Central Bank or the proposed Single Financial Regulator; and
- as a stand-alone entity.

Having outlined our views on the appropriate location of the Oversight Board, the Chapter proceeds to discuss its structure and funding and concludes with a discussion on the relationship which should exist with Government and the Oireachtas.

9.2 Department of Enterprise, Trade and Employment

As indicated earlier, the Department of Enterprise, Trade and Employment currently has responsibility for a number of the functions which have been discussed as appropriate for discharge by an Oversight Board. These include:

- the recognition of accountancy bodies and the authorisation of individual auditors;
- the approval of each body's constitution and professional standards;
- general supervision of the performance of these bodies in the areas of monitoring, investigation and discipline.

It is also the case that the Minister and her Department have been taking a more pro-active role in discharging the Department's oversight functions in recent years as circumstances of corporate malpractice have come to their attention. Their influence has led to a number of positive changes in the accountancy profession, e.g., in the area of openness and transparency.

In assessing the merits of continuing to locate the functions of the Oversight Board within the Department, the Review Group is however conscious that it has been engaged in recent times in re-focusing its role on policy and legislative development in many areas and has been moving towards a delegation of regulatory activity to discrete entities. Recent examples include the establishment of the Irish Takeover Panel, the decision to form the Office of the Director of Corporate Enforcement and the proposal to transfer the regulation of insurance companies to the Single Financial Regulator.

In addition, the wider oversight role envisaged by the Review Group for supervision of the accountancy profession would entail the recruitment by the Department of a number of professional staff, particularly staff with accounting qualifications. The Review Group considers that the nature of civil service recruitment and personnel policies make it difficult to build up a satisfactory level of ongoing Departmental expertise in the area.

The Review Group is also conscious that the Department of Enterprise, Trade and Employment is now a large organisation with a wide sphere of activity. In the long term, the Review Group considered that there was a danger that other Departmental priorities could emerge to eclipse the important ongoing role of supervising the auditing profession.

For these reasons, the Review Group does not believe that the continued location of expanded supervisory functions in the Department would be an optimal solution.

9.3 Office of the Director of Corporate Enforcement

The new Company Law Enforcement Bill proposes the establishment on a statutory basis of an Office of the Director of Corporate Enforcement. The Director of this Office will be given the present powers of the Tánaiste and Minister for Enterprise, Trade and Employment under the Companies Acts to:

- initiate and undertake company investigations;
- prosecute on a summary basis all breaches of the Companies Acts by companies, directors and other parties.

In addition, the Director will be given a variety of new powers to apply to the High Court:

- for restriction and disqualification orders under sections 150 and 160 respectively of the 1990 Act;
- for inspection of a company's books under section 243 of the 1963 Act;
- for examination of officers and other persons under section 245 of the 1963 Act;
- to require the payment or delivery of property under section 245A of the 1963 Act;
- to require persons to make good a default in complying with the Companies Acts;
- for the civil arrest of contributories, directors and other officers under section 247 of the 1963 Act;
- for a *Mareva*-type injunction to freeze directors' and other officers' assets;
- to enter upon property and seize assets belonging to a company.

It is envisaged that the resources of the Office will comprise some 30 staff, including persons with legal and accounting expertise, as well as seven members of the Garda Síochána, to assist with its compliance and enforcement mandate.

In considering the issue of locating the functions of an Oversight Board in the proposed Office of the Director of Corporate Enforcement, the Review Group is conscious that the mandate and ethos of the Office would be strongly directed towards compliance and enforcement activity under the Companies Acts. Auditors and related members of the accountancy profession are important players in the company law area, and the Review Group considers that where evidence of breaches of company or other law take place involving members of the accountancy profession in general, it is appropriate that the activity of such persons should be investigated by the Office or by other relevant authorities and brought before the Courts if appropriate.

However, the Review Group considers that much of the work envisaged for an Oversight Board is unlikely to sit easily within the mandate envisaged for the Corporate Enforcement Office. Distinguishing features of the Oversight Board identified by the Review Group include:

- the role envisaged for an Oversight Board in developing professional standards in partnership with the accountancy profession;
- the general supervisory role envisaged for the Board in reviewing the performance of the recognised accountancy bodies and in developing performance indicators for them;
- the role of encouraging compliance with detailed professional standards;
- in addition, the profession's professional standards reflect its activity in statutory areas beyond company law, such as the Central Bank Acts and other forms of financial regulation.

The Review Group has concluded that the focus and approach to the work of the two bodies should differ significantly and that the regulatory function to be discharged by the Oversight Board would not fit easily with the enforcement activities of the Enforcement Office. The objective of the Oversight Board will be to ensure that there is an effective system of self-regulation in place within the accountancy bodies, thereby seeking to ensure that difficulties do not arise. This positive objective contrasts with that of the Enforcement Office which will act only when problems have already arisen. Therefore, the focus of the Oversight Body's work should be more pro-active than that of the Enforcement Office.

In deciding to recommend that the general functions of oversight and professional development of the accountancy profession not be placed with the proposed Office of the Director of Corporate Enforcement, the Review Group is also conscious of the dangers of conflict in the working relationship between the Enforcement Office and the profession. The Review Group believes that there would be a significant risk that voluntary co-operation from members of the profession in examining their compliance with professional standards would not be secured by both the professional bodies and the Enforcement Office, if there was a serious risk of legal action against the person(s) involved at the end of the day by a regulator perceived to be intent on getting "heads".

9.4 The Central Bank or the Proposed Single Financial Regulator

The Review Group has also considered if the Oversight Board role should be discharged within the Central Bank or the proposed Single Financial Regulator which was recommended in the Report of the Single Regulatory Authority (SRA) – Implementation Advisory Group. The Review Group noted the following arguments against such a decision being made:

- the Central Bank and the proposed SRA would be heavily focused on a specific economic sector, namely financial institutions and other entities operating in the investment field, which represent only a fraction of the population of audited companies. Its priorities would accordingly be the supervision for prudential and consumer reasons of the former entities;

- the treatment of accounting and auditing issues should not be dominated by considerations relevant only to a particular, albeit highly important, sector in the economy. A risk would arise of developing responses on such issues which would be inappropriate for application in the wider economy;
- the primary legislation governing the auditing function in companies is located within the Companies Acts, and it would not therefore be appropriate to place the general function of auditing oversight within an organisation established to supervise the financial area.

The Review Group accordingly agrees that the distinctive role of auditing regulation should not be located within the Central Bank or the proposed Single Financial Regulator.

9.5 Stand Alone Oversight Board

Having considered the various options for the location of the functions appropriate to an Oversight Board, the Review Group has concluded that there is ample justification for the establishment of a stand alone Oversight Board on a statutory basis, viz:

- the role and functions of the Oversight Board have sufficient scale to justify the establishment of a separate entity;
- a separate Oversight Board would provide a visible public focus for resolving matters of concern relating to the standards of the profession;
- an Oversight Board outside the direct control of Government and the profession would provide assurance both to the profession and to the public at large that matters relating to professional standards were being properly managed;
- a separate Oversight Board would permit the development of a distinct ethos, enabling independent solutions to be developed to the demands of its remit, free from any dominant influences which might arise from incorporation in an existing body;
- a separate Oversight Board would permit reasonable certainty in the planning and execution of its supervisory remit.

Recommendation 9.1

The Oversight Board should be established by statute as a distinct legal entity on a stand alone basis.

The Review Group believes that this option represents the best means of ensuring that the Oversight Board meets the requirements of independence, leadership and responsiveness identified earlier. There is particular merit in the Oversight Board having a high visibility in the discharge of its supervisory role.

9.6 Establishment of the Oversight Board

Having regard to the importance of improving the supervision of the auditing profession and the rebuilding of public confidence in the general area of corporate governance, the Review Group considers that the Government and the Oireachtas should give priority to the drafting and enactment of the necessary legislation establishing the Oversight Board.

The Review Group has also given some thought to the question of transitional arrangements. As the Oversight Board will exercise statutory powers transferred from the Minister for Enterprise, Trade and Employment, it will clearly not be possible for the functions of the Oversight Board to be formally discharged prior to the commencement of the legislation. However, arrangements should be made to ensure that the Oversight Board will be fully operational, on an interim basis, early in 2001.

Recommendation 9.2

Priority should be given to drafting and publishing legislation providing for the establishment of the Oversight Board.

In parallel with the publication of the draft Bill, the Oversight Board should be established on an interim basis, and the recruitment of its staff should commence in advance of the enactment of the necessary legislation.

The Oversight Board should be in place, and operational, albeit on an interim basis, early in 2001.

The (Interim) Oversight Board should assist and advise the Department of Enterprise, Trade and Employment in finalising the legislation under which it will operate.

9.7 Structure of the Oversight Board

The Review Group has considered what would be the appropriate structure and staffing resources of the Oversight Board.

Recommendation 9.3

The structure for the Oversight Board should comprise:

- **an independent board; and**
- **a Director appointed by the Board.**

The staff levels and the expertise of staff should be adequate to carry out the comprehensive range of functions assigned to the Oversight Board.

The Review Group also believes that it is important for the credibility of the Oversight Board as an independent regulator that its Chairperson and Vice-Chairperson not be members of the accountancy profession.

Recommendation 9.4

The Chairperson and Vice-Chairperson of the Oversight Board should be independent and not be members of recognised accountancy bodies.

The Review Group also gave some consideration to the membership of the independent board and concluded that it should be broadly drawn from constituencies representing the main stake holders in the accountancy area.

Recommendation 9.5

The members of the Oversight Board should be appointed for a term of five years by the Minister for Enterprise, Trade and Employment and comprise no more than eight members of whom no more than two would be accountants. The members of the Oversight Board should represent the following interests:

- **two members of the accountancy profession, one of whom would be a practising auditor and neither of whom would be on the Council of a recognised accountancy body and**

at least one representative from each of:

- **the business sector of the economy;**
- **trade unions;**
- **the users of financial statements; and**
- **appropriate Government Departments/Agencies.**

Any member of the Oversight Board should not be a member for longer than two terms.

Having regard to the close relationship which exists between company law and the accountancy professions in Ireland and the UK, the Review Group considers that it would be appropriate that there be close liaison between the new Accountancy Foundation in the UK and the proposed Oversight Board.

As already outlined, the Central Bank is currently one of the nominating bodies to the Foundation. Once the Oversight Board is established, it would be appropriate for the Oversight Board to take over this role of the Irish nominating body to the Foundation from the Central Bank.

The Review Group also considered the nature of the Director's role. The (Interim) Oversight Board should, on its establishment, appoint a Director designate. In the normal course of events, the Director designate will be formally appointed Director once the necessary legislation is enacted. The Review Group discussed whether the Director should be, or not be, a member of the accountancy profession. However, the Review Group concluded that this and the wider job specification should be left for decision by the Oversight Board on its establishment.

Recommendation 9.6

The (Interim) Oversight Board should determine the job specification and the skills required for the position of Director (designate).

The Review Group also considered whether it should define in its Report the number and nature of staffing which should be employed by the Oversight Board. The Review Group decided that this was appropriate for decision by the Oversight Board on its establishment.

Recommendation 9.7

Decisions on the number of Oversight Board staff and the mix of skills among those staff should be made by the (Interim) Oversight Board within its budget.

9.8 Funding of the Oversight Board

In considering who would bear the costs of the Oversight Board, the Review Group has taken into account that both the State and the accountancy profession would benefit from a more effective supervisory regime. The public standing of accountancy professionals and the wider business community would be enhanced, and Ireland's international business reputation would be recognised to be of a high standard.

At the same time, the Review Group is aware that some of the recognised accountancy bodies are contributing to the costs of the Accountancy Foundation in the UK and that it is 100% funded by the profession. On the other hand, the Review Group is also conscious that the Oversight Board would be assuming some of the functions previously exercised by the Department of Enterprise, Trade and Employment. In all the circumstances, the Review Group has agreed that the profession and the State should both contribute to the costs of the Oversight Board on the following basis.

Recommendation 9.8

Having consulted the Department of Enterprise, Trade and Employment and the accountancy bodies, the Oversight Board should determine its annual budget, and the profession and the State should contribute to the normal recurring annual budget of the Board on a 60/40 basis respectively. Appropriate safeguards should be put in place to ensure that the Oversight Board has sufficient resources available to it to enable it to discharge its functions in an efficient and effective manner, while also ensuring that the costs to be borne by the accountancy bodies and the taxpayer are fair having regard to the nature and extent of services being provided.

The Review Group also recognises that there is considerable scope for disagreement on the contribution which each accountancy body would make to the budget of the Oversight Board. The Review Group considers that the contribution formula should be established by the Oversight Board following consultations with the accountancy bodies and that the Oversight Board's decision on the matter should be final, subject to it being reviewed on a regular basis.

The Review Group is anxious that the activities of an independent Oversight Board should not be subject to any funding difficulties or delays. Exchequer funding should be made available to the Oversight Board through the Department of Enterprise, Trade and Employment's Vote in the normal annual estimates process. The accountancy bodies should pay their contributions directly to the Oversight Board on an annual basis by means of a statutory levy.

Recommendation 9.9

An equitable apportionment of the 60% of Oversight Board costs among the recognised accountancy bodies should be the subject of annual discussions between the Board and the bodies, prior to a decision being made by the Board. Once the Oversight Board has made a final determination in relation to the costs to be borne by each body, there should be a binding obligation, underpinned by legislation, on the bodies to make the payments involved.

9.9 Exceptional Costs

The Review Group considers that the assurance of State funding would be particularly important if the normal budget of the Oversight Board were to be exceeded for any exceptional reason, e.g., meeting the costs of a public concern investigation or examining the validity of a material departure from accepted accounting standards. In the former case, the relevant accountancy body should pay for the costs of such an investigation from its own resources even where it is carried out by the Oversight Board, pending a determination on whether these costs should be levied on one or more parties at its conclusion.

In the latter case, the Review Group notes that the First Company Law Review Group[41] recommended that in addition to contributions from the State and the auditing profession, these particular costs should also be met by contributions from the Stock Exchange and major institutional investors. However, many such investors are no longer resident in Ireland, and the Review Group therefore acknowledges that this recommendation may no longer reflect market realities. Accordingly, discussions will need to be held with the Irish Stock Exchange to determine an equitable distribution of these costs as they arise.

The prospect of such exceptional costs will require the Oversight Board to maintain regular contact with both the Department of Enterprise, Trade and Employment and the accountancy bodies on budgetary matters. The necessary legislation will also require to be strong enough to enforce the payment by the relevant parties of their due contributions on a timely basis. In particular, the Oversight Board should be empowered to seek a High Court Order imposing the costs of its investigation or examination on the relevant parties, including the company concerned and its directors.

The Review Group considers it essential that the Oversight Board should have the freedom to proceed with a necessary course of action, pending a decision on the practicality of levying these exceptional costs on a particular accountancy body, company or other party.

Recommendation 9.10

Clear statutory rules, including access to the High Court, should be established to enable the Oversight Board meet any exceptional costs in discharging its duties. For example:

- **the costs of undertaking a public concern investigation should be met in the first instance by the relevant accountancy body, pending a decision on who should bear the costs;**
- **the costs of examining a material departure from accepted accountancy standards should be met, insofar as possible, by the major users of accounting standards. In the case of quoted companies, the allocation of costs should be agreed in conjunction with the Irish Stock Exchange.**

9.10 Accountability of the Oversight Board

The Review Group is of the firm view that the Oversight Board should exercise a strong independent role. The proposed arrangements outlined above reflect this stance.

[41] Company Law Review Group - First Report (December 1994), paragraphs 4.41 and 4.42.

At the same time, the Review Group recognises that the Oversight Board is discharging delegated responsibilities of oversight and would accordingly have to be accountable to Government and the accountancy profession in the discharge of its role and functions. The Review Group believes that the Oversight Board should establish benchmarks of its own effectiveness in consultation with the accountancy bodies, the Minister for Enterprise, Trade and Employment and other relevant parties, such as the Comptroller and Auditor General.

Recommendation 9.11

The accountability of the Oversight Board should comprise the following elements:

- **performance indicators, based on benchmarks of its effectiveness, should form part of the Oversight Board's Business Plan which should be the subject of consultation with the Minister for Enterprise, Trade and Employment and the accountancy bodies before adoption by the Board;**
- **the Oversight Board's financial statements should be audited by the Comptroller and Auditor General who should also have a value for money role;**
- **an Annual Report should be prepared and submitted to the Minister and laid before the Houses of the Oireachtas following Government approval. Arrangements should be made to have the Report discussed and adopted by the Oireachtas or by a relevant Committee of the Oireachtas;**
- **the Director of the Oversight Board should be required to attend before relevant Committees of the Oireachtas to discuss its activities.**

9.11 Liaison Group

The Review Group also believes that there should be regular contact and exchanges of information by the Oversight Board with the Central Bank/Single Financial Regulator, the Revenue Commissioners and the Office of the Director of Corporate Enforcement, in order to ensure that good co-operation exists among the principal supervisory authorities interested in upholding the highest professional standards in the State's financial and corporate affairs. The Review Group envisages that such co-operation could on occasion include staff-sharing on a temporary basis, if one of the parties requires to deal with an issue of urgent public importance.

Recommendation 9.12

A Liaison Group should be formally established to ensure a good flow of communication and co-operation among the Oversight Board, the Central Bank/Single Financial Regulator, the Revenue Commissioners and the Office of the Director of Corporate Enforcement .

9.12 Respective Roles of the Oversight Board and the Department of Enterprise, Trade and Employment

The Review Group envisages that the Oversight Board will take over a number of responsibilities from the Department of Enterprise, Trade and Employment as has already been outlined in detail in Chapter 8. In order for the Oversight Board to operate effectively and to avoid any potential for overlap, the Review Group considers that there should be, as far as possible, a clear delineation of roles and responsibilities between the Oversight Board and the Department. In principle therefore, the Department should not get involved in activities that the Oversight Board can carry out.

The Minister will retain a policy and legislative role in relation to company law and associated areas, including the development of the accountancy and auditing professions in the State. He/she will continue to be accountable to the Oireachtas for the discharge of this function. The Review Group considers that the Department should consult the Oversight Board on any policy initiatives in this area, although in reality, the need for any such initiatives may emerge from the work of the Oversight Board.

As we have earlier indicated, the Department of Enterprise, Trade and Employment is currently represented on a range of UK and EU committees and boards in relation to accountancy and auditing. The Oversight Board should as far as practicable replace the Department as the Irish representative on such committees. At UK level for instance, the Review Group considers that the Oversight Board should replace the Department of Enterprise, Trade and Employment at both the APB and at the Financial Reporting Council meetings.

Where political or Government representation continues to be necessary, then the Department would continue to attend such meetings. For example at EU level, the Department would have to participate at Council Working Groups at which draft Directives and Regulations were being negotiated. However, the Department should actively involve the Oversight Body in such work and in reaching an Irish negotiating position. It is envisaged in the coming number of years that there will be a number of new Directives or amendments to existing Directives in the accountancy field, and the Review Group considers that the existence of the Oversight Body will allow Ireland to participate more effectively in these negotiations.

CHAPTER 10

Strengthening the Investigation, Discipline and Appeals Process

10 Strengthening the Investigation, Discipline and Appeals Process

10.1 Introduction

The Review Group notes that there are three particular dimensions to this issue which it will have to address, namely:

- the handling by accountancy bodies of complaints made by aggrieved persons against their members[42],
- the role of the Oversight Board in regulating the functions of the accountancy bodies in this area and
- the public interest, in ensuring that the activity of both the accountancy bodies and the Oversight Board contributes to the development of standards in the accountancy profession.

10.2 General Principles

In an earlier Chapter, the Review Group has already identified effectiveness and equity as the two core concepts which should underpin audit regulation. In the particular context of investigation and discipline, the Group considers that fair play, both to the aggrieved party and the person against whom regulatory action is threatened, is a fundamental principle which requires to be satisfied. The Group also regards it as important that fair play should be seen to have been discharged in the conduct of that role.

Effectiveness and efficiency are important complementary principles in the investigation and disciplinary area, because it is important that appropriate remedial action is taken promptly where the circumstances of the case justify it.

The Review Group has considered what type of system is likely to deliver fair and effective outcomes. Having considered the matter, the Review Group has formed the view that the following qualities which we identified earlier in a more general context are important for the proposed system of investigation, discipline and appeals:

- accessibility, in terms of enabling the persons aggrieved by the conduct of an accountant or by a regulatory decision to have ready access to a remedial process. This would suggest a system of clear procedures and minimal cost;
- consistency, in terms of guaranteeing that the system of investigation and discipline operated by each accountancy body is similar, that all complaints are rigorously examined and properly determined and that common sanctions are applied for similar misconduct, regardless of the body involved;

[42] Unless the context otherwise requires, the term "member" in this Chapter includes individual auditors, auditing firms and other non-auditing members of the recognised accountancy bodies.

- efficiency, in terms of ensuring that decisions are made quickly in the interests of both the complainant and the professional person involved;
- independence, in terms of guaranteeing as far as possible that the decision to sanction (or not to sanction) is made on the facts presented and that unrelated matters are not allowed to influence the decision;
- proportionality, so that the scope of investigation and the subsequent decisions to discipline or not to discipline are proportionate to the indicated misconduct and
- transparency, so as to ensure that the regulatory system is seen to operate in a thoroughly professional manner.

The Review Group believes that the design and implementation of a system of investigation, discipline and appeals bearing these characteristics will provide as far as possible the necessary assurance to accounting professionals and the wider community that a fair system of regulation is in place in the accountancy profession.

10.3 Treatment of Complaints against Members of Accountancy Bodies

The Review Group recognises that the present system of investigation, discipline and appeals, as developed and operated by each of the recognised accountancy bodies and supervised by the State, exhibits to a greater or lesser extent each of the above qualities. More importantly in the context of its recommendations, the Review Group has satisfied itself that the above principles are capable of being met by reform of the present arrangements. Accordingly, the group does not propose that the present system be replaced by a new stand-alone system of investigation, discipline and appeals separate from the accountancy bodies.

Recommendation 10.1

The recognised accountancy bodies should continue to manage investigation and disciplinary matters within a reformed framework which better delivers on the important concepts of effectiveness and equity, subject to the overall supervision of the Oversight Board.

Mediation by an accountancy body between a complainant and a member of the body may often be sufficient to resolve the matter at issue. Where mediation proves to be insufficient, the accountancy body should proceed to institute a formal investigation of the complaint. Where a *prima facie* case of misconduct is subsequently established, the member will then be subject to the body's disciplinary process, and a decision to discipline (or not to discipline) the member in question will follow. It is subsequently open to the member to appeal to an Appeal Committee against any decision of the Disciplinary Committee or Tribunal to impose a sanction.

When judged against the accessibility criterion outlined above, the review group finds that the present investigation and disciplinary structures of the accountancy bodies accord little status to the complainant relative to the member of the accountancy body. In most (but not all) cases, the proceedings are held in private, and the complainant is not given a right to attend or be heard. This situation runs the risk that in answering the complaints made, the member may be able to offer without challenge statements of explanation for his/her behaviour which are incomplete or have little or no basis in fact. The lack of transparency also tends to generate a suspicion of less than full and fair examination of the complaint which may often be unjustified.

The Review Group is aware that a number of the recognised accountancy bodies have taken steps in recent times to improve the transparency of their proceedings by permitting public access. Similarly, some bodies have sought to enhance the independence of their decision-making by appointing a significant proportion of non-accountants to their Investigation, Disciplinary and Appeal Committees. The Review Group welcomes these moves.

However, the Review Group considers that further work is needed to develop a system of investigation, discipline and appeals which better meets the core concepts of effectiveness and equity outlined earlier. The Review Group's particular recommendations to enhance the transparency and independence of the process of investigation and discipline follow, and it wishes these to be implemented by all of the recognised accountancy bodies.

Recommendation 10.2

Information should be prepared in consultation with the Oversight Board and made freely available by each recognised body to its members and the general public (as the case may be) describing *inter alia:*

- **the standard terms of engagement between an accounting member and the accountant's client, the scope for, options and procedures for making complaints in the event of dissatisfaction by the client with the member's work,**
- **the accountancy body's investigation and disciplinary procedures,**
- **the type of complaints which it will handle,**
- **its policy and practice with respect to the complaints it receives and**
- **outlining what information is required to be submitted by any person who wishes to lodge a complaint against one of its members.**

Recommendation 10.3

The proceedings of an accountancy body at Disciplinary and Appeal Committee levels should be held in public. However, the proceedings undertaken by the Investigation Committee should not be open to the public, on the basis that a member's reputation may be unfairly tainted by publicity in circumstances where the subsequent finding was that no *prima facie* case of misconduct had been established against the member.

Recommendation 10.4

In the Bye-Laws of the accountancy bodies, both the member and the complainant should be given a right to attend and be heard at each stage of the hearing of the complaint, including that undertaken at Investigation Committee level.

Recommendation 10.5

A majority of independent persons, i.e., non-members of recognised accountancy bodies, should comprise the membership of the Investigation, Disciplinary and Appeal Committees. The Oversight Board should satisfy itself that the proposals of individual accountancy bodies in these areas are sufficient to guarantee independent decision-making.

Recommendation 10.6

Notifications of decisions emanating from the accountancy bodies in response to complaints should contain the reasons for the decisions made.

The Review Group also considered if each accountancy body should be required to notify the Oversight Board of the existence of all complaints and of all decisions made on those complaints. The Review Group accepts that a reporting arrangement in this area will require to be put in place between the Oversight Board and the accountancy bodies in due course. However, it decided that it was an operational matter for the Board to determine the content and frequency of reporting, following consultations with the accountancy bodies.

Recommendation 10.7

Each accountancy body should be required to notify the Oversight Board, in a manner and at a frequency to be determined by the Board, of the existence of all complaints and of all decisions made on those complaints.

