Discussion Paper

10/3

Financial Services Authority &
Financial Reporting Council

Enhancing the auditor's contribution to prudential regulation

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Financial Services Authority

Contents

The Financial Services Authority (FSA) and the Financial Reporting Council (FRC) invite comments on this Discussion Paper (DP). Comments should be submitted by 29 September 2010. This DP contains a number of questions for respondents, which can be submitted to us using an electronic response form. The FSA and the FRC would prefer you to use this electronic form when sending your responses. Comments should be sent by electronic submission using the form on the FSA's website at http://www.fsa.gov.uk/pages/Library/Policy/DP/2010/dp10_03_response.shtml.

Alternatively, please send comments in writing to:

Patricia Sucher Financial Services Authority 25 The North Colonnade Canary Wharf London E14 5HS	or	Marek Grabowski Financial Reporting Council 5th Floor, Aldwych House 71-91 Aldwych London WC2B 4HN
Telephone: 020 7066 5644 E-mail: dp10_03@fsa.gov.uk		Telephone: 020 7492 2325 E-mail: M.Grabowski@frc-apb.org.uk

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List of acronyms

A list of acronyms used in this paper is set out below.

Accountancy and Actuarial Discipline Board, a part of the FRC	AADB
Audit Inspection Unit, a part of the FRC	AIU
Auditing Practices Board, a part of the FRC	APB
Accounting Review Team, within the FSA	ART
Accounting Standards Board, a part of the FRC	ASB
Australian Securities & Investments Commission	ASIC
Board for Actuarial Standards, a part of the FRC	BAS
Basel Committee on Banking Supervision	BCBS
Committee of European Banking Supervisors	CEBS
Committee of European Insurance and Occupational Pensions Supervisors	CEIOPS
Committee of European Securities Regulators	CESR
Capital Requirements Directive	CRD
European Union	EU
Financial Reporting Council	FRC
Financial Reporting Review Panel, a part of the FRC	FRRP
Financial Services Authority	FSA
Financial Services and Markets Act 2000	FSMA
Generally Accepted Accounting Principles	GAAP

International Auditing and Assurance Standards Board	IAASB
International Accounting Standard	IAS
International Accounting Standards Board	IASB
Institute of Chartered Accountants in England and Wales	ICAEW
International Financial Reporting Standard	IFRS
International Standards on Auditing, issued by the IAASB	ISA
International Standards on Auditing (UK & Ireland), issued by the APB	ISA (UK&Ireland)
Practice Note (issued by the APB)	PN
Recognised Supervisory Body	RSB
Return Assurance Report, prepared under section 166 of FSMA	S.166 RAR
Skilled Persons Report, prepared under section 166 of FSMA	S.166 SPR
Securities and Exchange Commission (in the United States)	SEC
Supervisory Enhancement Programme	SEP
Solvency and Financial Condition Report	SFCR
Senior Supervisors Group	SSG
United Kingdom	UK
United States	US

1 Overview

Executive summary

1.1 Following the financial crisis, the Financial Services Authority (FSA) continues to review intensively all aspects of its approach to prudential regulation, in close consultation with other regulatory bodies at home and overseas. As set out in *The Turner Review*, one important aspect of this is the role of accounting in the FSA's regulatory work. This paper focuses on a key aspect of how accountancy interacts with prudential regulation – the role of audit and assurance.

1.2 This paper is published jointly by the FSA and the Financial Reporting Council (FRC), an independent body with overarching responsibility for the regulation of auditing in the United Kingdom. The UK is fortunate in being a globally recognised centre of excellence in accountancy and audit, and the FRC's Audit Inspection Unit (AIU) has previously concluded that, while improvements can be made, the quality of auditing in the UK is fundamentally sound in overall terms. This was based on the AIU's inspections for 2008/9, which primarily encompassed 2007 year-end audits across a range of industries. The AIU's report for 2009/10, which will provide further detail about its latest findings (primarily based on 2008 year-end audits), is expected to be published shortly.

1.3 The purpose of this paper is to stimulate debate on how the FSA can best use audit and auditors to meet its statutory objectives. In particular, this paper examines how the FSA, the FRC and auditors can best work together to enhance how auditors can contribute to prudential regulation in the future. Below, we consider the main themes of each chapter in turn.

1.4 Chapter 2 discusses why these issues are topical. The financial crisis has highlighted a number of reasons for examining the role of auditors in prudential supervision. The Treasury Committee has raised concerns about the usefulness of audit for banks and whether the FSA uses external auditors' expertise in the best way to support its objectives. The FSA's more intensive approach to supervision in response to the financial crisis has also caused it to question aspects of how auditors undertake their audit and assurance work in particular areas.

1.5 Chapter 3 discusses the quality of audit and assurance relevant to prudential regulation in the UK. Confidence in published accounts (as well as high quality reporting in respect of client assets) is vital to the FSA's objectives of market confidence, financial stability and consumer protection.

1.6 In this chapter we stress the importance of auditors applying a high degree of professional scepticism when examining key areas of financial accounting and disclosure which depend critically on management judgement. Both the FSA and the FRC believe auditors need to challenge management more. Arising from its more intensive approach to supervision, the FSA has questioned whether the auditor has always been sufficiently sceptical and has paid adequate attention to indicators of management bias. Although the difference between the FSA's view, what management has done and the auditors have accepted may not be material to whether the financial statements are fairly stated overall, there are concerns that the auditor sometimes portrays a worrying lack of scepticism in relation to these key areas.

1.7 In some cases that the FSA has seen, the auditor's approach seems to focus too much on gathering and accepting evidence to support management's assertions, and whether management's valuations meet the specific requirements of accounting standards. It is important for auditors to also consider if the standards' requirements have been applied thoughtfully so as to ensure that the objectives behind the requirements have been met.

1.8 Where there are materially different approaches to determining accounting estimates for similar items, a narrative disclosure of the approach adopted is likely to be necessary, given the importance of the underlying judgements. Such diversity should trigger auditors to apply greater scepticism and to challenge management's judgements about modelling approaches and inputs. Given their corporate access to the approaches to valuations undertaken by their portfolio of clients, auditors may be in a good position to challenge their client on whether their judgements are appropriate and their disclosures adequate.

1.9 There have been significant improvements in the quality of disclosures about credit exposures, and risks and uncertainties in recent bank financial statements. The FSA and FRC believe these improvements should have been achieved earlier, with less need for intervention. They also believe this shortcoming may partly reflect a lack of effective challenge by auditors and the effectiveness with which auditors use available levers to influence management, such as reporting their concerns to the FSA.

1.10 In particular we note that 'true and fair' is a dynamic concept and that the disclosures necessary to achieve a true and fair view will vary over time, depending on factors such as the wider economic environment in which the firm operates and what is relevant to investors and other stakeholders. For example, in the earlier stages of the financial crisis there was a significant loss of confidence in banks' financial reporting, as there were concerns that they did not capture the reality of emerging problems.

1.11 We move on to outline the FSA's concerns about auditors' work on client assets and how auditors interpret their duty to report to the FSA under the Financial Services and Markets Act 2000 (FSMA).

1.12 The remainder of the paper examines the regulatory environment in which auditors operate and suggests possible measures to enhance how auditors contribute to prudential supervision.

1.13 Chapter 4 considers how audit could be made more effective for the FSA. We note that, partly in response to the financial crisis, auditing standards and guidance have been or are being strengthened. The FSA and FRC intend to enhance their cooperation and information sharing to optimise the focus of the Audit Inspection Unit's (AIU) work, and to leverage each other's knowledge to pursue the FSA's and the FRC's regulatory objectives. This should increase auditors' incentives to enhance the quality of their work.

1.14 The FSA also sees scope to provide direct feedback to the audit committees of high impact firms.

1.15 The FSA is also pursuing, or considering, ways in which the auditors' duty or right to report to the FSA can work better. The FSA has provided input to the revision by the Auditing Practices Board of Practice Note 19, which gives non-exhaustive examples of where a legal duty to report is likely to arise. More generally, the FSA anticipates that its enhanced engagement with auditors (see below) will help to improve information sharing.

