

Guidance consultation

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

March 2013



Introduction

This Code of Practice (the Code) comprises of general guidance made under section 157(1) of the Financial Services and Markets Act 2000 (FSMA).

The external auditor has an important role to play in the regulatory framework, which requires confidence in audited financial information to ensure that supervisory efforts and policies are effective, appropriate and based on accurate data. This requires an open, cooperative and constructive relationship between the supervisor, discharging the responsibilities of the Financial Conduct Authority (FCA), and the auditor, so 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 the supervisor and auditor, as well as regulated firms.¹

This Code sets out principles that establish, in the context of a particular regulated firm:

- 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 particular regulated firms. Other wider relationships also exist between the regulator and audit firms (both individually and collectively) through which inputs to the regulatory process take place (such as the requirement to report on Client Assets under SUP 3.10). 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 about particular regulated firms will inform and guide discussions at all levels of dialogue between the regulator and audit firms.

¹ A 'regulated firm' denotes any person who is supervised by the FCA.

The nature of the relationship and information-sharing between the regulator and audit firms should be considered in the context of the respective roles and responsibilities of auditors, a regulated firm's management and those charged with the governance of a regulated firm:

- A regulated firm's management is responsible for maintaining an effective system of internal control for producing 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 the regulated firm's assertions on those financial statements, taken as a whole within the context of a true and fair audit opinion.
- As part of its governance structure, a regulated firm's audit committee is charged with holding the management of the regulated firm to account for internal control and financial reporting, overseeing the external audit process and appointing external auditors.

While the relationship with the regulator 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: Auditors duty to report

There is a duty of the auditor to report to the regulator under the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001. The auditors should communicate to the FCA circumstances in section 2(2) of the Regulations in a timely and cooperative fashion. Auditors should also have regard to ISA (UK & Ireland) 250 Section B.

Principle 2: 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 regulator any information or opinion on a matter that the auditor reasonably believes is relevant to any function of the regulator.² The overriding consideration should be to disclose information that, according to the judgement of the lead audit partner, would help the FCA to carry out its functions. Such information should be disclosed in a timely way by the auditor directly to the supervisor or other relevant FCA contact. On many occasions, these matters will have already been discussed with the regulated firm as appropriate. It is not sufficient for the auditor to rely on the regulated 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

² FSMA, sections 342(3) and 343(3).

auditors and the circumstances in which it can be shared, the presumption should be that the supervisor will want to share information it has that is likely to contribute to higher quality audits.

There are also requirements placed on auditors by the FCA Handbook, for example SUP 3.8.2R and guidance provided in the Financial Reporting Council's Practice Notes.

Principle 3: Supervisors and auditors shall seek an open, cooperative and constructive relationship

There should be an open and constructive two-way dialogue between the auditor and supervisor to support the effective fulfilment of their respective statutory functions. Communication could be both through formal channels, such as scheduled bilateral³ and trilateral⁴ meetings with relevant individuals, and through informal channels, such as telephone calls and meetings as appropriate. The nature and frequency of communications should be proportionate to the size and complexity of the regulated firm.

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 have a relationship where views can be expressed on an informal basis.

Principle 4: Supervisors and auditors should engage in regular dialogue

Communication between the supervisor and the auditor should be as frequent as necessary and in whatever form to ensure that the two parties' statutory responsibilities are effectively fulfilled. The form, content and frequency of this dialogue will vary depending on the characteristics and circumstances of the regulated firm.

For formal meetings, there should be at least one routine bilateral per year for regulated firms categorised as Conduct Supervision Category C1 and Prudentially Critical P1. The meetings should cover all issues that may interest the other parties in carrying out their functions.

There should also be at least one routine bilateral per year between the regulator and audit firms to collectively discuss regulated firms categorised as Conduct Supervision Category C2 and Prudentially Significant P2 plus themes arising from other regulated firms supervised by the FCA that are audited by these audit firms.

