

# FS 11/1

Financial Services Authority &

Financial Reporting Council

## Enhancing the auditor's contribution to prudential regulation

Feedback on DP10/3





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This joint Feedback Statement reports on the main issues arising from the joint Discussion Paper DP10/3 *Enhancing the auditor's contribution to prudential regulation*.

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# Acronyms used in this paper

<b>AADB</b>	Accounting and Actuarial Discipline Board
<b>AIU</b>	Audit Inspection Unit
<b>APB</b>	Auditing Practices Board
<b>ARROW</b>	Advanced, Risk-Responsive Operating Framework
<b>ASB</b>	Accounting Standards Board
<b>BBA</b>	British Bankers' Association
<b>BIPRU</b>	Prudential Standards sourcebook for Banks, Building Societies and Investment Firms
<b>BSA</b>	Building Societies Association
<b>COREP</b>	Common European Reporting
<b>DP</b>	Discussion Paper
<b>EBA</b>	European Banking Authority
<b>EU</b>	European Union
<b>FRC</b>	Financial Reporting Council
<b>FRRP</b>	Financial Reporting Review Panel
<b>FSA</b>	Financial Services Authority
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>GABRIEL</b>	Gathering Better Regulatory Information Electronically
<b>IASB</b>	International Accounting Standards Board
<b>ICAEW</b>	The Institute of Chartered Accountants in England and Wales

<b>ICAS</b>	The Institute of Chartered Accountants of Scotland
<b>IAS</b>	International Accounting Standard
<b>IAASB</b>	International Auditing and Assurance Standards Board
<b>IFRS</b>	International Financial Reporting Standards
<b>ISA</b>	International Standards on Auditing
<b>ISQC</b>	International Standard on Quality Control
<b>ISRE</b>	International Standard on Review Engagements
<b>POB</b>	Professional Oversight Board
<b>RAR</b>	Return Assurance Report
<b>SPR</b>	Skilled Person Report

In this paper the following terms have the following meanings:

- the term ‘firms’ means FSA-regulated firms, unless the context indicates otherwise;
- the term ‘auditors’ means firms’ external auditors, and the terms ‘audit’ and ‘assurance’ refer to the audit and assurance work performed by those auditors; and
- ‘we’ (and correspondingly ‘us’ and ‘our’) refer to both the Financial Services Authority (FSA) and the Financial Reporting Council (FRC).

# 1

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## Overview

### Purpose and structure of this paper

#### 1.1 In this Feedback Statement we:

- set out the feedback we received to the questions in the Discussion Paper, and our responses to this feedback. Our response includes the actions the Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have taken since the Discussion Paper was published and the progress being made in enhancing auditors' contribution to prudential regulation (Chapters 2 to 5); and
- discuss the next steps planned and our expectations for the future. This sets out our intent to continue enhancing our interaction with external auditors, making use of the guidance and frameworks we have developed, and the need for close monitoring of our success in these efforts (Chapter 6). This will continue under the operating model envisaged by the regulatory reform being proposed and consulted upon by HM Treasury.

#### 1.2 We received 29 responses from a range of accountancy firms, accountancy bodies, trade bodies, financial institutions, and individuals. We are grateful to those who took the time to respond. A full list of non-confidential respondents is set out in Annex 1 and copies of individual responses are available on request and from the FRC's website (see page 3).

### Background

#### 1.3 DP10/3: *Enhancing the auditor's contribution to prudential regulation*<sup>1</sup>, published jointly between the FSA and the FRC ('the Discussion Paper'), was intended to stimulate debate on how the FSA can best use audit and auditors to meet its statutory objectives. In particular, it explored how the FSA, the FRC and auditors can work together more effectively to enhance auditors' contribution to prudential regulation.

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1 FSA/FRC (2010)

- 1.4 The Discussion Paper covered a number of areas where supervisory responses to the financial crisis highlighted the need to examine the role of auditors in prudential supervision.
- 1.5 The Discussion Paper began by discussing the quality of audit and the extent of professional scepticism applied by auditors, and the impact of this on financial statement estimates and disclosures. The quality of auditors' reporting on client assets was also addressed. We then went on to examine the regulatory environment in which auditors operate and possible measures to enhance auditors' contribution to prudential regulation. This included discussion of improved co-operation and information sharing (including the FSA's interaction with auditors and audit committees), the enforcement powers of the FSA and the powers of the FRC, the FSA's use of section 166 (s.166) skilled persons reporting (SPRs) as a regulatory tool, and the desired scope of assurance provided by auditors on firms' regulatory reporting and other topical matters as they arise.

## Summary of key themes and our feedback

### Dialogue with firms' audit committees and auditors

- 1.6 Overall, respondents supported better dialogue between the FSA, auditors and audit committees. Our plans to achieve this involve more frequent and enhanced bilateral meetings between auditors and supervisors, and selective, risk-based use of trilateral meetings involving audit committees and/or other relevant non-executive directors of firms. Additionally, we will continue to hold higher level meetings with audit firms periodically to discuss topical financial reporting and audit issues. These topical meetings are also complemented by discussions with relevant industry bodies.
- 1.7 A Code of Practice was published in draft by the FSA, supported by the Bank of England, on 10 February 2011 for a public consultation period.<sup>2</sup> The Code provides guidance on the nature of the relationship between supervisors and external auditors for all UK regulated firms. Additionally, an improved process will facilitate better communication with the FSA of certain issues and concerns by auditors under their duty to report.

### Auditor scepticism

- 1.8 There was widespread recognition from respondents that the application of professional scepticism is fundamental to the audit process. While regulated firms and their auditors noted that they believe auditors are already sufficiently sceptical, they expressed a willingness to debate the issue and explore various means of increasing the transparency of the audit, thereby improving the visibility of the challenge auditors pose to management. There remains a difference of views between us and the auditors on whether they were

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<sup>2</sup> FSA (2011), and included as Annex 2



always being sufficiently sceptical. While recognising that this may be exacerbated by the fact that it is often difficult to identify in retrospect whether auditors have been sufficiently sceptical, we have each held or will hold separate meetings with individual audit firms to explain the specific matters that led to our conclusions. Our concerns include whether there was sufficient challenge in relation to particular judgements and whether scepticism is adequately embedded in the audit firms' processes and training.

**1.9** Our approach in addressing this issue is to focus our efforts on continued monitoring of the application of auditor scepticism and measures that seek to improve the application and transparency of scepticism by auditors in future.

**1.10** This approach includes actions the FRC plans to take:

- through the Auditing Practices Board (APB)
  - to ensure a consistent understanding of the nature of auditor scepticism and its role in the audit;
  - to identify any implications for its auditing standards;
  - to improve the transparency of auditor scepticism; and
  - to consider the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been subject to significant challenge by auditors.
- through the Audit Inspection Unit (AIU)
  - to continue to focus on the extent to which scepticism has been applied in practice.
- through the Professional Oversight Board (POB)
  - to explore how scepticism is recognised within the audit firms' competency frameworks.

**1.11** Additionally, enhanced audit guidance from the APB on auditing banks and building societies (in the form of an update to Practice Note 19) is designed to improve audit quality.

**1.12** The FSA's deeper relationship with auditors will also assist them in observing and understanding the extent to which auditors challenge management's estimates and disclosures in their financial statements.

## **Disclosures**

**1.13** Respondents shared concerns regarding the nature and extent of disclosures in annual reports about management's key judgements but expressed differing views as to how this should be enhanced and what the FSA's role should be in this respect.

- 1.14 Since users' needs are dynamic, if they are to be provided with decision-useful information, our view is that firms may need to go beyond the specific minimum required disclosures. This can be aided by further challenge of management by auditors. This is consistent with the FSA's messages in DP 09/5 and the associated Feedback Statement (*Enhancing financial reporting disclosures of UK credit institutions*).<sup>3</sup>
- 1.15 The FSA's Accounting Review Team (ART) assists supervisors in dealing with complex accounting and disclosure issues. This function was supported by respondents.

### **Section 166 skilled person reporting and assurance on regulatory returns**

- 1.16 Most respondents believed that the FSA should commission s.166 SPRs more often, with preventative/diagnostic objectives as well as for enforcement purposes. Respondents also felt that targeted s.166 return assurance reporting (RAR) could be a more efficient mechanism than a general audit requirement to gain assurance over regulatory returns. However, some were in favour of introducing a requirement for firms to provide reconciliations of certain data between the financial statements and regulatory returns.
- 1.17 We have already begun to adopt a more centralised approach to scoping and oversight of s.166 engagements, whilst using them more frequently and proactively. We agree that provision of and assurance over reconciliations of regulatory to financial reporting data is worth considering further. Furthermore, we will consider expanded, more regular use of s.166 RARs, providing assurance on regulatory reporting from firms.

### **Audit of Pillar 3 and other regulatory capital information, and additional reporting by auditors to the FSA**

- 1.18 Most respondents did not support a requirement for the audit of Pillar 3 disclosures; but views were mixed on the need for assurance on regulatory capital numbers in the annual report. As the FSA continues to promote improvement in firms' disclosures, it will monitor users' responses to Pillar 3 disclosures and reflect further on assurance over regulatory capital measures, but is not proposing changes at this time.
- 1.19 There was a strong consensus from respondents that additional direct reports from auditors to the FSA would not be beneficial. We accept this, but note that we may reconsider this when the new regulatory arrangements come into effect.

### **FSA and FRC powers**

- 1.20 There was little appetite among respondents for the FSA to seek enhanced enforcement powers over auditors given the perceived risk of duplication and confusion that could be caused by overlap. However, there was support for increased co-operation between the FSA and the FRC on audit and accounting matters.

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<sup>3</sup> FSA (2010a)

- 1.21 A Memorandum of Understanding between the FSA and the AIU<sup>4</sup> has been published which includes a commitment for the FSA and AIU to meet regularly (at least four times a year) to discuss areas of mutual concern or interest.
- 1.22 HM Treasury has agreed that minor changes are necessary to FSMA to clarify that, where an audit firm is appointed auditor, the FSA's power to disqualify auditors applies to individual auditors, and not just the audit firm as a whole.
- 1.23 There was mixed support for the FRC to increase the scope of its monitoring activities and to enhance the scope and clarity of its powers to investigate. The FRC is considering its powers, taking into account the responses received, and will be discussing them with stakeholders and with government prior to consultation on specific proposals.