It is possible to envisage a situation where an aggrieved party has made no formal complaint to an accountancy body about the conduct of a member. Yet, information may come into the hands of the Oversight Board itself or into another authority, e.g., the Central Bank or the Revenue Commissioners, which gives cause for concern as to the professional standards of a particular member of a recognised accountancy body. In such circumstances, it should be possible for the Board and other authorities to refer the matters in question to the relevant body for investigation.

Recommendation 10.8

Where necessary, the Oversight Board and other authorities should be given the necessary *locus standi* in the Bye-Laws of each recognised accountancy body or otherwise to make such a complaint against a member.

10.4 The Appeal of Accountancy Body Decisions

The Review Group is broadly satisfied with the opportunities for appeal available to the member of a recognised accountancy body.

However, the Review Group understands that the complainant has no right to appeal a decision of a recognised accountancy body against a member, if, for example, he/she believes that the determination made is erroneous or that the sanction imposed is too lenient. It is unsatisfactory, in the view of the Review Group, that no such formal opportunity exists. However, the Review Group does not propose that a complainant be given a direct right of appeal in the Bye-Laws of each recognised accountancy body. Instead where, in response to representations made by an aggrieved complainant, the body refuses to voluntarily accept that the decision made warrants reconsideration, the Review Group is of the view that the Oversight Board should be capable of intervening, in response to a complaint made to it or otherwise, where it is satisfied that circumstances suggest that the decision was unsatisfactory.

Recommendation 10.9

The Oversight Board should be invested in law with a right to intervene in relation to any decision of a recognised accountancy body in a case involving the alleged misconduct of a member.

Such a right of intervention would apply in a wide range of circumstances, including where a recognised accountancy body:

- has failed to examine a complaint, on the basis *inter alia* that it is mischievous or vexatious;
- has determined that no *prima facie* case of unprofessional behaviour or misconduct exists;
- has imposed a sanction which is considered to be too harsh or too lenient.

The Review Group envisages that this right of intervention, when exercised, will apply:

- to require the investigation by a recognised accountancy body of a complaint, where the accountancy body has refused to do so; or
- to require that a body undertake a fresh investigation on a basis acceptable to the Oversight Board where a decision taken at Investigation or Disciplinary Committee levels is considered to be inadequate; or
- to remit to the High Court any decision of an Appeal Committee which is considered to be unsound.

The above proposals are of course without prejudice to the right of any party to seek to exercise his/her right of judicial review of the decision to the High Court or other appropriate Court.

10.5 Imposition of Sanctions

In broad terms, the Review Group is satisfied that the range of sanctions open to a recognised accountancy body is adequate. These sanctions (which may be more than one of the following in individual cases) may be summarised as:

- power to reprimand the member privately;
- power to reprimand the member publicly;
- power to impose fines and/or costs and/or restrictions on the member's work;
- suspension or withdrawal of an audit practising certificate or other authorisation;
- expulsion from membership of the body.

The Review Group was made aware of Article 34.1 of the Constitution which generally requires that justice be administered in the Courts. However, the Group also noted that under Article 37 of the Constitution, limited functions and powers of a judicial nature may be exercised by persons or bodies duly authorised by law to do so. Having considered the matter, the Review Group is satisfied that it is permissible for accountancy bodies to discipline their members in a number of ways, provided that the bodies comply with certain procedural rules and

safeguards and provided also that there is a mechanism for recourse to the Courts. While different legal practices and procedures obtain in the disciplinary area across the various professions, the Group notes that the Teaching Council Bill, 2000, particularly section 43 thereof, proposes to follow this approach.

Recommendation 10.10

Recognised accountancy bodies should continue to determine and impose sanctions:

- **where a member of a recognised body and the complainant expressly accept the determination of the accountancy body and the sanction which it proposes to impose and**
- **where a member and the complainant do not decide to challenge by way of judicial review the determination and the proposed sanction within a prescribed period.**

On the subject of financial sanctions, the Review Group regards as insufficient the level of fines which are capable of being imposed by many accountancy bodies for serious misconduct. This particularly applies to the large accountancy firms. The Review Group is aware that costs, when levied against a sanctioned member, may often substantially exceed the level of fine. However, the Group is not satisfied that this situation should continue as costs plus a small fine will not represent an adequate sanction in all cases.

Recommendation 10.11

The level of fines should be substantially raised, in order to apply more meaningful penalties against members infringing or ignoring their duties of professional conduct in valuable engagement assignments. If necessary, statutory backing should be given to the imposition of such higher penalties.

10.6 Transparency of Sanctions

The Review Group believes that reputation is an important element in establishing a member's success in the accountancy profession. The Group holds the view that those who fail to uphold the profession's accepted standards should be named publicly, so that the public at large will be aware both of the identity of the individual involved and of the nature of the transgression. Where a member may have breached a client's trust, it is particularly important that this be done, in order that the same unfortunate result is not visited on other unsuspecting members of the public.

The Review Group believes that public exposure would be a powerful deterrent in discouraging members from resiling from the best professional standards in the accountancy profession.

Recommendation 10.12

Following completion of the investigation and disciplinary process, the sanctions to be imposed on a member should normally be circulated for publication to the national, local and professional media, as appropriate, and a copy of each press release should be forwarded to the Oversight Board. At least once a year, the Board should publish a full list of those sanctioned.

A legal obligation should be imposed on each recognised accountancy body to create and maintain an up-to-date register of members who have been disciplined by their body. This register should also contain brief information on the nature of the transgression(s) in each case. The Oversight Board should be legally responsible for approving the nature of the information to be made available, the manner of its promulgation and the length of time for which particular types of breaches of professional standards should be displayed. The identities of persons expelled from membership should be permanently displayed by the bodies.

The Oversight Board should review all decisions by a body not to publish a sanction imposed on a member.

10.7 Role of the Oversight Board

It is the view of the Review Group that if the investigation and disciplinary arrangements outlined above are implemented, there is no reason why the Oversight Board should be involved in the day-to-day administration by the recognised accountancy bodies of complaints made against their members. Even in circumstances where a complaint was tendered first to the Oversight Board, it should be a matter of normal practice for the Board to refer the complaint for investigation to the relevant recognised body in the first instance.

The Oversight Board's primary role will be that of quality assurance. In other words, it will encourage best practice in monitoring the discharge by the recognised accountancy bodies of their mediation, investigation and disciplinary role.

Recommendation 10.13

In order to discharge its quality assurance role, the Oversight Board should have power:

- **of access to all papers and explanations from each of the recognised accountancy bodies, so as to be capable of reviewing the conduct of the accountancy body in any individual case. This power would apply both to the Board's own staff and to any other person appointed to act on the Board's behalf;**
- **to issue, following consultations with the bodies concerned, directions on the future conduct of such proceedings, either generally or individually. Such action might, for instance, include guidelines for the imposition or publication of sanctions, so as to achieve broad consistency in the area by each of the bodies concerned;**
- **to require, following consultations with the bodies concerned, changes to the structures, resources and procedures employed on investigations or changes to the professional standards to which members are required to adhere. For example, if a member acted unprofessionally but was found not to have infringed the standards laid down in the body's Ethical Code, it would be desirable that that omission should be rectified in the Code and in the Codes of the other recognised bodies.**

10.8 Scope of the Oversight Board's Role

The role of the Oversight Board has been described above as relating to the six recognised accountancy bodies. The Review Group initially considered if the oversight role should apply to:

- all of the members of the recognised bodies, or
- only to those members possessing an audit practising certificate, or
- only to those against whom a complaint is made while acting as auditor.

The Review Group has concluded that the accountancy bodies, by virtue of their recognition, enjoy a particular status which applies to all of their members, whether they are auditors or not, and that it would be impractical for the Oversight Board not to have jurisdiction over all of the members of the recognised accountancy bodies.

Recommendation 10.14

The Oversight Board should supervise the investigation by the recognised accountancy bodies of departures from professional standards in respect of all of their members and not only the members who are auditors.

In this context, the Review Group has noted that some of the recognised accountancy bodies only register individual members, while others also register the firms with which the individuals are associated. The Group regards the former arrangement as unsatisfactory in that it is generally the firm which signs off on the annual audit of a company's accounts. Where that audit is found not to have been conducted properly, the auditing firm, as well as the relevant individual members of the firm, should be subject to sanction. The same situation would apply to non-audit firms where breaches of professional conduct arise.

Recommendation 10.15

All recognised accountancy firms should be registered with at least one accountancy body which should generally be the body with which the majority of their partners are associated, without prejudicing the right of other bodies to monitor the performance of their members in that firm.

10.8.1 ICAEW/ICAS

The Review Group also considered if the Oversight Board could effectively enforce the same requirements on the investigation and disciplinary regimes of the two recognised accountancy bodies not located within the State, namely the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland. The Group believes that those of their members undertaking Irish business would have to be treated on the same basis as the members of the other recognised bodies.

Recommendation 10.16

The Oversight Board should discuss with its counterpart in the UK and the UK-based recognised accountancy bodies the manner in which it will give effect to its requirements in respect of those of their members undertaking Irish business.

10.8.2 Unrecognised Accountancy Bodies

The Review Group is also conscious that there are a number of unrecognised accountancy bodies with a presence in the State which have members engaged in accounting practice. The organisations in question include the Chartered Institute of Management Accountants (CIMA), the Chartered Institute of Public Finance and Accountancy (CIPFA)) and the Association of International Accountants. The members of the first and third bodies are primarily engaged in business. Members of CIPFA undertake audit work in central and local government, although they are legally precluded from auditing companies and similar entities, unless they possess an audit practising certificate from a recognised body. An application from the Association of International Accountants for recognition under the Companies Act, 1990 is currently being considered by the Department of Enterprise, Trade and Employment.

The Review Group believes that the ethical standards of unrecognised accountancy bodies based in the State should be similar to those demanded of the recognised accountancy bodies, so as to ensure a uniform level of high standards in the auditing and accountancy professions.

Recommendation 10.17

The Oversight Board should have powers to approve (with or without amendment) and supervise compliance with the professional standards of unrecognised accountancy bodies similar to those recommended earlier for the recognised bodies.

This would suggest the need for some form of statutory recognition by the Oversight Board of accountancy bodies that satisfy a specified level of compliance by their members with satisfactory ethical standards.

The Review Group believes that the general role to be exercised by the Oversight Board in the public interest should apply to the accountancy profession in general, so that all members are subject to investigation and disciplinary regimes which serve to uphold the required professional standards. There may indeed be other bodies not identified above in the general accountancy area over which the Oversight Board should exercise some supervisory function.

Recommendation 10.18

The Minister for Enterprise, Trade and Employment should discuss the role of the Oversight Board with the unrecognised accountancy bodies, with a view to ensuring a comprehensive role of oversight in the investigation and disciplinary field.

10.8.3 Institute of Internal Auditors

In addition, the Institute of Internal Auditors (IIA) represents members acting in a supporting role to company directors and management. Many internal auditors are employees of companies or of State entities and as such, would be subject to the normal disciplinary processes in those organisations. In addition, some internal auditors are members of professional accountancy bodies and would be subject to regulation by those bodies. While anxious to see the development and maintenance of the highest standards in internal audit, the Review Group is reluctant to recommend any role for the Oversight Board with respect to internal auditors, in the absence of it offering any added value.

10.8.4 Comptroller and Auditor General

The Review Group also considered if a direct relationship should obtain between the Oversight Board and the Comptroller and Auditor General and his Office. Article 33 of the Constitution recognises the particular remit of the Comptroller which includes the auditing of all accounts of moneys administered by or under the authority of the Oireachtas. Aside from this role, the Comptroller's special position of independence would seem to preclude any direct relationship applying between the Comptroller's Office and the Oversight Board.

The Review Group understands and welcomes the fact that the Comptroller has taken steps to obtain an independent assessment of the quality of work undertaken by his Office. The Group also believes that in the same way as this Report proposes that regulation of private sector audit should be subject to accountability, the C&AG should similarly prepare and publish explicit goals and performance indicators of the work of his Office in the public sector. The Review Group would expect that much of the work of the Oversight Board would have general application in the public sector and that a close informal working relationship would be beneficial to the work of both parties.

10.8.5 Local Government Audit Service

The Review Group also understands that members of the Local Government Audit Service audit accounts in the local authority sector in their own name and that some of the auditors involved are not members of recognised accountancy bodies. Local government audit work is performed in accordance with a code of audit practice which embraces audit standards and ethical regulations. The Group would encourage the Service to undertake peer reviews of its activity, so that it receives a regular independent assessment of its performance vis-à-vis best professional practice. In summary, all public sector auditing should be subject to the same standards as that of audits regulated by the recognised accountancy bodies.

Recommendation 10.19

The Office of the Comptroller and Auditor General and the Local Government Audit Service should prepare and publish explicit goals and performance indicators, and the quality of audit service provided should be subject to regular peer review.

10.9 Public Concern Complaints

In the case of public concern complaints, such as might arise from a tribunal of inquiry or any other significant development involving one or more members of the accountancy profession, only three such investigations have arisen to date. As noted earlier, these have been undertaken by one recognised accountancy body, and the Minister for Enterprise, Trade and Employment has acted to secure unrestricted access for her Department to any such proceedings initiated by any of the recognised accountancy bodies.

The Review Group notes that the term "public concern" is not defined in the constitutions of the recognised accountancy bodies, and the Group did not attempt to produce such a definition. The Review Group believes that individual circumstances will dictate what will be recognised as a complaint of public concern, and it considers that in any case of doubt, the matter should be determined by the Oversight Board.

Normally, the recognised accountancy bodies will conduct their own investigations of public concern cases. However, the Review Group acknowledges that circumstances could arise in the future where the public demand for an independent investigation in such a case would necessitate the holding of an inquiry by a third party. Even where this did not arise, there may be circumstances, e.g., possible conflicts of interest, where it would be inappropriate for the recognised accountancy body itself to hold the investigation. In such circumstances, the conduct of a case of public concern would be best organised by the Oversight Board.

Recommendation 10.20

The Oversight Board should have the legal option to determine if a complaint of public concern should be independently investigated.

In that event, the Oversight Board would be responsible for the establishment and conduct of the necessary investigation and would be entitled to require the accountancy body or bodies concerned to bear the associated costs. The issue of underwriting the expenses of the Oversight Board in such circumstances is dealt with in greater detail in the previous Chapter.

However, once the Oversight Board is satisfied that the proposed arrangements for investigation by the recognised accountancy body concerned is sufficient to provide public assurance that a rigorous and independent result will be achieved, the Board may well decide that there is no need for any formal intervention on its part.

10.10 Statutory Underpinning of the Investigation/Disciplinary Process

The Review Group has favourably considered the suggestion of one of the recognised accountancy bodies that the bodies' investigation and disciplinary powers should be underpinned by statute. This would allow the bodies to operate more effectively and would reduce their reliance on the member's co-operation in investigating complaints.

Recommendation 10.21

The investigation and disciplinary regime of recognised accountancy bodies should be supported by statutory powers, enabling the bodies *inter alia:*

- **to discover documentation, not only from members but from third parties, e.g., clients of the member,**
- **to require the taking of evidence under oath, if necessary, and**
- **to apply to the High Court for orders and directions, including compelling the parties involved to co-operate.**

10.11 Conclusion

The Review Group considers that implementation of the proposals contained in this Chapter will help to restore public confidence in the upholding of professional standards in the accountancy profession in Ireland. In particular, the Group is of the view that complaints of professional misconduct should be dealt with by a system of investigation, discipline and appeals within each accountancy body which exhibits the principles of effectiveness and equity outlined above. Such a system, which will be supervised by an independent Oversight Board, will offer a modern and reputable form of determining complaints of professional misconduct which will balance the rights of members of the auditing and accountancy professions with those of the consumers of accounting services in the State.

CHAPTER 11

Other Regulatory Shortcomings

11 Other Regulatory Shortcomings

11.1 Introduction

This Chapter discusses a number of residual matters relating to the regulation of the accountancy profession. Specifically, it deals with:

- the position of individually authorised auditors;
- the possibility of according statutory protection to the titles "auditor" and "accountant";
- the limited remedial measures open to the regulatory authorities where the auditor is outside the State;
- the publication of the names of registered auditors;
- the monitoring of annual returns and accounts filed in the Companies Registration Office (CRO);
- the filing of the annual auditor's report in respect of unlimited and certain other companies which are not required to file a balance sheet with the annual return;
- the circumstances under which an auditor is required under section 194 of the Companies Act, 1990 to report to the Registrar of Companies the failure of company directors to keep proper books of account; and
- risk-based monitoring of members of the recognised accountancy bodies.

11.2 Individually Authorised Auditors

This issue was discussed earlier in Part II of the Report, where the Review Group indicated that it was unsatisfactory that the individual auditors who are not members of a recognised accountancy body but who were authorised prior to 3 February, 1983 by the then Minister are not subject to any regular monitoring. Even if the numbers involved are only about 50 at this time, the Review Group is of the opinion that the absence of ongoing regulation in this area should be resolved in the public interest. In considering possible remedial measures, the attention of the Review Group was drawn to the parallel position in the UK some time ago, where several thousand persons stood individually authorised following the withdrawal of the Ministerial power to authorise such persons.

Part of the UK solution to the problem of monitoring these individuals involved compelling them to join a recognised accountancy body. Thus, the Association of Authorised Public Accountants (AAPA) was formed and subsequently recognised as a supervisory body by the UK's Department of Trade and Industry, and many individually authorised auditors became members of the Association. As the number of its active auditor members declined and as it found itself unable to provide the required technical support and regulatory infrastructure, the Association subsequently agreed to become a subsidiary of the Association of Chartered Certified Accountants (ACCA). Its members continue to be subject to the ACCA's rules and regulations.

The Review Group does not consider the UK approach to be a practical option having regard to the small numbers involved and the likelihood that some of them at least may not be very active auditors at this stage. Having made enquiries, the Review Group is nevertheless satisfied that a number of the present recognised accountancy bodies would be prepared to consider applications for membership or regulation from individually authorised auditors.

Having taken legal advice, the Group is satisfied that:

- it would be a reasonable use of statutory power to compel individually authorised auditors either to become members of recognised accountancy bodies or at a minimum to be regulated by them;
- an individual authorisation could be suspended or revoked for failure to comply or to meet the body's competency and other standards for the conduct of audit work; and
- such a move was unlikely to be regarded as constitutionally objectionable by the Courts.

The Review Group appreciates that there may be situations where an individually authorised auditor may not immediately attain the present standards required by the body for the issue or continuance of an audit practising certificate. Clearly, some period of grace (say three years) should be permitted to the individual to reach the acceptable auditing standards, before any final decision is made to suspend or withdraw his/her individual authorisation. In the context of individually authorised auditors who have long experience of auditing work, the Review Group accepts that the term "acceptable auditing standards" may not need to equate with the current level of academic achievement which new entrants to the profession must attain. However, the standard should be of a sufficiently high level to provide public assurance of the quality of audit work undertaken by those individuals on an ongoing basis. Obviously, the proposed Oversight Board, as the successor of the Minister in this area, should work closely with the relevant recognised accountancy bodies in determining the appropriate standards which should be set and subsequently in withdrawing an individual's authorisation in the event of a person's failure to meet the required standards.

The Review Group notes that it is the policy of the Department of Enterprise, Trade and Employment to encourage any qualified auditors who wish to practise in Ireland under the provisions of the Mutual Recognition Directive 89/48/EEC or otherwise to join with or be regulated by a recognised accountancy body. The Group supports this stance.

Recommendation 11.1

The Companies Acts should be changed:

- **to compel individually authorised auditors either to become members of recognised accountancy bodies or at a minimum to be regulated by them;**
- **to provide for the suspension or revocation by the Oversight Board of an individual authorisation for failure to comply with or to meet the body's competency and other standards for the conduct of audit work following a transition period of three years.**

11.3 Statutory Protection for "Auditor"

The Review Group is conscious that the new regulatory regime outlined in this Report will be more demanding of auditors (and accountants). There is therefore the danger that persons not wishing to meet the required standards might simply seek to opt out of the regime and yet continue to offer the same professional services as they have done in the past.

Chapter 4 has already noted that section 187 of the Companies Act, 1990 already provides that the task of auditing is restricted to properly qualified persons, and subsection (9) makes it an offence for any person to audit while disqualified from doing so. The Review Group agrees that the offence of acting as auditor should be supplemented by a new offence of holding oneself out as an auditor for the purposes of the Companies Acts without being qualified to do so. This restriction is not intended to apply to an honorary auditor who is entrusted with the task of confirming that the annual accounts prepared for sports clubs or other similar voluntary activity are in order.

Recommendation 11.2

The Companies Acts should be changed to prohibit persons holding themselves out as an auditor, regulated auditor or registered auditor for the purposes of the Companies Acts, without being qualified to do so.

11.4 Statutory Protection for "Accountant"

The Review Group also considered if the provision of accountancy services and the holding of oneself out as an accountant should also be the subject of statutory protection.

On the first issue, the Review Group considered that restricting the provision of accountancy services to accountants or registered accountants under the Companies Acts would be extremely difficult. In the first place, such a move would be questionable under competition law. Even if one could overcome the very difficult task of defining the term "accountancy services" in a new Act and distinguishing them adequately

from bookkeeping or business advisory services, the Review Group has concluded that the interpretation and enforcement of such a legal provision would be highly problematic and would be likely to be very costly.

The Review Group then considered if it should recommend mirroring the 'holding out' prohibition for accountant and registered accountant which it intends should apply to the terms auditor, regulated auditor and registered auditor. Some of the pros and cons of such an approach considered by the Group were:

Arguments for:

- there is a business and consumer benefit to be derived from distinguishing between those persons who are qualified accountants and those who are not;
- this distinction is more important as higher professional standards, coupled with improved statutory oversight of the accountancy and auditing profession, are demanded of both properly qualified accountants and auditors;
- the costs of improved regulation for the profession should be balanced by a benefit based on a clear association of the terms accountant and registered accountant with those higher standards;
- many other professions, e.g., doctors, solicitors, enjoy such statutory control in the public interest.

Arguments against:

- the term "accountant" or "registered accountant" is not suitable for protection having regard to the diverse nature of accountancy services and the common usage of the term. Services such as those provided by a legal costs accountant or turf accountant are not intended to be covered by such legal protection. Even within the accountancy area, many persons would be competent to prepare a proper set of accounts, even though they may not be formally qualified;
- it is up to each of the accountancy bodies to promote the merits of its accountancy qualification, and each member of such a body can readily distinguish his/her standing for the benefit of business and the general public by appending that membership to his/her name;
- there is no evidence of public demand for such a protection, and no evidence of abuse of the term has come to the attention of the Department;
- such a statutory protection would impose costs on the State for little benefit, as the unqualified persons would simply re-describe themselves as a financial consultant or some such term.

On balance, the Review Group has concluded that there is no compelling case in favour of recommending statutory protection for these titles at this time. However, the Review Group is also conscious of the risk that the more rigorous regime being recommended by the Group for those engaged in audit work could lead some individual auditors to opt out of the regulatory framework while still providing accounting and related services. Against this background, the Review Group considers that it is important that this issue be kept under review to ensure that the Group's conclusions are not undermined.

Recommendation 11.3

The Oversight Board should, from time to time, review:

- **the extent to which accountancy and related services are being provided by persons who are not subject to its remit;**
- **whether this is having any material adverse impact on the overall effectiveness of the regulatory framework; and**
- **if so, make recommendations to the Minister for Enterprise, Trade and Employment for any appropriate remedial action.**

11.5 "Non-Resident" Auditors

During the course of its work, the Review Group was made aware of the substantial numbers of auditors outside the State who belong to the recognised accountancy bodies and who are nominally qualified to audit Irish-registered companies in the State. Chapter 5 suggested that the figure might be of the order of 19,000, although only a fraction of that number would act as auditors to Irish companies. The legal position is that such auditors have to be registered with the Registrar of Companies before they are legally entitled to audit in the State.

While enquiries about the Irish audit work of non-resident auditors is capable of being made of their recognised accountancy body, the Review Group is nevertheless concerned that any auditor outside the State of an Irish company might be beyond the jurisdiction of the Minister or the proposed new Director of Corporate Enforcement in respect of any breach of the Companies Acts. In the circumstances, it is essential that those auditing Irish companies, whether resident in the State or not, should equally be subject to the jurisdiction of the Companies Acts. It follows that any auditor, whether resident or not, who appears to have committed an offence under the Acts should similarly be capable of being brought to account.

Recommendation 11.4

Appropriate legal or other co-operation arrangements should be sought with EU and other relevant jurisdictions to enable auditors who are not in the State to be brought to account for any breaches of the Companies Acts or similar legislation.

11.6 The Register of Qualified Auditors

Reference has been made earlier to the register of qualified auditors which is required to be maintained by the Registrar of Companies under section 198 of the Companies Act, 1990. The Review Group believes that this register should be regularly updated and made continuously available for the information of the general public who may need to check on the status of persons whom they propose to engage as auditors.

The Review Group believes that a similar onus should be placed on each of recognised accountancy bodies to identify each of their members, their status within the body and the nature of the activity which each is authorised to undertake.

Recommendation 11.5

The Review Group recommends that:

- **the Registrar of Companies should permanently display an up-to-date list of qualified auditors on the CRO Website;**
- **each recognised accountancy body should maintain on its website or in hard copy form an up-to-date list of members, identifying *inter alia* the status of each member and the nature of the activity which each is authorised to undertake.**

11.7 Company Annual Returns

As indicated earlier in Chapter 6, the Review Group was disappointed to learn that the Registrar of Companies and his staff do not systematically check the annual returns of companies to ensure that the person who signs the audit report attached to those returns is a qualified auditor. It is the view of the Group that this situation should be remedied urgently, if necessary by obtaining additional staffing resources for that purpose.