1.16 We also note how, given the significant shortcomings in reporting on client assets, the FSA intends to publish a Consultation Paper on proposals to improve the quality and consistency of auditors' reports in September.

1.17 Finally, we raise the issue of whether the FRC and FSA's powers in relation to auditors' work should be amended so they could be used in a more targeted and proportionate manner.

1.18 Chapter 5 explains that, if the FSA is to use auditors' skills and knowledge appropriately, it needs to engage more effectively with auditors. We set out a number of ways in which the FSA plans to implement this in this chapter. Notably, the FSA envisages:

- meetings with auditors of high impact firms will be more frequent and take place earlier in the accounts preparation process;
- meeting with audit committees of high impact firms; and
- improvements in the flow of relevant information to auditors.

1.19 Chapter 6 considers skilled persons reporting to the FSA under section 166 of FSMA and whether there is scope for enhanced reporting by auditors to the FSA. Although the FSA has increased its use of skilled person reports, this still remains quite limited. The FSA is undertaking several pieces of work designed to ensure these powers are used so maximum regulatory benefits are secured in relation to cost. This work is expected to be completed in Q3 2010, after which the FSA will consider whether existing practices need to be revised.

1.20 The FSA is concerned about errors in the regulatory returns made by some firms and is considering how this should best be addressed. One possibility would be to impose an audit requirement on some or all returns where this does not already exist (insurance company returns are subject to audit). However, a more cost effective approach might be for the FSA to make greater use of the recently introduced section 166 Return Assurance Reports.

1.21 The FSA is also considering whether it would be appropriate to request auditors to provide reports on specific subjects, e.g. areas of significant accounting judgement, or some form of post-audit report.

1.22 Chapter 7 raises the question of whether Pillar 3 disclosures and prudential information disclosed in the annual report should be subject to audit.

1.23 As noted at the outset, the purpose of this paper is to stimulate debate rather than to set out firm conclusions, and the FSA and FRC encourage stakeholders to respond to any of the issues raised.

Who should read this paper?

1.24 The issues we raise in this paper will be relevant to all FSA regulated firms (other than those who do not have to appoint an auditor). However, this paper is likely to be more important for larger, relationship-managed firms and of the greatest relevance for the very largest banks, other deposit-takers and insurance firms. These large firms usually hold a significant amount of the type of complex financial instruments that require a high level of expertise to understand and value. It is here, where such instruments exist, that the auditor's expertise and judgement in ensuring that firms are making appropriate valuations of such instruments are most needed.

1.25 This paper will also be of interest to firms subject to client asset audits, institutional investors, analysts, commentators, audit firms, firms and individuals that undertake section 166 reporting ('skilled persons'), accountancy and audit bodies and financial regulators.

> 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?

Terms used in this paper

1.26 In this paper:

- 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;
- the term 'management' has the same meaning as defined by the Auditing Practices Board, i.e. the persons holding executive responsibility for the conduct of a firm's operations;

- the term 'those charged with governance' has the same meaning as defined by the Auditing Practices Board, i.e. the persons responsible for overseeing the strategic direction of the firm and obligations related to the accountability of the firm. This includes overseeing the financial reporting process. Therefore 'those charged with governance' includes the executive and non-executive directors of the firm and the members of the audit committee where one exists; and
- many of the footnotes provide references in the form 'Author (Year)', for example 'FSA (2010)'. These can be found in the bibliography at the end of this paper, which provides further details.

2 Why are we considering the effectiveness of audit and assurance for the FSA now?

Background

2.1 High quality governance of firms and effective communication between the Financial Services Authority (FSA) and firms and their auditors are critical to achieving the FSA's objectives relating to market confidence, financial stability and consumer protection. These matters are also central to the Financial Reporting Council's (FRC) complementary objectives in promoting high quality corporate governance and reporting to foster investment. The legislation underpinning the FRC's role seeks to ensure companies are well run in their investors' interests.

2.2 High quality corporate reporting and high quality audit and assurance support effective governance and are key elements of market confidence and market discipline that support the work of the FSA.

2.3 There is therefore a strong mutuality of interest between the FSA and the FRC in many aspects of governance, including the role of audit. As a result, the FSA and the FRC concluded that the joint development of this Discussion Paper (DP) would support their mutual objectives.

2.4 Many firms face increasing complexity in their products, services, financial instruments' structure, global regulation, accounting, disclosure requirements, the related risks they face, and the systems they must build and operate to address them. This complexity increases the importance of high quality audit and assurance by firms' auditors.

2.5 In this chapter we outline our reasons for considering the effectiveness of audit and assurance for the FSA at this time. These are:

- the Treasury Committee's observations on audit and the FSA's use of auditors;
- the FSA's increased use of firms' financial statements and accounting judgements;
- the need for developments in governance in firms identified in *The Walker Review*;
- the significance of accounting systems and internal controls in firms;
- concerns about the quality of regulatory returns; and
- significant deficiencies identified in client assets reporting.

2.6 In relation to the above, we believe there is a need to clarify what is expected of firms' auditors, to consider their effectiveness, how they fulfil their obligation to report to the FSA on these and other matters, and how they can enhance their contribution to prudential regulation.

2.7 Other parties are also considering some of the matters set out in this paper. The European Commission has recently published a Green Paper, *Corporate governance in financial institutions and remuneration policies*, which makes certain suggestions about the role of auditors in auditing financial institutions.[1] The Institute of Chartered Accountants in England and Wales' (ICAEW's) project, *Audit of banks: lessons from the crisis*, recently issued its report which suggests a range of measures in relation to the audit of banks and the FSA's interactions with bank auditors.[2] And the Future of Banking Commission – established by the consumer group *Which?* – also recently published its report, which encourages FSA dialogue with auditors and includes proposals to extend the scope of auditors' public reporting.[3]

The Treasury Committee's observations on audit and the FSA's use of auditors

2.8 Against the backdrop of the role of the auditor in the financial crisis, the House of Commons Treasury Committee commented (in its report following its inquiry into the banking crisis[4]) that:

- although it had received little evidence that auditors failed to fulfil their duties as currently stipulated, the fact that the audit process failed to highlight developing problems in the banking sector calls into question exactly how useful audit currently is; and
- the FSA should make more use of audit knowledge and consider ways in which the links between the FSA and auditors could be strengthened.

2.9 The matters discussed in this paper are directly relevant to both these points. Chapters 3, 4 and 7 concern the first point, while chapters 5 and 6 relate to the second point.

Greater use by the FSA of firms' financial statements and accounting judgements

2.10 As a consequence of the lessons learned during the financial crisis, the FSA has adopted a more intensive supervisory approach (the Supervisory Enhancement Programme, or SEP). However, as *The Turner Review*[5] explained, the SEP needed to be reinforced by other changes. One change is that there should be 'a major shift

1 European Commission (2010)
2 ICAEW (2010)
3 Future of Banking Commission (2010)
4 See http://www.parliament.uk/business/committees/committees-archive/treasury-committee/bankingcrisis/
5 FSA (2009b)

in the role which the FSA plays in relation to published accounts and accounting judgements, with far more intense contact with bank management and auditors on these issues'. *The Turner Review* goes on to explain that there is 'a strong case for bank regulators such as the FSA to be far more involved than in the past in the review and comparison of accounting approaches to fair value estimates and loan impairment provisions… [a] new approach is required, entailing detailed FSA comparative review of the judgements made by different banks, and meetings with management and auditors to explore the reasons for outlier positions'.

2.11 The FSA has been liaising with firms on the calibration of the methodologies they use to measure various types of complex unquoted instruments and to understand, if those methodologies result in 'outlier' measures, why that is so. The effect of this change is to extend its proactive involvement to other areas involving key accounting judgements so information in firms' published financial statements and the auditor's knowledge of that firm are fully exploited to inform the FSA's supervisory view.

2.12 In order to implement those changes, the FSA established the Accounting Review Team (ART) in early 2010. The ART is a team of experienced qualified accountants whose primary role is to support supervisors on accounting and audit-related matters. The ART does this by reviewing and analysing published financial statements and other financial information on a continuous basis. It uses the results of those reviews to provide supervisors with advice, insights and analysis about the firms they supervise and the sectors in which these firms operate, the transactions and other activities those firms are involved in, and the accounting judgements they have made. The ART also provides supervisors with support in their various discussions with firms' management and auditors.