## Scope

- 1.24 The first question asked respondents to consider whether the scope of the Discussion Paper was adequate, as follows:
- Q1: In addition to the matters set out in this paper, are there any other matters you would like to raise concerning the auditor's contribution to prudential regulation?*
- 1.25 Where possible, we have amalgamated the points raised by respondents in reply to this question under the most relevant of the other 14 questions in the chapters that follow. This is because generally respondents used this question to re-iterate the key points of their overall response. That said, there were some other themes and observations arising from the responses that are set out below.
- 1.26 Many respondents highlighted the importance of any changes in regulation – whether through changes in law, the FSA Handbook or existing FSA practices – being undertaken in a proportionate manner. Respondents did not want changes to have an undue impact on all firms when the underlying problem being addressed related to a distinct subset of firms or sectors.
- 1.27 Respondents noted that the issues raised in the Discussion Paper were one part of the current debate on the framework for corporate governance, reporting and assurance, noting that it would be important to ensure that any changes made by the FSA or FRC were consistent with developments in those other areas and consistent internationally, where relevant.

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4 FSA/FRC (2011)

## Our response

Any decisions to implement changes to existing policies or guidance will be taken through appropriate consultation processes and implemented in a proportionate manner.

We welcome the debate on the role of audit and the lessons from the financial crisis. We will contribute through all the relevant forums to ensure as far as possible that any changes made by the FSA and FRC are consistent with developments in those areas (e.g. the FSA's input into the work of the relevant subcommittees of the Basel Committee on Banking Supervision at the international level, the FRC's co-operation with other audit regulators through the International Forum of Independent Audit Regulators and its input to the work of the International Auditing and Assurance Standards Board (IAASB), and through our contribution to the debate at European level, via our responses to the European Commission's consultation on audit policy (*Audit Policy: Lessons from the Crisis*)).<sup>5</sup> The FRC also issued its paper – *Effective Company Stewardship – Enhancing Corporate Reporting and Audit* – in January 2011<sup>6</sup> and launched its Inquiry into Going Concern and Liquidity Risk in March 2011<sup>7</sup> as a further contribution to this debate.

## Who should read this Feedback Statement?

- 1.28** This paper will be of interest to UK and international financial institutions and their trade associations, investors, analysts, audit firms, accountancy bodies, financial regulators and standard setters.
- 1.29** The issues raised in the Discussion Paper and in this Feedback Statement are relevant to all FSA-regulated firms who are required to appoint an external auditor. However, this paper is likely to be more relevant to larger firms including banks, other deposit-takers and insurance firms. The nature of these firms' business activities results in more complex transactions (in particular, relating to financial instruments) and judgements with respect to financial reporting, which requires extensive accounting and audit expertise.
- 1.30** This paper will also be of interest to firms subject to audits of compliance with client assets rules and those who undertake s.166 skilled persons reporting.

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<sup>5</sup> European Commission (2010)

<sup>6</sup> FRC (2011a)

<sup>7</sup> FRC (2011b)

# 2

## Auditor scepticism and disclosures

2.1 This chapter summarises the feedback from respondents to questions 2 and 3 which address auditor scepticism and disclosures of key management judgements, as well as our responses.

*Q2: Given that professional scepticism on the part of firms' auditors is especially important in their audit of key areas of judgement in relation to accounting estimates and related disclosures, how could the requirement for professional scepticism and its application in practice be enhanced in these areas?*

2.2 We received 22 responses to this question with widespread recognition from respondents that the application of professional scepticism is fundamental to the audit process. Most respondents, including regulated firms, expressed a view that auditors are sufficiently sceptical in their work. A number of respondents observed that there was no body of evidence to suggest a widespread problem. However, one respondent, an investor representative body, agreed with the Discussion Paper that auditors did sometimes lack scepticism, focusing too much on gathering and accepting evidence that supports managements' assertions rather than challenging those assertions.

2.3 Many respondents suggested that the degree to which professional scepticism has been applied in an audit is generally not observable after the event, and therefore greater transparency about the work of auditors could help to underpin and demonstrate the exercise of scepticism. A number of ideas to achieve this greater transparency were raised by respondents, including:

- disclosures by the audit committee about their discussions with auditors on key areas of judgement; and

- more reporting to stakeholders on a wider range of matters by auditors such as changes to accounting policies, the sensitivity of accounting estimates, and key judgements, assumptions and uncertainties.

- 2.4 Some respondents emphasised that, while auditors must challenge the reasonableness of management's judgements based on available evidence and their own knowledge, it is not the role of the auditor to develop alternative judgements or estimates and then convince management to accept these.
- 2.5 Some respondents, particularly those from accountancy firms and accountancy bodies, suggested that auditors' acceptance of estimates made by management did not necessarily imply a lack of scepticism simply because the FSA felt that these estimates should be more prudent. One respondent observed that whilst prudence was an important consideration for the FSA as a prudential regulator, it was less important for financial statements as the *IASB<sup>8</sup> Framework for the Preparation and Presentation of Financial Statements* states that prudence should not override neutrality or reliability through, for example, overly prudent provisions.
- 2.6 Some respondents felt that the audit profession itself was best placed to consider the issue of auditor scepticism, noting that there are already a number of measures to support auditors in exercising scepticism, including requirements in the recently revised auditing standards.<sup>9</sup> It was suggested that these should be allowed to have an effect before the need for further action is considered. They noted that the revised standards place more emphasis on the need for auditors to evaluate how management has considered alternative assumptions and to review how management has arrived at accounting estimates for indications of management bias.<sup>10</sup>
- 2.7 Others noted the discussion in the APB Discussion Paper, *Auditor Scepticism: Raising the Bar<sup>11</sup>* and that the APB is the appropriate body to take forward this debate.

### Our response

Concerns about auditor scepticism were raised in the Discussion Paper because of specific instances that caused us to question whether auditors have always been sufficiently sceptical in their work. We did not intend to infer that this is a widespread issue affecting all audits. However, neither was it the case that we had encountered a small number of isolated cases. We described it as 'worrying' because an appropriate degree of professional scepticism is critical to the delivery of a high quality audit. It fundamentally underpins the risk-based approach in the auditing standards. This is because the extent and nature of audit procedures (and therefore the degree of assurance the auditor obtains) is driven by the auditor's assessment of the risks of material misstatement of

8 IASB: International Accounting Standards Board

9 Revised ISAs were issued by the IAASB in October 2009 and are effective for periods ending on or after 15 December 2010.

10 ISA 540 – *Auditing accounting estimates, including fair value estimates and related disclosures*, (paragraph 15 for management's alternative assumptions and paragraph 21 regarding management bias).

11 APB (2010)

the financial statements. Confidence that an appropriate degree of scepticism is applied in making those risk assessments is an essential determinant of confidence in the whole audit.

In the Discussion Paper, we raised concerns about auditor scepticism particularly in the context of accounting estimates, including fair value estimates, which have a degree of uncertainty. The more uncertainty there is, the more judgemental are management's estimates and, in turn, the more important are high quality disclosures about the key judgements management have made. In these circumstances, transparency through appropriate disclosures aids comparability and underpins market stability. Furthermore, the more uncertainty there is, the more important it is for the auditor to challenge management's judgements and the adequacy and quality of their related disclosures and to be seen to do so. This is necessary to enhance stakeholders' confidence that such challenge is effective, to enhance their confidence in audited financial statements and in turn to support market stability.

We recognise that accounting estimates are the responsibility of management, not auditors. Our concern is about circumstances where auditors do not sufficiently consider whether there are alternatives not considered by management and therefore do not challenge whether management are making the most appropriate judgements. Under the new auditing standards, where accounting estimates give rise to significant risks, auditors will be required to evaluate specifically how management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.<sup>12</sup>

With regard to some respondents' concerns over the role of prudence in accounting estimates, the FSA, as a prudential regulator, has a variety of supervisory tools to influence the safety and soundness of financial institutions which are employed outside of the financial statements. We recognise the need for unbiased and neutral estimates in financial reporting.

In light of responses to this question that indicated that regulated firms and their auditors do not accept the basis for our conclusion that auditors are not always sufficiently sceptical, both the FSA and FRC have held (and in some instances are to hold) separate meetings with individual audit firms to explain what led us to this conclusion. Although these discussions have not resulted in a meeting of minds with those auditors we have met about the basis for our concerns, there is a common understanding that the exercise of professional scepticism is fundamental to audit quality.

We note that, although expressed in different terms, similar concerns appear to underlie questions raised by others in the aftermath of the financial crisis. For example, the House of Commons Treasury Select Committee's call for the APB

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<sup>12</sup> ISA (UK and Ireland) 540, *Auditing accounting estimates, including fair value accounting estimates, and related disclosures*, paragraph 15(a).

to consult on whether there should be a total prohibition on auditors providing non-audit services to the entities that they audit reflects perceptions that the relationship between the auditor and management can undermine the auditor's ability to challenge management effectively.<sup>13</sup> Similar issues were raised in the European Commission's consultation: *Audit Policy – Lessons from the Crisis* published in October 2010.<sup>14</sup>

We acknowledge that professional scepticism is a particular mindset and therefore that direct evidence of its exercise, or otherwise, may be hard to observe after the event and is often circumstantial. Going forward, we believe it is important that our focus is on improving confidence that an appropriate degree of scepticism will be applied consistently by auditors.

To that end we, along with the Bank of England, are engaging with the relevant individuals from the audit firms to agree steps to address our concerns. While the focus initially was on banks, we are addressing this for other financial services sectors as well. We will jointly review progress with the senior partners at the end of the 2010 financial reporting season and continue to monitor going forward.

Concurrently with the issue of this Feedback Statement, the APB has published its Feedback Statement addressing the responses received to its Discussion Paper, *Auditor Scepticism: Raising the Bar*.<sup>15</sup> We note the broad recognition of the importance of professional scepticism in responses to that paper, from all categories of respondents, including audit firms. In its Feedback Statement, the APB indicates that the AIU will continue to focus on the extent to which scepticism has been applied in practice in the course of those audits subject to future inspection and will review the application of the new requirements of ISA (UK&I) 540 on the audit of accounting estimates, and the POB will explore how scepticism is recognised within the audit firms' competency frameworks.