Recommendation 11.6

The Registrar of Companies should, as a matter of urgency, arrange that his Office:

- **institute a systematic checking of the annual returns of companies to ensure that the person who signs the audit report attached to those returns is a qualified auditor registered on the register of auditors maintained by his Office under section 198 of the Companies Act, 1990;**
- **inform the proposed Office of the Director of Corporate Enforcement of the identity of any non-qualified person who has acted as auditor to a company, so that enforcement action under section 187 of the 1990 Act can be considered.**

11.8 Unlimited Companies and Other Exempted Companies

Unlimited companies are generally required to have their annual accounts audited. Because the members of such companies assume personal liability for any debts, no legal requirement has been imposed to have information relating to the financial status of the company filed in the CRO. This form of corporate entity is accordingly attractive for companies wishing to maintain commercial secrecy for their businesses.

However, the Review Group acknowledges that this legal position is unsatisfactory for two particular reasons:

- in the absence of anything being filed in the CRO, the public at large does not know if the annual accounts of such companies are being audited as required by law;
- similarly, it is a matter of public interest for the employees and creditors of such companies to know that the annual financial statements are in order, particularly where these entities are large undertakings whose debts might not be capable of being secured fully by the personal liability of its members.

The Review Group has therefore decided that this deficiency should be addressed by requiring the annual filing in the CRO of the audit reports of all unlimited companies.

The same considerations apply, albeit to a somewhat lesser extent, in respect of private companies exempted from the Companies (Amendment) Act, 1986 by virtue of section 2(1). These are essentially companies formed for charitable purposes or are companies not trading for the acquisition of gain by their members.

Recommendation 11.7

The Companies Acts should require that the annual audit reports for unlimited companies (and for other exempted companies as defined in section 2(1) of the Companies (Amendment) Act, 1986) be promptly filed with the Registrar of Companies after the end of their financial year.

11.9 Review of Section 194, Companies Act, 1990

The Review Group has already discussed the requirement imposed on auditors by section 194 of the Companies Act, 1990 to notify the Registrar of Companies of any failure by a company and its directors to take "the necessary steps to ensure that proper books of account are kept" (subsection (2)). It has been represented to the Group that the term "necessary steps" does not offer sufficient guidance to an auditor as to the precise circumstances under which he/she is required to act under the section and notify the Registrar.

While no particular drafting solution has been offered to the Review Group and the Group appreciates that it may not be practical to be more definitive, it nevertheless supports a review of the section, in order to examine if greater legal clarity can be provided for auditors as to when they are required to notify the Registrar under section 194 of the 1990 Act.

Recommendation 11.8

Section 194(2) of the Companies Act, 1990 should be reviewed, in order to establish if more precise guidance can be provided to auditors on when company directors have taken (or not taken as the case may be) the necessary steps to comply with section 202 of the 1990 Act which requires inter alia the keeping of proper books of account.

11.10 Risk-Based Monitoring

In Chapter 6, we noted that some of the recognised accountancy bodies now operate a risk-based system of monitoring (quality review), which focuses more frequently on those members which have a large client base or which are auditing clients in the higher risk categories. We agree that the risk-based selection of members for monitoring is desirable in all of the recognised accountancy bodies, provided there are reasonable maximum periods within which all members receive scrutiny.

Recommendation 11.9

All recognised accountancy bodies should adopt a risk-based approach to the selection of members/member firms for monitoring visits, with those members in larger practices or having audit clients in higher risk categories (e.g., those operating in the financial area) receiving more frequent scrutiny.

11.11 Conclusion

The Review Group now moves on to discuss the important issue of auditor independence in the following Chapter.

CHAPTER 12

Auditor Independence

12 Auditor Independence

12.1 Introduction

In this Chapter and in the next Chapter on the external audit and corporate governance structures the Review Group sets out its views on the current rules and safeguards in relation to auditor independence, assesses their adequacy in the light of the findings of the DIRT inquiry report and the increasing threats to auditor independence. Based on national experience, international developments and best practice the Review Group recommends improvements to auditor independence safeguards as well as to corporate governance structures (Chapter 13).

The primary purpose of statutory audits is to provide company shareholders with an expert independent opinion that the annual accounts of a company show a true and fair view. According to FEE, independence is the main means by which an auditor demonstrates that he can perform his task in an objective manner[43]. The overall effectiveness of the provision of audit services depends on three separate groups of criteria:

- the independence of the auditor and the transparency of that independence;
- professional criteria, including the competence, due care, professional standards and quality assurance processes which are applied in the performance of audit work;
- market criteria, i.e. the availability of a free choice of auditor to the audit client and fair pricing of audit services.

Auditors owe a duty of care to shareholders of a company, rather than its Directors or managers. However, in reality, auditors are selected and monitored by and work with the managers and Directors. Given the business relationship that exists between audit firms and companies, there will always be some degree of interdependence between them. Taken to extremes, audit firms could be slow to stand up to the management of client firms where differences in opinion arise between management and auditors as they may not wish to run the risk of losing a subsequent year's audit contract not to mention non-audit services. Consequently absolute auditor independence may, in reality, not be possible as an audit firm is, to a lesser or greater extent, dependent on earning an income from the provision of services to these clients. The objective, therefore, is to ensure that the auditor is in a position to carry out an audit in an independent and objective manner as possible.

There is a public interest dimension to the external audit function. Auditors of financial institutions have a duty to report to the Central Bank as regulators of this sector. Auditors also have to report to the Revenue Commissioners where lack of compliance with certain statutory provisions are detected by an auditor. Following from the Report of the

[43] Fédération des Experts Comptables European, The Role, Position and Liability of the Statutory Auditor in the EU, January 1996, page 24

Working Group on Company Law Compliance and Enforcement[44] a Bill has just been published that will, once enacted, require auditors to report to the relevant authorities if fraud or another offence under the Companies Act is detected[45]. This will further underline the duty of an auditor to the general public. The introduction of a public interest dimension to the work of the auditor requires that the independence of the auditor should become more transparent. Accordingly, it is necessary to put in place restrictions and disclosure rules to publicly demonstrate the independence of the audit function.

12.2 The Provision of Non-Audit Services

12.2.1 The Range of Other Services

As well as providing audit services, audit firms now commonly offer a range of other non-audit services to companies that are summarised in Table 12.1.

Table 12.1: Non-Audit Services Provided by Audit Firms[46]
Non-audit services that are permitted provided that safeguards are maintained
Provision of internal audit services
Services in connection with mergers and acquisition activity
Provision of tax planning advice
Services in connection with the development, acquisition and installation of computer systems
Actuarial services
Provision of financial management advice
Corporate finance and strategy
Provision of management consultancy services
Provision of investment services and investment advice
Computation of tax liabilities
Human resources including recruitment
Preparation of financial statements
Provide assistance to company secretaries, for example, filing of annual returns
Audit-related services
Assurance engagements required to be carried out by an entity's auditors such as:
• certification of grant claims;
• reporting compliance under Section 13 of the Prompt Payment of Accounts Act reviewing the interim statements or agreeing the preliminary announcement of a listed company.
Special reports to audit committees or management on specific internal control and corporate governance issues.
Preparation of reports in connection with Stock Exchange requirements relating to investment circulars.

[44] Report of Working Group on Company Law Compliance and Enforcement, December 1998
[45] Chapter 14 outlines the legislative provisions concerning external auditor's obligations to report to statutory authorities.
[46] There are also some non-audit services prohibited by professional accountancy bodies. Auditors are prohibited from:
- acting as receivers and liquidators;
- providing insolvency services;
- promoting or underwriting shares issued to the public;
- undertake functions that include adoption of a managerial decision making role;
- acting as company secretary and preparing accounting records and financial statements of a listed or public interest entity, save for routine clerical assistance or in an emergency.

The threat posed to the independence of auditors by the provision of these non-audit services to the same client is well recognised and can arise where:

- there is an over dependence on non-audit fees earned by an audit firm, from an individual client company;
- auditors or audit firms, by virtue of involvement in the provision of other non-audit services could have an overly close relationship with management;
- audit firms are involved in the installation of management information systems;
- audit firms are involved in work that could unduly influence the judgement of management or the amounts at which assets and liabilities may be stated in the balance sheet;
- services are undertaken on the basis of payment by contingency fees.

The Review Group considers these threats to auditor independence may make external auditors reluctant to make objective judgements on the annual accounts, in particular where differences of opinion with management of a client company arise during the course of the audit. It may also result in audit firms, in effect, auditing their own work.

The threat to the independence of auditors by non-audit services has increased as the range of non-audit services by audit firms has expanded. These consultancy services are, increasingly, the more profitable element of audit firms' business. In the US, the SEC have indicated that since 1993 auditing revenues have been growing by 9% on average each year while consulting and similar services have been growing at a rate of 27% each year[47]. In addition the US Big Five audit firms' fees from consulting services, not including tax, "*for their SEC clients increased from 17% of audit fees in 1990 to 67% in 1999*"[48].

While similar statistics are, currently, unavailable for Ireland the Review Group considers that the US evidence demonstrates that the statutory audit may, at times, merely be viewed as a means of gaining a foothold into companies. Furthermore the Review Group considers that this can lead to "low balling" in relation to pricing of audit services precisely for this purpose.

There is also an additional threat to the independence of an auditor where the auditor has worked with an individual company over a number of years, and a relationship has built up such that the auditor may be too close or too familiar with the workings of a company to ensure independence.

[47] SEC Press Release, 'Chairman Arthur Lewitt Concerned About Auditor Independence Proposes Ruling and Other Measures to Maintain Quality of Financial Reporting', 12 May 2000. Website address: http://www.sec.gov/news/press/2000-62.txt

[48] Public Oversight Boad, Panel on Audit Effectiveness, Report and Recommendations, Exposure Draft, 31 May 2000, page 102. Website address:www.pobauditpanel.org/download.html

12.2.2 DIRT Report

The PAC DIRT inquiry highlighted a number of weaknesses in the external audit process in relation to financial institutions that, in the view of the Sub-Committee, contributed to the problems associated with the collection of DIRT. In a number of instances, the DIRT Report questioned whether these audit failures were due to:

- auditor independence being compromised by the existence of contracts for the provision of non-audit services;
- the long term business relationships between the banks and audit firms.

This, according to the PAC DIRT Report, is "*a complication*"[49] in the external audit process.

12.2.3 Current Provisions to Safeguard Auditor Independence

12.2.3.1 Legislative Provisions

In recognition of the threats to auditors' independence posed by the provision of non-audit services to audit client companies, a number of safeguards are in place with the objective of enhancing auditor independence. Section 187(2) of the Companies Act, 1990 prohibits certain persons from being appointed auditor to a company such as officers of companies or connected persons to officers of companies.

12.2.3.2 Stock Exchange Rules

The Irish Stock Exchange rules deal with the issue of auditor independence and objectivity and the provision of non-audit services by the external audit firm in the context of the relationship between the audit committee and the external auditor as outlined by the Combined Code. This Code was developed in consultation (principally in, but not restricted to, the UK) between the accountancy profession, companies and shareholder groups. The Combined Code is appended to the listing rules of both the London and Irish Stock Exchanges. Directors of companies listed on either exchange are required to report to shareholders annually on their compliance with the Code. The Code, which attempts to set out principles of good governance states that "*where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review seeking to balance the maintenance of objectivity and value for money.*"[50]

12.2.3.3 Ethical Guidelines

The accountancy profession recognises the importance of auditor independence and objectivity and has established rules relating to the conduct of audits and non-audit services provided by accountants and auditors so as to support and demonstrate independence.

[49] Public Accounts Committee; DIRT Report, Volume 1, page 70.
[50] UK Combined Code, page 23

For example, the professional ethical guidelines prohibit an auditor from:

- having a close family, personal or business relationship with an audit client;
- giving a loan to or accepting a loan from a client;
- accepting goods, services or hospitality from a client.

An auditor should also avoid holding an investment with a client company.

In addition the ethical guidelines recognise that threats to auditor independence and objectivity can arise in various circumstances many of which are linked to the provision of non-audit services. These are summarised in the following Table 12.2.

Table 12.2: Threats to Auditor Independence[51]	
Self-interest threat	Where an auditor is financially dependent on the audit client or where an auditor or someone closely associated with him/her has a financial or other interest in the audit client.
Familiarity threat	The relationship between the auditor and client is long-standing or otherwise is so familiar that the auditor becomes involved in advising the client or acting in a management role.
Self-review threat	A judgement is required of the auditor which demands that previous work of the firm (whether audit or non-audit) be challenged or re-evaluated.
The trust threat	The auditor becomes too trusting of directors and management preventing a proper testing of management information and representations.
The intimidation threat	The auditor is intimidated by actual or potential pressures from the client or other party.
The advocacy threat	The auditor becomes involved in actively promoting or defending the client's interests.

Ethical guidelines suggest safeguards against specific types of threat to independence. For example guidelines suggests that the dependency threat to auditor independence can be alleviated by refusing to accept an audit or a similar financial reporting assignment from a client which provides an unacceptable proportion of fees (ranging from 10% to 15% depending on the professional accountancy body and the type of company) of gross practice income.[52]

[51] ICAI Handbook, Ethical Guidelines for Members: Section C, Statement on Integrity, Objectivity and Independence

[52] For example ICAI Handbook, Ethical Guidelines for Members, Section C, Statement 1 and CPA Handbook 2000, Code of Professional Ethics Conduct and Practice, Part B

12.2.3.4 Auditing Standards

The APB does not have responsibility for establishing standards in relation to ethical matters such as independence or objectivity. However, as it is difficult to entirely separate ethical from technical issues, many of its publications and standards also cover ethical issues.

Recent publications of relevance include:

- *The Audit Agenda* - Next Steps (1996) which sets out an auditor's code of nine fundamental principles of independent auditing.
- *Audit Briefing Paper on Communication between External Auditors and Audit Committees (*1998) which sets out the APB's views on communications between auditors and audit committees so as to assist development of working practices of both auditors and audit committees.
- *The Exposure Draft for a Revised Standard on Quality Control for Audit Work* (SAS 240), published in January 2000. This proposes that audit partners consider whether adequate arrangements are in place within the audit firm to safeguard their objectivity and to document their conclusions. This Exposure Draft indicates that in order to safeguard objectivity and independence audit firms should consider carefully whether to accept a new audit engagement. The proposed SAS, if implemented, will lead to a strengthening of the required behaviour within audit firms to actively consider the independence of the audit.

12.3 International Developments on Auditor Independence

The question of auditor independence is under review internationally, most significantly by the SEC in the US and by the EU Committee on Auditing. The Review Group considers that it would be undesirable for Ireland to be significantly out of step with international practice, as this could place Irish businesses at a competitive disadvantage, particularly in the financial services sector. However, it is desirable that Ireland should have the most up to date regime for the protection and transparency of auditor independence.

The Oversight Board should keep international developments and initiatives in relation to auditor independence under constant review to ensure that Ireland's regime in relation to auditor independence remains at the forefront of international developments.

12.3.1 US Developments

SEC rules apply to companies registered with the SEC which are generally public companies listed on the US stock exchanges. The SEC does not currently prohibit the provision of non-audit services by audit firms to audit clients in the US. A recent report by the SEC into independence issues at PricewaterhouseCoopers detected a large number of violations of their independence rules that is having implications for the structure of some audit firms. These violations of

independence rules arose from, amongst other issues, partners holding "*investments or interests in affiliates of clients to which a professional provided services*"[53] rather than from the provision of other non-audit services to clients. As a result, at the SEC's request, the Public Oversight Board is sponsoring similar independent reviews at other firms and will oversee development of enhancements to quality control and other professional standards.

A recent statement by the Chief Accountant of the SEC emphasised a number of key concepts in relation to auditor independence and the provision of other services including:

- auditors should not provide services that affect the numbers in the financial statements such as valuation used for financial statements purposes and internal auditing;
- auditors should not provide services requiring them to be an advocate for the client;
- audit firms should not be part of a web of business relationships that gives them a mutuality of financial interests with an audit client;
- there should be no financial interests or employment with clients.[54]

The SEC is therefore considering steps to strengthen its enforcement of existing rules governing independence. More recently the SEC announced a review of rules to safeguard the independence of auditors. A number of measures are being considered by the SEC including:

- "*SEC rule making to clarify activities that may be inconsistent for an independent auditor of financial statements to perform for audit clients;*
- *support for a plan by the profession's independent overseer in the US, the Public Oversight Board, to enhance its powers and responsibilities;*
- *a self-evaluation by each of the major accounting firms of past compliance with the SEC's and the profession's financial investment rules and their system of internal controls for monitoring those investments.*"[55]

While the recent SEC announcement refers to "*more appropriate limits on the type of services that an audit firm can render to a client or demarking certain services inconsistent with an independent audit and greater disclosure of other services*" it does not intend to introduce a rule prohibiting audit firms from providing all non-audit services to their audit clients.

[53] Lankler, Siffert & Whol LLP: SEC Report of the Internal Investigation of Independence Issues at PWC, January, 2000 website address: www.sec.gov/news/presinder

[54] Speech by Lynn Turner, Chief Accountant of the SEC, 27 January 2000. Website address: http://www.sec.gov/news/speeches/spch340.htm

[55] SEC Press Release, 'Chairman Arthur Lewitt Concerned About Auditor Independence Proposes Ruling and Other Measures to Maintain Quality of Financial Reporting'.Website address: http://www.sec.gov/news/press/2000-62.txt

Interestingly the Public Oversight Board recently issued for public comment a report prepared by an independent expert Panel on Audit Effectiveness. This independent Panel was unable to "*agree to support or reject an exclusionary rule that would prohibit an audit firm from providing non-audit and non tax services*".[56] Instead there are two statements in the exposure draft one supporting and a second opposing such a prohibition on audit firms. This demonstrated to the Review Group the difficulties involved in tackling this issue.

As the Review Group was reaching a conclusion on its Report the SEC issued proposals on new rules governing the independence of the accountancy profession in the US. Of most relevance to the work of the Review Group are the rules proposed by the SEC governing the provision of non-audit services. The SEC acknowledges that certain services do not impair an auditor's independence and is not proposing an absolute prohibition on the provision of all non-audit services by audit firms to audit clients. The SEC identifies certain non-audit services that, in their view, are inconsistent with auditor independence. These include, amongst other things, book-keeping, valuation services, actuarial services, management functions, internal audit and legal services.[57]

Recently a number of the global accountancy firms have decided to put their consulting operations and, in particular, the larger scale IT consultancy operations, into separate entities. The extent to which this trend is driven by commercial rather than regulatory factors, such as the recent SEC investigation into PricewaterhouseCoopers is open to debate. While it is not yet clear how this split of the big firms in the US will affect the related Big Five Firms in Ireland, it is unlikely, in any event, that this will result in accountancy firms limiting their role solely to auditing and similar work and they will continue to offer other auxiliary/non-audit services to clients.

12.3.2 EU Developments

There have been a number of recent developments at European level in relation to auditor independence. With the establishment of an EU Committee on Auditing in 1998, the EU Commission is also increasingly active in considering auditor independence in the context of moving towards a single EU financial services and capital market. A 1996 EU Green Paper on Auditing concludes that practice has shown that preventing an auditor from providing other services is not viable[58] as it is too easy to circumvent by having the service provided to the audit client by an affiliated or associated firm. This has been the experience in two EU Member States, France and Belgium, that currently prohibit statutory auditors practising in multi disciplinary firms. In these Member States larger audit firms were able "*to circumvent this restriction by providing services other than audit services through separate legal entities*".[59]

[56] Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations, Exposure Draft 31 May 2000, Introduction, vi.

[57] SEC, Fact Sheet: The Commission's Proposal to Modernise the Rules Governing the Independence of the Accounting Profession, 27 July 2000. Website address:www.sec.gov/news/extra/audfact.htm

[58] Official Journal of the European Communities, 'The Role, the Position and the Liability of the Statutory Auditor within the EU (96/C 321/101)

[59] Buijink et al, report commissioned by the EU 'The Role. Position and Liability of the Statutory Auditor within the EU' 1996, page 71.

FEE set out a common core set of principles for the guidance of the European profession on auditor independence and objectivity in a discussion paper published in July 1998. The provision of non-audit services to an audit client was identified as being a threat to the appearance of auditor independence, but FEE concluded that it *"may not be possible or appropriate to draw up a comprehensive list of all those situations where the provision of consultancy services to an audit client would no longer be compatible"*[60].

The EU Committee on Auditing is currently discussing the issue of auditor independence with a view to establishing common auditor independence requirements within the EU. It is the intention that these discussions will eventually lead to an EU Recommendation setting out a common core of independence principles as a benchmark for statutory auditor's independence throughout the EU.

The agreed approach being taken during the discussions between the European Commission, the Member States and the profession is that the EU Recommendation will adopt a framework approach setting down principles in relation to auditor independence, the threats to and the safeguards required, to protect auditor independence. It will not set out a strict set of rules, as the view of the Committee of Auditing, is that such rules would not be sufficiently flexible to react to future developments in the business and audit environment.

From the discussions held to date at EU level it is unlikely that the EU Recommendation will propose to prohibit the provision of non-audit services by audit firms. In future years as the market for audit and non-audit services develops within the EU this issue may be revisited. While it is likely that the Recommendation will recognise the risk posed by the provision of other services it will not draw up a definite list of forbidden services. The final version of the Recommendation will probably set out principles concerning threats posed by the provision of non-audit services and give examples of the type of services, such as valuation services and the preparation of financial accounts, that pose significant risks and should not be undertaken by a company's auditors.

12.4 Options for Regulating the Independence of Auditors

Arising from the review of current regulations, the findings contained in the DIRT Report and the current international developments the Review Group concluded that the existing rules governing auditor independence in Ireland are no longer sufficient. The Review Group considered two options to further safeguard auditor independence. These are:

- a total prohibition on the provision of non-audit services to audit clients;
- the establishment and maintenance of a framework to ensure there are adequate safeguards in place to protect the objectivity of the auditor.

[60] FEE 'Statutory Audit, Independence and Objectivity, Initial Recommendations, July 1998, page 15

12.4.1 Absolute Prohibition on Auditors Providing Non-Audit Services to Audit Clients

A growing number of commentators consider that the provision of non-audit services by audit firms poses so great a threat to the independence of auditors that, audit firms should be prohibited from providing non-audit services to audit clients such as those outlined in Table 12.1 above.

This approach would significantly reduce the risks posed to auditor objectivity and enhance the appearance of auditor independence. However, prohibition could have unintended side effects on the professional and market criteria which are also important contributors to audit effectiveness.

Some advantages can accrue to the audit process where audit firms also provide non-audit services. The provision of non-audit services to audit clients may improve the quality of the audit, as the audit firm is more familiar with, and has more knowledge of, the workings of a client company. It is argued that specialisation in accountancy firms in areas such as taxation or IT that are available to assist auditors, may no longer be available to the auditor if audit firms are prohibited from providing non-audit services. As the Review Group is not considering prohibiting audit firms providing non-audit services to companies that are not audit clients a counter argument to this viewpoint is that this expertise should continue to be available to auditors.

A total prohibition on the provision of non-audit services by audit firms to client companies or the mandatory rotation of audit firms after a fixed period would not be in line with current international practice including the most recent set of rules proposed by the SEC. Many multi-national companies with a base in Ireland or operating in the financial services sector in the IFSC have one international auditor. It could act as a disincentive to multi-nationals to locate or continue to have a base in Ireland, if they were required to have a different auditor in Ireland. Of course a company could retain the audit firm which it uses internationally if it were to use a different firm to provide non-audit services in Ireland.

The Review Group concluded that it is not feasible or practicable for a small open economy such as Ireland to adopt rules completely out of line with current international practices or the forthcoming EU Recommendation by requiring a complete separation of the audit function from all other consultancy activities.

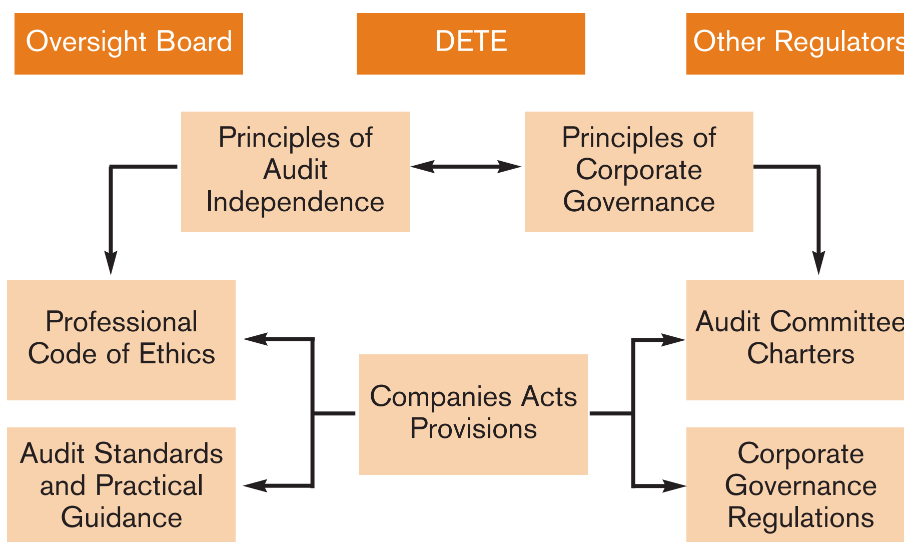
There is a need to consider the interests of clients of the audit and non-audit services provided by audit firms. Due to the increasing complexity of the business environment and regulatory requirements most companies require external assistance in order to remain competitive and to meet their various obligations. A prohibition on auditors providing such services to audit clients could limit the source of advice available to companies and increase costs. The mandatory rotation of auditors could lead to similar difficulties for the customers of audit firms. However, the market for business services may develop so that while audit firms rotate, business services other than auditing services, may still be provided by the same firm.

The above discussion mainly relates to the difficulties associated with the relationship between the large audit firms, PLCs and large financial institutions. In the SME sector the relationship between an auditor and a company is somewhat different where individual auditors play an important role in providing expert business, taxation and accountancy advice on an ongoing basis to clients. Preventing an auditor providing such services could have serious implications for the capacity of management in the SME sector, in particular in areas where there may not be affordable, alternative sources of such advice.