2.13 The shift in the FSA's role in relation to audited financial statements and accounting judgements has two elements that are worth emphasising:

- Although the impetus for change was the FSA's experience with banks during the financial crisis, its interest in audited financial statements and accounting judgements is not only limited to banks. The FSA is taking a close interest in the audited financial statements and accounting judgements of all high impact firms[6] and, from time to time, other firms as well.
- The FSA's interest in audited financial statements and accounting judgements is not only limited to implications these have for prudential supervision. Recent experience has shown how important confidence is to financial stability overall and to the well-being of individual firms, and this is more difficult to achieve if the accounting judgements in audited financial statements creates uncertainty and/or the disclosures in the financial statements does not clarify uncertain areas.

2.14 This change, which is still evolving, has caused the FSA to question aspects of how audit is conducted; in particular, the auditors' approach to auditing disclosures, valuations, and complex one-off transactions, and how they fulfil their obligation to report to the FSA.

6 These are firms whose failure could cause significant market or consumer disruption

Governance in firms

2.15 Although there are many causes of the financial crisis, it is widely recognised that there were governance failures in financial institutions, e.g. patterns of behaviour at Board level and the governance of risk. *The Walker Review*[7] recommended improvements including, for example, establishing Risk Committees and appointing Chief Risk Officers in certain regulated entities. The FRC has recently issued an updated UK Corporate Governance Code[8] which includes requirements to disclose the business model and to enhance risk monitoring. The FSA needs to be satisfied that these changes are being implemented effectively. It also needs to be warned of problems as they start developing, rather than after they have manifested.

2.16 It is, perhaps, natural for management to be optimistic and, in addition to its own interventions, the FSA looks to those charged with governance and the auditors to challenge and seek to moderate management's unrealistic expectations when they make assumptions about the future that underlie the audited financial statements and prudential returns. In this regard, it is particularly important for auditors to follow the requirement in auditing standards that auditors exercise professional scepticism when making their judgements.

Accounting systems and internal controls

2.17 Accounting and internal control systems are particularly stressed by high growth strategies, acquisitions, rapid product development and fast changing market conditions. These events have converged in some of the larger firms during the crisis. One example can be seen in Northern Rock, where pressure to meet targets led to mortgage arrears data being misreported, both internally to the board of directors and externally to the market.[9] This led to the FSA fining and banning the individuals concerned.[10] The FSA and those charged with governance need to be satisfied that the systems and internal control are robust and reliable and can cope with stressed environments. The auditors' comments on systems they review as part of their audit work are reported on at least annually to those charged with governance, and can provide information about potential or actual system stresses.

Quality of regulatory returns

2.18 The FSA's analysis and use of the information reported in firms' regulatory returns has highlighted issues about the quality of this information. The FSA has an interest in obtaining assurance about the quality of the data reported, but not all such returns are currently subject to audit.

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7 Walker (2009a) and Walker (2009b). The FSA consulted on implementing the FSA-specific recommendations set out in *The Walker Review* – FSA (2010d).

8 FRC (2010)

9 See http://www.ft.com/cms/s/0/f232963e-4729-11df-b253-00144feab49a.html

10 See http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/066.shtml

Client assets

2.19 Client asset protection is a key aspect of maintaining market confidence and consumer protection. The FSA has reviewed how firms have, in practice, complied with its client asset rules, and at how effective auditors have been at providing the FSA with comfort that firms have complied with the client asset regime. The FSA's initial investigations, which are explored further in Chapter 3, indicate there is significant scope for improvement.

Summary

2.20 Following on from the initial impacts of the financial crisis, questions are being asked by a number of parties, including the Treasury Committee as well as the FSA itself, about the effectiveness of audit and assurance for the purposes of the FSA's regulatory objectives, how the FSA can work more effectively with auditors and how auditors' contribution to prudential regulation can be enhanced. The FSA's more intensive approach to supervision in response to the financial crisis has also caused it to question some aspects of how auditors undertake their audit and assurance work in particular areas.

2.21 The FSA and FRC have come together to explore possible answers to these questions. In the rest of this DP we discuss the issues and possible solutions in more detail. Chapter 3 provides more background to concerns over the approach taken by auditors in respect of disclosures, valuations, reporting to the FSA and assurance on client assets. Chapter 4 outlines the responses that have been, are being or could be made to address these concerns. Chapters 5, 6 and 7 cover how the FSA's engagement with auditors could be enhanced and the potential role of the auditor with respect to Pillar 3 and other regulatory disclosures.

3 Quality of audit and assurance relevant to prudential regulation

The FSA's reliance on audit and assurance

3.1 As noted earlier, audit and assurance is important to the Financial Services Authority's (FSA) objectives of market confidence and financial stability. The FSA's consumer protection objective is also relevant in relation to client asset assurance. Audited financial information is an important part of the information the FSA relies on in supervising firms; in many cases, calculations of regulatory measures (such as regulatory capital) have their origin in audited numbers. The FSA also needs to effectively communicate with auditors to better understand, assess and influence the critical judgements underlying the audited financial information.

3.2 To be confident that its supervisory efforts are effective and that any policy proposals it makes are appropriate and based on accurate data and reliable assessments of costs and benefits, the FSA needs to have confidence in the information provided in audited accounts and regulatory returns. Areas of particular importance – given their materiality and subjectivity – include fair values and impairment.

3.3 In this chapter we outline the extent of the FSA's reliance on, and related issues arising from, the auditor's input in these areas:

- the quality of audit relevant to prudential regulation;
- professional scepticism;
- client assets assurance; and
- the auditors' duty to report to the FSA.

3.4 While this chapter focuses on the audit function, it is the directors of a firm that are responsible for preparing financial statements that give a true and fair view in accordance with the applicable financial reporting framework. The auditors' role is to independently assess and report on whether the financial statements prepared by the directors achieve this.[11]

11 Annex 2 sets out an overview of the governance and reporting responsibilities of regulated firms and their auditors.

Quality of audit relevant to prudential regulation

3.5 The UK Audit Inspection Unit (AIU) has inspected and provided reports on the application of current auditing and independence standards in the largest audit firms. In its latest Overview report,[12] which gives an overview of the findings from the AIU's inspection work in 2008/9, the AIU, while identifying a number of areas requiring improvement, also states that it found the overall quality of major public entity audit work in the UK to be 'fundamentally sound'. This was based on the AIU's inspections for 2008/9, which primarily encompassed 2007 year-end audits across a range of industries, not just financial services.

3.6 As the financial crisis developed and the FSA, as part of its more intensive supervision, moved into a more detailed dialogue with firms and their auditors, there continued to be some examples of good audit and assurance practice, where auditors had challenged management valuations and/or extended the nature of their assurance reporting. In some cases auditors were also very receptive and collaborative in senior level dialogue with the FSA on overall areas of key accounting risk. However, that does not mean there is no room for improvement in how auditors approach their audit work.

3.7 In their audit work on valuations and provisions for impairment, auditors should take a robust approach and question management's valuations and provisions for impairment. Has management provided sufficient evidence to justify the valuations of hard to value items? Do the valuations appropriately reflect the economic substance of the transaction? Are management's assumptions consistent with the auditor's own assessments of market conditions (which will probably include considering industry experts' views and assumptions used by the firm's peers where available), and observable inputs?

3.8 In their audit work on disclosures, auditors should look beyond whether management has complied with individual aspects of the accounting standards, and assess whether the accounts are fairly stated overall.[13] Has management met the overall objective of relevant accounting standards to provide information to users to evaluate, among other aspects, the nature and extent of risks arising from financial instruments?

3.9 In some cases the FSA has seen concerning valuations, provisions and disclosures, the auditor's approach seems to focus too much on gathering and accepting evidence to support managements' assertions, and whether managements' valuations and disclosures comply with the letter of accounting standards, rather than whether the standards' requirements have been applied in a thoughtful way that would better meet the standards' objectives.