In addition, the APB plans to:

- ensure that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of audits;
- review International Standards on Auditing (ISAs) (UK and Ireland) for possible ambiguities in relation to the nature and importance of professional scepticism and propose such changes as may be needed to make sure the position is clear;
- review International Standard on Quality Control (ISQC) (UK and Ireland) to ensure that it has sufficient requirements and guidance relating to the need for firms to have appropriate policies and procedures for promoting the competencies that underlie professional scepticism;

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<sup>13</sup> See [www.parliament.uk/business/committees/committees-archive/treasury-committee/bankingcrisis/](http://www.parliament.uk/business/committees/committees-archive/treasury-committee/bankingcrisis/)

<sup>14</sup> European Commission (2010)

<sup>15</sup> APB (2010)



- consider how transparency as to the application of scepticism can be increased in communications with audit committees and regulators; and
- consider, with other parts of the FRC, whether there is a need for guidance on the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been the subject of significant challenge by auditors.

The FRC is also consulting more broadly on how to enhance the transparency of the audit and other aspects of corporate reporting in its Discussion Paper, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*, published in January 2011.<sup>16</sup> In that Discussion Paper the FRC indicates that it is particularly keen to ensure that the right environment is created for increased auditor scepticism when assessing material assumptions and estimates. The FRC comments that:

*The effective exercise of professional judgement is fundamental to the quality of every audit and it is required at numerous stages during an audit. If auditors are to exercise that professional judgement effectively, they must approach issues such as these with an appropriate mindset – a mindset that includes professional scepticism. Such scepticism would be enhanced by greater transparency, with the assessments made by auditors being open to effective challenge by the Audit Committee and investors.*

In addition to efforts to enhance the application of scepticism, the FRC is also exploring a fuller audit committee report which sets out matters of significance raised by the auditors and communicated to the audit committee. This could have the effect of increasing transparency in audits and of increasing public confidence in the level of challenge and scepticism applied by auditors.

The FRC is also currently consulting on its 2011/2012 work plan. In light of responses to this and to the Effective Company Stewardship paper, the FRC will consider whether further guidance is needed:

- for audit committees, to emphasise the link between scepticism and the audit committee's evaluation of audit effectiveness; and
- for preparers, audit committees and auditors on forming accounting-related judgements especially those relating to impairment estimates.

In Chapter 3, we describe steps being taken to enhance effective dialogue and information-sharing between auditors and supervisors and to enhance dialogue between the FSA and firms' audit committees. This should also contribute to creating the right environment for the exercise of an appropriate degree of auditor scepticism and opportunities for auditors to demonstrate their appropriate exercise of scepticism.

Steps being taken in relation to expectations of auditors regarding disclosures are further discussed in our response to question 3 below.

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<sup>16</sup> FRC (2011a)

*Q3: Do you agree that management and auditors should pay particular attention to the provision of disclosures about management's key judgements, especially in cases where other specific disclosures required by the accounting standards may not fully inform users about the economic substance of a transaction, or about a firm's financial position and performance more generally?*

2.8 We received 23 responses to this question. All of those respondents agreed that disclosures about the key accounting judgements made in preparing the financial statements represent an important element of financial reporting.

### **Enhancing the existing public disclosures**

2.9 There were, however, differing views as to whether existing disclosure practices in this area needed to be enhanced. For example, a number of responses – particularly those from accountancy firms, accountancy bodies, financial institutions and their trade bodies – expressed the view that existing reporting requirements in this area are already sufficient and are being applied appropriately by management and considered appropriately by auditors.

2.10 Some respondents, noting the length and complexity of disclosures already provided, also cautioned that further disclosures might increase the volume of disclosure without adding information of value to users.

2.11 In the Discussion Paper, we explained that, if the underlying judgements in areas such as fair value estimates and impairment provision estimates are not the subject of appropriate disclosure, the differences may impede comparability between firms. However, some respondents thought that comparability was difficult to achieve through disclosure and there were also practical limitations to achieving greater comparability through changes to valuation practices or audit procedures performed. It was, for example, argued that firms have different circumstances and access to varying levels of information, that the existence of illiquid markets can reduce the comparability of valuations, and that an auditor's confidentiality constraints typically preclude sharing of detailed information amongst client engagement teams.

2.12 In addition, several respondents expressed concern that the FSA might be trying to encourage greater public disclosure solely in order to obtain additional information needed for supervisory purposes through firms' public reporting. They pointed out that the FSA has the power to obtain the information it needs without having to insist it is provided through public reporting, and that information that is important for the FSA is not necessarily relevant to or useful for other users. Indeed, bearing both this and the concerns about forward-looking information and the length of reporting in mind, some respondents suggested that any additional information about key management judgements and risk might be better dealt with through private reports to the FSA.

- 2.13** On the other hand, other respondents thought enhancements to current disclosure practices were desirable. For example, many respondents suggested that further thought was needed on how existing disclosures on risks could be made more effective. The view of one investor representative body was that management and auditors had paid insufficient attention to such disclosures prior to the financial crisis and that, as a result, the disclosures failed to provide sufficient ‘early warning’ signals. Others suggested that improvements could be made regarding the ‘piecemeal’ presentation of such disclosures, and the provision of more forward-looking information.
- 2.14** Some respondents suggested that more effective implementation of the existing requirements was needed and additional guidance might help in that respect. The FRC’s guidance on going concern<sup>17</sup> was highlighted as an example of how this could be done effectively. For example, one respondent highlighted Code Provision C.1.2 of the June 2010 UK Corporate Governance Code<sup>18</sup>, which states that ‘The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company’ and suggested that the FRC should provide guidance on what they would expect to see disclosed.

### **The FSA’s involvement in the enhancement of public disclosures**

- 2.15** Several respondents expressed concern about the way the FSA is involving itself in the enhancement of public disclosures. They emphasised the importance of the FSA not encroaching on the accounting standard-setting responsibilities of the International Accounting Standards Board (IASB) and the ASB. In their view the FSA should limit itself to conveying its views on disclosures in statutory financial statements to the IASB and FRC. To do otherwise, they argued, risks causing confusion – and therefore difficulty – for firms.
- 2.16** One respondent suggested that the FSA nevertheless has an important role to play because it is the only stakeholder that has access to judgements made across the whole market and is therefore best-placed to benchmark and collate industry-wide data that would help auditors ‘to exercise a more knowledgeable challenge regarding the appropriateness of judgements and disclosures’.

#### **Our response**

##### *Application of existing reporting requirements*

As was explained in paragraph 3.24 of the Discussion Paper, the expectations of users as to the information that should be presented in the financial statements change over time in response to circumstances. New issues emerge and existing issues change in significance, often at short notice, necessitating

<sup>17</sup> FRC (2009)

<sup>18</sup> FRC (2010)

changes to the disclosures. It is not therefore realistic to expect the specific disclosure requirements in standards and the law to represent a comprehensive description of the information that the financial statements should provide to users. Additionally, it is often the case that particular issues affect specific industries. Standards apply to entities in all industries so it is not appropriate to make them industry specific. It follows that if intended users are to be provided with information that meets their needs, preparers may need to go beyond the requirements for specific disclosures in IFRS or enhance the way in which they apply these requirements to adapt to changing circumstances. Indeed, IAS 1 – *Presentation of Financial Statements* requires additional disclosures when compliance with specific IFRS requirements is insufficient to enable users to understand particular transactions, events and conditions.<sup>19</sup>

Furthermore, as set out in the FSA's Feedback Statement, FS 10/3 *Enhancing financial reporting disclosures by UK credit institutions; Feedback to DP09/5*<sup>20</sup>, the British Bankers' Association (BBA) has put in place a *Code for Financial Reporting Disclosure* (the BBA Code) which states: 'As necessary, UK banks will continue to consider going beyond what is required by IFRS, statutory and regulatory requirements and listing rules to ensure that the information they provide to stakeholders meets these objectives.'<sup>21</sup>

As an example, the objective-based disclosure requirements set out in IFRS 7 – *Financial Instruments: Disclosures*, help stakeholders to focus on the key disclosure principles, but the way those principles are best met will vary over time. Firms need to be alive to this and apply such standards thoughtfully. Our observation is that, although some firms do this, others do not.

One of the issues that has changed in significance is the desire of users for comparability – in other words, presenting and disclosing information in a way that enables users to discern and evaluate similarities and differences over time and across different institutions. Experience during the crisis showed that users are placing greater emphasis on this than ever before. Information that is relevant and representationally faithful can be enhanced by making it more comparable.

Risk disclosure was raised by many respondents as another area for improvement. We agree with this and emphasise that high-quality risk disclosures and disclosures about the related key accounting judgements that are both comprehensive and user-friendly are an essential part of a modern set of financial reports. For that reason we are encouraging the BBA and other relevant industry groups to take action to achieve those improvements, while avoiding 'boilerplate' disclosures in this area.

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19 IAS 1 *Presentation of financial statements*, paragraph 17(c)

20 FSA (2010a)

21 BBA (2010)

The FSA believes it is also very important that auditors consider carefully the disclosures to be provided and challenge their clients to meet the needs of intended users, which may go beyond the requirements for specific disclosures. The auditor's obligation is to evaluate whether a firm's financial statements are true and fair in accordance with the relevant accounting framework. Insofar as the accounting framework contains over-arching requirements that set out objectives in addition to specific requirements, there is often a high degree of judgement in determining and assessing the adequacy of disclosures to meet the 'true and fair' objective. Any observations or concerns the auditor has about the adequacy of the disclosures its client is providing or instances of debate between auditors and firms over compliance with the specific and objective-based requirements should be shared with the FSA as part of their ongoing dialogue (as guided by the Code of Practice for the relationship between the external auditor and the supervisor referred to in Chapter 3).

#### *Length and complexity of disclosures*

We share the concerns of respondents about the length and complexity of financial statements, and we agree that additional disclosure can mean less useful information. For that reason what is needed is better disclosure, not necessarily more. Therefore, echoing the principles in the BBA Code, we are encouraging firms to apply the existing disclosure requirements thoughtfully and with care, allowing for flexibility in detail and presentation as circumstances and needs of intended users dictate.