12.4.2 Framework Approach to Safeguarding Auditor Independence

Adoption of a framework approach is more likely to balance the requirements for auditor independence and transparency against the other requirements to achieve an effective audit. The development of a comprehensive framework to safeguard the independence of the auditor would approach the issue from the dual perspectives of the auditor and the client. A possible framework is illustrated in Figure 12.1.

Figure 12.1: A Framework for Audit Independence



In the framework, the Review Group envisages that the Oversight Board would have responsibility for setting the high level principles on which auditor independence should be founded. The professional accountancy bodies would give effect to these principles through the development of audit standards and practical guidance for auditors. The ethical codes of the professional bodies would be strengthened. A key element of the framework would be the arrangements to document the consideration of auditor independence made by the audit engagement partner. The implementation of the framework by audit firms would be monitored by the professional bodies whose work would be monitored by the Oversight Board as envisaged in Chapter 9 of this report.

From the audit oversight perspective, it will be necessary to enshrine the additional safeguards in the relevant parts of the framework, in particular in auditing standards and ethical codes. This could have implications for how auditing standards are developed and applied in Ireland. There may be a need for Ireland to develop standards in areas not currently covered by the APB or in areas where the APB does not propose to act. The status of these standards would need to be worked out between the Oversight Board, the professional accountancy bodies and possibly the APB and the new Ethics Board in the UK. The need for such standards would also need to be considered in the context of the increasing globalisation of both accounting and auditing standards.

The Review Group considers that strengthening the arrangements for auditors to have regard to their independence would not of itself be sufficient to ensure the effectiveness of the framework. Accordingly, the Review Group believes that suitable development of the corporate governance arrangements within audit client companies, particularly considering the involvement of audit committees in reviewing in detail the relationships between the external auditor and management, is also required particularly in large companies, financial institutions and public interest organisations. The Review Group's specific recommendations in respect of corporate governance are set out in Chapter 13.

Recommendation 12.1

There is a need to introduce additional safeguards to protect the independence of an auditor of a client company from the threat posed by the provision of non-audit services to the client company. This is best achieved through the development and maintenance of a framework for auditor independence.

The Review Group is of the opinion that audit firms should not be able to circumvent these new safeguards to auditor independence by establishing associated or affiliated firms, or companies, to specifically provide non-audit services to audit clients. Consequently the Review Group's recommendations apply both to auditor firms and to any associated or affiliated firm or company. The Oversight Board should define what constitutes an associated or affiliated firm.

12.5 Specific Safeguards to Strengthen Audit Independence

12.5.1 Non-audit fees[61]

Currently audit fees are disclosed in the annual financial statements but there is no requirement for the disclosure of non-audit fees, which may be more significant than the audit fee. Since 1991 there has been a requirement in the UK for the full disclosure in the annual financial statements of the total fees paid or owing to the audit firm in respect of audit and non-audit contracts.

[61] Non-audit fees covers all income earned from an individual client company including commissions.

Disclosure of non-audit fees together with an analysis and the nature of non-audit services in the annual financial statements would ensure shareholders are fully aware of the extent of the relationship between the client company and the audit firm. The Review Group also considers that where non-audit fees are significant, it would be good practice to present an analysis of non-audit fees over the different categories of services provided.

Such disclosure should make audit firms less likely to accept an audit contract for fees significantly lower than those charged to its other clients, or by other auditors, in the hope of winning the more lucrative non-audit contracts as the value of such contracts will also be fully disclosed.

Below cost pricing of an audit may lead to a perception that objectivity is being compromised and the audit is not being carried out to sufficiently high standards. In cases of audit failure, a low fee level could be used as evidence that the audit firm did not undertake a sufficiently rigorous audit or did not devote sufficient resources to an audit.

Difficulties may arise in clearly and consistently defining audit and non-audit fees. Some assignments carried out by an audit firm as part of its role as external auditor while not strictly part of the statutory audit are of an audit nature (e.g. providing assurances to third parties on a company's affairs). These difficulties should be dealt with in a professional practice note.

The Review Group considers that this requirement should apply to all companies required to have an annual audit[62]. The existing provision in company law requiring disclosure of audit fees should be amended to include non-audit fees. However this requirement should not be overly burdensome on medium or small companies and the level of detail required to be disclosed by companies that fall into these categories should be set out by the accountancy bodies in a practice note.

Recommendation 12.2

Non-audit fees paid by a company to their audit firm and the nature of the services provided should be disclosed and analysed in adequate detail in the annual financial statements.

12.5.2 Restriction of Non-Audit Fee Income

At present, there are no restrictions on the amounts of non-audit fees which may be paid to the external auditor by an audit client and audit firms can earn many multiples of the audit fee from their audit clients, whether in a given year, or over time. The Review Group considers that this gives rise to concerns about the risk, whether real or perceived, that the primary focus of the audit firm in dealing with such clients would be on maintaining the level of fee income from the client and that this could compromise the independence of the audit firm in relation to the audit.

[62] Small companies with turnover of less that £250,000 and balance sheet total of less than £1.5 million are exempted from the requirement to have accounts audited.

The Review Group is of the opinion that, in principle, the primary focus of the business relationship between the audit firm and the client should always be on the audit. This could best be demonstrated where, over time, the level of audit fee is greater than the level of non-audit fees. There was extensive debate within the Review Group on whether it should recommend a restriction so that the level of non-audit fee should not exceed the audit fee earned from a client company.

Notwithstanding this principle, the Review Group acknowledged that companies may, at times, feel that the audit firm is best placed to provide a significant level of non-audit services. The Review Group did not wish to overly restrict companies in the proper conduct of their business or companies' freedom of choice when selecting a firm to carry out a particular non-audit service. In addition the Review Group accepted that there may also be a particular once off service which the audit firm are, in the view of a client company, best placed to provide.

Therefore on balance taking into consideration these two viewpoints, as well as international developments, the Review Group concluded that the case was not sufficiently clear to warrant recommending a restriction on the level of non-audit fee income which an audit firm could earn from a single client.

The Review Group considered that when the non-audit fee exceeds the audit fee this should be agreed by an audit committee in an open and transparent manner. This would be achieved by requiring management to report to audit committees where non-audit fees exceed the level of audit fees setting out the reasons why the non-audit services were obtained from the auditor. The audit committee would have to satisfy itself and report to shareholders whether in their view this does not compromise the independence of the audit. If the audit committee has concerns that the level of non-audit fees compromises the independence of the external auditor then it should recommend to shareholders that they hire a new audit firm.

The concerns giving rise to this recommendation primarily apply where the total fees are significant and, accordingly, an appropriate de minimis exemption from this requirement should be provided.

Recommendation 12.3

When the non-audit fee earned by an audit firm from a client company exceeds the audit fee then the audit committee of the client company must set out in the annual report to shareholders the reasons why the non-audit services were obtained from the audit firm and confirm that it is satisfied that this does not compromise the independence of the auditor.

12.5.3 Restrictions on Fee Income from a Single Client

Currently the professional bodies have limits on the proportion of total firm income that can be earned from any individual client company or group of companies. As already outlined the limits differ in the different ethical guidelines of the professional accountancy bodies. The limits range from 10% to 15%.

This safeguard guards against the threat to auditor's independence by not permitting an audit firm becoming overly dependent on the fees earned from any one client company or group of companies. The Review Group concluded that current regulations would be enhanced by setting consistent limits across all professional bodies on allowable fees earned from any one client.

The Review Group considered that there was little evidence available to them indicating that the professional accountancy bodies actively monitored firms to ensure that they observed ethical guidelines.

Audit firms should therefore be required to make a statement to their professional body:

- confirming that the limits have not been breached;
- declaring where fees earned from any one client company is coming close to the maximum allowable.

The Review Group was conscious of the potentially anti-competitive side effects to this rule, and felt that there may need to be specific exemptions from this requirement for new, small or expanding accountancy firms. These exemptions may also be applied to established firms reducing or winding down their professional activities.

The Review Group considered that this safeguard could be set out in an audit standard rather than in the ethical guidelines of professional bodies as is currently the case. The Oversight Board should confirm that this provision is monitored regularly by the professional bodies.

Recommendation 12.4

The maximum allowable proportion of overall fee income contributed by any one client company or group of client companies to the total portfolio of the audit firm should, at most, be limited to 10%. A lower limit of 5%[63] should apply in the case of listed companies, financial institutions and public interest companies and more formal monitoring for compliance with this requirement should be put in place.

[63] As recommended in the Report of the Financial Reporting Commission (Ryan Commission) in 1992, para 7.56 and in the Company Law Review Group, First Report, 1994, para 4.43, page 37

12.5.4 Prohibiting Certain Non-Audit Services

The ethical guidelines of the professional bodies recognise that certain non-audit assignments may lead to, or be seen to lead to, a loss of auditor independence. These guidelines do not provide a comprehensive list of assignments that pose particular risk but leave it to the professional judgement of auditors or audit firms to decide whether it is appropriate to accept, or otherwise, non-audit assignments.

The Review Group considers that there is a case for the prohibition of certain non-audit services, where the provision of the non-audit service can result in an audit firm auditing the output of its own work or their own judgement. Providing such services can pose a significant threat to auditor independence. The Review Group fully endorsed the principle that an audit firm should not be permitted to accept a contract that would result in the firm auditing its own work.

As the independence of an audit depends largely on the objectivity and professionalism of an individual auditor or audit firm, it is extremely difficult to draw up an all encompassing, precise list of non-audit services that could apply in all situations. The list of non-audit services incompatible with the audit service may change over time as the relative frontiers of audit and corporate governance evolve. Nevertheless the Review Group considered that some services pose a significant risk to auditor independence.

As already outlined both the SEC in the US and the European Commission are also currently reviewing auditor independence rules with a view to revising existing rules or introducing new rules. As both of these reviews are ongoing the Review Group did not have at its disposal the final rules or guidance that will be adopted by the SEC or agreed by the European Commission concerning the provision of non-audit services. Nevertheless during its extensive discussions on this issue the Review Group found public statements from the SEC[64] concerning its review of audit independence rules and the initial document prepared by the European Commission[65] for the April, 2000 Committee on Auditing very useful.

Both of these point to the risks involved in auditors being involved in providing valuation services and to a lesser extent to internal audit services to audit clients. In the EU document referred to above valuation services are "*services which lead to the valuation of amounts material in relation to the financial statements or the valuation of which involves a significant degree of subjectivity inherent in the item concerned*".[66] An example of an inappropriate valuation service is actuarial services where the result is material to the financial statements.

[64] In particular speech by Lynn Turner, Chief Accountant of the SEC, 27 January 2000

[65] Paper prepared on Statutory Auditors Independence by the Internal Market DG of the EU Commission for the Committee on Auditing of the 10/11 April 2000

[66] Paper prepared on Statutory Auditors Independence by the Internal Market DG of the EU Commission for the Committee on Auditing of the 10/11 April 2000, page 16

Recommendation 12.5

The Review Group recommends that the following principles apply in relation to non-audit services:

- **audit firms should not audit their own work;**
- **audit firms should not provide non-audit services to an audit client that affect the numbers in the financial statements such as valuation;**
- **audit firms should not provide internal audit services.**

A professional standard should be developed (in the manner outlined in Chapter 8, Section 2.4) that prohibits the provision of specified non-audit services by an audit firm to an audit client company.

The Oversight Board should be empowered to impose a professional standard, prepared by the Oversight Board, on the professional accountancy bodies to address this issue. However, this power should only be exercised where an undue amount of time is being taken to develop the standard.

To ensure that there is no uncertainty concerning which non-audit services are permitted and which ones are not prohibited the auditing standard to be developed to implement this recommendation should list the type of valuation services that are not permitted.

Of course an audit firm should be free to provide all services to non-audit clients.

12.5.5 Exchange of Information within Audit Firms in relation to Non-Audit Services

Where non-audit partners of an audit firm have information in relation to a client company which may be relevant to their audit of that company, the audit engagement partner's responsibility to take account of such information for the purposes of the audit is not clear, particularly where that information is withheld from the audit partner. The Review Group recommends that this should be rectified in the appropriate audit standards.

Audit engagement partners are presumed to know everything relevant to the audit of a client company that other partners in the firm are aware of. The partners who provide tax and other non-audit services will have an onus to report all such issues, including cases of statutory non-compliance, to the audit engagement partner.

The Review Group acknowledges that this requirement could be difficult to monitor. In the absence of full disclosure of all relevant information to the audit partner the audit firm would be exposed to action in the event of audit failure. The Review Group believes that audit firms should include documentation of the communication between the audit engagement partner and other partners responsible for the provision of non-audit services in their internal quality assurance procedures. The audit firm should take proper account of information when it could affect the audit so that it is treated in a responsible manner particularly since in partnership law the knowledge obtained by one partner in the course of partnership business may be imputed to the entire partnership. This safeguard should be set out in an auditing standard and apply to all audit firms.

Recommendation 12.6

The audit engagement partner and staff of a firm should be presumed to know everything relevant to the audit of a client company that other partners in the firm or an associated firm are aware of in relation to the company. A firm appointed as auditor of a company needs to have in place appropriate procedures to ensure that the partner responsible for the audit function is made aware of any other relationship which exists between any department of the audit firm and the company when that relationship could affect the audit firm's responsibilities as auditors.

12.5.6 Documenting Risks to Auditor Independence

Under the ethical guidelines of the professional bodies and best practice as outlined in the Combined Code it is the responsibility of audit firms and the corporate governance structures within a client company to deal with risks posed to auditor independence by the provision of non-audit services. There is currently no requirement to document these risks or any discussions that take place concerning these risks. However, the recent APB Exposure Draft on "*Quality Control for Audit Work*" begins to tackle this issue.

Documenting significant risks could clearly demonstrate where the business relationship between the audit firm and the client company could potentially impair the independence of the auditor. This should also document how these issues have been resolved and are being dealt with and how auditor independence is protected.

This requirement to document risks to auditor independence should be set out in the ethical standards of the professional accountancy bodies and should apply to all companies required to have their accounts audited.

Recommendation 12.7

Audit firms should be required to set out their general policy concerning risks to auditor independence and to document how risks to auditor independence are dealt with in relation to individual client companies during an audit. The general policy of the firm towards the identification and management of risks to audit independence should be set out in the letter of engagement. Information relevant to the management of risk during the audit engagement should be included in the management letter or a separate letter addressed to the audit committee.

12.5.7 Auditor Rotation

When considering this issue the Review Group decided to increase the scope of the its consideration concerning the introduction of a maximum term of five years for an auditor to include all companies and not just financial institutions.

Within the EU Committee on Auditing discussions on auditor rotation are focusing on systematic rotation of audit team members within a reasonable period of time defined as 5 to 7 years. It is therefore unlikely that mandatory rotation of audit firms will be proposed in the forthcoming EU Recommendation on auditor independence.

Neither auditing standards nor the ethical guidelines of the professional bodies require audit firms to resign from an audit engagement after a fixed number of years. Also, corporate governance rules and statute do not require companies to change their auditors after a reasonable period of time. Nevertheless the threat posed to auditor independence from over familiarity with an audit client is well recognised. To guard against this threat professional accountancy bodies' ethical guidelines do not permit an audit partner to remain in charge of an audit contract for longer than seven consecutive years. This means that within an audit firm audit partners should be rotated after seven years[67].

Ethical rules[68] exempt sole practitioners and small audit firms from the requirement to rotate audit partners and senior staff on the basis that smaller audit firms would find it difficult to implement such rules or in the case of sole practitioners this option would not be available to them.

The introduction of a mandatory rotation of audit firms after a fixed period would improve the appearance of auditor independence and would prevent audit firms from becoming over familiar with the management of individual client companies.

[67] For example, ICAI, Handbook Section C: Ethical Guide for Members, Statement 1 and ACCA Rulebook, page 298
[68] For example, ACCA Rule Book 2000, page 299 and CPA Handbook 2000 Code of Professional Ethics, Conduct and Practice, para 8.13, page 25

There could be a number of drawbacks to the mandatory rotation of audit firms. These drawbacks would impinge on the other criteria which contribute to the effectiveness of an audit. For example, mandatory rotation of auditors may:

- interfere with, and restrict, the choice of shareholders in selecting an audit firm;
- affect the quality of the audit as this could remove experienced personnel from an audit;
- be impractical given the size of Irish business and the concentrated nature of the auditing industry.

As outlined earlier the mandatory rotation of audit firms is not currently required in other EU Member States or in the US. The imposition of such a rule in Ireland could place additional costs on multinationals locating here and place Ireland at a competitive disadvantage. Overall, the Review Group considered that the introduction of mandatory auditor rotation could undermine the effectiveness of audits.

The Review Group then considered whether it would be desirable to introduce a mechanism which would periodically require companies to reconsider the audit contract in an open and transparent way. This could be achieved by requiring audit contracts be put out to tender after a fixed period. This could add a greater degree of transparency into the appointment of auditors and ensure that companies do not automatically renew the contract with an audit firm with which they have worked for long periods without considering alternatives. It would also introduce more competition into the market for audit services. However the Review Group questioned whether the advantages from mandatory tendering of audit contracts arising from the increased appearance of auditor independence would, in reality, be out-weighed by possible adverse affects on the quality of the audit.

In the opinion of the Review Group, the quality of the audit could be adversely affected by mandatory audit contract tendering for the following reasons:

- the downward pressure on audit fees arising from the competitive aspects of the tendering process could lead to a downward pressure on audit quality;
- mandatory tendering of audit contracts could provide a client company with a legitimate means of replacing an external audit firm that carries out its audit work to the highest professional standards (who in essence, asks the difficult questions) with a more ‘easygoing’ audit firm;
- evidence has shown that audit failure is more likely to occur in the first few years of an audit contract and audit tenders might exacerbate this problem.

In reaching a final conclusion on this complex topic the Review Group accepts that there is clearly a need for a more open and transparent process in the awarding of audit contracts. However the Review Group are unconvinced that introducing mandatory requirement on companies to send audit contracts out to tender would achieve this objective. In fact, in some circumstances, it could adversely affect audit quality.

On balance therefore the Review Group concluded a mandatory requirement on companies to put the audit contract out to tender should not be imposed. However many companies are expected to adopt such a practice on a voluntary basis when audit committees and Boards of Directors are considering the audit contract each year. The next Chapter (Chapter 13) considers how to strengthen the role and responsibilities of audit committees in a number of areas including the appointment of the auditor and setting the audit fee. The Review Group considers that the most appropriate body to determine whether to put the audit contract out to tender is the audit committee.

Recommendation 12.8

The audit contract should be awarded on an annual basis in an open and transparent manner. This should include consideration by audit committees on an annual basis whether to put the audit contract out to tender. The audit committee should justify its decision in its recommendation to shareholders on the appointment of auditors as outlined in Recommendation 13.4.

12.6 Review of Auditor Independence Framework

The Review Group recognises that ongoing developments may require changes to the framework approach to auditor independence recommended in this Report. In particular, the Review Group believes that after an implementation period of three years the Oversight Board should conduct a review of these auditor independence safeguards taking account of international developments and experience at national level in implementing the recommendations contained in this Report. This general review should also include an analysis of the effectiveness, or otherwise, of the operation of audit committees under the enhanced corporate governance structures outlined in the next Chapter.

In addition, the Review Group decided that there is a specific need for the Oversight Board to undertake a review of Recommendation 12.3. Once Recommendation 12.2 has been in operation for a number of years the Oversight Board will have available to it statistical data on the level of non-audit fees earned by audit firms from audit client companies. This information will allow the Oversight Board to evaluate the extent of the business relationships between audit firms and audit client companies in Ireland and to reach an informed judgement on whether the extent of this relationship compromises auditor independence.

Recommendation 12.9

The Oversight Board should undertake, within three years, a review of the level of non-audit fees and should make known its judgement as to whether or not any new rules are required to safeguard auditor independence.

12.7 Application of Recommendations

It is a well established principle in company law that the disclosure requirements on medium and small companies in relation to annual accounts are less onerous than those for larger private companies and PLCs. For example, Section 11(1) of the Companies Act 1986 allows medium sized companies to prepare short form profit and loss accounts in which certain items may be combined under one heading.

The Review Group accepted that in medium and small companies the relationship between the auditor and a company is somewhat different where individual auditors play an important role in providing expert business, taxation and accountancy advice on an ongoing basis to clients.

Under the Companies (Amendment) (No. 2) Act 1999 a further subset of small companies are now completely exempted from the requirement to have their annual accounts audited. Ireland's threshold limits for medium companies, small companies and for the audit exemption are considerably lower than the maximum allowed by EU law and those in operation in other EU Member States. For example, in the UK the audit exemption threshold limit has recently been raised to a turnover of £1 million sterling and the UK Government are considering a further move to a turnover of £4.8 million sterling in the light of the proposals of the UK Company Law Review.[69]

The Review Group supports the cautious approach taken by the Irish Government in introducing an exemption from having a statutory audit at relatively low levels. Nevertheless it does not want to place additional regulatory burdens on small and medium sized companies that would impose costs that could impact on their competitive position. Simplification of company law is the major task assigned to the Company Law Review Group (CLRG) in its first work programme (2000 –2002). Within this context it intends to review the need for a more user-friendly regime for small and medium sized companies, e.g. with regard to corporate governance. Therefore the Review Group does not want to start imposing additional regulatory burdens on small and medium companies at a time when national and EU policy appear to be moving in an opposite direction and lessening regulatory requirements on small and medium sized companies.

[69] Company Law Review Steering Group, Modern Company Law for a Competitive Economy, Developing the Framework (March 2000), page 281, para 8.28

Placing limitations on auditors providing non-audit services to small and medium sized companies could also have serious implications for the capacity of management in particular geographical areas where there may not be affordable, alternative sources of such advice.

The Review Group reviewed the recommendations contained in this Chapter from this perspective and decided that Recommendations 12.1, 12.2, 12.4, 12.6 and 12.7 should apply to small and medium sized companies. This is outlined in tabular format in **Appendix VIII.**

12.8 Conclusion

The Review Group is satisfied that the recommendations contained in this Chapter will significantly enhance auditors' appearance of and actual independence from audit client companies. Effective corporate governance and auditor independence rules at the forefront of best international practice will, in the opinion of the Review Group, ensure that Ireland's reputation as a reputable place to do business is enhanced and attract further high quality international investment to the State.

CHAPTER 13

Corporate Governance Structures and the External Audit

13 Corporate Governance Structures and the External Audit

13.1 Issues

This Chapter considers the second component in the framework for auditor independence - the development of effective corporate governance structures. Corporate governance structures within companies should, if effective, provide a means of ensuring that shareholders' rights and the public interest are protected even where a close business relationship exists between a company and its auditors.

13.1.1 DIRT Report

Under existing company law, it is the responsibility of the shareholders at AGMs to appoint auditors and approve auditors' fees. There are practical difficulties in shareholders playing an active role in carrying out their responsibilities. Consequently, auditors' fees and appointments are commonly agreed without debate at AGMs. Furthermore, AGMs may empower Directors to fix the auditors' remuneration and expenses. This means that, in reality, individual shareholders are not involved in determining auditors' fees. In most cases, audit fees are negotiated between audit firms and management who make recommendations to the Board of Directors. This can create a perception that an auditor's duty of care is to the management and directors, rather than to the company and its shareholders or to the wider public interest. Directors and/or management may not sufficiently value the external audit process. They may agree audit fees at inappropriately low levels that will not permit a sufficiently rigorous audit to be undertaken by the external auditors. External auditors may place greater importance on maintaining the more lucrative contracts for non-audit services with a client and may accept a lower fee for carrying out the audit, and the quality of the audit may reflect the fee.

It is suggested in the PAC's DIRT Report that the role of the management in agreeing/negotiating audit fees, and the close working relationship that evolved between the external auditor and management, contributed to certain banks' external auditors accepting non-disclosure of potential DIRT liabilities in the annual financial statements.

Auditors may be reluctant to challenge the views or the interests of management, for example, on items coming to light during an audit that could, if disclosed in the financial statements, adversely affect the overall reported financial position of a company. When such disclosures adversely affect the overall reported profit, and consequently dividends, shareholders may also prefer the auditor to accept non-disclosure. Examples of sensitive disclosures might include tax liabilities or contingent liabilities in respect of contested court cases. This can mean that in certain circumstances the general public interest and the specific interests of shareholders of a company may diverge in the short term.

However, as delays in accepting and reporting liabilities, which can be accumulating, can have an even more serious impact on a company than recognition from the outset, it is clear that it must be in the interests of both the company and the shareholders (other than short-term holders of the stock) that any liabilities arising are recognised as and when they are identified. This principle should be adhered to at all times.

13.1.2 Audit Committees

Best international practice would suggest that improvements in corporate governance, in particular enhancing and formalising the role of audit committees comprising a majority of non-executive directors, may provide a means of improving auditor objectivity. The theory is that audit committees act as a 'buffer' between management and the external auditor.

Audit committees are sub-committees of full Boards of Directors. Boards can delegate certain tasks to audit committees, in particular in relation to the external audit. However Boards retain responsibility for these matters. Audit committees comprising non-executive directors are, in theory, in a better position to adopt independent views and stances than full Boards of Directors on which management are represented.

13.1.3 Audit Committees: Weaknesses

The financial institutions referred to in the DIRT Report had audit committees. The Report raised serious questions concerning the effectiveness and influence[70] of audit committees in financial institutions, and their existence did not ensure that the banks were more compliant or the audit more effective.

International literature on the role and functions of audit committees emphasise the importance of audit committees comprising non-executive and therefore "independent" directors. The assumption that non-executive directors are, or indeed could be, completely independent does not in reality stand up. The nature of the relationship between non-executive directors and the company, the status associated with being a director of a large PLC, the process of appointment and directors' fees earned means that it would be difficult to consider any director to be completely independent.