The Annex to this Code provides guidance on the content of these meetings. The topics suggested in the Annex are examples of the potential content of meetings for any regulated firm, as circumstances may dictate.

When a regulated firm's audit firm is appointed to conduct a skilled persons' review under section 166 or 166A of FSMA⁵ and where the responsible partner for the skilled persons' report is different from the lead audit partner, the supervisor should consider discussing the scope of the review with the lead audit partner before formal commissioning to benefit from any relevant insights he/she might have.

Similarly, when a skilled person other than the regulated firm's audit firm is appointed to undertake the skilled persons' review, the supervisor will determine whether to engage with the auditor when scoping the

³ A bilateral meeting is a meeting involving representatives of the regulator and the audit firm.

⁴ A trilateral meeting is a meeting involving representatives of the regulator, the audit firm and the regulated firm.

⁵ Sections 166 and 166A of FSMA give the regulator the power to commission skilled persons to provide or collect and update information.

engagement. The auditor will ordinarily have access to the final scope and findings of the engagement, which should be discussed with the supervisor as it is relevant to the audit.

Principle 5: Supervisors and auditors shall treat information shared between the two parties or received from regulated firms confidentially

Both the regulator and auditors are required by statute to treat much of the information received while carrying out their functions as confidential. Within legal constraints, there are, however, statutory gateways that allow auditors and the FCA to share information. There is specific provision within FSMA for the regulator to share confidential information with auditors for enabling or assisting either the FCA or the auditor to perform their functions. FSMA also allows auditors to communicate in good faith with supervisors without contravening other duties they are subject to⁶ (as discussed under Principle 2).

The regulator and auditors, when in receipt of information from the regulator, are both 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 further disclosure of information passed to auditors.

⁶ Section 342 of FSMA provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the regulator any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the regulator.

Annex:

Guidance on content of auditor/supervisor bilateral meetings with C1 and P1 firms

To improve the quality of the audit and the effectiveness of supervision, the content of meetings between the supervisor and auditor of C1 and P1 firms could be focused on areas such as those below, to the extent that relevant information has come to the attention to the audit firm in their capacity as auditor. Please note that these lists are not exhaustive and should only be considered as a guide.

Dual-regulated entities (Conduct Supervision Category C1)

- Risk assessment and scope – both the auditor’s and supervisor’s assessments in light of the external environment and the regulated firm’s performance, business model, risk appetite, etc.
- Discuss recent supervisory risk assessments, skilled persons’ report findings and other supervisory reviews.
- The regulated firm’s strategy and business model.
- The regulated firm’s competitive position.
- The regulated firm’s approach to risk management.
- Observations on internal control (governance effectiveness, control environment, application controls, IT controls, monitoring controls, etc) and material control weaknesses identified.
- Culture and tone set from the top.
- Management incentives and their impact on culture and conduct risk.
- Provisions made in relation to conduct risk matters.
- Additional matters arising from the audit.
- Plans for potential skilled persons’ reviews in the coming year.

FCA-only regulated entities (Prudentially Critical P1)

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.

- Risk assessment and scope – both the auditor’s and supervisor’s assessments in light of the external environment and the regulated firm’s performance, business model, risk appetite, etc (specifically including risks relating to the valuation and impairment of financial instruments).

- Discuss recent supervisory risk assessments, skilled persons' report findings and other supervisory reviews.
- Audit strategy/approach and views on materiality.
- Observations on internal control (governance effectiveness, control environment, application controls, IT controls, monitoring controls, etc) and material control weaknesses identified.
- 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.
- Assessment of risks relating to the going concern assumption.
- Accounting policy application and changes.
- Critical accounting estimates and indications of management bias.
- Culture and tone set from the top.
- Discussion of adequacy and reliability of disclosures in light of statutory reporting requirements and risks, transactions, judgments, assumptions discussed in this and previous meetings.
- Unadjusted misstatements and the auditor's evaluation in light of materiality
- Additional matters arising from the audit.
- Anticipated modifications to the audit report.
- Plans for potential skilled persons' reviews in the coming year.