

Guidance consultation

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

February 2011



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Introduction

This Code of Practice (the Code) comprises of 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 firm¹, 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 and a regulated firm's management. Specifically, a regulated firm's management is responsible for maintaining an effective system of internal

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

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 bilateral² and trilateral³ 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 trilateral⁴ per year for banks, building societies and insurance companies that are categorised as 'high impact' (as determined in accordance with the ARROW Impact Score Guidance⁵). 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

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 including building societies and insurers.

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, are determined discretionally and communicated to firms accordingly).

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 FSMA⁶, 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.

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 FSA⁷. The overriding 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.

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.

⁷ FSMA, sections 342(3) and 343(3).

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 to⁸ (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.

⁸ 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:

Timing and content of auditor/supervisor bilateral meetings with 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, judgments, 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.