Audit committees are expected to represent shareholders' interests. As such, they should provide some protection to shareholders' interests where there is a conflict of interest between shareholders and management. The role of audit committees in relation to protecting the wider public interest may not be as straightforward, in particular when the public interest appears to be in conflict with interests of shareholders. The negative impact of adverse disclosures (such as potential tax liabilities) on dividends, and possibly share values, as well as the adverse publicity, can be in direct conflict not only with management's and directors' interests, but also with the interests of shareholders at least in the short term. In summary the problem is that there may be a clash

[70] Public Accounts Committee; DIRT Report, Volume 1, page 144

between public interest disclosure compared with private interest non-disclosure. However audit committees should be aware at all times that current non-disclosure for short term gain could lead to a situation in the longer term where the impact of having to address the liabilities at a later stage could have more serious negative consequences for the company.

Audit committees are dependent on the information provided by management and may, at times, be briefed selectively by management. Management may in certain circumstances decide to suppress or delay the disclosure of important information to the audit committee.

As a consequence the mere existence of audit committees will not, in itself, ensure that the interests of the shareholders, and especially the general public interest, are protected in the interaction between the management of a company and the external auditors. The challenge therefore is to improve the effectiveness of audit committees in enhancing auditor independence. But audit committees, however effective, cannot be solely relied upon to secure auditor independence from management, to protect the public interest or to improve compliance if the external auditor is not prepared to tackle these issues.

13.1.4 US Blue Ribbon Committee[71]

The US Securities and Exchange Commission (SEC) set up a Blue Ribbon Committee in October 1998 to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process. This Committee was established in response to concerns of the SEC about the adequacy of the oversight of external audits undertaken by independent directors on audit committees. The Blue Ribbon Report made a number of recommendations on improving the operation of audit committees, some of which provided a useful model for the Review Group when considering how the effectiveness of audit committees could be improved in Ireland.

13.2 Current Regulations

13.2.1 Legislative Provisions

Currently there are no company law provisions concerning audit committees.

13.2.2 Stock Exchange Rules

Both the London and Irish Stock Exchanges[72] now require Directors of listed companies to state in their annual reports the degree to which they have complied with the UK Combined Code of June 1998. This Code which is appended to the Stock Exchange's Rules, sets out the most recent rules in relation to corporate governance that apply to PLCs in Ireland. The Code states that "*the Board should establish an audit committee of at least three directors, all non-executive with written terms of reference which deal clearly with its authority and duties.*" It goes on

[71] Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. Available through the website address: www.nasd.com

[72] Stock Exchange Listing Rules, January 1999, 12.34A

to indicate that the "*duties of the audit committee should include keeping under review the scope and results of the audit and its costs, effectiveness and the independence and objectivity of the auditors.*"[73] Consequently it is now normal practice for companies listed on the Irish Stock Exchange to have audit committees in line with the recommendation of the Combined Code. The period covered by the DIRT Report pre-dated the Combined Code recommendations on audit committees. This is not to suggest that the Combined Code in itself could have ensured that the problems revealed in this Report would not have arisen.

13.2.3 Auditing Standards

In a recent Briefing Paper[74] the Auditing Practices Board (APB) set out the role of audit committees as including:

- appraising and, where appropriate, challenging the actions and judgements of management as they relate to the financial reporting process;
- monitoring management's commitment to the establishment and maintenance of a control environment and a sound system of internal control;
- considering the adequacy of arrangements for external audit and supporting the independence and objectivity of the external auditors by:
  - (a) understanding the focus of the audit,
  - (b) facilitating discussion of audit findings,
  - (c) helping to resolve the differences of view between the management and the auditors,
  - (d) reviewing the nature and the extent of non-audit services,
  - (e) making recommendations in respect of the appointment of an auditor.

13.2.4 Ethical Guidelines

The ethical guidelines of the professional accountancy bodies do not deal with audit committees.

13.3 Strengthening Audit Committees

Arising from the discussion above and in order to formalise and strengthen the position of audit committees as an essential part of the corporate governance structures of companies, the Review Group considers that the establishment of audit committees should be required by legislation.

[73] Committee on Corporate Governance, The Combined Code, June 1998, page 23
[74] APB, Audit Briefing Paper, Communication between External Auditors and Audit Committees, June 1998

Recommendation 13.1

Boards of Directors of PLCs, financial institutions and public interest companies should be required by legislation to establish audit committees the membership of which is made up of non-executive directors.

13.3.1 Audit Committee Meetings

In order to ensure that audit committees are in a position to carry out their role in an effective and professional manner, they need to set out and agree a timetable for regular meetings. While the number of meetings of audit committees may depend on the size of the company and the topics under discussion, it is essential that the audit committee sets out at the beginning of each year a programme of meetings.

Recommendation 13.2

Audit committees should have regular meetings each year.

13.3.2 Audit Committee Charter

The Blue Ribbon Committee, referred to above, recommended that each audit committee have a written charter. The view of the Review Group is that an advantage of such a charter is that it clearly outlines its responsibilities and roles to the members of the audit committee at least on an annual basis. This charter would seem to go further than the Combined Code's written terms of reference as it appears to place additional emphasis on responsibilities, processes and relationships with the internal auditor, management and external auditors.

The audit committee would have to:

- review and reassess the adequacy of the audit committee charter on an annual basis;
- disclose in the company's annual report to its shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the previous year in compliance with its charter;[75]
- have the charter endorsed by shareholders.

Recommendation 13.3

Each audit committee should have a formal written charter, approved by the Board of Directors, that specifies the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements.

[75] Report and Recommendations of the SEC Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, page 13

13.3.3 Relationship between Audit Committees and External Auditors

Audit committee charters should cover audit committee responsibilities in relation to the external audit function, and following from this the audit committee should exercise these responsibilities more actively. Audit committees should have the authority and responsibility to select, evaluate and, where appropriate, replace the external auditors, or alternatively, to nominate external auditors for shareholder approval. The difference between the two alternatives is not significant, as normally shareholders approve the appointment of auditors and auditor fees, as recommended, without discussion at the AGM. This means that audit committees would, in practice, in both alternatives, be responsible for the appointment of auditors and setting of the auditor's fee. Although individual shareholders object rarely to the appointment of an auditor or to auditor's fees, nevertheless it is considered important by the Review Group that shareholders retain this right.

Recommendation 13.4

Shareholders should approve the appointment of auditors and set their fees, based on a recommendation from the audit committee rather than management as is currently the case. This should include a consideration on whether it is appropriate, or not, in any given year to change auditors or to send the audit contract out to tender as outlined in Recommendation 12.8.

Currently the accountancy bodies' ethical guidelines do not permit contingency fees in respect of audit work or in some cases in respect of "*professional services*"[76]. Contingency fees are where the amount of the fee paid to the audit firm is dependent on the result of work undertaken. Such methods of charging for non-audit work may also be perceived as a threat to objectivity and are therefore only permitted after careful consideration. The Review Group shares this concern and payment of an audit firm for audit or non-audit work by means of contingent fees is inappropriate in most cases. In the small number of exceptional cases, for example staff recruitment services, where contingency fees may exist, they should be disclosed and fully justified by management to the audit committee.

It is common practice for former employees of audit firms to gain employment in audit client companies. This should not compromise auditor independence in the case of relatively junior or middle ranking positions particularly given that many accountants are trained in and therefore employed by the larger accountancy firms at the early stages of their careers. But the Review Group recognises that it can cause difficulties in a situation where a significant number of senior management positions such as CEO, Finance Director and the Internal Auditor within a company are all taken up by former employees of the audit firm. The audit committee should review senior appointments to the top management of the company. If a number of senior managers were

[76] CPA, Handbook 2000, Code of Professional Ethics, Conduct and Practice, para 8.8

previously employed by the audit firm the audit committee should examine the impact on auditor independence from the existence of this close business relationship and if necessary propose that a new audit firm be engaged.

Recommendation 13.5

In its charter, the audit committee should be given the following responsibilities:

- **ensuring receipt from the external audit firm of a formal written statement outlining all current and relevant previous business and personal relationships between the audit firm and the company;**
- **for actively engaging in a dialogue with the audit firm so that all relationships that may impact on the objectivity and independence of the auditor are fully disclosed;**
- **approving the procedures for the appointment of the audit firm to provide any non-audit services;**
- **assessing and approving in advance all contracts with the audit firm having regard to all business and personal relationships between the company and its audit firm;**
- **monitoring the number of former employees of the audit firm currently employed in senior positions in the company and assessing its impact on auditor independence;**
- **reviewing the audit firm's statement concerning their general policy to risks to independence (see Recommendation 12.7);**
- **approving in advance any contracts with the audit firm payment of which will be made on a contingency basis.**

The auditor should discuss with the audit committee, and a representative of financial management, adjustments, management judgements and accounting estimates, significant new accounting policies and disagreements with management.

Recommendation 13.6

Audit committees of companies should meet their external auditor a number of times each year, both in the presence of management and independent of management. Such meetings must be held at both the planning stage of the audit and following the completion of the audit.

13.3.4 Management Letters

Auditing standards require auditors to consider whether matters which have come to their attention during the audit should be included in a report to Directors or management. Specifically, auditors are required to report material weaknesses in the accounting and internal control systems in writing to the Directors, the audit committee or an appropriate level of management on a timely basis. Given the importance of these management letters, the Review Group believes that the protocols around the issuing and timing of them should be strengthened. Management letters should also be made available as soon as possible to the audit committee, preferably in advance of the approval of the financial statements.

Recommendation 13.7

Management letters from auditors to the Board of Directors should refer to the existence of any other audit related letters (e.g. letters of detail) and should make these available to the Board and the audit committee on request.

Management letters should be available to the Board and the audit committee in advance of approval of the financial statements. Given the tight reporting deadlines, a preliminary draft containing all issues but possibly excluding some management responses is acceptable.

Audit committees should establish a time frame within which management responses should be received in respect of management letters, internal audit reports and any other audit related letters (e.g. letters of detail).

13.3.5. Relationship between Audit Committees and the Internal Auditor

Responsible financial reporting is derived in large part from an effective system of internal controls. Management is responsible for the system of internal controls. Internal auditors should be in a position to evaluate and report on the adequacy and effectiveness of those controls and processes. In companies with an internal audit function, the internal auditor can play "*a significant role in working with management, the outside auditor and the audit committee in ensuring the effectiveness of internal controls and in bringing any weakness to the attention of the appropriate parties*".[77] Internal audit is, therefore, a key element in corporate governance.

[77] Report and Recommendations of the SEC Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, page 29

One of the roles of internal auditors is to assess risks that would impact negatively on a company's ability to achieve its business objectives. Risks arising in areas such as the reliability of IT systems, the adequacy of human resources and the clarity of strategy are potential subjects for internal audit review. The internal audit function should encompass those activities which attempt to ensure the accomplishment of the organisation's objectives and goals.

The primary objectives of internal control are to ensure:

- the reliability and integrity of information;
- compliance with policies, plans, procedures, law and regulations;
- the safeguarding of assets;
- the economical and efficient use of resources;
- the accomplishment of established objectives and goals for operations or programmes[78].

This definition encapsulates the broad approach to internal control which considers all of an organisation's operations, not just those which are finance orientated.

The Review Group recognises that in practice there can, in certain circumstances, be tensions between the application of a common set of auditing standards for internal auditors and the internal auditor's role in assisting Directors discharge their responsibilities. However the Review Group's opinion that the role of internal auditors would be enhanced and strengthened if there was a consistent set of common standards developed for and applied to the internal audit profession.

The internal auditor occupies a unique position as an employee, who at the same time is expected to review the conduct of management. The Review Group recognises that this is a difficult role that can create significant tension, in particular, where issues relating to lack of compliance or irregularities come to light as a result of the internal auditor's work.

Recommendation 13.8

All PLCs, financial institutions and public interest companies should have a properly resourced internal audit function set up independently of management and the external auditor.

[78] The Institute of Internal Auditors, Standards and Guidelines for the Professional Practice of Internal Auditing

The internal auditor's independence from management is necessary for the internal auditor to objectively assess management's actions. However, it is clear that the internal auditor is dependent on management for continued employment and advancement. Recognising this tension, it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee.

The Review Group considers that formal mechanisms between the internal auditor and the audit committee should in practice mean that:

- there are regular meetings between them without management present;
- work plans of the internal auditor, and any reports on significant matters, should be submitted to and approved by the audit committee;
- if the internal auditor identifies a problem that in his judgement management is unwilling to deal with, the internal auditor has a duty to disclose this information to the audit committee;
- discussions on significant or important issues by the internal auditor with the audit committee.

Recommendation 13.9

Audit committees should meet the internal auditors regularly at times without management present.

Recommendation 13.10

The internal auditor's appointment should be endorsed by the audit committee and internal audit reports to the Board and to the audit committee should be retained for six years.

The Review Group considers that following implementation of these recommendations it will be clear that internal auditors should report to audit committees and ultimately the Board of Directors rather than management.

13.3.6 Relationship between the External Auditor and the Internal Auditor

In most cases the internal auditor no longer performs work similar to the external auditor. However the external auditor should make use of the work of the internal auditor and the internal auditor's output should be considered by the external auditor who decides whether and to what extent reliance can be placed on the conclusions and the work of the internal auditor.

Recommendation 13.11

Internal audit programmes, and all internal audit reports and findings, should be made available to the external auditor at the earliest possible opportunity.

13.3.7 Audit Committees: Reports

At present the audit committee of a company reports to the company's Board of Directors. The audit committee should also make a written report to the shareholders in the company's annual report. The Review Group considers that the audit committee's report should disclose whether or not with respect to the period covered by the report:

- Management has reviewed the audited financial statements with the audit committee, including a discussion of:
  - (a) the appropriateness of the accounting principles and accounting standards as applied,
  - (b) significant judgements affecting the company's financial statements, and
  - (c) compliance by the company with tax obligations and other relevant statutory requirements;
- External auditors have reviewed with the audit committee, without management present, the external auditors' judgements of the appropriateness of those policies and accounting standards as applied and compliance by the client company with company law, tax obligations and other relevant statutory requirements;
- The audit committee has itself discussed, without management or the external auditor present, all information available to it relevant to the financial statements and compliance by the company with tax obligations and all other relevant statutory requirements. The audit committee's view on the company's compliance with its statutory obligations should inform the Board of Directors' report to shareholders on compliance with statutory obligations as recommended in Recommendation 14.1.

Where an audit committee is not satisfied with the treatment of any of the above issues in the annual report then they should bring their dissatisfaction initially to the attention of the Board of Directors and, in the absence of a satisfactory resolution by the Board of Directors, to the attention of the shareholders.

The audit committee's report should highlight any differences of opinion that arose with the Board or with management in relation to the external audit.

Recommendation 13.12

Audit committees should prepare an annual report for presentation to the shareholders. This should include their view on the Directors' compliance report. (Recommendation 14.1)

13.4 Implementation

The Review Group considers that the requirement for PLCs, public interest companies and financial institutions to establish audit committees comprising of non-executive directors should be set out in legislation.

In small and medium companies with a smaller number of Board members and more limited resources at their disposal it is not necessary for the full Board to set up a separate audit committee. For these categories of companies the recommendations contained in this chapter should be recognised as best practice in corporate governance that the full Board of Directors should, where relevant, adopt.

Recommendation 13.13

The above recommendations concerning the duties of audit committees and their relationships with external auditors and internal auditors should be set out in legislation for PLCs, financial institutions and public interest companies.

CHAPTER 14

Compliance with Statutory Provisions: The Role of the External Auditor

14 Compliance with Statutory Provisions: The Role of the External Auditor

14.1 Issues

The establishment and operation of companies is governed by a legal framework set out in company law. This framework defines the rights and obligations placed on companies and on those involved in running companies, i.e. Directors, shareholders and company managers. In addition, tax law contains a range of provisions particular to the treatment of the corporate sector while financial institutions are covered by an additional regulatory framework supervised by the Central Bank.

The existing body of legislation places obligations on external auditors in relation to compliance with law and regulations most notably in:

- Company Law provisions relating to the form and content of company financial statements;
- Taxation Law provisions, where auditors become aware that non-compliance has occurred and no corrective action has been taken;
- Central Bank legislation, where auditors become aware of matters of significance to the Central Bank

The Company Law Enforcement Bill published on 3 July 2000 will, if enacted, impact on the approach auditors take to compliance issues within companies.

Obligations imposed on companies by legislation directly influence the financial accounts as compliance, or otherwise, with such legislation can impose costs on a company. In addition, while some elements of the legislation involved may not impose specific examination and reporting obligations on external auditors, failure to comply with such legislation may be such that the financial effect is material to the financial statements on which auditors report. A failure by the directors to provide for the financial consequences of non-compliance, or to disclose appropriate information concerning any potential liability should lead, to auditors qualifying their opinion on the financial statements concerned.

Given the lack of compliance among a number of financial institutions with the legislation requiring collection and payment and DIRT and the fact that the external auditors of these financial institutions were apparently aware of this lack of compliance the PAC DIRT inquiry report questioned the role of the external auditors in ensuring compliance with statutory provisions.

14.2 External Auditors: Statutory Reporting Requirements

14.2.1. Company Law

The principal responsibilities of auditors derive from the Companies Acts 1963 to 1999. Auditors have a statutory responsibility to report to the shareholders whether in their opinion the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Acts. They are also required to report to the members:

- whether proper accounting records have been kept by the company;
- whether the company's balance sheet and profit and loss account are in agreement with the books of account;
- whether they have obtained all the information and explanations which they consider necessary for the purpose of their audit;
- whether the directors' report is consistent with the financial statements; and
- whether a "*financial situation*"[79] requiring the convening of an extraordinary meeting exists.

Section 194 of the Companies Act, 1990 requires the auditor to report to the Directors and ultimately to the Companies Registration Office if proper books and records are not maintained and if no corrective action has been taken.

Section 185 of the 1990 Act also requires a resigning auditor to send to the Registrar of Companies either a statement of reasons for the resignation which he considers should be brought to the notice of the company's members or creditors or a statement that there are no such reasons.

The recently published Company Law Enforcement Bill, 2000, will if enacted give effect to the recommendations dealing with auditors responsibilities in relation to company law contained in the "McDowell" Report on Company Law Compliance and Enforcement (published in March 1999). This Bill also proposes to transfer the Minister's functions in relation to investigations under Part 2 of the Companies Act, 1990 to the new statutory office of the Director of Corporate Enforcement. The Office of the Director of Corporate Enforcement will, once established, also seek to address key issues in relation to improving compliance with statutory provisions by both Directors and auditors.

The provisions of this Bill impose additional reporting requirements on auditors, in this instance to the Office of the Director of Corporate Enforcement.

[79] Determined by reference to whether the net assets of the company as stated in its balance sheet are less than half of the amount of its called-up share capital.

These are:

- The reporting requirement currently imposed on auditors under section 194 of the Companies Act, 1990 concerning the failure of a company to keep proper books of account will be extended to provide,
  (a) that auditors will be required to provide information relevant to the failure to keep proper books of account to the Director of Corporate Enforcement,
  (b) that auditors will be required to report to the Director instances of suspected breaches of other provisions of the Companies Acts which come to their notice,
  (c) that auditors will be required to report suspicions that a company is being used for a fraudulent purpose or that the directors are defrauding the creditors, members, etc. to the Director and the Gardaí.
- Recognised accountancy bodies will be required to report to the Director where a disciplinary committee of the body has reasonable grounds for believing that a member may have committed an indictable offence under the Companies Acts.

14.2.2 Taxation Laws

Auditors consider tax liabilities of client companies in the context of forming an opinion on the financial statements as a whole. As taxation liabilities generally represent a significant factor in the financial position of a company an external audit includes a review of the tax liabilities disclosed in the financial statements and, in particular, whether these liabilities represent the full amount due in the context of giving a true and fair view of the financial statements. Therefore the work of auditors impacts directly on issues relating to tax compliance and is integral to the operation of the tax system as it affects business.

In addition to the general necessity to review tax liabilities in the course of audits Section 1079 of the Taxes Consolidation Act, 1997 (originally enacted as Section 172 of the 1995 Finance Act) imposes certain obligations on an auditor (or a tax adviser) in circumstances where the auditor becomes aware of material tax offences during the course of his work. Specifically, the auditor (or adviser) is required to draw the attention of the company to the offences and request the company to rectify the situation or to report the offences to the Revenue Commissioners within six months. If the company fails to do so the auditor is obliged to cease as auditor and not to act as auditor for the company concerned for 3 years, or until the matter has been rectified. An auditor who is required to resign under the provision must notify the company of the resignation and copy the notification to the Revenue Commissioners.

14.2.3 Central Bank Acts

In addition the current legislation provides that the Central Bank, as the regulator of financial institutions, receives certain information from external auditors and gives the Central Bank certain legal powers in relation to the external audit of financial institutions.

Auditors of financial institutions have a statutory duty to report to the Central Bank in certain specified circumstances. These are:

- Section 47(1) of the Central Bank Act, 1989, requires a bank auditor to report to the Central Bank in writing without delay where, arising from his/her audit work:
  - (a) he/she has reason to believe there exist circumstances likely to affect the bank's ability to fulfil its obligations to depositors;
  - (b) he/she has reason to believe there are material defects in the financial systems and controls or accounting records;
  - (c) he/she has reason to believe there are material inaccuracies in or omissions from any returns of a financial nature made to the Central Bank;
  - (d) he/she proposes to qualify any certificate which he/she is to provide in relation to financial statements or returns under the Companies Acts or the Central Bank Acts;
  - (e) he/she decides to resign or not seek re-election as auditor.
- Regulations 7 and 8 of S.I. No. 267 of 1996 (the Post-BCCI Directive) impose a duty on the auditor of a financial institution to communicate to the Central Bank any fact or decision of which he becomes aware while conducting an audit which:
  - (a) is liable to constitute a material breach of the laws, regulations or administrative provisions; or
  - (b) is liable to affect the continuous functioning of the financial undertaking;
  - (c) is liable to lead to a refusal by the auditor to certify the accounts or to the expression of reservations by the auditor.

The Central Bank has the power to request information and reports such as:

- Under Section 47(2) of the Central Bank Act, 1989 the Central Bank has the power to request the external auditor of a financial institution to furnish to the Central Bank a report stating, whether in his opinion and to the best of his knowledge, the financial institution has or has not complied with a specified obligation of a financial nature under the Central Bank Acts. If an auditor refused to co-operate, the Central Bank could impose a condition on the licence holder under Section 10 of the Central Bank Act, 1971 as amended,

to require the financial institution to co-operate or it could use its powers under the Central Bank Act, 1989 (Sections 36 and 47) to directly request reports from the auditor. In this case the Central Bank would probably be obliged to pay the auditor's fees.

- Under Section 47(5) of the Central Bank Act, the Central Bank has the power, whenever it is of the opinion that the exercise of its functions under the Central Bank Acts or the protection of the interests of depositors so requires, to require the auditor of a financial institution to supply it with such information as it may specify in relation to the audit of the business of the financial institution.
- Under Section 17 of the Central Bank Act, 1971 as substituted by Section 36 of the Central Bank Act, 1989 the Central Bank can carry out on-site inspections of financial institutions. In practice these inspections are carried out by the Central Bank's examiners[80] but the Central Bank has the power to appoint "*an appropriate person duly authorised in writing in that behalf by the Governor of the Central Bank ("an authorised person....") for the purpose of the performance by the Central Bank of its statutory functions*". Thus an external auditor could be appointed as 'an authorised person' to carry out a theme investigation or such other work as the Central Bank considers necessary for the purpose of the performance by the Central Bank of its statutory functions.

In addition Regulation 19 of Statutory Instrument No. 395 of 1992 which implemented in Ireland the Second Banking Co-ordination Directive permits the Central Bank to communicate with the auditor of a regulated entity but only if the Central Bank is satisfied that the auditor has obligations in regard to professional secrecy or non-disclosure of information corresponding to obligations imposed in the Central Bank Acts.

14.2.4 Other Legislation

The Insurance Act, 1989, the Trustees Savings Act, 1989, the Building Societies Act, 1989, the Investment Intermediaries Act, 1995 and similar legislation also require the auditor to report, in specified circumstances, to the Regulators of these industries.

The Whistleblowers Protection Bill, 1999 currently being enacted provides protection from civil liability to employees who make certain disclosures "reasonably and in good faith" in relation to the conduct of the business and affairs of their employers. The Bill also prohibits penalisation of employees by their employers in such circumstances. As such this Bill, if enacted, may have implications for internal auditors rather than external auditors.

[80] The practice in Ireland is different to that in the UK. The Financial Services Authority (FSA) requires banks to commission reports under Section 39 of the Banking Act, 1987 from "reporting accountants", who may be the external auditors, on aspects of their business. These generally act as a substitute for on-site inspections.

14.2.5 Auditing Standards

Auditing standards relevant to this issue are set out in Statement of Auditing Standard No. 120 "*Consideration of Law and Regulations*" (SAS 120) issued in 1995.

When developing SAS 120, the APB sought to achieve a balance between meeting the expectations of some regulators and users of financial statements who thought that an objective of an audit was to detect all contraventions of law and regulations and what was realistic for auditors to achieve in the context of an audit of financial statements.

SAS 120 establishes:

- a responsibility on auditors to obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in, the financial statements;
- a requirement for auditors to perform certain procedures to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the continuance of its activities (SAS 120.3);

The commentary contained in SAS 120 states that the auditor is not required to plan and perform other procedures to identify possible instances of non compliance with law or regulations other than those that impact on the financial statements, because to do so would be outside the scope of an audit of financial statements. However, the SAS requires that auditors:

- remain 'alert' for instances of actual non-compliance with other law or regulations which might affect the financial statements;
- if they become aware of an actual or potential breach of any law or regulations, evaluate its effect on the financial statements and determine appropriate reporting of the issue, including whether the matter is such as to require a report to be made to an appropriate authority.

Confidentiality is an implied term of the auditors' contract and this can constrain auditors from communicating their suspicions regarding possible contraventions of law and regulations to third parties. Auditors would not be justified, or protected in law, disclosing non-compliance to a third party, unless the third party concerned is an appropriate person/organisation to whom/which to report the matter.