3.10 In some areas, it can be questioned whether auditors always exhibit sufficient professional scepticism. Auditors and audit regulators are currently debating this subject. In the next section we discuss in more detail what professional scepticism is and how it should manifest itself in auditing key valuations, other accounting estimates and disclosures, before turning to examples which illustrate what the FSA has seen in its more intensive approach to supervision.

12 AIU (2009)

13 ISA (UK and Ireland) 700, *The auditors report on financial statements*.

Auditors' professional scepticism

3.11 Auditing standards require that auditors should plan and perform an audit with professional scepticism. The standards emphasise that scepticism 'includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.'[14]

3.12 Professional scepticism is particularly important when the auditor is faced with possibly contradictory and/or limited independent evidence to support valuations in the financial statements which are particularly subjective. In the case, for example, of complex financial instruments which are not traded on an exchange, applying fair value will often necessitate using valuation techniques that involve models to derive values. And where there are significant unobservable inputs, it is likely that there will be a variety of assumptions and possible techniques that could result in a range of estimates for those fair values. The auditor then has to assemble evidence and may need to use experts. Assessing whether the inputs, models, assumptions, range of estimates, and the particular estimate used by their client is appropriate demands a high degree of professional scepticism.

3.13 The auditor's objective is to evaluate whether management have made a reasonable and unbiased valuation consistent with the requirements of the accounting framework and with their approach to valuing other similar instruments, based on what could be a myriad of inputs. It is not sufficient to simply conclude that the valuation is acceptable just because it falls within a range of values that valuation experts would generally consider plausible. The auditor also has to evaluate whether management have provided sufficient appropriate disclosures of the key estimates and assumptions. In some areas, the accounting standards may not specify disclosures and in such circumstances the auditor needs to evaluate whether additional disclosures may be necessary to give a true and fair view. This means it is necessary for the auditor to challenge management's accounting estimates and the appropriateness of their disclosures. A sceptical mindset, combined with the audit firm's knowledge of the range of possible approaches to accounting estimates and disclosures, should give the auditor a sound basis to do this.

Application of professional scepticism

3.14 The Financial Reporting Council (FRC) has raised its concerns over insufficient auditor scepticism with the major global audit firms based on the AIU's recent and previous rounds of inspections of major audits,[15] which encompassed a sample of audits of large companies across the economy (not just financial services firms). The AIU's report for 2009/10, which will provide further detail about its findings, is expected to be published shortly.

3.15 In its inspection of major audits for 2008/09, which primarily encompassed 2007 year-end audits across a range of industries, the AIU considered and reported on

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14 ISA (UK and Ireland) 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (UK and Ireland).*

15 The term 'major audits' is further explained on the FRC's website – http://www.frc.org.uk/images/uploaded/documents/Scope%20of%20Independent%20Inspection%202009-10.pdf – and includes all UK incorporated listed companies and large private companies (including building societies).

the work performed by auditors over significant audit judgements, including the rationale for accounting treatments and the reasonableness of assumptions used in valuations and accounting estimates. Whilst the AIU was 'generally satisfied' with the audit work in these areas, it noted that 'issues relating to the adequacy of the audit evidence obtained or the appropriateness of significant judgements made were identified at all [audit] firms. The areas in which issues arose included the recognition of certain provisions, the appropriateness of applying hedge accounting, the appropriateness of the carrying value of certain assets, the appropriateness of loan provisioning assumptions and the basis on which the work of experts was relied upon.'[16]

3.16 Other regulators have expressed similar concerns about whether auditors are being sufficiently sceptical in their audit of key areas of management judgement. For example a recent audit inspection report from the Australian Securities & Investments Commission (ASIC) noted that in some cases 'auditors did not adequately document or challenge whether the key assumptions used by management provided a reasonable basis for measuring fair value and disclosures'.[17] The ASIC report also highlighted some common flaws concerning the audit of fair value measurements and impairments, including the use of high growth rate assumptions and poor documentation of sensitivity analyses.

> 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?

Questions regarding professional scepticism in the context of financial reporting and disclosures

3.17 Through its more intensive approach to supervision, the FSA has identified a number of areas of financial reporting and disclosures where exercising auditors' professional scepticism is particularly important. These areas include fair value estimates, impairment provision estimates, disclosures on areas where there are diversities of approach in practice, as well as other complex accounting areas, in particular hedge accounting and one-off transactions structured to achieve a particular accounting treatment.

3.18 The following paragraphs give examples where the FSA has questioned whether the auditor has been sufficiently sceptical and has paid adequate attention to management bias indicators. Although the difference between the FSA's view, what management has done and the auditors have accepted may not be material to whether the financial statements are fairly stated overall, there are concerns that the auditor sometimes portrays a worrying lack of scepticism about firms' estimates, related judgements and disclosures. If the underlying judgements are not suitably explained through appropriate disclosure in financial statements, the differences may

16 AIU (2009)
17 ASIC (2010)

impede comparability between firms and may impair the ability of users to better understand and critically assess the financial performance and position of the firm.

Adequacy of financial statement disclosures

3.19 Firms are subject to a set of requirements prescribing the disclosures they should provide in their financial statements. Those requirements have been enhanced – in some cases quite substantially – following the crisis, and there have been other, significant, improvements in the quality of disclosures about credit exposures, risks and uncertainties provided by banks in their most recent financial statements. Nevertheless, concerns remain about the quality of disclosures being provided, as is apparent from the FSA's recent discussion paper on disclosures by UK credit institutions.[18]

3.20 The FSA and FRC's concern is not that firms are not complying with the specific detailed disclosure requirements of the standards. It is rather that some firms need to be more thoughtful in how they apply the existing disclosure requirements and some need to be more willing to consider the possible need for disclosures that go beyond those specifically required.

3.21 For example, in addition to specific detailed disclosures required, IAS[19] 1 *Presentation of Financial Statements* requires that management's key judgements that could significantly affect the amounts in financial statements are disclosed. These include key assumptions made concerning the future and other sources of estimation uncertainty (e.g. those made in determining fair values and impairment provisions) and other judgements (e.g. those relating to off balance sheet structures, revenue recognition, held to maturity assessments). We believe that disclosures provided to meet these generalised requirements should in many cases be enhanced.

3.22 The majority of the improvement made in the quality of disclosures on credit exposures, risks, and uncertainties provided by banks in their most recent financial statements is a result of guidance issued by various bodies[20] and undertakings given by banks to the Financial Reporting Review Panel (FRRP) to improve specific areas of their financial statement disclosures.[21] The FSA and the FRC believe these improvements should have been achieved earlier and with less intervention on their part.

3.23 We suspect some firms may believe it is rarely necessary to provide disclosures that go beyond the specific detailed disclosure requirements. Given that the standards are framed to be used by entities of a wide range of size and complexity, it should be no surprise that disclosures that go beyond the specific detailed requirements will usually be necessary for larger and more complex financial institutions, such as major international banks, which by their nature are somewhat opaque.[22] The same would be true of many other financial institutions.

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18 FSA (2009c)

19 IAS: International Accounting Standard

20 Including, for example guidance issued by the International Accounting Standards Board Expert Advisory Panel – IASB (2008); the Committee of European Securities Regulators – CESR (2008); the Committee of European Banking Supervisors – CEBS (2009); and the Senior Supervisors Group – SSG (2008).

21 FRRP (2009)

22 Morgan (1998)

3.24 It needs also to be borne in mind that 'true and fair' is not a static concept. The FRC's Accounting Standards Board (ASB) describes the true and fair view as 'a dynamic concept because its content evolves in response to changes in, inter alia, accounting and business practice. … It is inherent in the nature of the true and fair view concept that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. Such expectations change over time…'[23] Therefore, the disclosures necessary to achieve a true and fair view may vary over time, depending on factors such as the wider economic environment in which the firm operates and what is relevant to investors and other stakeholders. For example, in the earlier stages of the financial crisis there was a significant loss of confidence in banks' financial reporting, as investors and other stakeholders were concerned that published accounting figures did not capture the reality of emerging problems.[24] Users increasingly expect to be provided with enhanced disclosures about key accounting judgements.