As changes occur in the economic environment and/or the entity's position, so will the expectations of users change as to the information that should be presented in the financial statements. In some areas it will be necessary to provide more granular information. However, in other areas, the level of detail that was previously needed may no longer be relevant – in which case they should be omitted. Again, these are concepts set out in the BBA Code.<sup>22</sup>

#### *Public vs. private disclosures*

Some respondents expressed concern that the FSA might be trying to encourage greater public disclosure solely in order to obtain additional information needed for supervisory purposes through firms' public reporting. That is not the FSA's intention. We have observed that, particularly in times of stress, market discipline is negatively affected by the uncertainty that can arise from financial statements in which key accounting judgements or other significant aspects of firms' activities or financial position are left unexplained or when the firm has applied practices that result in it appearing to be an outlier without supporting explanations. Appropriately enhanced *public* disclosures in these areas reduce (and perhaps even eliminate) this uncertainty and therefore improve market discipline in respect of the individual firms involved and the sector as a whole.

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22 BBA (2010)

Enhancements to the information provided exclusively to the FSA will not address this. The FSA is considering how more frequent information about regulatory capital could be published outside the annual report.

#### *Interaction with standards setters*

In response to the concerns raised by some about the way the FSA is involving itself in the enhancement of public disclosures, the FSA has no desire to be an informal accounting standard-setter. It fully recognises the difficulties it would create were it to encroach on the accounting standard-setting responsibilities of the IASB and FRC.

The FSA sees its intervention in the debate about the quality of public disclosure as reinforcing the need for greater transparency for users so as to enhance market discipline and confidence. Users are able to make their views known to firms and others about the quality of the financial reports they receive. However, their focus often tends to be on the present and foreseeable future, and may be less focused on the uncertainty that accounting practices and disclosures might reveal in times of crisis. The FSA strives to compensate for this by anticipating uncertainty and addressing the causes of it before it can affect market confidence.

The FSA has begun a process of exchanging views with various industry groups (such as the BBA, the Building Societies Association (BSA), and the Association of British Insurers (ABI)), including periodic meetings which anticipate key financial reporting issues for forthcoming reporting periods.

Furthermore, we describe in Chapter 3 of this Feedback Statement the enhanced dialogue between the FSA and auditors, which will facilitate sharing views and influencing firms' disclosures.

#### *Additional guidance*

Some respondents thought that additional guidance might help in achieving more effective implementation of the existing requirements, and one suggested that the FRC might provide that guidance. However, the IASB and ASB provide the overall framework setting out the requirements. Within this framework, regulators, standard setters and industry groups may assist by providing examples of best practice in some developing areas, in particular where the standards are not sufficiently detailed.

We believe that firms can enhance disclosure practices and methodologies by working together through proactive and energetic industry bodies. We are therefore encouraging the development of practices and methodologies by such bodies. The FSA believes it can also contribute by highlighting good and bad practices it has seen, such as in a guide to good and poor practice the FSA will be issuing in the near future on loans that are subject to forbearance strategies. We recognise the limitations that auditors face with respect to visibility of

valuations across a peer-group; however, the FSA currently has no intention to publish benchmarking data on key areas of valuation. Where appropriate, the FSA will continue to share (on an anonymous basis) results of work it has undertaken on aspects of valuation methodology with firms and auditors so that they are aware of the range of valuations and approaches. Also, the FSA will continue to monitor the effectiveness of the BBA Code and of increased intervention by auditors to determine whether its concerns have been addressed.

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## Summary

- 2.17** In this chapter we summarised the responses to the questions addressing auditor scepticism and firms' disclosures.
- 2.18** Respondents, while expressing mixed views on the level of professional scepticism applied to audits in the past, generally agreed that this is an important consideration worthy of further debate and initiatives to enhance practice as well as perceptions. In addition to the next steps proposed by the APB pursuant to its Feedback Statement on scepticism, we will continue to promote and support initiatives to improve the transparency of audits and the judgements made therein, to make more publicly visible the key challenges, debates and decisions made by management and auditors.
- 2.19** The focus on scepticism extends to auditors' work on financial statement disclosures as well as the underlying accounting estimates made by management. We have outlined our view that management must actively consider the decision-making needs of users when applying accounting standards in the most useful way, and auditors should challenge in this respect and communicate with the FSA as appropriate.

# 3

## Enhancing dialogue and sharing information

**3.1** This chapter summarises the feedback and our responses regarding questions 4, 8 and 9, which were focused on enhancing the FSA's interaction with auditors and audit committees. Given the link between questions 4 and 8, we have amalgamated the responses we received to these questions and our feedback to those responses.

*Q4: Do you agree with our proposal to enter into dialogue with firms' audit committees and auditors as set out [on page 34 of the Discussion Paper]? If not, why not?*

*Q8: How can the FSA's more intensive engagement with firms' accounting and the audit thereof be most effective?*

**3.2** We received 25 responses to Q4, and 24 responses to Q8. Overall, respondents, including those from firms, auditors and industry groups, supported enhanced dialogue between the FSA, auditors and the audit committee, in principle, recognising that such dialogue is an important element of effective audits and supervision. As some respondents also noted, for high impact firms<sup>23</sup>, the FSA already meets with the chair of the audit committee and indeed with all directors as part of its close and continuous supervisory regime.

**3.3** Some respondents expressed concerns about certain aspects of the dialogue that were suggested in the Discussion Paper. In particular, respondents were unconvinced that this dialogue should explicitly consider the appointment or re-appointment of the auditor. They noted that the firm was likely to discuss a change of auditor with the FSA in any case, and that any perceptions that the FSA had selected (or deselected) a firm's auditor could lead to legal challenges, particularly if such a change arose from exclusively bilateral meetings between the

<sup>23</sup> A firm with an ARROW score of 425 or above (or a bank/building society with 400,000 + customers) is 'high impact'. ARROW (Advanced, Risk-Responsive Operating frameWork) is the FSA's risk framework used for firm supervision and thematic work.



FSA and the audit committee. Some respondents questioned whether the FSA was in a position to assess auditor performance and whether the FSA was the appropriate body to take forward concerns about the audit rather than this solely being the remit of the FRC.

- 3.4 Some respondents cautioned the FSA to take care to ensure the result of any enhanced dialogue does not blur the existing responsibilities of the directors for the preparation of the accounts and the auditors' independent verification role.
- 3.5 However, overall there was very strong support for the FSA to engage more intensively with firms' auditors and audit committees, including through trilateral meetings and more dialogue with auditors throughout the audit process. Respondents also noted that these elements would need to be balanced against:
- the time commitment that would be placed on members of the audit committee and the potential for this to reduce the pool of available non-executives for audit committee positions;
  - challenging audit timetables;
  - the risk that the FSA might be perceived to be responsible for firms' financial reporting; and
  - consideration of how differences of view might be resolved or otherwise dealt with.
- 3.6 A number of respondents were supportive of the work of the FSA's Accounting Review Team, recognising its relevance as part of an effective programme of engagement with firms and their auditors.
- 3.7 One respondent suggested the FSA should attend more industry-wide meetings, noting in particular that the FSA holds regular meetings with the BBA, but has less interaction with equivalent groups in other sectors.

### Our response

The FSA believes it can enhance the effectiveness of audit committees through engaging with them on accounting and financial reporting issues to a greater extent. In particular, there is scope for more trilateral engagement between a firm's audit committee and management, the responsible FSA supervisor, and the firm's external auditor. This need for enhanced engagement is recognised in the principles and guidance set out in the draft Code of Practice for the relationship between the external auditor and the supervisor which we published for public consultation on 10 February 2011 (attached as Annex 2). This draws on the work of a working group, established by the Bank of England, of which the FSA and FRC were members along with representatives from the large audit firms and the ICAEW.

Given the role of the audit committee in a firm's financial reporting, FSA supervisors and audit committees would both benefit from discussions on aspects of the audit committee's remit (e.g. culture, risk appetite, business models, key accounting judgements, key transactions and disclosures). This would also enable the FSA to highlight to the audit committee any issues of concern in relation to the particular firm. In this way the audit committee can be aware of the key areas being discussed with the external auditors and there can be an even more effective dialogue between the audit committee, auditors and executives. The FSA's primary objectives in its dialogue with audit committees would be to support them in their key role, to assist in making them more effective, and to draw comfort and strength from that effectiveness.

In respect of the quality of audit work, the FSA is not suggesting that the proposed dialogue should in any way be an alternative to the work of the FRC on audit regulation. Nor is it suggesting that it is in a position to make an overall assessment of the quality of an auditor's work. However, the FSA does rely on the work of auditors of firms and it is in a position to have insights about the quality of that work which it will share with the FRC as necessary.

Appointment of the auditor is the responsibility of the firm's audit committee and the FSA does not intend to interfere in this, though the Discussion Paper does draw firms' attentions to the relevant FSA rules and related guidance<sup>24</sup>; this includes reference to circumstances where the FSA may intervene in the appointment of an auditor.

The FSA understands the concerns about the blurring of boundaries and responsibilities. Handled badly, a dialogue between the FSA and a firm's audit committee could diminish the effectiveness of the audit process and the role of the audit committee, and that is the opposite of what the FSA is seeking to achieve. Instead we are looking to strengthen the relationship. As noted by one respondent:

*In particular, we believe that the tri-party relationship between the audit committee, the auditor and the prudential regulator is critical in providing the market with high quality financial reporting incorporating relevant and informative disclosures. Each party is significantly influenced (within the context of their different roles and responsibilities) by the views of the others and when each is operating effectively a real and demonstrable challenge of views takes place. In considering a revised and coherent reporting framework for financial institutions it is vital that we do not strengthen individual silos to the detriment of the assurance landscape as a whole.*

As laid out in the Code of Practice, the FSA continues to build on its commitment to enhance engagement with external auditors through more meetings between supervisors and auditors of the high impact firms that it supervises. Furthermore, for certain identified high impact firms, a minimum of three bilateral meetings

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24 FSA Handbook: SUP 3.3 (appointment), SUP 3.4 (required skill), and SUP 3.5 (independence)

a year between supervisors and external auditors is prescribed (including discussions surrounding the ARROW assessments as and when they occur). Two of these are aligned to the audit cycle (e.g. around the time of planning, execution and completion). The likely content of the bilateral meetings is laid out in the annex to the Code of Practice.

For all high impact firms, the FSA's Supervisory Enhancement Programme initiated a requirement for a minimum of one bilateral meeting between the supervisor and external auditor, which will continue under the guidance provided by the Code of Practice. Where there are other substantive issues to discuss there would be more bilateral discussions – both formal and informal, as needed. Furthermore, where regulatory colleges exist in the supervision of cross-border firms, the content and output of this increased dialogue will likely be relevant to their objectives in considering the key issues relevant to the groups being supervised.