Auditors need to obtain sufficient audit evidence to give reasonable assurance that the financial statements are not materially misstated. In carrying out their work on the audit of financial statements, auditors recognise that material misstatements may arise from non compliance with

law or regulations. Auditing standards require that "*auditors should obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of or the inclusion or disclosure of specific items in, the financial statements*". (SAS 120.2)

Breaches of law are often related to fraud. APB has issued Statement of Auditing Standard 110 "*Fraud and Error*". This standard points out that it is the responsibility of the Directors to take reasonable steps to prevent and detect fraud. The standard requires auditors to assess the risk that fraud and error may cause material misstatement in the financial statements and to design and undertake procedures that have a reasonable expectation of detecting such misstatements.

APB has developed a consultation paper "*Fraud and Audit: Choices for Society*" to address issues in relation to the auditor's role in identifying fraud. The paper sets out a number of issues relating to the benefits of placing greater responsibilities on auditors to find and report instances of fraud, and discusses the practical issues that militate against discovery of fraud in the course of a financial statement audit. It has identified that increased detection and prevention of fraud is possible but requires some additional procedures, increased time and increased cost.

14.2.6 Ethical Guidelines

The Ethical Guidelines of the professional bodies do not make reference to the role of the external auditor in ensuring compliance with statutory provisions. However rules of professional conduct include provisions relating to the discovering of non-compliance by a client[81].

14.2.7 Level of Reporting by External Auditors

It is clear from the above, albeit non exhaustive list, that there is a range of statutory provisions and professional standards establishing how external auditors should deal with non compliance with statutory provisions.

The Review Group considered the level of actual reporting by auditors under the statutory provisions mentioned above and noted the following:

14.2.7.1 Company Law

Chapter 5 (Table 5.1) details the number of notifications to the Registrar of Companies from 1995 to 1999 from auditors under section 194 of the Companies Act, 1990 where an auditor formed the opinion that specified companies were contravening or had contravened Section 202 (that proper books of account had not been kept). In 1999 the Registrar of Companies received 11 such notifications.

[81] ICAI Handbook, Miscellaneous Legal Ethical and Practical Guidance Statement P5 'Unlawful acts or defaults by clients or members'.

In addition in that year the Registrar of Companies received 689 notifications under Section 185 (resignation of auditor) of the Companies Act, 1990 where an auditor gives either a statement of reasons for his resignation which he considers should be brought to the notice of the company's members or creditors or a statement that there are no such reasons.

14.2.7.2 Taxation Law

No reports have been received by the Revenue Commissioners under obligations imposed on external auditors who have become aware of material tax offences. Yet the Revenue Commissioners discover irregularities in the affairs of companies the financial statements of which have been audited by an external auditor. This raises the question of whether there was wilful non-compliance with Section 1079 of the Taxes Consolidation Act 1997.

14.2.7.3 Central Bank Acts

While the Central Bank has received a number of reports under Section 47 of the 1989 Act none of these highlight material weaknesses as they mainly relate to the resignation of an auditor.

14.2.8 Review Group's Assessment of Record of Reporting by Auditors of Non-Compliance with Statutory Obligations

The Review Group considers the degree of reporting by external auditors under the above specific pieces of legislation as extremely low.

This may be as:

- the level of reporting accurately reflects the degree of non compliance among companies;
- an external auditor seeks to work with a client company to ensure greater compliance in advance of an audit report being completed by using, as a threat to a company, the possibility of a qualified audit report on their obligation to report to relevant authorities;
- some auditors may be unaware of their statutory obligations;
- neither the Directors of non compliant companies nor their external auditors take their obligations under various statutory provisions or the professional standards that deal with these issues with sufficient seriousness.

Given the findings of the PAC DIRT inquiry report and other revelations emerging from Tribunals it is clear that non compliance by companies with their statutory obligations is more widespread than previously envisaged. The Review Group acknowledges that, in many cases, auditors may prefer to work with their clients in promoting better compliance. However the Review Group considers that it is likely that some auditors are failing to respect their statutory obligations.

14.3 Strengthening the Role of the External Auditors in Companies' Compliance with Statutory Provisions

Compliance with statutory provisions is the responsibility of a company's management and ultimately the Board of Directors. However delineated, the auditor's role cannot take the place of that played by Directors of entities, who have prime responsibility in law for direction of the entity's activities and their compliance with the law, or of the Revenue Commissioners who have the powers to enforce collection of taxes or other State authorities. It is not the intention of the Review Group to dilute the responsibilities of Directors.

In addition, given that the primary purpose of an audit is to express an opinion on the financial statements, its focus in relation to compliance would generally be on non-compliance with law and regulations where the financial impact is material to the company's financial statements. To expect that an audit could uncover all instances of non compliance would require a significant extension of the scope of the audit and consequently involve considerable extra cost. Therefore the Review Group accepts that without a fundamental shift in the scope and nature of the audit, it cannot, in itself, ensure full compliance with all statutory provisions.

While the Review Group was anxious to strengthen the role of auditors in relation to compliance with statutory obligations, it felt that this should be achieved in a balanced manner that would not impose significant additional costs on companies.

Imposing a requirement on Boards of Directors to make a positive statement regarding compliance will emphasise to members of Boards the importance of their role and responsibilities in this regard. Boards may also be more reluctant to unquestioningly accept management's views on compliance where they are aware that their statement will be the subject of a report from external auditors. This Recommendation should therefore ensure that Directors take additional steps to ensure that the company conducts its affairs in a responsible manner in particular in relation to its compliance with law and regulations. The Review Group decided that because of the potential adverse consequences on a business and as non-compliance could, for example, be due to the negligent action of an employee the Directors' report should not have to disclose the detail of where and how non-compliance arose during the year. The Directors' report should confirm that the company has complied with statutory provisions and, in the event of non-compliance, that such non-compliance has been reported to the relevant statutory authority.

The Review Group considered that non-compliance which the auditors are aware of and which has not been dealt with in the Directors' compliance report should be reported to the shareholders by the auditors. The Review Group considered that the auditors should review the directors' compliance report and report to the shareholders whether

in their view the Directors' report is reasonable. The auditors, in making this report, should address any instances of non-compliance, or suspected non-compliance, that they are aware of. If these have not been dealt with in the Directors' report details should be given by the auditors in their report.

By imposing a requirement on Directors to report in the event of non-compliance to the Revenue Commissioners in the case of tax issues and to the proposed Director of Corporate Enforcement in the case of company law matters gives Directors a clear understanding of what is expected of them when they become aware of non-compliance with statutory requirements.

Recommendation 14.1

Directors of a company should be required to report on an annual basis to the shareholders on the company's compliance with its obligations under company law, taxation law or other relevant statutory or regulatory requirements. The report should confirm that any instances of non-compliance have been reported to the relevant regulatory authority and that in all other respects the company has complied with its obligations under company law, taxation law and other relevant statutory or regulatory requirements. The report should be appended to the annual financial statements.

Detailed guidance on the application of this Recommendation will be required. All relevant parties should be consulted to identify regulations and administrative provisions considered to be relevant in advance of enactment of legislation.

Recommendation 14.2

The external auditors should report as to whether, in their opinion, the Directors' report of the company's compliance with its obligations is reasonable.

- **In making their report, the auditors should specifically address whether the directors have made appropriate disclosure concerning any circumstances of which the auditors are aware that give reasonable grounds to believe the company has not, or may not have, fulfilled its obligations.**
- **Where in the auditor's opinion such circumstances have not been so disclosed by the directors, and the directors have not amended their report, the auditors should include relevant information in their report.**

The report should be appended to the annual financial statements.

The Review Group also considered what should happen in the situation where Directors fail to issue a compliance report. This may be for justifiable or minor reasons, for example where differences of opinion have arisen among Directors, or it may be as Directors are aware of instances of non-compliance that they do not wish to report. The Review Group considered that the external auditor should be obliged to report to the Director of Corporate Enforcement on the Directors' failure to report. In this report, the external auditor could outline whether there is a reasonable explanation, or otherwise, for the absence of a Directors' compliance report. The Director of Corporate Enforcement should be able to impose fines, where necessary, on companies where Directors' compliance reports have not been issued.

Recommendation 14.3

In situations where the Directors have not issued the report referred to in Recommendation 14.1 within a specified timeframe then the external auditors will have a duty to report that failure to the Director of Corporate Enforcement.

14.4 On-going Professional Training for Auditors on Compliance Issues

The Review Group has already suggested that one of the possible reasons given for the low level of reporting by external auditors to statutory authorities under various Acts is the lack of awareness among some auditors of their obligations. The Review Group considers that there is clearly a need for auditors to undergo continuing professional education in relation to auditors' roles and responsibilities under company law and other relevant statutory provisions as outlined in this Chapter. Aside from such periodic training, the recognised accountancy bodies should continue to inform their members of relevant statutory changes as they arise.

The need for all auditors to be fully up to date with existing and new obligations under the various legislative provisions will be further underlined when Recommendations 14.1 to 14.3 are implemented requiring auditors to make a judgement on the soundness, or otherwise, of the Directors' compliance report. The effectiveness of these recommendations could be undermined, if in practice, auditors are unaware of both companies' obligations under law as well their obligations as auditors.

Recommendation 14.4

As part of the continuing professional development programme for their auditing members, each of the recognised accountancy bodies should include refresher courses on auditors' statutory obligations under the Companies Acts (including the additional obligations outlined in Recommendations 14.2 and 14.3) and similar legislation and on their duties under the body's code of ethics.

14.5 Implementation

The Review Group considers that these recommendations should be enshrined in legislation and should apply to all companies. The view of the Review Group is that these recommendations should, where relevant, even apply to those companies not now required to have a statutory audit. Of course Recommendations 14.2 and 14.3 will not apply to those companies who decide to avail of the exemption from statutory audit.

In addition, the Review Group noted that some of the provisions of the Company Law Enforcement Bill, 2000, will, when enacted, impose significant new obligations on external auditors which were not in place during the period covered by the PAC DIRT Inquiry Report.

The Review Group considers that the combined impact of these new provisions and the implementation of its recommendations should help deliver an environment where compliance with statutory requirements is the norm.

In practice the effectiveness of these recommendations should be strengthened if the recommendation in Chapter 8 to establish a financial review panel, on an ad hoc basis, under the Oversight Board to investigate material departures in financial statements from accounting standards is implemented.

CHAPTER 15

The Audit Of Financial Institutions

15 The Audit Of Financial Institutions

15.1. Issues

15.1.1 Dirt Report

The previous chapter sets out the Review Group's considerations and recommendations in relation to the role of auditors regarding compliance with statutory provisions. All of those recommendations relate to financial institutions. The DIRT PAC inquiry report[82] contains a number of specific recommendations regarding the interrelationship between external auditors and the Central Bank as the regulator of financial institutions that the Review Group considers in this chapter.

Given their key role in the economy, financial institutions are subject to a particular regulatory regime in addition to company law and other statutory regulations. In the context of this regime the work done by auditors can form an important resource to the regulator. This chapter sets out and assesses the role of the auditor in relation to financial institutions, and their regulatory framework. Based on this assessment this chapter contains a number of recommendations for improvements.

In October 1998 the Government agreed in principle to the establishment of a Single Regulatory Authority (SRA) for the financial services sector. It is recommended by the Implementation Advisory Group that all financial services providers should, in principle, be supervised by the SRA. The Review Group considers that both the commentary and the recommendations contained in this chapter apply to all financial institutions[83] whatever body is responsible, in the future, for their regulation.

15.2. Current Regulations

15.2.1 Auditing Standards

The Statement of Auditing Standards (SAS 620) on the "*Auditors' Rights and Duty to Report to Regulators in the Financial Services Sector*" (1994) establishes standards and provides guidance on the circumstances in which external auditors of financial institutions are required to report directly to a regulator, information which comes to their attention in the course of the work undertaken in their capacity as the external auditor of the regulated entity.

The Auditing Practices Board (APB) view is that it is not desirable to issue auditing standards restricted to the audit of financial statements of a particular industry and it has not identified any specific issues that would justify additional standards[84]. Industry specific standards could also lead to more detailed procedural standards that the APB does not favour. However, the APB has issued guidance in the form of Practice Notes concerning the application of auditing standards to the audit of financial institutions.

[82] Public Accounts Committee; DIRT Report, Volume 1, Part VII, Chapter 17, Section 3

[83] While the legislation will have to define precisely what constitutes a financial institution it should include the following: credit institutions, insurance undertakings, investment firms, moneybrokers, stockbrokers, credit unions, exchanges and IFSC entities. There are a number of small financial entities (for example, retail investment intermediaries and insurance intermediaries, small credit unions) which fall into the small business category. The degree to which the recommendations in this Chapter apply to these smaller financial entities has to be examined further.

[84] APB's submission to the Review Group, page 7

The most recent APB publication in relation to financial institutions is APB Practice Note No 19 on Banks in the UK published in May 1999.

Practice Note 19 contains guidance on:

- auditors' rights and duty to report to the Financial Services Authority (FSA) in its capacity as banking regulator in the UK;
- reports under Section 39 of the UK Banking Act 1987 where the FSA can require a bank to provide reports additional to the audit;
- trilateral and bilateral meetings between financial institutions, auditors and the FSA.[85]

The UK Practice Note Number 19 replaced earlier guidance on this topic. In Ireland such earlier guidance dating back to 1992 is still in place. While some very preliminary discussions have taken place concerning the development of an Irish version of Practice Note 19, the Review Group was surprised at the lack of progress made by the accountancy bodies in developing an Irish version of this Practice Note.

Nevertheless some of the guidelines contained in Practice Note 19 are already being used by some audit firms and the Central Bank. For example the Central Bank has recently started a programme of systematic communication with external auditors of credit institutions with the prior consent of the institutions. It holds a meeting with the external auditor either with the financial institution (trilateral) or without the financial institution (bilateral) as it deems appropriate, to discuss matters of mutual interest.

15.2.2 Ethical Guidelines

The ethical guidelines of the professional bodies recognise that the objectivity of an auditor may be threatened or appear to be threatened by a loan to or from an audit client to the external auditor and such loans are therefore not permitted. However overdrafts, loans and home mortgages from an audit client financial institution to partners or members of staff employed by the external audit firm granted in the normal course of business are permitted, provided the partner is not the engagement partner in relation to the client.[86] Larger international accountancy firms may in practice apply stricter rules than those set by the professional bodies in relation to the provision of loans, etc. from audit clients in order to meet US SEC requirements.

Similarly Section 10.3(iii) of the Central Bank's Licensing and Supervision Requirements and Standards for Credit Institutions requires that a credit institution shall not grant an advance or credit facility to its audit engagement partner.

[85] In addition to Practice Note 19, the APB has issued Practice Notes containing equivalent guidance for auditors of UK building societies (Practice Note 18), insurance companies (Practice Note 20) and investment businesses (Practice Note 21).

[86] See for example ICAI Handbook, Part C, Page 9

15.2.3 Central Bank's Role as Regulator

The Central Bank is responsible for the supervision or regulation of a broad spectrum of financial entities ranging from some of the world's largest international banks to very small investment intermediaries, almost all of which are subject to audit by external auditors. The total number of financial institutions is of the order of 1,040 as set out in the following table.

Table 15.1 Number of Financial Institutions

Type	No
Credit Institutions *(i.e. banks and building societies)*	82
IFSC Entities	257
Finex Related Entities	81
The Stock Exchange	1
Stockbrokers	14
Investment Intermediaries	592
Moneybrokers	6
Approved Professional Bodies[87]	5

The Central Bank is also responsible for the authorisation and on-going supervision of collective investment schemes. At the end of 1999 collective investment schemes authorised by the Central Bank numbered 784 (1,996 including sub-funds).

A recent report by the Comptroller and Auditor General divided financial regulation into three types of supervision.

These are:

- *'Prudential supervision aims to establish that financial institutions comply with a set of rules designed to ensure their continuing solvency and liquidity. The rules cover prudential and financial stability, internal control arrangements and corporate governance.*
- *Systemic supervision aims to establish that risks to the financial system as a whole are minimised.*
- *Conduct of business supervision aims to establish that there is a degree of protection for depositors with credit institutions and clients of investment firms. Aspects of conduct of business supervision dealing with consumers of financial services are not within the statutory mandate of the Central Bank.'*[88]

The enactment in 1995 of legislation to counter money laundering has increased the scope of regulation of financial institutions.

[87] The Central Bank has approved these bodies (which are generally accountancy bodies) to regulate their members who provide investment intermediary services. Approximately 1,000 Irish members of these bodies provide investment intermediary services.

[88] Comptroller and Auditor General, Report on Evaluation and Effectiveness; Central Bank Financial Regulation, December 1999, Summary, Page ii

In order to fulfil its obligations as a regulator the Central Bank requires information on a timely basis concerning the operations of the financial institutions that fall within its remit. A number of sources for such information exist, primarily:

- reports from those responsible for the management and direction of the entities concerned;
- inspections undertaken by the regulator;
- reports commissioned from independent third parties, including (but not limited to) the statutory auditors of entities incorporated under company law;
- information available from other sources e.g. management letters and audited financial statements.

Whilst prime responsibility for the provision of information to the Central Bank lies with the Directors of financial institutions, audited financial statements provide a source of reliable information for the Central Bank. For example, Central Bank examiners use audited accounts to identify trends in individual financial institution's performance and financial position from year to year. Audited accounts are also used in peer group comparisons and in analysing profitability for the total banking system. The auditor's report is checked to ascertain whether it is a clean report which contains no qualifications or reservations regarding any matters of opinion and fact on which the auditor must report. The Central Bank also uses the audited balance sheet to indirectly check the accuracy of financial institutions' returns to the Central Bank at their year-end date.

The existing statutory provisions concerning external auditors of financial institutions and the Central Bank are set out in detail in Chapter 14.

15.3. Strengthening of System/Structure

15.3.1 Areas of Common Interest for the Central Bank and the External Auditor

While the objectives and responsibilities of the supervisor and those of the external auditor should not become "blurred" the Review Group's view is that the Central Bank as regulator of financial institutions and the external auditors of financial institutions have a number of interests in common.

15.3.1.1 Interests of Consumers of Financial Services

The Central Bank is primarily concerned with the stability of the financial institutions in order to protect the interests of consumers of financial services (e.g. depositors and investors). Therefore, the Central Bank monitors its present and future viability and uses financial statements to assist in assessing its developing activities. The external auditor, on the other hand, is primarily concerned with reporting to shareholders on the financial position and on the results of its operations. In doing so, the institution's continuing viability is considered in order to support the "going concern" basis on which the financial statements are prepared.

15.3.1.2 Internal Control and Accounting Systems

The Central Bank is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the bank's business. The external auditor, in most situations, is concerned with the assessment of internal control to determine the degree of reliance he can place on the system in planning and carrying out his work. The Central Bank is concerned with the existence of a proper accounting system as a prerequisite for obtaining reliable information for the measurement and control of risk. The auditor is concerned to obtain assurance that the accounting records from which financial statements are prepared have been properly maintained.

15.3.1.3 Corporate Governance

The Central Bank and the external auditor attach importance to obtaining an understanding of the quality of information provided by an entity. The Central Bank also attaches great importance to obtaining an understanding of the quality of the Board and management. In this connection, arrangements for corporate governance, including the roles of audit committees and internal auditors, are of considerable importance. The Central Bank has recently sent a letter to all financial institutions stating that it expects that the Board of each institution should involve itself directly in confirming compliance on at least an annual basis with supervisory, taxation, consumer and corporate governance issues in general. Since the mid-1990s, the Central Bank, in carrying out its regulatory role, reviews the reports of internal auditors as a source of assurance on the continuing adequacy of internal controls and on the orderly management of the supervised institutions. The degree of reliance placed on the work of internal auditors depends on the Central Bank's assessment of the adequacy and independence of the internal audit function. Similarly the external auditor, in the course of his audit, would normally take into account the work of the internal auditor in determining the work programme of external audit procedures.

15.3.2 Confidentiality

Auditors and the Central Bank need to exchange information. The Central Bank also needs to exchange information with other regulators. Current legislation can preclude these exchanges. Subject to the constraints of the EU Second Banking Co-ordination Directive (as amended), the Review Group recommends adapting legislation to remove barriers, such as confidentiality, to information flows.

There are specific provisions in the Central Bank Acts relating to non-disclosure of information by officers of the Central Bank other than in certain specified circumstances. Regulation 19 of Statutory Instrument No. 395 of 1992, which implemented in Ireland the Second Banking Co-ordination Directive (as amended), permits the Central Bank to communicate with the auditor of a regulated entity but only if the Central Bank is satisfied that the auditor has obligations in regard to professional secrecy or non-disclosure of information corresponding to obligations imposed in the Central Bank Acts.

Confidentiality is an implied term of auditors' contracts with their clients. However, in the circumstances where there is a legal duty to report, auditors are entitled to communicate to regulators in good faith information or opinions relating to the business or affairs of the regulated entity or any associated enterprise without contravening the duty of confidence owed to the regulated entity. The programme of systematic communication with external auditors recently initiated by the Central Bank is generally conducted with the prior permission of the regulated entity to allay any concerns regarding client confidentiality. Any legislative changes arising from the recommendations for increased use by the Central Bank of external auditors' work in the supervisory process will have to address the issue of confidentiality to ensure there is clarity and no ambiguity regarding protection, both for officers of the Central Bank and for the external auditor.

The post-BCCI Directive enables the Central Bank and similar regulators to share information on certain conditions. However, the transposition of this Directive into Irish law does not permit co-operation between responsible financial and company law authorities. The implementation of the non-mandatory provisions in the Directive including the provision regarding information sharing between the Central Bank and company law regulators, requires primary legislation which to date has not been enacted. This can have the effect of constraining effective communication between the Central Bank and third parties such as auditors and in the future could constrain communication between the Central Bank and the proposed Oversight Board. Concerns over breaches of confidentiality rules have, in the past, in the view of some members of the Review Group, limited the exchange of information between the Central Bank and external auditors of financial institutions.

Given the evidence that has emerged in recent years concerning the level of suspected malpractice in banking and other economic sectors, the Review Group considers that such co-operation between financial and company law regulators should be enshrined as a general principle in Irish law, so that a wider examination of possible breaches of the law can take place.

There seems in particular no valid reason why the Central Bank, Insurance and other associated Acts should not be amended to provide for such co-operation, given that the option of doing so is already enshrined in European law. The Review Group also understands that regulators are obliged under section 57(2) of the Criminal Justice Act, 1994 to report to the Gardaí a suspicion that an entity it supervises has committed or is committing the offence of money laundering or related offences. The offence of money laundering relates to the proceeds of all criminal activity including breaches of tax legislation. The Central Bank may already disclose confidential supervisory information where required by a court in connection with criminal proceedings.

From a public interest viewpoint the Review Group considers that an additional measure, to facilitate the transmission of information from the Central Bank and other regulators to the Revenue Commissioners should be explored from a legal point of view in the context of the requirement of professional secrecy under EU supervisory directives (e.g., Article 12 of the First Banking Directive, as amended).

15.3.3 Review Group's Assessment of Relationship between the Central Bank and Auditors of Financial Institutions.

The Review Group is in agreement with the International Statement on Auditing issued by IFAC and the Basle (Bank) Supervisors Committee in July 1989 which concluded that "*greater mutual understanding and, where appropriate communication, would improve the effectiveness of bank audits and supervision to the benefit of both disciplines*" and that "*in many respects the supervisor and the auditor have complementary concerns.*"[89]

While recognising that the focus of work may be different and that, at times, the interests of shareholders and those of depositors may differ, the Review Group concluded that both the Central Bank and external auditors of financial institutions should be concerned with the integrity of a financial institution's systems of accounting and internal control. There is scope for the Central Bank to get more information arising from the external auditor's work and to use this information in the supervisory process. The Review Group considers that the present arrangements for the provision of such information from the external auditor to the Central Bank are insufficient and, at times, barriers exist preventing the external auditor from providing information to the Central Bank.

15.3.4 Standards for the Audit of Financial Institutions

The Review Group considers that an Irish equivalent to Practice Note 19 should, in addition to providing guidance on the provision of additional reports by auditors on systems of internal controls or other matters as envisaged in Recommendation 15.4, provide clear guidance on the application of a number of other key SASs, for example:

- SAS 620, "*The Auditor's Rights and Duty to Report to Regulators in the Financial Sector*", issued in March 1994, so as to reflect the requirements of legislation relating to regulated entities other than banks and building societies (e.g. investment business firms, stockbrokers, etc.) and the requirements of the Post-BCCI Directive which impose certain duties on the auditors of all credit and financial institutions and in some instances their associated enterprises;
- SAS 120 "Consideration of Law and Regulations",
- SAS 230 "Working Papers",
- SAS 300 "*Accounting and Internal Control Systems and Audit Risk Assessments*"[90]
- SAS 610 "*Reports to Directors or Management*".

[89] IFAC, International Statement on Auditing; The Relationship between Bank Supervisors and External Auditors (July 1989), Paras 1.30 and 5.1.1989

[90] APB is undertaking a review of SAS 300

Recommendation 15.1

The accountancy profession should commence work as a matter of urgency on updating and strengthening auditing pronouncements relating to the audit of Irish financial institutions. The accountancy profession should engage in prior consultation with the Central Bank in advance of revision to auditing pronouncements.

In the view of the Review Group this updated guidance should, in addition to covering issues dealt with in UK Practice Note 19, cover additional issues arising from the PAC DIRT Report, such as taxation and contingency provisions and the recommendations contained in this Report.

The revision of auditing pronouncements should allow the Central Bank more flexibility in its interaction with external auditors and should set out guidelines for its working relationship with external auditors.

In the course of developing such guidance, the Review Group concluded that it may be that recommendations should be made to the APB for the development of Auditing Standards specifically related to financial institutions.

15.3.5 Increased use by the Central Bank of the External Auditor in the Supervisory Process

Recommendation 15. 2

The external auditors of a financial institution should provide an annual positive statement to the Central Bank on whether anything has come to their attention that gives rise to a legislative duty to report to the Central Bank. In order to ensure proper consideration of all relevant information, accounting firms undertaking audits of financial institutions should establish lines of communication sufficient to ensure that non-audit work undertaken for a financial institution is brought to the attention of the partner responsible for its audit so he can consider it in the course of his work.