3.25 Although it is ultimately management's responsibility to provide appropriate disclosures for their entity, it is the auditor's responsibility to challenge management when it believes the disclosures are inappropriate. Therefore, the preparers and auditors of financial statements need to 'stand back' and ask themselves whether the financial statements contain all the information needed. Only if management and auditors play their role to the full can we be confident about the quality of the disclosures provided.

3.26 Both the FSA and FRC believe auditors need to challenge management more on the quality of their disclosures. We accept the auditor's ability to carry through their challenge depends on the availability of effective levers over management. The ultimate sanction available to the auditor is to qualify the audit report. However, depending on the seriousness of the matter, this may be disproportionate and may not therefore be a credible response. Other levers available to the auditor are then more important, such as effective mechanisms for the auditor to draw the matter to the attention of a supportive audit committee and the FSA.

3.27 In the case of the very largest firms, the financial statements already run to many hundreds of pages – arguably too long – so it is important to emphasise that enhanced disclosure does not necessarily mean more disclosure. The FSA has previously noted that the use of boilerplate or formulaic disclosures and of extensive disclosures of less significant items adds unnecessary length to financial statement disclosures.[25]

3.28 For example, although there are challenges in preparing appropriate disclosures about key judgements, especially given the potentially numerous and diverse valuation techniques incorporating many assumptions with significant consequences, these disclosures are required where the effect of such judgements is material. Firms have to develop strategies for summarising such data in a way that is relevant and yet not so extensive that the detail obscures the overall picture.

23 ASB (1999)
24 FSA (2009a)
25 FSA (2009c)

Fair value estimates

3.29 The use of valuation techniques to derive fair values for assets and liabilities for management purposes and the incorporation of the amounts into the financial statements has increased significantly in recent years. Understanding the assets and liabilities involved, as well as the valuation techniques used, can be complex and challenging for management, those charged with governance and auditors. A further challenge posed by the financial crisis and the seizing up of markets is that firms have had to develop new models to deal with the greater uncertainties and illiquidity experienced.

3.30 The FSA's reviews of banks' valuation and impairment methodologies – which were initially carried out as part of its work on bank recapitalisations and asset protection schemes – highlighted significant variations in approach across banks. As a result, in 2008 the FSA expressed concern that firms' valuation processes and controls had become stretched and in some cases had proven to be materially flawed or inadequate.[26]

3.31 Based on its work in this area, the FSA is concerned that the dispersion in valuations – both within and between firms – for similar items is higher than might be expected. Although such valuations are not necessarily outside the range of acceptable practice, the FSA believes the dispersions can affect comparability across firms. Therefore, given the higher level of judgement exercised by management in this area, there is a particular need for those charged with governance, the auditors and the FSA to be satisfied that the modelling approaches adopted and the assumptions used are robust, reliable and consistently applied.[27] However, the FSA's work has led it to question whether auditors are sufficiently sceptical when challenging management's basis for determining the models and assumptions used to derive ranges of fair value estimates – in particular, the selection of particular estimates from within such ranges of probable estimates – where key inputs may be unobservable.

3.32 The FSA has previously noted that calculating credit valuation adjustments was an example of diversity of practice among firms.[28] This diversity should trigger auditors to be more sceptical and to challenge management's judgements about modelling approaches and inputs. Given their corporate access to the approaches to valuations undertaken by their portfolio of clients within the constraints of client confidentiality (e.g. through their accounting and valuation experts' experiences), auditors may be in a good position to assess whether individual clients have approaches to, for example, valuations that are materially different from other market participants. They can therefore challenge clients on whether their judgements are appropriate.

3.33 Diversity of practice can also be seen in assumptions used to derive valuations of more illiquid fair values when applying bid-offer adjustments. For example, some

26 FSA (2008)

27 There is little direct guidance about the issues that arise in developing models to support financial accounting values. However, the FRC's Board for Actuarial Standards (BAS) recently issued a standard on modelling for actuaries (BAS (2010)). Although developed for a different purpose, much of the principles and guidance in that standard is also likely to be relevant in considering models to support financial accounting values.

28 FSA (2009c)

adjustments that have caused the FSA concern are set out in Box 3.1. In some cases the FSA challenged preparers' approaches and therefore the auditors' agreement with these. While it is possible that the amounts involved are not material in the context of the financial statements taken as a whole, some firms' approaches appear to be systematically aggressive, and the concern is that this may be indicative of their approaches to valuation more generally.

Box 3.1: Bid offer adjustments

Examples that have caused concern involve firms:

- **not making bid-offer adjustments for some parts of their portfolios;**
- **netting non-equivalent risks as if they were homogenous;**
- **implicitly assuming that a static hedge neutralises open risk; and**
- **taking a generally inconsistent approach regarding how issues associated with concentrated or particularly illiquid positions are treated from a bid-offer perspective.**

In some cases, these examples have been seen in combination. They could then compound one another, creating bid-offer adjustments smaller than what would be the actual costs of liquidating the positions.

Impairment provision estimates

3.34 The FSA has noted that there is a wide range of loan loss provisioning levels across banks. While they may be complying with accounting standards, the reasons for the differences are not immediately obvious in terms of the credit quality or collateralisation of their books, particularly where impairment provisions are low as a percentage of non-performing loans. Under current IFRS[29] requirements, impairment provisions are only recognised when objective evidence shows a loss has been incurred at the reporting date. Larger loans are assessed individually for evidence of impairment, and a collective assessment is made for other items. However, the objective in both cases is to provide only for losses that have been incurred. As such, no direct relationship exists between the amount of non-performing loans and the impairment provisions; not all non-performing loans are necessarily impaired. It follows that there can be good reasons why impairment provisions are low as a percentage of non-performing loans. That makes it important for firms to provide good quality, firm-specific disclosures in this area to help those using the information provided in the financial statements about impairment to put that information in its proper context.

3.35 Box 3.2 shows two specific areas of concern: circumstances where forbearance strategies are employed and where a collective impairment provisioning model is used. As the box explains, in both areas the FSA has seen instances that have caused it concern, in the absence of disclosures that clarify the position.

29 IFRS: International Financial Reporting Standards

3.36 The FSA notes that the risks in bank loan portfolios differ widely, which is why it is important to investors and other stakeholders that they are provided with high quality information about each loan book and each bank's circumstances. As discussed above, IFRS requires disclosures to be made about the significant estimation uncertainties that could materially adjust the carrying amount of assets and liabilities in the next twelve months. In view of the significant adjustments to the carrying value of loans and other financial assets that occurred in 2008 and 2009, the FSA believes that bank auditors should have placed greater importance on the disclosure requirements in 2007 and 2008, while accepting this reflects the benefit of hindsight to a degree. Had more extensive disclosures been made earlier in the credit crisis, it is plausible that this could have mitigated some of the uncertainties that unsettled the markets.

3.37 Furthermore, in relation to retail loan books, as noted in the FSA's recent Financial Risk Outlook,[30] firms' 'forbearance strategies are mutually beneficial to consumer and lender, enabling consumers to retain their homes and avoiding losses through forced sales'. However, there is concern that there is little disclosure of the volumes of loans where some sort of forbearance strategy has been adopted, thus potentially obscuring the true credit risks of the book such as payment holidays or changing loans from repayment to interest only. Loans subject to forbearance strategies may not fall within IFRS-mandated specific disclosures – for instance, they may not be regarded as 'impaired loans' and they may not be considered to be in arrears or past due under their renegotiated terms, even if such terms are not consistent with the market. Again, the auditor has a key role to play in challenging management to consider such disclosures if necessary for a true and fair view, even though they are not specifically required by the applicable accounting standards.

3.38 Similar comments can be made about impairment provisions arising from a collective assessment. There are some significant differences in the levels of the collectively assessed impairment provision from firm to firm. It is important therefore that disclosures help users to understand the key factors and assumptions that underlie the collectively assessed impairment provisions made and any other reasons why there might be differences in the levels from firm to firm.