At least one trilateral meeting will take place between the supervisor, external auditor and chair of the audit committee (or alternate non-executive as circumstances may dictate). The FSA will begin holding these meetings and more bilateral meetings during 2011 for a selection of the relevant high impact firms. This will involve a resource commitment by all parties and it will be important to review how efficiently and effectively this is working. In 2012 the FSA will review how the engagement is operating.

The engagement at individual firm-level between the FSA supervisors and external auditors is only one element, albeit very important, of the engagement between the FSA and external auditors. The FSA has held, and will continue to hold, bilateral meetings with each of the largest audit firms to discuss specific aspects of their statutory audit work in relation to supervised firms, particularly issues identified by ART's review of annual reports and related documents of high impact firms. Additionally, the FSA continues with periodic round-table discussions with the audit firms anticipating and discussing key financial reporting issues for the forthcoming reporting season.

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*Q9: Are you aware of any significant barriers to mutual information sharing between auditors and the FSA, and, if so, what should be done to remove them?*

- 3.8** Overall, respondents did not perceive that there were any significant barriers to the sharing of information between auditors and the FSA. However, responses from audit firms and accountancy bodies generally stated that a legal obligation for the FSA to share with the auditor information that may affect the audit should be considered, as this would promote greater information sharing and enhance audit quality.
- 3.9** The Discussion Paper stated that the 'default mode' should be to share relevant information in the absence of restrictions that would prohibit it from being shared. Whilst we set out

this position in the context of the FSA sharing information with auditors, one respondent expressed concern that it may risk harming constructive relationships between auditors and their client firms, if firms took the view that discussing any potential issues with their auditor would immediately lead to the auditor sharing this information with the FSA.

**3.10** Respondents also noted some other factors which, whilst not regarded as significant barriers, were noted as aspects of information sharing that that might need to be considered. These included:

- the confidentiality of information being shared;
- the costs involved;
- guidance to help FSA supervisors assess which information can be shared, which would also help enhance consistency of approach by different FSA supervisors;
- protocols between all parties to enhance the quality of dialogue; and
- greater clarity of FSA contact points for those firms which are not high impact, with no allocated supervisor.

### **Our response**

#### *Code of Practice*

The Code of Practice, described in our response to the feedback on questions 4 and 8, provides guidance on the desired and anticipated relationship between supervisors and auditors.

As laid out in the Code of Practice, whilst broad information-sharing gateways exist between auditors and the FSA, the communication of information between the two parties can be made more effective by being more relevant, open and timely. The Code of Practice sets out several principles of effective interaction between supervisors and auditors, and recognises that timely and relevant information-sharing is essential to improving both the audit and the effectiveness of regulatory supervision. While both supervisors and auditors have a duty to treat information as confidential, the Code of Practice highlights the existing statutory gateways that enable information sharing to take place.

Complementing the Code of Practice, the FSA has delivered guidance and training for FSA supervisors addressing information-sharing protocols with external auditors, covering what information can and should be shared, how auditors can use this information, protocols for meeting external auditors and relevant questions that supervisors should ask auditors.

*The auditor's duty to report to the FSA*

The FSA has developed procedures to enhance the way it deals with reports submitted by auditors under their duty to report to the FSA.<sup>25</sup> It has established a central email inbox to which auditors and supervisors shall send all such reports (auditor'sdutyore@fsa.gov.uk).

This will allow such reporting to be dealt with consistently and efficiently while also monitoring the level of whistle-blowing reports we receive from each audit firm.

*Updates to APB Practice Note 19 – Audit of banks and building societies in the United Kingdom (PN19)*

The APB is consulting on updates to PN19 which, among other aspects of auditing relevant institutions, provides guidance on bilateral and other periodic meetings between auditors and the FSA. Also, it will include examples of where a duty for the auditor to report to the FSA may arise.

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## Summary

- 3.11** In this chapter we summarised the responses to the questions addressing communication between the FSA and firms' auditors, and audit committees. We described the relevant actions we have taken to facilitate more effective communication.
- 3.12** The responses we received to these questions supported our commitment to enhanced engagement with auditors and our closer engagement with audit committees, ensuring that this is done in a way that does not undermine the respective responsibilities of each party, but enhances the ability of each party to operate effectively.
- 3.13** This greater engagement will be facilitated by the Code of Practice guiding the relationship between auditors and supervisors (who will be given adequate support and training), to be implemented initially in 2011 and closely monitored thereafter to assess its effectiveness in practice.
- 3.14** Our engagement on financial reporting issues also occurs on a broader level via meetings with the large audit firms as well as industry bodies.

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<sup>25</sup> FSMA sections 342(5) and 343(5)

# 4

## Scope of reporting

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- 4.1 This chapter covers feedback received and our responses to questions 10 to 15 of the Discussion Paper on the scope of reporting by auditors and others (including for s.166 skilled persons reports).

*Q10: In what ways should the use of s.166 SPRs be developed so that they are of greatest benefit in terms of the FSA's statutory objectives?*

- 4.2 We received 21 responses to this question. Almost all respondents were of the view that the FSA should use s.166 SPRs more often. Whilst some respondents noted that the FSA's use of s.166 SPRs has increased in recent years, it was still seen as too infrequent.
- 4.3 Respondents felt that s.166 SPRs should be used more often for preventative purposes as well as enforcement purposes and that the perception of s.166 SPRs as an enforcement tool rather than a supervisory tool needed to be addressed.
- 4.4 Respondents' suggestions of how s.166 SPRs could be developed echoed the ideas raised in the Discussion Paper and included:
- development of standardised scopes for the more common types of s.166 work;
  - ensuring that the scope of work is properly considered, so that it results in more meaningful reports that focus on the issues arising;
  - use of s.166 SPRs for all firms, not just larger firms; and
  - use of s.166 SPRs as a diagnostic and monitoring tool.
- 4.5 In general, respondents did not express concern about using the firm's auditor to carry out s.166 work providing that existing guidelines about independence (as set out in the FSA Handbook) were met, and that each case was assessed on its particular facts and circumstances.

- 4.6 One respondent suggested that the FSA should consider using a firm's internal audit function, on the basis that it may not face the same potential conflicts as the external auditor in relation to competing for non-audit work in the relevant area. In addition, the respondent also noted the internal auditors would also be better informed about the firm than an external party.

#### Our response

S.166 SPRs are already being used more frequently than in the past. The FSA estimates that 140 will be initiated in 2010/11 compared with 88 in 2009/10 and only 18 in 2006/07.

The FSA believes that s.166 SPRs are a supervisory as well as an enforcement tool. Recent FSA communications convey this message and the more widespread use of s.166 SPRs should alter the perception that it is only an enforcement tool.

The FSA has sought to increase the effectiveness of s.166 SPRs as a supervisory tool, based on more centralised oversight and review of scoping of such engagements, including the development of standardised scopes where appropriate. Additionally, the FSA is holding regular meetings with the main providers of these reports.

The FSA does not believe that a blanket ban on appointing firms' auditors as skilled persons is appropriate. Each appointment will be assessed on its particular facts and circumstances.

The FSA does on occasion require firms' internal audit functions to perform work although this is not done within s.166 of FSMA, given the need for independent reporting.

*Q11: Would some form of external assurance on regulatory returns be helpful in ensuring that data in returns is complete and accurate? If so, why, and would greater use of s.166 Return Assurance Reports be preferable to introducing an audit requirement for all returns?*

- 4.7 We received 25 responses to this question. Respondents were of the view that any requirement for external assurance on regulatory returns should be applied in a proportionate and risk-based manner, rather than, for example, an audit requirement for all returns of all firms. They noted that a general requirement of this nature would incur significant costs without commensurate benefits. As such, most respondents felt that greater use of the existing s.166 RAR framework would be an appropriate way to improve the quality and reliability of regulatory returns.

- 4.8 Respondents also made a number of other points on regulatory returns, including suggestions to:
- review the usefulness of each return to ensure that the data the FSA needs for its supervision is appropriately reflected in the returns, and that data that is not used is not collected;
  - substantially enhance guidance for completing returns on the basis that existing guidance was not seen as helpful and included, for example, circular rule references;
  - review the programming underlying GABRIEL<sup>26</sup>, on the basis that some errors in reporting may arise from requiring firms to complete data fields that are not applicable; and
  - reinstate a requirement for firms to provide reconciliations of certain data between the financial statements and regulatory returns.

### Our response

In line with the majority of respondents, the FSA believes that applying external assurance to regulatory returns is best achieved through more use of s.166 RARs rather than a general audit requirement on regulatory returns. However, against a backdrop of growing international demand for public disclosures of prudential information, the FSA will consider the merits of introducing additional measures to promote more reliable reporting of regulatory capital. This may include public reporting of regulatory returns and more regular and frequent assurance reporting via the s.166 RAR framework.

In the meantime, the FSA will be encouraging the use of s.166 SPRs and s.166 RARs by supervisors by implementing standard scopes and opinions to minimise the investment of time required by both supervisors and skilled persons upfront. This should ensure skilled person reports are produced more efficiently, resulting in more frequent use of this supervisory tool. The FSA is currently engaging internally, with the audit profession and with the ICAEW on appropriate standard scopes and the best way to publicise their use.

The FSA continually reviews both the use of data and the guidance for regulatory returns. Data usefulness and guidance is monitored via feedback and queries from internal and external users of data (e.g. firms, software vendors and internal FSA functions that use data for risk/peer/trend analysis or individual firm monitoring). In light of these comments and queries we continually seek improvements, for example clarifying the reporting guidance and updating data fields to reflect underlying policy developments. The data model the FSA began

<sup>26</sup> GABRIEL (Gathering Better Regulatory Information Electronically) is the FSA's online regulatory reporting system for the collection, validation and storage of regulatory data.



with for integrated regulatory reporting was streamlined and, with experience, it has been enhanced through several consultations since 2007. Having said this, the FSA is currently scoping a project which may produce more guidance; for example in the form of FAQs. The FSA is also assessing how to use the RAR framework more comprehensively in this area.

In the future the FSA's ability to decide what data it collects will be significantly influenced by EU directives and regulations (e.g. Solvency II,<sup>27</sup> COREP<sup>28</sup>).

The FSA agrees that the requirement to submit reconciliations of financial statements to regulatory returns is worth pursuing. The FSA will be discussing this with internal and external stakeholders to decide how to take this forward.