This recommendation could be implemented by legislative change to require the provision of an annual positive statement. This may be done by an extension of Section 47 of the Central Bank Act, 1989 (and analogous legislation relating to other regulated entities). It must take account of the Regulations implementing the Post-BCCI Directive. It may be possible for the Central Bank to supplement this legal power by placing a requirement on financial institutions to commission such reports. The Review Group's view is that this recommendation will also require consultation between the Central Bank and the accountancy profession to ensure that auditors are aware of their duty to report and the circumstances giving rise to such reports.

Auditing Standards and related guidance applicable to the statutory duty to report to Central Bank are set out in SAS 620 "*The Auditors' Rights and Duty to Report to Regulators in the Financial Sector*" (issued in 1994). The duty to report applies to auditors of financial institutions in that capacity and so does not extend automatically to any information obtained by an accounting firm regardless of its source. For example, information concerning a financial institution may be obtained when the firm undertakes other non audit services for the financial institution or when partners or staff of an accounting firm which is appointed as its auditor carry out work for another client company. In the latter case, information obtained in the course of work relating to another entity audited by the same firm is confidential to that company and auditors are not required, and have no right, to report to a regulator confidential information concerning another client. However, SAS 620 sets out that accounting firms undertaking audits of financial institutions need to take steps to ensure that information relevant to the duty to report to the Central Bank is given proper consideration and where appropriate make enquires in their capacity as the auditors of a particular financial institution in order to determine whether a report should be made. Complying with this process should ensure that reports are made to the Central Bank as appropriate without breaching the auditor's duty of confidentiality.

Recommendation 15.3

There should be increased liaison between the Central Bank and the external auditors of financial institutions. To facilitate this, a protocol concerning the exchange of information should be agreed between the Central Bank and the accountancy profession. If necessary, legislation should be enacted to permit this exchange of information.

Recommendation 15.4

The Central Bank should have the power to obtain reports from external auditors or other reporting accountants on financial institution's accounting and other records, their internal control systems, and any other issues that, in the opinion of the Central Bank, are appropriate or necessary for regulatory purposes.

It is a matter for consideration whether Recommendation 15.4 can be implemented within the existing legislative framework (e.g. Section 17 of the Central Bank Act, 1971, as substituted by Section 36 of the Central Bank Act, 1989) or whether new legislation is required to provide for the commissioning of "special" reports, similar to Section 39 of the UK Banking Act, 1987.

The Review Group acknowledges that this recommendation will require consultation between the Central Bank and the external auditor to clarify what work is required regarding each particular case.

Given the growing extent and complexity of regulation, consideration of the impact of non-compliance with statutory and regulatory requirements needs increasingly careful consideration in the course of an external audit. Statement of Auditing Standards SAS 120 "*Consideration of Law and Regulations*" (applicable to all financial statement audits) requires auditors, *inter alia,* to perform procedures to help identify possible or actual instances of non-compliance with those laws and regulations that provide a legal framework within which the entity conducts its business and are central to its ability to conduct that business. Laws and regulations that are regarded as central to a financial institution's ability to conduct its business when either compliance with them is a pre-requisite of obtaining a licence or non-compliance may reasonably be expected to result in the financial institution's ceasing operation or otherwise calls into question its status as a going concern. The external auditor should therefore concern himself/herself with compliance with statutory provisions. SAS 120 also sets out steps to be taken by auditors in the event of detection of any non compliance.

The Review Group considers that in line with the recommendations concerning compliance reports for all companies in Chapter 14, similar reporting requirements should be placed on external auditors of financial institutions to the Central Bank.

Therefore Recommendations 14.1 to 14.3 should apply to financial institutions with the reports on compliance being made by Directors and external auditors to the Central Bank rather than the Director of Corporate Enforcement.

Consultation would be required among all relevant parties (including financial institutions, the Central Bank and the accountancy profession) to obtain clarity regarding legislation, regulations and administrative provisions considered to be relevant.

Recommendation 15.4 will require an amendment to legislation (perhaps the 'duties of auditors' provisions of the Central Bank Act and analogous legislation relating to other regulated entities). It will also require consultation between the Central Bank and the external auditor (and perhaps the legislators and other interested parties) to provide guidance on which statutory and regulatory requirements are fundamental to the regulated entity's ability to conduct its business and whether there are other statutory and regulatory requirements which are important to the regulated entity and on which it is reasonable to expect the external auditor to have a knowledge.

Recommendation 15.5

The accountancy profession and the Central Bank should agree a protocol, and if necessary, legislation should be enacted, to make audit working papers available on request to the Central Bank.

This recommendation can be implemented with the co-operation of the client or alternatively an enabling piece of legislation is required. The Review Group considers that it is preferable to enact new legislation to provide for the possibility of access by the Central Bank to auditor's working papers without the regulated institution's knowledge or permission should this be deemed necessary by the Central Bank.

15.3.6 Management Letters

Management letters are commonly issued on completion of an audit and contain issues which come to the auditor's attention during the course of his/her normal audit work which he/she considers should be included in a report to directors or management. SAS 610 requires that such reports are made in relation to any material weakness in the accounting and internal control system that is identified during the audit.

It is the opinion of the Review Group that the scope and content of these reports should continue to be agreed between the auditors and financial institutions in accordance with SAS 610. At the moment the Central Bank can access management letters from regulated entities. The management letter is a confidential communication and the auditor's written consent is generally required if a copy of his report is to be provided to a third party. However, in the opinion of the Review Group it would assist the Central Bank in effectively carrying out its supervisory duties if management letters for financial institutions were sent directly to the Central Bank by the external auditor at the same time as the final management report (i.e. incorporating the regulated entity's management response) is issued to the regulated entity. The auditor generally expressly disclaims any liability to third parties. Therefore, in future, auditors should be made aware that the Central Bank may seek to rely on his/her work for regulatory purposes.

Recommendation 15.6

The Central Bank should automatically receive management letters from external auditors of financial institutions at the same time as the 'final' (i.e. incorporating management response) management letter is issued to the regulated entity. The auditor should inform the Central Bank if no report is being issued.

The Review Group considers that the provision of management letters in accordance with this recommendation does not take away from Directors' responsibility to bring relevant issues to the attention of the Central Bank. The Review Group considers that this recommendation will trigger a need for an audit standard on the nature and content of management letters to ensure that adequate information continues to be provided in management letters. Otherwise the Review Group recognises that there is a danger that information currently contained in management letters would, following the implementation of this recommendation, be transferred to letters of detail.

15.3.7 Joint Auditors

Increasing the level and quality of information received by the Central Bank on the external audit of financial institutions and the strengthening of audit standards for this sector are, in the view of the Review Group, an effective means of overcoming the shortcomings identified in the DIRT inquiry report concerning the regulation of financial institutions. The Review Group concluded that any further advantages that may accrue from introducing an additional requirement to have joint auditors in financial institutions, one of which would be appointed by the Central Bank, are outweighed by the disadvantages associated with joint audits. These include increasing the costs of audits, inefficiencies, blurred responsibilities, the possibility of omissions during the audit with one firm blaming the other for mistakes, the danger of Irish financial institutions being on an "unlevel playing field" vis-à-vis their European and international counterparts. In addition the Bingham Report[91] which inquired into the failed Bank of Credit and Commerce International considered the issue of joint auditors. This Report concluded that having considered the arguments for and against joint auditors the subject does not lend itself to the laying down of absolute rules.

Currently the Central Bank has the legislative basis to appoint "*an appropriate person duly authorised in writing in that behalf ('an authorised person') ... for the purpose of the performance by the Central Bank of its statutory functions*".[92] Thus an entity's external auditor could be appointed as 'an authorised person'. Alternatively the Central Bank may appoint a different auditor or other "appropriate person" for the purpose of the performance by the Bank of its statutory functions. Currently the Central Bank's practice is to use its own staff to conduct on-site inspections and to carry out its statutory duties and it obtains the co-operation of the regulated entity to appoint its external auditor or other consultant to carry out "special reports". Also, on occasion, the Central Bank uses its statutory powers to request auditors to furnish reports. The Review Group is aware that the Central Bank is considering increasing its use of this power particularly in relation to theme audits for example compliance with money laundering guidelines and compliance of credit institutions policies on property lending.

Recommendation 15.7

Since the Central Bank already has the legislative basis to appoint an external auditor (or other "appropriate person") for the purpose of the performance by the Central Bank of its statutory functions, it is not necessary that joint auditors be routinely appointed by the Central Bank to financial institutions.

The Review Group accepts the Central Bank's view that its present power to veto an auditor's appointment and its ability to appoint an auditor and to commission special reports is as far as its power should extend.

[91] Inquiry into the Supervision of the Bank of Credit and Commerce International, HMSO, 1992 para 3.32

[92] Section 17 of the Central Bank Act, 1971, as substituted by Section 36 of the Central Bank Act, 1989, and analogous provisions in legislation relating to other regulated entities (e.g. investment business firms, stockbrokers, etc.).

Legislation may need to be amended, particularly to address confidentiality issues, in order to give the Central Bank specific powers to appoint external auditors (either directly or indirectly via the regulated entity) to prepare reports on certain matters such as accounting and other records, "returns" submitted by the regulated entity to the Central Bank, internal control systems, etc.

15.4. Implementation

The recommendations of the Review Group also include the revision of current auditing pronouncements relating to the audit of Irish financial institutions. The Review Group considers that this revision would also benefit greatly from advance consultation and co-operation between the Central Bank and the accountancy profession to ensure that each has an understanding of the other's objectives and processes. Any new or revised auditing pronouncements should provide for flexibility in the interaction between the Central Bank and external auditors. This consultative process cannot replace or undermine the respective responsibilities of the external auditor to the shareholders and of the Central Bank to consumers, such as users of financial services and depositors, but rather it should enhance the work of both parties. There should also be emphasis on the primary responsibilities of the Board and senior management of regulated entities to manage, ensure compliance with statutory provisions and control its business as well as providing information to the regulator.

The recommendations of the Review Group are likely to lead to a need for substantial legislative revisions. The Review Group is strongly of the opinion that these revisions would benefit greatly from advance consultation by the legislators with the Central Bank and the accountancy profession, particularly to provide clarity that any "special" reports which the Central Bank may require from external auditors (either directly independent of the regulated entity or indirectly with the co-operation of the regulated entity) are provided for in legislation without any concerns regarding "non-disclosure of information" provisions or client confidentiality considerations. This consultative process should ensure that the underlying objectives of the regulator and those of the external auditor do not conflict and are not compromised or will not become blurred.

The Review Group is conscious that many of the recommendations contained in this chapter could be difficult to implement if confidentiality issues are not addressed, if necessary, by legislation.

The considerations and recommendations contained in this chapter relate to financial institutions, defined as those institutions regulated by the Central Bank. In the opinion of the Review Group it would appear to be sensible to apply these recommendations to other regulated sectors of the economy such as the insurance sector and credit institutions which are currently regulated by the Department of Enterprise, Trade and Employment.

CHAPTER 16

Timetable for Implementation

16 Timetable for Implementation

The recommendations outlined in this Report involve changes to:

- statute, in the form of the Companies Acts, the Central Bank Acts, the Insurance Acts and possibly legislation governing other forms of financial entity, e.g., credit unions;
- auditing standards and
- the constitutions of the recognised accountancy bodies.

Insofar as these changes are concerned, the Review Group considers that the persons identified below have primary responsibility for giving effect to the recommendations which were contained in the Chapters identified in the following Table:

Table 16.1 - Persons Responsible for Recommended Legal, etc. Changes

Chapter	Changes Required to	Primary Responsibility
7	the Companies Acts	Minister for ET&E[94]
8	the Companies Acts	Minister for ET&E
9	the Companies Acts	Minister for ET&E
10	the Companies Acts Bye-Laws, etc.	Minister for ET&E Accountancy Bodies
11	the Companies Acts	Minister for ET&E
12	the Companies Acts Standards/Guidance	Minister for ET&E Accountancy Bodies
13	the Companies Acts	Minister for ET&E
14	the Companies Acts Standards/Guidance	Minister for ET&E Accountancy Bodies
15	the Central Bank Acts the Insurance Acts other legislation Standards/Guidance	Minister for Finance Minister for ET&E Ministers for Finance/ET&E Accountancy Bodies

The Review Group acknowledges that a substantial amount of work, including consultation with all relevant parties, will be required to consider the recommendations in this Report and to proceed to implement the required changes. However, the changes proposed are important, and the Review Group believes that appropriate priority should be given to securing their implementation at an early date. In the circumstances, the Review Group considers it reasonable that the required changes to legislation, etc. be made within twelve months of the publication of this Report.

[94] ET&E = Enterprise, Trade and Employment.

Pending the enactment of new legislation, the Review Group has already proposed in Chapter 9 that the Oversight Board should be established on an interim basis early in 2001, in order:

- to assist and advise the Department of Enterprise, Trade and Employment in finalising the drafting of the associated Companies Bill and
- to make all of the necessary arrangements, including the recruitment of the Board's Director and staff, to enable it to commence its work immediately following enactment of the necessary legislation.

Other recommendations in the Report are operational in the sense that they are capable of implementation either by:

- existing State agencies and the accountancy bodies, or
- following the enactment of new legislation by, for example, the Oversight Board.

The Review Group is satisfied that all of these recommendations, insofar as they relate to existing State entities or accountancy bodies, can be implemented by end-2001. The Group would expect however that a substantial number of the recommendations will be implemented within a much shorter timeframe.

Recommendation 16.1

Priority should be given to examining the recommendations in this Report, such that the necessary changes to statute, auditing standards and the constitutions of the recognised accountancy bodies are made within twelve months of the publication of this Report.

Appendices

Appendix I: Review Group on Auditing – Invitation to Comment

Appendix II: Source of Submissions to the Review Group on Auditing

Appendix III: Members of the Review Group on Auditing

Appendix IV: International Links of the Recognised Accountancy Bodies

Appendix V: Principal Statutory Provisions dealing with Auditors and Accounts Preparation under the Companies Acts, 1963-1999

Appendix VI: Membership of the Recognised Accountancy Bodies in 1999

Appendix VII: Staff/Members involved in Monitoring, Investigations and Disciplinary Work

Appendix VIII: Applicability of Recommendations in Review Group's Report to different catergories of companies.

Appendix I

Review Group on Auditing – Invitation to Comment

The Tánaiste and Minister for Enterprise, Trade & Employment, Mary Harney, has decided to establish a Review Group on Auditing. The Group, establishment of which is in line with the recommendation of the DIRT Inquiry Report recently completed by a Sub-Committee of Dáil Éireann's Committee of Public Accounts, will be asked to conduct its work and make a final report by 31 May, 2000 in accordance with the following Terms of Reference:

- Whether self-regulation in the auditing profession is working effectively and consistently,
- Whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what form should they take.

The Group will be also asked to examine and report on those issues concerning the auditing profession which were raised in the DIRT Inquiry Report. These include:

- the role of the external auditor in providing other services to the same institution,
- the impact of other functions such as tax advice and consultancy on the external audit process,
- the determination of fees, bearing in mind shareholder interests,
- the relationships between an external auditor and the management that appoints and remunerates him,
- the statutory provisions on auditing in the Companies Acts and related codes,
- the role of the external auditor in ensuring compliance with statutory provisions,
- the possible role of the Central Bank in regard to management letters issued by external auditors to financial institutions,
- the possible strengthening of audit standards relating to financial institutions,
- the suitability of having joint auditors to financial institutions with one being appointed by the Central Bank,
- the possible introduction of a maximum term of five years for an auditor to a financial institution.

The Group will also be asked to examine and report on any matters directly related to the foregoing.

Pending settlement of the composition of the Group, it has been decided to invite all interested parties to make written submissions on one or more elements of the Terms of Reference. Each submission should clearly indicate which part of the Terms of Reference it is addressing. Having regard to the tight time frame set for the preparation of the Group's report, all submissions should be sent to Mary Solan-Avison at the Department of Enterprise, Trade & Employment, South Frederick Street, Dublin 2, to arrive no later than 31 January, 2000 (e-mail address:solanm@entemp.irlgov.ie telephone: (01) 631 2652; fax: (01) 631 2834).

Please note that all submissions may be subject to release under the Freedom of Information Act, 1997.

Paul Haran
Secretary-General
Department of Enterprise, Trade & Employment
29 December, 1999

Appendix II

Source of Submissions to the Review Group on Auditing

1. Comptroller and Auditor General
2. Central Bank of Ireland
3. Revenue Commissioners
4. The Foundation for a New Independent Regulatory System for Accountants
5. Auditing Practices Board
6. Mr John Maher, Waterford Institute of Technology
7. Mr John McCallig, University College Dublin
8. Professor Edward Cahill, University College Cork
9. Institute of Certified Public Accountants in Ireland
10. Association of Chartered Certified Accountants
11. Institute of Incorporated Public Accountants
12. Association of International Accountants
13. Institute of Chartered Accountants in England and Wales
14. Institute of Chartered Accountants of Scotland
15. Institute of Chartered Accountants in Ireland
16. Institute of Internal Auditors
17. Chartered Institute of Public Finance and Accountancy
18. KPMG
19 Arthur Andersen
20. Deloitte & Touche
21. PricewaterhouseCoopers
22. Ernst & Young
23. Messrs J. O'Brien and W. Nolan
24. Mr Dermot O'Mahony, City Life
25. Mr Gearóid Costelloe
26. Irish Bankers' Federation
27. Chartered Institute of Management Accountants
28. Institute of Directors in Ireland
29. Irish Institute of Credit Management
30. Dublin Funds Industry Association
31. Fédération des Experts Comptables Européens (FEE)
32. Department of Enterprise, Trade and Employment
33. Financial Services Authority
34. Irish Association of Investment Managers
35. Mr Simon Quinn, Institute of Technology, Tralee
36. Irish Business and Employers Confederation
37. Department of Finance

Appendix III

Members of the Review Group on Auditing

Chair: Senator Joe O'Toole, General Secretary,
Irish National Teachers' Organisation;

Vice-Chairs: Professor Niamh Brennan, Michael MacCormac
Professor of Management, Department of Accountancy,
University College Dublin;

Ms Ann Fitzgerald, Secretary General,
Irish Association of Investment Managers;

Members: Mr Joe Brady, Joseph G. Brady Insurances Ltd;

Mr Shay Cody, Deputy General Secretary, IMPACT;

Mr John Corcoran, Assistant Secretary,
Department of Enterprise, Trade and Employment;

Mr Brendan Dennehy, Institute of Incorporated
Public Accountants Ltd;

Mr Colm Dunne, Director of Audit,
Office of the Comptroller and Auditor General;

Mr Alan Farrelly, Institute of Certified Public
Accountants in Ireland;

Mr Robert Grier, Director/Secretary,
Irish Business and Employers' Confederation;

Mr Jim Kelly, Principal Inspector of Taxes,
Office of the Revenue Commissioners;

Mr David Leonard, Association of Chartered
Certified Accountants;

Dr Irene Lynch-Fannon, Head of Department of Law,
University College Cork;

Mr Conor O'Mahony, Assistant Principal,
Department of Finance;

Dr Liam O'Reilly, Assistant Director General,
Central Bank of Ireland;

Mr Terence O'Rourke, Institute of Chartered
Accountants in Ireland;

Dr James Stewart, Senior Lecturer in Finance,
School of Business Studies, Trinity College Dublin.

Secretariat: Mr Paul Appleby, Department of Enterprise,
Trade and Employment

Ms Geraldine Hurley, "

Ms Mary Solan-Avison, "

Ms Nuala Moloney, "

Appendix IV

International Links of the Recognised Accountancy Bodies

	ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Recognised by DETE under the Companies Acts	●	●	●	●	●	●
Recognised by DTI under UK Companies Acts	●		●	●	●	
Members of CCAB-I	●	●	●			
Members of CCAB	●		●	●	●	
Members of FEE	●	●	●	●	●	
Members of IFAC	●	●	●	●	●	

Appendix V

Principal Statutory Provisions dealing with Auditors and Accounts Preparation under the Companies Acts, 1963 - 1999

- Sections 148 to 164 of the 1963 Act (No. 33 of 1963), together with the Sixth Schedule (as amended) thereto;
- Companies (Amendment) Act, 1986 (No. 25 of 1986) and the Schedule thereto[95];
- Part X of the Companies Act, 1990 (No. 33 of 1990) which revised and extended the 1963 Act provisions and which implemented Council Directive No. 84/253/EEC of 10 April, 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents;
- Companies Act, 1990 (Auditors) Regulations, 1992 (S.I. No. 259 of 1992) which made a number of amendments to the provisions of Part X of the 1990 Act;
- European Communities (Companies: Group Accounts) Regulations, 1992 (S.I. No. 201 of 1992) which implemented Council Directive No. 83/349/EEC of 13 June, 1983 on the co-ordination of national legislation on consolidated accounts;
- European Communities (Credit Institutions: Accounts) Regulations, 1992 (S.I. No. 294 of 1992) which implemented:
  - a) Council Directive No. 86/635/EEC of 8 December, 1986 on the annual accounts and consolidated accounts of banks and other financial institutions and
  - b) Council Directive No. 89/117/EEC of 13 February, 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents;
- European Communities (Accounts) Regulations, 1993 (S.I. No. 396 of 1993) which implemented:
  - a) Council Directive No. 90/604/EEC amending Directive No. 78/660/EEC on annual accounts and Directive No. 83/349/EEC on consolidated accounts as concerns the exemptions for small and medium-sized companies and the publication of accounts in ECUs;
  - b) Council Directive No. 90/605/EEC of 8 November, 1990 amending Directive No. 78/660/EEC on annual accounts and Directive No. 83/349/EEC on consolidated accounts as regards the scope of those Directives and
  - c) Article 11 of Council Directive No. 89/666/EEC of 21 December, 1989 on disclosures by branches;
- Part III of the Companies (Amendment) (No. 2) Act, 1999 (No. 30 of 1999) which exempts certain small companies from the requirement to have accounts audited.

[95] This Act does not however apply to unlimited companies, or in certain respects, to licensed banks and certain other companies in the financial services area.

Appendix VI

Membership of the Recognised Accountancy Bodies in 1999

1999 Reports of the Accountancy Bodies	ICAI[96]	ICPAI[97]	ACCA[98]	IIPA[99]
Total Number of Members world-wide				
(i) at the start of 1999	10,919	1,634	66,083	317
(ii) movement in numbers in 1999	+438	+173	+5,455	+13
(iii) at end-1999	11,357	1,807	71,538	330
Total Number of Members in Practice in the State at end-1999				
(i) Partners in Practising Firms	1,386	378	406	125
(ii) Employees in Practising Firms	1,094	297	706	103
Number of Registered Audit Firms at end-1999				
(i) Firms registered to sign audit reports for companies registered in the State	1,044	n.a.	789	n.a.
(ii) Firms (from (i)) resident in the State	800	n.a.	273	n.a.
Responsible Individuals (RIs) at end-1999				
(i) Members registered to sign audit reports for companies registered in the State	1,630	n.a.	n.a.	n.a.
(ii) Members (from (i)) resident in the State	1,243	n.a.	n.a.	n.a.
Registered Auditors (RAs) at end-1999				
(i) Members registered to sign audit reports for companies registered in the State	n.a.	378	1,271	125
(ii) Members (from (i)) resident in the State	n.a.	375	371	125

[96] The ICAI registers firms for audit. Those persons eligible and wishing to sign audit reports are designated as Responsible Individuals (RIs). Eligible persons who are not members of the ICAI become audit affiliates to gain RI status. The ICAI monitors the activities of all RIs in all firms to whom it grants Audit Registration.
[97] The ICPAI registers individuals only for audit.
[98] The ACCA registers individuals and firms for audit. Those persons eligible and wishing to sign audit reports are designated as Registered Auditors. The ACCA monitors the work of all Registered Auditors to whom it grants Audit Registration.
[99] The IIPA to date has only registered individuals for audit.

Appendix VII

Staff/Members involved in Monitoring, Investigations and Disciplinary Work

ICAI	ICPAI	ACCA	ICAEW	ICAS	IIPA
Quality Assurance 16 staff including 5 full time reviewers	Practice Review 3 full time 1 part time	Practice Regulation Department: 17 full time	Professional Standards Office (all aspects of regulation) 91 staff	Professional Authorisation and Legal Departments 16 staff	Practice Review 3 part time
JMU Additional staff is available if required.	Investigations/ Disciplinary: 4 full time	Legal Department 11 full time	Joint Monitoring Unit 36 staff	JMU 4 staff deployed on ICAS business	

Appendix VIII

Applicability of Recommendations in Review Group's Report to Different Categories of Companies

The following table relates to the Recommendations contained in Chapters 12 to 15 (inclusive) - which are directed at specific categories of companies. Some of the Recommendations could be related to audit firm size rather than category of client company.

The following is a definition of different categories of companies covered in the table:

Public Limited Companies (PLCs): Companies where members' liability is limited. At least seven shareholders. No upper limit on the number of shareholders. Shares may be offered for sale to the public.

Financial Institutions[100]: While legislation to give effect to the recommendations will have to define precisely what constitutes a financial institution it should include the following: credit institutions, insurance undertakings, investment firms, moneybrokers, stockbrokers, credit unions, exchanges and IFSC entities.

Public Interest Companies: Further work needs to be done to clearly define a public interest company. This can be done in the context of preparing legislation to give effect to the recommendations. For the purposes of this Report, the Group has adopted the definition contained in the ICAI Ethical Guide for Members[101] which is as follows: "*There are some unlisted companies and organisations, in both the public and private sectors, which are 'in the public eye' because of their size or the product or the service they provide. Example of such companies and organisations would be large charitable organisations and trusts, major monopolies, duopolies, building societies, industrial and provident societies or credit unions, deposit taking organisations and those holding investment business client money.*"

[100]There are a number of small financial entities (for example, retail investment intermediaries, insurance intermediaries and small credit unions) which fall into the small business category. The degree to which the recommendations (in Chapter 15) apply to these smaller financial entities has to be examined further.