3.39 One of the issues the FSA has seen is firms argue that, although the impairment provision made on the individually assessed assets may seem low, the overall provision is appropriate because the provision made on the collectively assessed assets is high. 'Trade offs' of this kind are problematic because, for prudential regulatory purposes, it matters whether a provision is made on the individually assessed financial assets or on the collectively assessed assets.[31] It also matters for the disclosures made in accordance with IFRS, because some requirements focus more on the individually assessed assets than on the collectively assessed assets. So, it is important that firms ensure provisions made on the individually assessed assets

30 FSA (2010b)

31 For regulatory capital purposes, for those firms following the standardised approach the total (collective and individually-assessed) provisions are deducted from core tier 1 capital and the collective provisions are added back to tier 2 capital. For firms following the Internal Rating-Based (IRB) approach, the total provisions are also deducted from core tier 1 capital. They are then added back 50:50 to tier 1 and tier 2 capital. These firms will sometimes have an element of their loan book that still follows the standardised approach.

and those on the collectively assessed assets are each appropriate. Auditors need to challenge management if this does not happen.

Box 3.2 – Forbearance strategies and collective provisioning

Forbearance strategies

Background

Lenders enter into renegotiations on loans which are likely to default and change the terms of the loans in a way that is beneficial to the borrower in the shorter term. This also results in a restructuring of the loan, through extending the loan's term and projecting higher collateral values at maturity. The restructuring results in a net present value that is unchanged or higher than before, and based on an existing effective interest rate. This avoids the need to recognise an impairment charge or to classify the loan as non-performing.

Issues

The FSA's work in this area suggests there may be an inadequate level of challenge to firms' management from auditors regarding managements' analyses of future cash flow projections for such renegotiated loans. This is based on instances where managements' assessments of future prices for the assets upon which the loans are secured (e.g. commercial or residential property), and the cash flow forecasts from the loans themselves, are not as robust as might be expected.

Collective provisioning

Background

Collective impairment provisions are measured by estimating cash flows and potential losses on a portfolio basis. This is often calculated by referring to probabilities of default, the loss given default and the emergence period for those losses which have been incurred but not reported.

Issues

In practice there is considerable variation between firms in the proportion of provisions against retail portfolios where collective impairment methodologies described above are used. Whilst this is partly the result of differing risk profiles, the FSA has found that firms' input assumptions vary significantly, which raises concerns about potentially aggressive provisioning strategies.

The FSA questions whether such divergent results can all fall within an acceptable range for financial reporting purposes. As part of its more intensive supervision, where appropriate, the FSA will continue to seek clarification from management and auditors to establish the basis of impairment provisions reflected in the financial statements.

Other areas where accounting treatment is complex

3.40 The FSA has noted a number of other areas where auditors do not appear to have provided the level of challenge expected in relation to complex areas of accounting. One example of this is illustrated in Box 3.3 in relation to hedge accounting.

Box 3.3 – Application of accounting requirements for hedge accounting

Background

Where an instrument which is measured at fair value is used to hedge one that is not, there could be inappropriate volatility in accounting results, and this is addressed by highly prescriptive hedge accounting rules in IFRS. Hedge designation documents must be put in place at the time of designation of a hedge, and hedge effectiveness testing must be performed (both retrospectively and prospectively) at each balance sheet date to provide evidence that the hedge is effective and is expected to remain so in the future. If any future cash flows on a hedged item are not expected to occur it is likely that the hedge will fail the effectiveness test because the changes in fair value of the cash flows may not be offset by changes in fair value of the hedging instrument.

Issues

In one case, the FSA discovered the auditor, when considering hedge effectiveness, appeared to have ignored that certain cash flows relating to a hedged item were not expected to occur in future, It appeared that the hedge failed the prospective hedge effectiveness testing and should no longer have been treated as a hedge. While this may not have materially affected the income statement of the year being audited, it would probably have had an impact on the disclosures in the financial statements.

Accounting for more complex or 'one-off' structured transactions

3.41 One issue that has surfaced in recent FSA supervisory work is that, in some complex transactions structured to achieve a particular accounting treatment, auditors did not always appear to be willing to robustly challenge key – and at least debateable – accounting judgements made by management, which were fundamental to the transaction. Sometimes there is little evidence that the audit firm has discussed with its client whether the overall accounting presentation of the transaction, as constructed, was appropriate. In some cases, auditors appear to apply only a weaker test of whether or not something is clearly inconsistent with accounting standards. In our view, this approach is not likely to result in high quality reporting or auditing.

3.42 Certainly in such cases it is even more important that there are adequate additional disclosures so users are not misled about the economic substance or implications of the relevant transactions.

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?

Client asset assurance

3.43 For firms that hold client money and assets ('client assets'), typically general insurance intermediaries and investment businesses (such as brokers, fund managers, and custodians), the FSA partly relies on external independent assurance to gain comfort that its client asset regime has been implemented appropriately. This is achieved by the firms' auditors reporting to the FSA, periodically, whether the firm has adequately maintained its systems to comply with the relevant client asset rules.[32]

3.44 In 2009, the FSA commenced supervisory work that specifically focused on assessing firms' compliance with the client asset rules. Its findings were reported in the FSA's Client Money and Asset report in January 2010.[33] This report highlighted concerns over firms' handling of client assets, and the action the FSA expects firms to take to address these. The weaknesses discovered within firms include poor management oversight and control; lack of establishment of trust status for segregated accounts; unclear arrangements for segregating and diversifying client money; and incomplete or inaccurate records, accounts and reconciliations.

3.45 In addition, the FSA's Consultation Paper, published on 30 March 2010, looks at enhancing the protections provided by the client assets rules.[34] The FSA's supervisory work continues, and may result in further reports and consultations.

3.46 Alongside this, the FSA also considered the quality of the client assets reports provided by firms' auditors. The auditors' assurance work on client assets is not an audit as defined for statutory purposes under the Companies Act 2006 and is not part of those statutory audits. Accordingly, the conclusions drawn about the quality of this assurance work do not directly implicate the quality of the firms' statutory audits. The requirement for the client assets auditor report is set out in the FSA Handbook and it is a report that is specifically addressed to the FSA. It is not subject to inspection by the AIU. However, the FSA can refer an audit firm to the Accountancy and Actuarial Discipline Board (AADB) and the auditors' professional bodies because of concerns in this area, as described later in this section.

3.47 Through its supervisory work the FSA has established evidence of material weaknesses in some of the client assets auditor reports it has received, including

32 These rules are included in the CASS section of the FSA Handbook, available at http://fsahandbook.info/FSA/html/handbook/CASS

33 FSA (2010c)

34 FSA (2010a)

indications of a lack of understanding by some auditors of the relevant FSA Handbook requirements. Evidence of this includes:

- auditors providing unqualified, 'clean', reports despite the regulated firm subject to audit having made significant material client assets breaches;
- the auditors' reports reporting on the wrong chapters of the FSA Handbook;
- failure to do the client assets audit or part of the audit because of the auditor not being aware of, or not understanding, the client assets audit requirements; and
- errors within some client assets audit reports, such as the auditor not signing or dating the report, quoting the wrong FSA Firm Reference Number, or referring to another firm within the body of the auditor report.

3.48 The Treasury's consultation for resolution arrangements for investment banks also identified that the quality of the client assets auditor reports could be improved and they have asked the FSA to consider additional requirements for the client assets audit report.[35]

3.49 The identified failings will, where appropriate, be considered for separate enforcement action that might include referral to the AADB, the auditors' professional bodies and/or FSA action. In accordance with the powers within the Financial Services and Markets Act 2000 (FSMA) and the associated statutory instruments, the FSA can disclose information to the AADB and the auditors' professional bodies to help them to carry out their duties. This will include instances where they need to assess if the auditors have breached their professional and ethical standards.

3.50 Because of the nature and number of issues identified, the indications are that the above failings are not localised to one or a few auditors, but rather they indicate a general deficiency in applying the FSA's requirements relating to client assets, and a need to take steps to improve the quality of auditors' reports on client assets. We examine the regulatory requirements for client assets' audits further in Chapter 4, where we also set out the steps being taken to address the above failings.