*Q12: Do you believe there could be benefit in auditors providing additional direct reports to the FSA? If so, what should these reports cover? What do you consider would be the additional costs of such reporting?*

- 4.9** We received 24 responses to this question. There was a strong consensus among respondents that additional direct reports to the FSA would not provide additional benefit.
- 4.10** Many respondents noted that the FSA already has access to reports from auditors to firms' management and audit committees, and that such reports encompassed many of the topics mentioned in this section of the Discussion Paper, such as internal control issues and observations, and matters of significant management judgement. Respondents also took the view that continuing enhancements in the quality, timeliness and frequency of dialogue between the FSA and auditors would help to reduce the perceived need for additional formal reporting.
- 4.11** Respondents also noted that the provision of additional information to the FSA was the responsibility of management, and it would not be appropriate for the auditor to provide such information. In addition, some respondents observed that the current s.166 reporting framework already allowed for additional reporting in cases where a specific need was identified.
- 4.12** As a consequence of the lack of support for additional direct reporting, most respondents made little mention about what such reports should cover and the additional costs that might arise.
- 4.13** However, two respondents suggested that additional direct reporting to the FSA and the firm's audit committee might be helpful for large or systemically important firms. Such a report could be a forward-looking thematic review produced annually (or at the FSA's

<sup>27</sup> The Solvency II Directive is a fundamental review of the prudential regime for European insurers and reinsurers. The Directive comes into effect from 1 November 2012 when it will replace the Solvency I requirements.

<sup>28</sup> From 2013, firms and groups subject to the Capital Requirements Directive (CRD) will have to report capital solvency data to regulators in a standardised way across the EEA, known as COREP (Common European Reporting).

request) which could cover specific business lines (such as insurance business, the trading book or banking book or both distinctly) and include qualitative assessments on topics such as remuneration, business models, risk appetite, systems and controls, board effectiveness, assessment of management information, credit, market and operational risk and the business model.

### Our response

The FSA accepts respondents' views that a new system of direct reporting is not currently justified given the FSA's use of auditors' reports to those charged with governance and the enhanced use of s.166 skilled person reporting.

More effective and wider use of s.166 is likely to cover the sort of reporting that some have suggested could be particularly helpful such as qualitative aspects of board effectiveness and credit, market and operational risk.

While the FSA is not currently seeking additional reporting from auditors outside of the current regulatory framework, including s.166 reports, the FRC and other bodies are in the process of considering and exploring potential new auditor and audit committee reporting requirements over subject matter such as risk management, business models, and enhanced narrative reporting by management and audit committees – see, for example, the FRC's *Effective Company Stewardship paper*<sup>29</sup>, as well as the Institute of Chartered Accountants in Scotland's (ICAS) *The Future of Assurance paper*<sup>30</sup>, both published in January 2011.

As this debate moves on, and the system of financial services regulation evolves over the next two years, it is possible that the need for specific auditor reports on more qualitative and forward-looking information for financial services firms may be revisited.

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*Q13: Would audit increase the decision-usefulness of Pillar 3 disclosures made by BIPRU firms? Would the benefits justify the costs?*

- 4.14** We received 22 responses to this question. Overall, respondents did not believe that external audit would increase the decision-usefulness of Pillar 3, or that the benefits would justify the costs. Many respondents also did not believe that there was demand among users of Pillar 3 for the information to be audited.
- 4.15** Although three respondents believed that, conceptually, external audit would increase the decision-usefulness of disclosures, these respondents either did not believe that the benefits would outweigh the costs or did not feel that they could answer this question. One

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<sup>29</sup> FRC (2011a)

<sup>30</sup> Institute of Chartered Accountants of Scotland (2011)

respondent commented that more research was needed to understand what represents decision-useful information with regards to Pillar 3. Another respondent argued that including Pillar 3 disclosures in the notes to the financial statements and subjecting the disclosures to some form of assurance would enhance the disclosures, especially as investors were likely to use them more in the future.

- 4.16** Some respondents believed that the audit of Pillar 3 information would require specialist resources (due to the complexities in auditing information on risk-weighted assets calculations) and would lead to Pillar 3 disclosures being published later. These respondents considered timeliness of the disclosures to be a more important factor to users than whether or not the information was audited. Another respondent did not think it was appropriate for certain internal models to be subject to audit.
- 4.17** Two respondents suggested that, rather than external audit, supervisors could operate conduct reviews on specifically targeted issues (perhaps under the s.166 regime). However, one cautioned that, depending on the nature of the reporting, auditors may be exposed to significant claims were a firm to fail, which could lead to unhelpful and defensive reporting.

### Our response

In line with the feedback received from respondents, the FSA does not believe that it would be appropriate to introduce an audit requirement for Pillar 3 disclosures at the present time, given that there is no clear appetite for such a requirement from users and the anticipated additional costs.

As noted in our response to question 3, we continue to promote continuous improvement in disclosures. Accordingly, the FSA shall continue to monitor users' responses to Pillar 3 disclosures. As was noted by some respondents, the FSA believes that promoting the spread of best practice through industry initiatives (e.g. through the European Banking Authority and other forums) remains the most appropriate way to improve the usefulness of Pillar 3 disclosures.

*Q14: Are the different approaches to audit of Pillar 3 information between BIPRU firms<sup>31</sup> and insurers justified, or should there be a common approach?*

<sup>31</sup> BIPRU refers to the Prudential sourcebook for Banks, Building Societies, and Investment Firms; a BIPRU firm is defined in BIPRU 1.1.6R.

- 4.18** We received 20 responses to this question. Most respondents did not believe that a common approach to the audit of prudential information was necessary between BIPRU firms and insurers. Some believed that a common approach was not desirable given the different risks faced by the different industries, and that the requirements applying to each sector should be considered on their own terms (in particular, one respondent noted that assurance requirements for insurers continued to be regarded as useful). Others believed that a common approach would be ideal, but was not necessary.
- 4.19** Two respondents did not think that differences in approach were justified. One of these respondents felt that it was unfair that insurers faced extra costs compared with BIPRU firms.

### Our response

The FSA accepts the views expressed by most respondents that the current situation, whereby different assurance requirements apply to prudential information produced by BIPRU firms and insurers, is appropriate given the different risks faced by each sector and appears to deliver useful information to users in both cases. Therefore, the FSA believes it is not currently necessary to pursue a common approach to the audit of prudential information between BIPRU firms and insurers.

*Q15: To what extent do you believe external audit of information linked to the regulatory capital numbers in the annual report, which is not covered by accounting standards, should be audited, and why? What do you consider would be the additional costs of such reporting?*

- 4.20** 22 respondents commented on this question and expressed mixed views.
- 4.21** Many respondents commented that extending audit to information on regulatory capital not covered by accounting standards would lead to an increase in costs. As with the audit of Pillar 3 disclosures, some respondents emphasised the specialist resources that would be needed to audit information about regulatory capital. Also, others felt that the cost could be significant due to the separation in many firms between financial reporting and risk systems and controls.
- 4.22** However, some respondents felt that this could be useful. Regulatory capital ratios and reconciliations between accounting and regulatory capital were specifically identified as measures that should be subject to audit. One respondent noted that this would be best achieved by publishing more information on regulatory capital within the notes to the financial statements (which are subject to audit). Another respondent suggested that many users of annual reports believe that such information is already audited and, as such, an

expectations gap exists. However, other respondents questioned whether there was a demand for increasing the scope of audit in this way.

- 4.23 Some respondents noted that information on regulatory capital published in the 'front half' of firms' annual reports must already be read by the auditors to consider whether there are inconsistencies with the financial statements.
- 4.24 Some respondents suggested that, were the FSA to require more assurance on regulatory capital information, this should be achieved via audits of the relevant regulatory returns. One respondent noted that stakeholders gain assurance about regulatory capital information from a perception that the FSA is satisfied with a firm's position.

### **Our response**

The FSA shall reflect further on those particular regulatory capital measures that would benefit from a greater level of assurance, particularly as the Basel III package of amendments to the regulatory capital framework (and its associated disclosures) is developed and implemented. Further to the response to the feedback on question 11, we believe there would be benefit in requiring reconciliations between regulatory capital resources and accounting information to be included within the audited disclosures in annual financial statements.

## **Summary**

- 4.25 In this chapter we summarised the responses to the questions addressing the scope of firms' reporting and levels of assurance thereon.
- 4.26 While there is no perceived need for additional ad hoc reporting by auditors to the FSA, there is support for expanded and more effective use of s.166 reporting as a supervisory tool. The FSA has begun to implement this, which it envisages will include assurance on regulatory return data, as needed. Additionally, the FSA believes there is merit in reconciliations between regulatory and financial statement data being included in the audited financial statement disclosures, and will explore this further.
- 4.27 The FSA's view, in line with respondents, is that there is no immediate need to introduce an assurance requirement over Pillar 3 information.

# 5

## FSA and FRC powers

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**5.1** Questions 5 to 7 dealt with the current and potential extension of powers and enforcement tools available to the FSA and FRC. The feedback received and our responses are summarised in this chapter.

*Q5: Do you consider that it would be appropriate to widen the scope of the FRC's independent monitoring arrangements? If so, what additional work do you believe should be covered by these arrangements?*

**5.2** There were 21 responses to this question. Of these, six respondents indicated that they did not consider it appropriate to widen the scope of the FRC's independent monitoring arrangements. However, a majority either positively supported widening the monitoring arrangements in certain areas or indicated that they were not opposed to it providing a case could be made.

**5.3** The respondents who objected to widening the scope of the FRC's monitoring arrangements gave a variety of reasons, including that they believe the current arrangements are appropriate and that regulators have shown themselves willing to take action when required.

**5.4** The accountancy bodies expressed particular concerns about the overlap with, and possible effect on, their responsibilities as Recognised Supervisory Bodies.

**5.5** Respondents who supported widening the scope of the FRC's monitoring arrangements suggested covering various areas of work, including:

- reporting on client money/assets;
- reporting on interim financial statements;
- investment circulars; and
- regulatory returns reported on by the auditor, or other reporting to the FSA.

- 5.6 Not all of the above, however, received equal support from those respondents who supported widening the FRC's monitoring arrangements. In particular, some respondents specifically indicated that there was no case for covering reporting on investment circulars. One respondent commented that the financial information in an investment circular is often based on existing financial information which has previously been audited and so is already subject to oversight.