[101]ICAI Ethical Guide, Part C, Statement 1, para. 19.6

Medium Sized Companies: Medium sized private companies are currently defined in company law as companies having: (a) a balance sheet total that does not exceed £6 million; (b) a turnover of £12 million and (c) not more than 250 employees[102]. A private company can be treated as a medium sized company if it satisfies at least two of these three criteria.

Small Companies: a small private company is a sub-set of the above and is defined as a company having: (a) a balance sheet total that does not exceed £1.5 million, (ii) a turnover of not more than £3 million and (c) not more than 50 employees.

Companies exempt from audit[103]: Certain private limited companies and partnerships with a turnover not exceeding £250,000 and a balance sheet total not exceeding £1.5 million and the number of employees not exceeding 50 are exempted from the requirement to have a statutory audit.

Note: It should be noted that not all companies fit into the above categories. For example, some unlimited companies may not fall within the definition of medium sized companies, are not PLCs and could not be considered to be public interest companies. The precise application of the recommendations to such companies will need to be clarified in the context of preparing legislation to give effect to the Report. However, they should at least be regarded as coming within the scope of any recommendation which applies to medium sized companies.

[102]SI 396 of 1993 European Community (Accounts) Regulations
[103]Companies (Amendment) (No. 2) Act, 1999, (No. 30 of 1999) Part 3.

Table1[104]

Chapter 12: Auditor Independence

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.1 There is a need to introduce additional safeguards to protect the independence of an auditor of a client company from the threat posed by the provision of non-audit services to the client company. This is best achieved through the development and maintenance of a framework for auditor independence.	✓	✓	✓	✓	✓	✗
Recommendation 12.2 Non-audit fees paid by a company to their audit firm and the nature of the services provided should be disclosed and analysed in adequate detail in the annual financial statements.	✓	✓	✓	✓	✓	✗

[104] In this Table: a "✓" means that the recommendation applies
an "✗" means that the recommendation does not apply.

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.3 When the non-audit fee earned by an audit firm from a client company exceeds the audit fee then the audit committee of the client company must set out in the annual report to shareholders the reasons why the non-audit services were obtained from the audit firm and confirm that it is satisfied that this does not compromise the independence of the auditor.	✓	✓	✓	✗	✗	✗
Recommendation 12.4[105] The maximum allowable proportion of overall fee income contributed by any one client company or group of client companies to the total portfolio of the audit firm should, at most, be limited to 10%. A lower limit of 5% should apply in the case of listed companies, financial institutions and public interest companies and more formal monitoring for compliance with this requirement should be put in place.	5%	5%	5%	10%	10%	✗

[105] Also applies to audit firms

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.5 The Review Group recommends that the following principles apply in relation to non-audit services: • audit firms should not audit their own work; • audit firms should not provide non audit services to an audit client that affect the numbers in the financial statements such as valuation; • audit firms should not provide internal audit services. A professional standard should be developed (in the manner outlined in Chapter 8, Section 2.4) that prohibits the provision of specified non-audit services by an audit firm to an audit client company. The Oversight Board should be empowered to impose a professional standard, prepared by the Oversight Board, on the professional accountancy bodies to address this issue. However, this power should only be exercised where an undue amount of time is being taken to develop the standard.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.6[106] The audit engagement partner and staff of a firm should be presumed to know everything relevant to the audit of a client company that other partners in the firm or an associated firm are aware of in relation to the company. A firm appointed as auditor of a company needs to have in place appropriate procedures to ensure that the partner responsible for the audit function is made aware of any other relationship which exists between any department of the audit firm and the company when that relationship could affect the audit firm's responsibilities as auditors.	✓	✓	✓	✓	✓	✗

[106] Also applies to audit firms

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.7[107] Audit firms should be required to set out their general policy concerning risks to auditor independence and to document how risks to auditor independence are dealt with in relation to individual client companies during an audit. The general policy of the firm towards the identification and management of risks to audit independence should be set out in the letter of engagement. Information relevant to the management of risk during the audit engagement should be included in the management letter or a separate letter addressed to the Audit Committee.	✓	✓	✓	✓	✓	✗
Recommendation 12.8 The audit contract should be awarded on an annual basis in an open and transparent manner. This should include consideration by audit committees on an annual basis whether to put the audit contract out to tender. The audit committee should justify its decision in its recommendation to shareholders on the appointment of auditors as outlined in Recommendation 13.4.	✓	✓	✓	✗	✗	✗

[107] Also applies to audit firms

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 12.9 The Oversight Board should undertake, within three years, a review of the level of non-audit fees and should make known its judgement as to whether or not any new rules are required to safeguard auditor independence.	✓	✓	✓	✗	✗	✗

Chapter 13: Corporate Governance Structures and the External Audit

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.1 Boards of Directors of PLCs, financial institutions and public interest companies should be required by legislation to establish audit committees the membership of which is made up of non-executive directors.	✓	✓	✓	✗	✗	✗
Recommendation 13.2 Audit committees should have regular meetings each year.	✓	✓	✓	✗	✗	✗
Recommendation 13.3 Each audit committee should have a formal written charter, approved by the Board of Directors, that specifies the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.4 Shareholders should approve the appointment of auditors and set their fees, based on a recommendation from the audit committee rather than management as is currently the case. This should include a consideration on whether it is appropriate, or not, in any given year to change auditors or to send the audit contract out to tender as outlined in Recommendation 12.8.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.5 In its charter, the audit committee should be given the following responsibilities: • ensuring receipt from the external audit firm of a formal written statement outlining all current and relevant previous business and personal relationships between the audit firm and the company; • for actively engaging in a dialogue with the audit firm so that all relationships that may impact on the objectivity and independence of the auditor are fully disclosed; • approving the procedures for the appointment of the audit firm to provide any other services; • assessing and approving in advance all contracts with the audit firm having regard to all business and personal relationships between the company and its audit firm; • monitoring the number of former employees of the audit firm currently employed in senior positions in the company and assessing its impact on auditor independence; • reviewing the audit firm's statement concerning their general policy to risks to independence (see Recommendation 12.7); • approving in advance any contracts with the audit firm payment of which will be made on a contingency basis.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.6 Audit committees of companies should meet their external auditor a number of times each year, both in the presence of management and independent of management. Such meetings must be held at both the planning stage of the audit and following the completion of the audit.	✓	✓	✓	✗	✗	✗
Recommendation 13.7 Management letters from auditors to the Board of Directors should refer to the existence of any other audit related letters (e.g. letters of detail) and should make these available to the Board and the audit committee on request. Management letters should be available to the Board and the audit committee in advance of approval of the financial statements. Given the tight reporting deadlines, a preliminary draft containing all issues but possibly excluding some management responses is acceptable. Audit committees should establish a time frame within which management responses should be received in respect of management letters, internal audit reports and any other audit related letters (e.g. letters of detail).	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.8 All PLCs, financial institutions and public interest companies should have a properly resourced internal audit function set up independently of management and the external auditor.	✓	✓	✓	✗	✗	✗
Recommendation 13.9 Audit committees should meet the internal auditors regularly at times without management present.	✓	✓	✓	✗	✗	✗
Recommendation 13.10 The internal auditor's appointment should be endorsed by the audit committee and internal audit reports to the Board and to the audit committee should be retained for six years.	✓	✓	✓	✗	✗	✗
Recommendation 13.11 Internal audit programmes, and all internal audit reports and findings, should be made available to the external auditor at the earliest possible opportunity.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 13.12 Audit committees should prepare an annual report for presentation to the shareholders. This should include their view on the Directors' compliance report. (Recommendation 14.1)	✓	✓	✓	✗	✗	✗
Recommendation 13.13 The above recommendations concerning the duties of audit committees and their relationships with external auditors and internal auditors should be set out in legislation for PLCs, financial institutions and public interest companies.	✓	✓	✓	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 14.1 Directors of a company should be required to report on an annual basis to the shareholders on the company's compliance with its obligations under company law, taxation law or other relevant statutory or regulatory requirements. The report should confirm that any instances of non-compliance have been reported to the relevant regulatory authority and that in all other respects the company has complied with its obligations under company law, taxation law and other relevant statutory or regulatory requirements. The report should be appended to the annual financial statements.	✓	✓	✓	✓	✓	✓

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 14.2[108] The external auditors should report as to whether, in their opinion, the Directors' report of the company's compliance with its obligations is reasonable. • In making their report, the auditors should specifically address whether the directors have made appropriate disclosure concerning any circumstances of which the auditors are aware that give reasonable grounds to believe the company has not, or may not have, fulfilled its obligations. • Where in the auditor's opinion such circumstances have not been so disclosed by the directors, and the directors have not amended their report, the auditors should include relevant information in their report. This report should be appended to the annual financial statements.	✓	✓	✓	✓	✓	✓
Recommendation 14.3[109] In situations where the Directors have not issued the report referred to in Recommendation 14.1 within a specified timeframe then the external auditors will have a duty to report that failure to the Director of Corporate Enforcement.	✓	✓	✓	✓	✓	✓

[108] This recommendation will not apply to those companies who decide to avail of the exemption from statutory audit.
[109] This recommendation will not apply to those companies who decide to avail of the exemption from statutory audit.

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 14.4[110] As part of the continuing professional development programme for their auditing members, each of the recognised accountancy bodies should include refresher courses on auditors' statutory obligations under the Companies Acts (including the additional obligations outlined in Recommendations 14.2 and 14.3) and similar legislation and on their duties under the body's code of ethics.	✗	✗	✗	✗	✗	✗

[110] Applies to all auditors

Chapter 15: The Audit of Financial Institutions

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 15.1 The accountancy profession should commence work as a matter of urgency on updating and strengthening auditing pronouncements relating to the audit of Irish financial institutions. The accountancy profession should engage in prior consultation with the Central Bank in advance of revision to auditing pronouncements.	✗	✓	✗	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 15.2 The external auditors of a financial institution should provide an annual positive statement to the Central Bank on whether anything has come to their attention that gives rise to a legislative duty to report to the Central Bank. In order to ensure proper consideration of all relevant information, accounting firms undertaking audits of financial institutions should establish lines of communication sufficient to ensure that non-audit work undertaken for a financial institution is brought to the attention of the partner responsible for its audit so he can consider it in the course of his work.	✗	✓	✗	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 15.3 There should be increased liaison between the Central Bank and the external auditors of financial institutions. To facilitate this, a protocol concerning the exchange of information should be agreed between the Central Bank and the accountancy profession. If necessary, legislation should be enacted to permit this exchange of information.	✗	✓	✗	✗	✗	✗
Recommendation 15.4 The Central Bank should have the power to obtain reports from external auditors or other reporting accountants on financial institutions' accounting and other records, their internal control systems, and any other issues that, in the opinion of the Central Bank, are appropriate or necessary for regulatory purposes.	✗	✓	✗	✗	✗	✗
Recommendation 15.5 The accountancy profession and the Central Bank should agree a protocol, and if necessary, legislation should be enacted, to make audit working papers available on request to the Central Bank.	✗	✓	✗	✗	✗	✗

Recommendation	PLC's	Financial Institutions	Public Interest Companies	Medium Sized Companies	Small Companies	Exempt Companies
Recommendation 15.6 The Central Bank should automatically receive management letters from external auditors of financial institutions at the same time as the 'final' (i.e. incorporating management response) management letter is issued to the regulated entity. The auditor should inform the Central Bank if no report is being issued.	✗	✓	✗	✗	✗	✗
Recommendation 15.7 Since the Central Bank already has the legislative basis to appoint an external auditor (or other "appropriate person") for the purpose of the performance by the Central Bank of its statutory functions, it is not necessary that joint auditors be routinely appointed by the Central Bank to financial institutions.	✗	✗	✗	✗	✗	✗

GLOSSARY OF TERMS

IRELAND

Recognised Bodies

Section 191(3) of the Companies Act, 1990 empowers the Minister for Enterprise, Trade and Employment to recognise a body of accountants to qualify and regulate its members as auditors. There are six accountancy bodies currently recognised as follows:

- the Institute of Chartered Accountants in Ireland (ICAI);
- the Institute of Certified Public Accountants in Ireland (ICPAI);
- the Association of Chartered Certified Accountants (ACCA);
- the Institute of Incorporated Public Accountants Ltd (IIPA);
- the Institute of Chartered Accountants in England and Wales (ICAEW);
- the Institute of Chartered Accountants of Scotland (ICAS).

CCAB-I

The Consultative Committee of Accountancy Bodies in Ireland is an umbrella body for the accountancy profession. The members of the CCAB are:

- Institute of Chartered Accountants in Ireland;
- Institute of Certified Public Accountants in Ireland;
- Association of Chartered Certified Accountants;
- Chartered Institute of Management Accountants (CIMA). *(A body not recognised by the Department of Enterprise, Trade and Employment for the qualification and regulation of auditors.)*

The ICAI chairs the CCAB-I which provides a forum for co-operation between recognised bodies on a number of joint committees namely:

- Accounting Standards; Consultative Committee;
- Business Law Committee;
- Taxation Committee;
- Insolvency Committee;

Ryan Report

Report of the Commission of Inquiry into the Expectation of Users of Published Financial Statements (January 1992). The Commission was established by the Institute of Chartered Accountants in Ireland. The Commission comprised representatives from industry, the Stock Exchange, financial institutions, universities and the ICAI.

CLRG

The Company Law Review Group was established in 1994 by the Minister for Enterprise and Employment to consider aspects of Irish company law including examinership, investigations, insider dealing and provisions relating to restrictions on directors and the recommendations of the Ryan Commission on Financial Reporting. The Group reported in December 1994. Its membership included representatives of the accountancy and legal professions, the financial services industry, trade unions, industry and Government.

The Company Law Review Group has recently been re-established by the Tánaiste and is currently working on a two year work programme covering items such as simplification of company law for SMEs and licensing of insolvency practitioners.

ODCE

Office of the Director of Corporate Enforcement which is a new office to be established by legislation (Company Law Enforcement Bill published on the 3 July 2000). It will be responsible for the enforcement of company law in Ireland and will take over the functions of the Minister for Enterprise, Trade and Employment in the area.

Big Five

The Big Five means the following accountancy firms: KPMG, Arthur Andersen, PricewaterhouseCoopers, Deloitte & Touche, and Ernst & Young.

UNITED KINGDOM

CCAB

Consultative Committee of Accountancy Bodies. The CCAB is an umbrella body for the accountancy professional bodies and oversees the following:

- CCAB - Ethics Liaison Committee;
- Ownership of the Auditing Practices Board, although this is due to change with the introduction of the Foundation for a new independent regulatory framework in the UK;
- Discussion of policy matters.

In addition to recognised accountancy bodies (see below) CIMA (Chartered Institute of Management Accountants) and CIPFA (Chartered Institute of Public Finance Accountants) are also members of the CCAB but are not recognised under the UK Companies Acts to supervise their members' audit work.

APB

Auditing Practices Board: Established in 1991 by the Consultative Committee of Accountancy Bodies in the UK to advance standards of auditing in the UK and Ireland and to provide a framework for the operation of the auditors role. Standards and practices and revisions thereto are notified to members of the recognised accountancy bodies on a regular basis. APB comprises auditing practitioners and non-practitioners in equal numbers together with a number of non-voting observers, e.g. representatives of the Department of Trade and Industry and of the Department of Enterprise, Trade and Employment. APB is funded by the accountancy profession. The APB will become part of the Foundation under the new UK regulatory arrangements (see Foundation below).

Cadbury Report

Report of the Committee, set up in 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession, on "The Financial Aspects of Corporate Governance". The Committee was chaired by Sir Adrian Cadbury. Membership consisted of accountancy and legal professions, industry, financial services, London stock exchange and the UK Government.

Greenbury Report Report of a Study Group chaired by Sir Richard Greenbury on Directors' Remuneration which was set up on the initiative of the Confederation of British Industry in 1995. Membership consisted of industry (mainly large PLCs), including the investment industry.

Hampel Report The Committee on Corporate Governance under the Chairmanship of Sir Ronald Hampel (Chairman, ICI PLC) was established in 1995 on the initiative of the Financial Reporting Council (see below) to review the implementation of the findings of the Cadbury and Greenbury Committees. The Committee's sponsors were the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the CCAB, the National Association of Pension Funds and the Association of British Insurers. The Committee published its final report in 1998.

Combined Code The Combined Code on Corporate Governance, which was published in June 1998, sets out the most recent best practice in relation to corporate governance structures that apply in the UK and Ireland. The Combined Code is derived, by the Committee on Corporate Governance, from its own report (Hampel) and from the Cadbury and Greenbury Reports.

FRC Financial Reporting Council is a representative body drawn from industry and commerce, the UK Government and the profession. FRC provides support and broad policy guidance to the Financial Reporting Review Panel and the Accounting Standards Board. The three bodies are supported and funded jointly by the Government, the accountancy profession (through the CCAB) and the City (the London Stock Exchange together with the banking and investment community).

FRRP Financial Reporting Review Panel is a subsidiary of FRC but is independent in exercising its functions. It examines apparent departures from accounting requirements of the UK Companies Act, 1985, including applicable accounting standards, and if necessary seeks an order from the Courts to remedy them. The Panel's ambit is public and large private companies.

ASB

Accounting Standards Board makes, amends and withdraws accounting standards and is a subsidiary of the FRC but is independent in exercising its functions.

The Foundation

A new framework of independent regulation for the accountancy and auditing profession is due to be implemented in the course of 2000. This framework is being introduced on a non-statutory basis using the existing powers of the professional bodies. The control of members' qualifications, registration and primary control for routine investigation and disciplinary matters will remain with the accountancy bodies.

The Foundation will have eight members which will not include any practising accountants. Members of the Foundation will be appointed by outside institutions and representative bodies with the closest interest in the regulation of the accountancy profession. The Central Bank of Ireland has a nominee on the Foundation.

The Foundation will establish three new boards, (i.e. Ethics Standards Board (ESB), Auditing Practices Board (APB) and Investigation and Discipline Board (IDB)) each with 60% representation independent of the accountancy profession. The Boards will be owned by the Foundation. The Foundation will also establish a Review Board of which one member may be a practising accountant but not a partner or employee of a firm of accountants. The Review Board will oversee the work of the new Boards and the other regulatory functions which remain with the accountancy bodies. The Review Board is to be chaired by the Comptroller and Auditor General in Britain.

The Foundation will be funded by the professional bodies.

Professional Accountancy Bodies

Under the UK Companies Act 1989, a number of bodies are recognised to supervise their members for audit work (Recognised Supervisory Bodies).
These are:
ACCA: Association of Chartered Certified Accountants
ICAEW: Institute of Chartered Accountants in England and Wales
ICAI: Institute of Chartered Accountants in Ireland
ICAS: Institute of Chartered Accountants in Scotland
AAPA: Association of Authorised Public Accountants

PROFESSIONAL STANDARDS

Accounting Standards

Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements. Standards give guidance on how professional judgement should be applied to a particular situation. Standards used by accountants are developed by the Accountancy Standards Board established in the UK in 1990. Standards are developed in line with UK Company Law. There is no recognition in Irish company law of these standards. The accountancy bodies here do have the right, either through the CCAB-I or individually, to comment on "Discussion Drafts" of proposed accounting standards (Financial Reporting Statements (FRS)) and to influence them at that stage of preparation.

Auditing Standards

Auditing standards (SASs) are the basic principles and essential procedures with which auditors are required to comply with in the conduct of any audit of financial statements. APB (a sub-committee of CCAB) are responsible for setting standards for UK and Ireland. SASs include explanatory and other material which, rather than being prescriptive, are designed to assist auditors in interpreting and applying auditing standards

Practice Notes

Practice Notes assist in applying Auditing Standards of general application to particular circumstances and industries.

Ethical Guidelines

Provide guidance to auditors on specific matters which have been approved for issue by the Councils of the accountancy bodies on how an audit is carried out. Most professional bodies set their own ethical standards.

EUROPE

FEE

Fédération Des Experts Comptables Européens is the representative organisation for the accountancy profession in Europe, grouping together the leading Institutes in 26 countries with a combined membership of over 400,000 individuals of which approximately 45% are in public practice. There is Irish representation through the professional accountancy bodies. FEE has working parties on auditing, ethics, accounting, banking and insurance.

EU Committee on Auditing

The EU Committee on Auditing, chaired by the Commission (Internal Market DG) was established in 1998. It meets two or three times a year. It is a platform where statutory audit regulators from the 15 Member States and the 3 countries of the European Economic Area, together with representatives of the audit profession, FEE, the internal auditors and the European representatives of the large audit firms, deal with statutory audit matters. Its overall objective is to develop a common view on statutory audit at EU level, in particular for matters that are not covered by existing EU legislation; the Eight Directive. It is a sub-committee of the Contact Committee (see below).

EU Contact Committee on the Accounting Directives (Contact Committee)

The Contact Committee is an advisory body composed of representatives of the Member States and representatives of the Commission. It was set up by the Commission in accordance with the requirements contained in Article 52 of Directive 78/660/EEC (4th Directive).
The functions of the Contact Committee are:

- to facilitate harmonised application of the Accounting Directives through regular meetings dealing in particular with practical problems arising in connection with their application;
- to advise the Commission, if necessary, on additions or amendments to the Accounting Directives.

EU Accountancy Technical Sub-Committee	The Accountancy Technical Sub-Committee is a sub committee of the Contact Committee and meets regularly to discuss matters particularly relating to International Accounting Standards.
EU Directives	Unlike EU Regulations which have direct effect, EU Directives specify the objectives to be achieved and requires that each Member State should enact the necessary laws and regulations to make the Directive's provisions binding in its country. A number of Directives have been issued in relation to company law. The Fourth, Seventh and Eight Directives are of particular relevance to accounting/auditing.
EU Fourth & Seventh Directives	The Fourth Directive deals with the annual accounts of individual companies and the Seventh Directive deals with consolidated accounts. Both Directives set out in detail the rules to be followed for the preparation of financial statements, particularly in relation to formats, valuation and disclosure.
EU Eight Directive	Eight Council Directive 84/253/EEC: The objective of the Eight Directive is to complete the series of Directives concerning company accounts, defining the qualifications of persons responsible for carrying out the statutory audits of the accounting documents required by the Fourth and Seventh Directives. The Directive applies to persons responsible for carrying out statutory audits of the annual accounts of companies and firms and verifying that the annual reports are consistent with those annual accounts in so far as such audits and such verification are required by Community law.

EU Green Paper on Auditing

A Green Paper on the Role, Position and Liability of the Statutory Auditor in the European Union was issued by the European Commission in 1996.

The Green Paper addresses the following issues:

- the role of the statutory auditor in determining *inter alia* the accuracy of financial statements, company solvency, the existence of fraud, respect by the company of legal obligations and responsibilities to the environment and society;
- the contents of the audit report;
- the independence of the auditor;
- rules on the appointment and dismissal of the auditor;
- the level of the audit fee;
- the auditing of small companies and groups of companies;
- whether the liability of the statutory auditor should be limited;
- application to the auditing profession of Community rules on freedom of establishment and freedom to provide services.

USA

SEC

The Securities and Exchange Commission is the primary overseer and regulator of the US securities markets. The SEC has statutory authority to establish financial accounting and reporting standards for Publicly Listed Companies (PLCs) under the Securities Exchange Act of 1934

OTHER INTERNATIONAL TERMS

IASC

The International Accounting Standards Committee was set up by the accountancy profession in 1973. Its membership currently numbers 143 professional accountancy bodies in 104 countries. IASC is the recognised body for the development of international accounting standards. It works closely with the national standard setting bodies, inter-governmental organisations and development agencies. The IASC's principal function is to issue standards, known as International Accounting Standards (IASs). The IASC is currently being re-structured in order to allow it better meet the need for accounting standards that can be accepted in most areas of the world.

IFAC

The International Federation of Accountants is a world-wide representative body for accountants and is based in New York. The world-wide accountancy profession, including Irish professional bodies, is represented. IFAC has 143 member bodies in 104 countries, representing 2 million accountants. Full membership in IFAC automatically includes membership in the IASC.

IAPC

The International Auditing Practices Committee is an IFAC Committee which works to improve the degree of uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and attest functions and promoting their acceptance world-wide.

OTHER TERMS USED IN REPORT

Corporate Governance

The term corporate governance refers to the process of supervision and control operating within companies. Company law provides the general framework within which companies operate.

Auditor qualification

The classes of persons qualified to act as auditors in Ireland are set out in section 187 of the Companies Act, 1990 (as amended). Aside from some 50 persons who were individually authorised as company auditors before 3 February, 1983, the remainder hold valid practising certificates from, and are members of, accountancy bodies recognised by the Minister for Enterprise, Trade and Employment under section 191 of the 1990 Act. A register of qualified auditors is maintained by the Registrar of Companies.

SMEs

Small and Medium Sized Enterprises:
The thresholds for medium sized companies are currently defined in company law (S.I. 396 of 1993 European Community (Accounts) Regulations) as:

1. having a balance sheet total that does not exceed £6 million,
2. a turnover of £12 million and
3. 250 employees.

A private company can be treated as a medium sized company if it satisfies at least two of these three criteria.

A small company is a subset of the above and is defined as:

1. having a balance sheet total that does not exceed £1.5 million,
2. a turnover of £3 million and
3. 50 employees.

IFSC

The International Financial Services Centre was established by the Government in 1987. The principal objective in establishing the IFSC is the development of a strong international financial services industry in order to create sustainable high quality employment in Ireland.

SRA (SFR)

Single Regulatory Authority: In October 1998 the Government agreed in principle to the establishment of a single regulatory authority for the financial services sector and established the McDowell Implementation Advisory Group to progress the necessary work. The Group reported in May 1999. The Group recommended that the SRA should be an entirely new independent organisation.
A minority of the Group preferred to locate the SRA within the overall framework of the Central Bank. The Group considered that all financial service providers should, in principle, be dealt with by the SRA and that a compelling case would have to be made for the exclusion of any provider from its remit.

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