Auditors' duty to report to the FSA

3.51 The auditors' duty to the FSA is set out in regulations made by the Treasury under sections 342(5) and 343(5) of FSMA.[36] Practical guidance on these regulations is provided in the relevant auditing standard and Practice Notes (PNs)[37] from the Auditing Practices Board (APB). Although we have gone through the most severe financial crisis for many years, and there have been conversations on aspects of going concern for some firms, the number of reports received from auditors under these regulations has not increased. The FSA understands this is because if any

35 HM Treasury (2009), paragraph 4.58 and question 41

36 The Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (S.I. 2001/2587).

37 ISA (UK and Ireland) 250B, *The Auditors Right and Duty to Report to Regulators in the Financial Sector; Practice Note 19, The Audit of Banks and Building Societies in the United Kingdom (Revised); Practice Note 20, The Audit of Insurers in the United Kingdom (Revised); and Practice Note 21, The Audit of Investment Businesses in the United Kingdom (Revised).*

events exist that might trigger the legal obligation to report, the auditor persuades the firm itself to notify the FSA of the potential breach.

3.52 However, FSMA requires the auditor to communicate the matters covered by the regulations to the FSA,[38] and it is normally appropriate for the report to be made directly (not indirectly via the firm). This is reinforced by the relevant auditing standard which states that 'where a statutory duty to report arises, the auditor is required to make such a report regardless of: (a) Whether the matter has been referred to the regulator by other parties (including the company, whether by those charged with governance or otherwise); and (b) Any duty owed to other parties, including the [sic] those charged with governance of the regulated entity and its shareholders (or equivalent persons)'.[39]

3.53 The auditor's approach to report as described above, if true, suggests an emphasis on the auditor-client relationship and client confidentiality in preference to disclosing information to a regulator in the public interest.

3.54 This is an area where the European Commission is also suggesting the auditor's duty to report to supervisory authorities could be widened.[40]

Summary

3.55 In this chapter we have noted the AIU's conclusion, based on its inspections of 2007 year-end audits across a range of sectors in the economy, that the overall quality of audit in the UK is fundamentally sound, but expressed concerns about whether auditors are always sufficiently sceptical in their approach to the audit of valuations, provisions for impairment and related disclosures. We also noted some of the audit inspection reports which discuss auditor scepticism.

3.56 We then provided more detailed examples of the FSA's concerns over how, in some cases, auditors seem not to be exhibiting sufficient professional scepticism in their approach to areas of substantial management judgement. Finally, we noted concerns over assurance work on client assets and how auditors fulfil their legal obligation to report to the FSA.

3.57 In the next chapter, we explore how these concerns are being addressed and how they could be addressed in future. In Chapter 5 we explore approaches to greater FSA engagement with auditors.

38 In section 342(5)
39 ISA (UK and Ireland) 250B, *The Auditors Right and Duty to Report to Regulators in the Financial Sector.*
40 European Commission (2010)

4 Making audit and assurance more effective for the FSA

4.1 This chapter and the following two chapters set out several possible ways in which the Financial Services Authority (FSA) and Financial Reporting Council (FRC) could respond to the issues identified in previous chapters. In this chapter we outline how we could make audit more effective for the FSA by:

- revising the Auditing Practice Board's (APB's) auditing standards and Practice Notes (PNs);
- improved cooperation between the FSA and the FRC;
- the FSA providing feedback to firms' audit committees;
- clarifying how auditors fulfil their duty to report to the FSA;
- enhancing auditors' reporting on client assets; and
- enhancing FSA and FRC powers.

4.2 It should be borne in mind that some concerns which have been noted in this paper might be mitigated, at least in part, by enhancing how auditors and the FSA collaborate, as discussed in Chapter 5.

4.3 The responses to the identified concerns are aimed at helping the current UK regulatory structures work more effectively. Our focus is primarily on the audit of the major firms the FSA supervises, especially the major deposit takers.

4.4 We note that the FSA's more intensive supervisory engagement with auditors is likely to provide the FSA with greater ability to air any concerns with auditors, obtain comfort over the amount and nature of audit work undertaken in relation to key areas of management judgement and to assist the auditors in their work.

Revisions to APB auditing standards and PNs

4.5 Where there is scope for management to exercise substantial judgement in the recognition, measurement and disclosure requirements of accounting standards, enhanced auditing standards and guidance on how auditors should audit such areas can help them more robustly challenge managements' assertions in financial statements.

4.6 The FRC, through the APB, is responsible for setting auditing standards in the UK and Republic of Ireland.[41] The APB also issues PNs which, among other topics, cover the application of ISAs (UK and Ireland)[42] to specific sectors of the financial services industry such as insurance and banking.

4.7 Over the last two years, in response to the financial crisis, the APB has issued bulletins to alert auditors to the challenges posed to audit as a result of the financial crisis.[43] The general consensus is that these bulletins have helped framing the debate between auditors and preparers on issues such as disclosures around liquidity risk and going concern.

4.8 The APB has also issued new and revised auditing standards that apply to 2010 audits. These are more robust than the existing standards, particularly in the difficult areas of auditing estimates, including fair values and disclosures. For example, the revised ISA (UK and Ireland) 540, *Auditing, accounting estimates, including fair value accounting estimates, and related disclosures*, has more emphasis on the necessity 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. Both these elements are designed to and should bolster auditors in taking a more sceptical approach to audits of accounting estimates.

4.9 The APB issued Practice Note 23, *Auditing Complex Financial Instruments – Interim Guidance (Revised)*, in draft form in December 2008 and finalised it as interim guidance in October 2009. The UK is the first jurisdiction applying ISAs to publish such guidance, and it is being used as the basis for the update of the International Auditing Practice Statement, IAPS 1012, which is not expected to be in effect until 2011. The APB expects to undertake its own review, based on progress with the development of IAPS 1012, of PN 23 to determine whether to issue the international document as a PN, revised to include additional UK and Ireland guidance where appropriate, or an independently revised PN. This will be undertaken with the full input of the FSA (and others with relevant practical experience).

4.10 Practice Note 19, *The Audit of Banks and Building Societies in the United Kingdom (Revised)*, was last updated in 2007 with advice and assistance from the FSA. It is now being updated again for the new auditing standards and consideration given to how the guidance might be enhanced, again with advice and assistance from the FSA. Given the importance of matters such as governance, the processes for addressing risks, accounting systems and internal controls, and the other areas of concern identified in this paper, guidance is being carefully reviewed to indicate how these matters are addressed, their relevance for audits of such entities and the importance of communicating the auditor's observations on such matters to the audit committee and to the FSA.

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41 These auditing standards are based on International Standards on Auditing (ISAs) set by the International Auditing and Assurance Standards Board (IAASB), which are implemented in the UK and Ireland with the addition of any specific audit requirements following from UK or Irish requirements. Therefore auditing standards issued by the APB are referred to as International Standards on Auditing (UK and Ireland), or ISAs (UK and Ireland).

42 ISA: International Standards on Auditing

43 APB (2008a) and APB (2008b)

4.11 The enhanced auditing standards and guidance should help to make auditing of accounting estimates and disclosures and auditor reporting more robust, provided they are applied effectively. While this is one aspect where the enhanced monitoring and enforcement set out in this chapter can help, given the timing of the implementation of the revised auditing standards and PNs, it is too early to say how effective their application will be in mitigating the concerns we outlined in Chapter 3.

Improving cooperation between the FSA and the FRC

4.12 The monitoring of the quality of work undertaken by auditors, with the application of appropriate sanctions if inadequate practices are identified, increases the reputational cost to auditors of non-compliance (including a lack of professional scepticism) in applying auditing standards and other applicable requirements and guidance. Monitoring the quality of major audits, including the application of auditing standards in the UK, is the responsibility of the Audit Inspection Unit (AIU). The AIU reports publicly[44] on the findings of its monitoring work at each of the major audit firms although it does not attribute its findings to individual audit engagements or the underlying economic sectors.

4.13 Given the scale and complexity of financial reporting of the leading UK banks and insurers and the resources available to the AIU, it is possible only to review a sample of audit engagements and selected audit areas on those engagements. The AIU adopts a risk– based approach to the selection of firms to be reviewed and the focus of such reviews.