### Our response

In relation to client money and custody assets, as part of its more intensive approach to supervision and enhanced focus on client assets, the FSA has reviewed the quality and consistency of auditors' reports submitted in relation to a firm's compliance with the rules on client assets. A number of serious failings were identified that indicated a general deficiency by auditors in applying the FSA requirements on them in relation to those reports, and a need to take steps to improve the quality of those reports. One of the steps that could be taken is increased monitoring of auditors' work on client assets.

The FSA issued a consultation paper in September 2010 – CP10/20 *Improving the auditor's report on client assets*.<sup>32</sup> This paper sets out the recent actions taken by the FSA to improve the quality of the auditor's reports on client assets. This includes active monitoring of audit firms' compliance by the FSA's Client Assets Sector team and the establishment of a referral arrangement with the ICAEW and the Accounting and Actuarial Discipline Board (AADB), which has been actively used.

We intend to publish a Policy Statement within the next month setting out a summary of the consultation feedback we have received in relation to CP10/20. The Policy Statement will also set out those proposals we have decided to implement into final rules, with the objective of improving the quality and consistency of auditors' client asset reports.

In relation to client assets reporting and the other areas of auditors' work referred to above, the FRC is consulting further with the FSA on whether there is a case for increased monitoring of this work by the FRC. We note that, although reports by auditors on listed companies' interim financial statements are voluntary, there is an APB standard<sup>33</sup> that applies to reviews by auditors of such interim financial information. We also note that there are mixed views as to the merits of monitoring reporting accountants' work on investment circulars.

<sup>32</sup> FSA (2010b)

<sup>33</sup> International Standard on Review Engagements (ISRE) (UK and Ireland) 2410, 'Review of Interim Financial Information by the Independent Auditor of the Entity'.

The FRC is still considering the costs and benefits of possible changes to the scope of its monitoring activities and will consult in due course on any proposed changes, should they be considered necessary. In the event that consultation on such change is considered to be appropriate, the means by which this should happen will be discussed with the Recognised Supervisory Bodies.

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*Q6: Do you believe that the FRC's powers should be improved in scope and clarity, and its resources increased, to conduct investigations in a short timeframe on areas of concern?*

- 5.7 There were 21 responses to this question. Eight respondents were against any increases in the FRC's powers in this area. Many of these respondents expressed the view that the current regime for investigations was sufficient, and that the FRC already has considerable powers of investigation through the Financial Reporting Review Panel (FRRP) and the Audit Investigation Unit (AIU).
- 5.8 Another six respondents did not express a clear view one way or the other, with some of them commenting that there was insufficient information available to them. However, the general tone of many of these responses suggested that increases in the FRC's powers and resources would need a clearer justification.
- 5.9 The other seven respondents expressed support for enhanced powers for the FRC although the support varied in strength – three of these respondents expressed strong support.

### **Our response**

The FRC is considering its powers, taking into account the responses received and will be discussing them with stakeholders and with government prior to consultation on specific proposals.

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*Q7: Do you think the FSA should seek an enhanced range of enforcement tools in relation to audit firms as described [on page 38 of the Discussion Paper]? If so, do you think that there should be powers to take enforcement action against individuals within an audit firm as well as the audit firm as a whole? If not, why not?*

- 5.10 We received 22 responses to this question. Most respondents stated that the FSA already has sufficient enforcement tools for audit firms. The rationale for this included a view that existing enforcement tools over the audit profession (including the tools available to the FRC and its operating bodies) were well developed and appropriate. Some respondents also



felt that further enforcement powers for the FSA would be duplicative and could cause confusion as to the roles and responsibilities of the FSA and the FRC. In this regard it was noted that any new enforcement powers, if needed, should be given to the FRC.

- 5.11** Some respondents also noted that the FRC's enforcement tools, taken together with the existing established information gateways between the FSA and the FRC, meant that there was no need for the FSA to seek further powers over auditors. Respondents were supportive of the FSA continuing to work closely with the FRC and an increased level of communication between the two.
- 5.12** Two respondents were in favour of enhancing the FSA's enforcement tools along the lines set out in the Discussion Paper. One of these noted that any power to impose penalties against individuals within an audit firm would need to be exercised with caution, in order to ensure that it did not act as an inappropriate deterrent to capable persons entering the profession, which would result in a reduction in standards. Similarly, another respondent, whilst not in favour of enhanced enforcement powers, agreed that it would be appropriate for the FSA's existing power to disqualify auditors to apply to individuals as well as the whole audit firm, as this would allow the power to be used more proportionately.

### Our response

As noted in the Discussion Paper, the FSA's concerns over an auditor's performance can be referred to the AADB and the auditor's professional body. The FSA would generally expect to do this where it has such concerns rather than investigating the auditor's performance itself. This ensures there is no duplication of enforcement on auditors between the FRC and the FSA.

With the move to the new financial services regulatory structures in the UK, FSMA will be amended. HM Treasury's consultation document published in February 2011 states that as part of those amendments, it will be made clear that the regulatory authorities will have the power to disqualify any individual professional they deem to have failed to comply with the duties under FSMA, irrespective of whether they were appointed as an individual or were representing their firm.<sup>34</sup>

A Memorandum of Understanding between the FSA and the Audit Inspection Unit (AIU) was published on 17 January 2011. This includes a commitment for the FSA and AIU to meet regularly, at least four times a year, with the intention of each body informing the other about topics or issues of mutual concern or interest, so as to enable each body to take account of such discussions in carrying out their duties.

In October 2010 the FSA held the first of a series of meetings with the AIU. Insights were shared from the work of the FSA's Accounting Review Team and

<sup>34</sup> HM Treasury (2011)

some of the key risks and issues discussed between the FSA and statutory auditors of those regulated firms whose audits are likely to be included in the AIU's upcoming audit inspection cycle.

In light of the above, the FSA is not seeking additional enhanced enforcement powers at this time.

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## Summary

- 5.13** In this chapter we summarised the responses to the questions on the respective powers of the FSA and FRC, and whether or not they require expansion or enhancement.
- 5.14** The FSA has heightened its focus on monitoring client assets audits and is coordinating with the FRC regarding potential monitoring of this work. Alongside this, the FRC is in the process of considering possible changes to the scope of its monitoring activities. No decisions have been made regarding changes to the FRC's powers but this is being considered and will involve appropriate consultation.
- 5.15** The distinction between the FSA and the FRC's enforcement tools is important and must be maintained to avoid confusion or overlap. However, with the recently published Memorandum of Understanding, improved coordination between the two bodies will ensure that issues of mutual concern are better addressed.
- 5.16** While, given the relationship between the FSA and the FRC described above, the FSA will not be seeking additional enforcement powers at this time, the FSA will be seeking clarification of provisions in FSMA for disqualifying individual auditors within audit firms.

# 6

## Next steps and expectations for the future

- 6.1** In the previous chapters we set out the responses to the questions posed by the Discussion Paper on how the FSA and auditors can work together to enhance auditors' contribution to prudential regulation. We also outlined our feedback to points raised by respondents and the direction the FSA and FRC have taken and plan to take on these matters.
- 6.2** There were differences of view over the degree to which auditors have been sceptical in their work, though all acknowledged the importance of professional scepticism to an effective audit. Respondents were supportive of greater cooperation and information sharing between auditors and the FSA, whilst recognising the need for continuous improvement in the quality of audits and financial statement disclosures. We have outlined our view that management must actively consider the decision-making needs of intended users when applying accounting and disclosure standards in the most useful way, and auditors should apply challenge in this respect and communicate with the FSA as appropriate.
- 6.3** We have set out various actions we have taken and plan to take to achieve this, which to a large extent is focused on increased engagement with auditors. This will be guided by the Code of Practice which aims to enhance both the quality of audits and our supervisory efforts. In addition to the additional and enhanced bilateral meetings between auditors and FSA supervisors, which are laid out in the Code of Practice, trilateral meetings, involving the audit committee or other non-executives of the firm, will be a key initiative that we implement and monitor. Our supervisory efforts will also be strengthened with more effective use of s.166 skilled person reporting. The FRC will continue its focus on monitoring audit quality, especially on professional scepticism and will be undertaking a number of steps to ensure there is a consistent understanding of the nature of scepticism, to enhance its transparency and to consider how it is dealt with in the auditing standards. Our focus on topical financial reporting issues will continue to be influenced and shared via meetings with industry groups such as the BBA and BSA.

- 6.4** Other developments in 2011 will contribute to the enhancement of the auditor's role in prudential regulation against a backdrop of the FSA's continued intensive supervisory approach. Some of these developments relate to the frameworks against which audit work are performed such as enhanced reporting on client assets and implementation of clarified ISAs and APB practice notes. Additionally, the formalised information-sharing arrangements between the AIU and FSA and the clarification of the FSA's legal ability to disqualify individual auditors, should assist in our enforcement of this area. The FRC will also consider (and consult upon as necessary) other enhancements to its powers and the scope of its monitoring abilities (such as client asset assurance work and the assurance work undertaken on investment circulars).
- 6.5** We recognise the need for ongoing monitoring of progress in the various initiatives covered in this Feedback Statement. This will entail continued close engagement between the FSA and the FRC, and our continued contribution through the various international committees to the debate on the effectiveness of external audit. Moreover, the FSA will actively monitor the success of its increased engagement with auditors and audit committees and use of s.166 reporting.
- 6.6** Finally, we will monitor users' responses to Pillar 3 disclosures and explore the benefits (and costs) of introducing assurance requirements on certain aspects of regulatory reporting.
- 6.7** Success in all our combined efforts to enhance the role of the auditor in prudential regulation will result in enhancement of the quality of debate and interaction between firms' supervisors and its auditors to achieve more effective supervision. This will in turn improve the quality of audit work undertaken by auditors on areas of key importance to the FSA including financial instrument valuations, financial statement disclosures and client assets.

## Annex 1

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# List of non-confidential respondents

Association of British Insurers  
Association of Chartered Certified Accountants  
Association of Financial Markets in Europe  
Association of Financial Mutuals  
Association of International Accountants  
Aviva plc  
Barclays plc  
BDO LLP  
British Bankers' Association  
Building Societies Association  
Capita Group plc  
Chartered Institute of Internal Auditors  
Compos Mentis  
Deloitte LLP  
Ernst & Young LLP  
Grant Thornton UK LLP  
HSBC Holdings plc  
Investment Management Association

KPMG LLP

Leeds Building Society

London Society of Chartered Accountants Regulation and Ethics Review Panel

Ms Mira Makar

Operational Risk Reform Forum

PricewaterhouseCoopers LLP

Standard Chartered Bank

Standard Life plc

Mr Timothy Bush

The Institute of Chartered Accountants of Scotland

The Institute of Chartered Accountants in England and Wales

## Annex 2

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# Draft Code of Practice

### **Code of Practice for the relationship between the external auditor and the supervisor**

#### **Introduction**

This Code of Practice (the Code) comprises general guidance made under section 158(1) of the Financial Services and Markets Act 2000 (FSMA).

The external auditor has an important role to play in the regulatory framework. This requires an open, cooperative and constructive relationship between the supervisor and the auditor so that they can both provide effective input to the regulatory process. It is important, therefore, that the terms and scope of this relationship are clearly defined and understood by both parties.

This Code sets out principles that establish, in the context of a particular regulated firm<sup>1</sup>, the nature of the relationship between the supervisor and auditor, the form and frequency that communication between the two parties should take, and the responsibilities and scope for sharing information between the two parties.

The aim and focus of the Code is to enhance the regulatory process and contribute to high quality external auditing by promoting an effective relationship between the auditor and supervisor in the context of a particular regulated firm. Other wider relationships exist between the FSA and audit firms (both individually and collectively), through which inputs to the regulatory process take place (such as insights into developments relevant to macro-prudential supervision). These wider relationships are not addressed in the Code. However, the subject matter and concerns that are envisaged in the Code to be raised between supervisors and auditors in the context of particular firms, will inform and guide discussions at all levels of dialogue between the FSA and audit firms.

The nature of the relationship and information sharing between the FSA and audit firms should be considered in the context of the respective roles and responsibilities of auditors

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<sup>1</sup> A 'regulated firm' denotes any firm regulated by the FSA, i.e. an authorised person under FSMA.

and a regulated firm's management. Specifically, a regulated firm's management is responsible for maintaining an effective system of internal control for the production of its financial statements, applying accounting policies, forming judgements and developing appropriate assumptions in doing so. Auditors are responsible for gathering sufficient and appropriate evidence to form an independent opinion about management's assertions on those financial statements, taken as a whole within the context of a true and fair audit opinion. While the relationship with supervisors as guided by the Code is designed to enhance the effectiveness of both the audit and the supervisory process, it does not detract from the independent role the auditor plays in forming judgements and opinions on a regulated firm's financial statements for the benefit of investors and other stakeholders.

To the extent that they are relevant, the principles set out below should be applied in a manner that is proportionate to the level of risk of the regulated firm.

### **Principle 1: Supervisors and auditors shall seek an open, cooperative and constructive relationship at all levels**

There should be an open and constructive two-way dialogue between the auditor and supervisor at all levels to support the effective fulfilment of their respective statutory functions. Communication should be both through formal channels, such as scheduled bilateral<sup>2</sup> and trilateral<sup>3</sup> meetings with relevant individuals, and through informal channels, such as telephone calls and meetings as appropriate. At the level of an individual-regulated firm, the primary relationship will be between the relevant supervisory team leader and the lead audit partner, but there will be occasions when there is dialogue between other individuals within the two parties.

At all times, both parties should aim to create an open and cooperative relationship that supports the other in carrying out their statutory functions. Auditors and supervisors are encouraged to cultivate a relationship where views can be expressed on an informal basis.

### **Principle 2: There should be regular dialogue between the supervisor and auditor**

Communication between the supervisor and the auditor should be as frequent as is necessary and in whatever form is most appropriate to ensure the effective fulfilment of the two parties' statutory responsibilities.

In terms of formal meetings, there should be a minimum of at least one routine bilateral and one routine trilateral<sup>4</sup> per year for banks, building societies and insurance companies that are categorised as 'high impact' (as determined in accordance with the ARROW Impact

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2 A bilateral meeting is a meeting involving representatives of the FSA and the audit firm.

3 A trilateral meeting is a meeting involving representatives of the FSA, the audit firm and the regulated firm.

4 Initially, trilateral meetings will not apply to all high impact firms. Rather, these will be implemented gradually, beginning with a subset comprising those banks considered very high impact and a selection of other high impact firms including building societies and insurers.



Score Guidance<sup>5</sup>). The trilateral meetings should involve, at a minimum, the supervisory team leader, the lead audit partner, and an independent non-executive (e.g. chair of the audit committee). The meetings should cover all issues that they consider may be of interest to other parties in carrying out their statutory functions.

Additional bilateral meetings between the supervisors and auditors of regulated firms categorised as 'very high impact' will be necessary around the time of the planning and conclusion of the annual audit. The Annex to this Code provides guidance on the timing and content of these meetings. The topics suggested in the Annex also serve as examples of the potential content of meetings for any firm, as circumstances may dictate.

In the course of formal supervisory risk assessments of very high-impact regulated firms, there should be at least one bilateral meeting between the supervisory team and the lead audit partner during the preparation phase of the assessment, and the draft findings of the assessment should be shared with the lead audit partner ahead of finalisation.

When supervisors commission a regulated firm's auditors to conduct a skilled persons' report under section 166 of FSMA<sup>6</sup>, the scope of the report should be discussed and agreed with the partner responsible for the section 166 engagement before formal commissioning. In cases where the lead audit partner of the firm is not the responsible partner for the skilled persons' report, the supervisor should consider discussing the scope of the review with the lead audit partner before formal commissioning to benefit from any relevant insights they might have.

Similarly, when a third party audit firm is commissioned to undertake the section 166 engagement, the supervisory team leader will determine whether to involve the lead audit partner in the scoping of the engagement. The auditor will ordinarily have access to the final scope and findings of the engagement, which should be discussed with the supervisory team leader on a timely basis, to the extent relevant to the audit.

When the regulated firm's auditor is responsible for the section 166 engagement, it is desirable to ensure that regular dialogue is maintained throughout the investigation work between the audit team responsible for the engagement and the supervisory team, to ensure that the output from the engagement meets the requirements of the supervisor.

Feedback on the quality of the output of the section 166 engagement should be provided by the supervisory team leader to the audit partner responsible for the engagement at the end of the process.

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5 This guidance states that a firm with an ARROW score of 425 or above (or a bank/building society with 400,000+ customers) is 'high impact'. Very high impact firms are a subset of these, and are determined discretionally and communicated to firms accordingly.

6 Section 166 of FSMA gives the supervisory authority the power to commission reports by skilled persons to provide an independent assessment of a regulated firm.

### **Principle 3: Supervisors and auditors shall share all information relevant to carrying out their respective statutory duties in a timely fashion**

FSMA permits auditors to communicate to the FSA, broadly speaking, any information or opinion on a matter that the auditor reasonably believes is relevant to any function of the FSA.<sup>7</sup> The over-riding consideration should be to disclose information that, according to the judgement of the lead audit partner, would assist the FSA in carrying out its functions. Such information should be disclosed in a timely fashion by the auditor directly to the supervisor. It is not sufficient for the auditor to rely on the firm to notify the supervisor.

The supervisor should disclose information to the auditor that it judges to be relevant to the fulfilment of the auditor's statutory duties. While there are restrictions on the information the supervisor can share with auditors and the circumstances in which it can be shared, the presumption should be that the supervisor will want to share any information it has that is likely to contribute to higher quality audits.

There are also requirements placed on auditors by the FSA Handbook and guidance provided in the Auditing Practices Board's Practice Notes. The Code does not address the duty of the auditor to report to the FSA under the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001.

### **Principle 4: Auditors and supervisors shall respect their duty to treat information shared between the two parties or received from firms confidentially**

Both the FSA and auditors are required by statute to treat much of the information received while carrying out their functions as confidential. There are, however, statutory gateways that permit auditors and the FSA to share information. There is specific provision within FSMA for the FSA to share confidential information with auditors for enabling or assisting either the FSA or the auditor to perform their functions. FSMA also provides for auditors to communicate in good faith with supervisors without contravening other duties they are subject to<sup>8</sup> (as discussed under Principle 3 above).

Both the FSA generally, and auditors, when in receipt of information from the FSA, are bound by the confidentiality provisions under Part 23 of FSMA. Auditors are also bound by professional ethical standards on confidentiality.

There may be situations where supervisors impose additional restrictions on the onward disclosure of information passed to auditors.

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<sup>7</sup> FSMA, sections 342(3) and 343(3).

<sup>8</sup> Section 342 of FSMA provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the FSA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.

## Annex to Code of Practice

### Timing and content of auditor/supervisor bilateral meetings regarding regulated firms categorised as very high impact

To improve the quality of the audit and the effectiveness of supervision, the timing and content of meetings between the supervisor and auditor of a regulated very high impact firm should be aligned to the typical phasing of the regulated firm's audit and should focus on the key issues and judgements within the scope of that audit. The lead audit partner and the supervisory team leader should liaise closely around the annual audit of such regulated firms and hold additional meetings as necessary. It is suggested, as a minimum, that two meetings be held before the close of the audit. The following sets out guidance on the possible scope of these meetings:

#### *Meeting 1 – Planning stage of audit*

- Risk assessment and scope – both auditor's and supervisor's assessments in light of the external environment and the firm's performance, business model, risk appetite, etc.
- Discussion of recent supervisory risk assessments, section 166 engagement findings and other supervisory reviews.
- Audit strategy/approach; views on materiality.
- Observations on internal controls (control environment, application controls, IT controls, monitoring controls, etc).
- Views and judgements on key risk areas based on audit/supervisory work performed to date, including specific significant transactions, material valuations and impairment decisions, methodologies, assumptions, etc.
- Analysis of management's going concern assessment.
- Accounting policy application and changes.
- Indications of management bias.
- Culture and tone set from the top.
- Actions from previous years.

#### *Meeting 2 – Pre-close*

- Update on all areas covered in meeting 1.
- Discussion of adequacy and reliability of disclosures in light of statutory reporting requirements and risks, transactions, judgements, assumptions discussed in this and previous meetings.

- Content of (anticipated) reporting to those charged with governance.
- Unadjusted misstatements and the auditor's evaluation in light of materiality.
- Material control weaknesses identified.
- Additional matters arising from the audit.
- Anticipated modifications to the audit report.
- Plans for potential section 166 engagements in the following year.

One or more subsequent meetings may be held, as appropriate, after the close of the audit to debrief on matters considered during the annual audit cycle and to consider any assessment of risks and anticipated issues.

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