4.14 The AIU has inspected and provided reports on the application of current auditing and independence standards in the largest audit firms. Given the specific interest in the audit of banks, the AIU has recently identified banks as a defined segment for inspection work and has increased the scope of work to include all banks incorporated in the UK. This will result in committing greater resources to inspecting the audits of banks.[45] The AIU also issues letter style reports to the auditors, who are expected to share them with the firm's directors, on the findings from their inspections of individual audit engagements. These letters could provide useful information to the FSA on the AIU's views on the quality of individual firms' audits.

The FSA and the AIU

4.15 The FSA has concerns about how some auditors in some situations may not be exercising sufficient professional scepticism in their approach to the audit of key areas of management judgement. To help mitigate these concerns, the FSA will, via enhanced input into the AIU's work, enable the AIU to exercise its responsibilities over auditors more efficiently and effectively. The FSA and the AIU are discussing how to improve information sharing, as they believe they would benefit from closer links. In particular, the FSA is exploring with the AIU how it can share the insights obtained from its more intensive supervision in the case of individual firms, e.g.

44 See, for example AIU (2008) and AIU (2009)
45 See http://www.frc.org.uk/pob/press/pub2260.html

where the FSA identifies that firms have taken particularly aggressive approaches to fair values or impairment, and the auditors do not seem to have been sufficiently robust in their challenge. This could facilitate closer inspections of the relevant auditor's work by the AIU.

4.16 Where appropriate, the FSA can, through its gateways in the regulations which permit it to disclose confidential information,[46] disclose information to the AIU for the purpose of enabling or assisting the AIU to discharge its functions.

4.17 In addition, the FSA and the AIU are now moving forward in developing a Memorandum of Understanding on information sharing between the FSA and the AIU.

The FSA and other FRC bodies

4.18 Incentives for enhanced quality in audit work are likely to be greater where the FRC's independent monitoring and disciplinary arrangements are as effective as possible, as they increase the likelihood that deficient work will be detected and sanctioned. They are also likely to be greater if the financial reporting circumstances around any potential audit deficiency or failure are understood so that the monitoring, investigation and disciplinary actions are fully informed.

4.19 In view of this, the FSA and the Financial Reporting Review Panel (FRRP) plan to enhance the way they share their concerns and related information about individual firms' financial statements that emerge from their respective regulatory responsibilities. The FSA also plans to enhance how it shares concerns that emerge about possible deficiencies in the work of auditors with the Accountancy and Actuarial Discipline Board (AADB). This will enable the AADB to consider what action, if any, is appropriate.

FSA feedback to audit committees

4.20 Existing FSA requirements give a firm responsibility to ensure the appointed auditor has the required skill, resources, experience and independence to perform such a role.[47] To assist high impact firms, the FSA could participate in dialogue with the regulated firm's audit committee and auditor to share its experiences of interactions with the auditor in the context of its supervision of the firm. This could be linked with the FSA's other discussions with the audit committee which are discussed in Chapter 5.

> Q4: Do you agree with our proposal to enter into dialogue with firms' audit committees and auditors as set out above? If not, why not?

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46 The Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (S.I. 2001/2188). Schedule 1 to the Regulations permits disclosures of confidential information to 'any body carrying on activities concerned with matters in section 16(2) of the Companies (Audit, Investigations and Community Enterprise) Act 2004'. Section 16(2)(f) identifies certain provisions of Schedule 10 to the Companies Act 2006, which concern arrangements for the performance of statutory audit functions in respect of major audits to be monitored by means of inspections carried out under those arrangements.

47 SUP 3.4.2R; SUP 3.4.4G; SUP 3.5

Clarifying how auditors fulfil their duty and right to report to the FSA

Duty to report

4.21 Though their general statutory duty is to provide an audit report to shareholders,[48] auditors also have an express statutory duty to report to the FSA on certain matters, as described in Chapter 3.[49]

4.22 To address the concern that auditors are not sufficiently complying with this duty to report, the FSA has provided input to the APB's ongoing revision of PN 19, giving non-exhaustive examples of when this duty may arise. The FSA will also provide input to other relevant PNs as they are revised. It is also proposed to establish procedures within the FSA to ensure reports submitted by auditors to the FSA under the duty to report are dealt with consistently, so there is a clear line of communication for the reports. This could include, for example, further clarity on an appropriate contact person within the FSA for auditors when making reports (or perhaps a central reporting 'post box'), and set procedures for acknowledging and dealing with them.

Right to report

4.23 In addition to the auditor's obligation to report to the FSA, under FSMA the auditor has a right to share information with the FSA in specific circumstances. This applies to information which the auditor has become aware of in his capacity as a firm's auditor, on the condition he is acting in good faith and that he reasonably believes that the information or opinion is relevant to any functions of the FSA.[50] In Chapter 5 we describe how it is expected that, over time, enhanced engagement between the FSA and auditors will help deliver the full benefits of the auditor's right to report to the FSA.

4.24 Enhanced engagement between the FSA and auditors through more frequent bilaterals between them (as described in the next chapter), as well as the other measures outlined in this chapter, signals the FSA's increased interest in auditors' work and findings. We anticipate that these will act as further incentives for auditors to improve on the currently low level of auditor reporting under the duty to report. In addition, as noted by the Basel Committee, 'where contacts between external auditors and banking supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience of collaboration has enabled each to benefit from the other's work. Experience in those countries indicates that the conflicts of interest that auditors may in principle perceive as preventing close collaboration with supervisors assume less importance in practice and do not present an obstacle to a fruitful dialogue'.[51]

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48 As specified in the Companies Act 2006 (Part 16, Chapter 3)

49 E.g. information which may be of material significance in relation to a firm satisfying and continuing to satisfy the threshold conditions.

50 FSMA 2000, section 342(3). This applies to information which the auditor has or had become aware of in his capacity as the auditor of the authorised person in question.

51 BCBS (2002)

Enhancing auditors' reporting on client assets

4.25 High quality auditors' reports on client assets are important as they are one of the key tools that the FSA uses to monitor compliance with its client assets requirements and to determine the need for greater supervisory attention. In its recent supervisory work, the FSA has found clear evidence of material weaknesses in some of the client assets auditor reports we have received. The FSA has established a client assets advisory group that includes the audit professional bodies and a selection of auditors to assess the causes of the above noted failings and to identify proposals to drive improvements in the quality and consistency of auditors' reports in this area. In line with the FSA's *2010/11 Business Plan*, it is their intention to consult on these proposals by the end of September 2010. This section sets out areas of likely focus in that consultation.

4.26 As noted in Chapter 3, the failings observed by the FSA in auditors' reporting on client assets are not localised to one or few auditors; rather, it appears there is a general deficiency in applying the requirements.

4.27 The current regulatory regime sets out requirements for firms' auditors to periodically report to the FSA on, for example, whether the firms' systems were adequate to comply with the custody rules, collateral rules and client money rules (except CASS 5.2)[52] during the reporting period. These requirements are generally applicable to investment businesses and insurance intermediaries. Additionally, if a firm chooses to adopt an alternative method of internal reconciliation of safe custody assets or client money balances than that set out within CASS, prior to doing so, that firm is required to send to the FSA written confirmation from its auditor that its systems and controls are adequate to enable it to do so effectively.[53] This is also required prior to a firm adopting an alternative approach to complying with the segregation requirements for client money.[54]

4.28 As they currently stand, the requirements (which are mainly in the Supervision module of the FSA Handbook, SUP 3.10) set out the areas and the limits of the period to be reported upon, the timing of submission and the action the auditor must take in case the requirements cannot be met. The FSA Handbook does not provide guidance on the assurance processes to be undertaken by auditors to establish their opinion. Rather, the APB provides such guidance, specifically in Practice Note 21, *The Audit of Investment Businesses in the United Kingdom (Revised)*, which gives guidance on the procedures undertaken, clarification on materiality and documentation to support the client assets report.

4.29 The FSA Handbook also sets out the matters on which the auditor is required to opine, but it does not specify a required report format where opinions are qualified or where there are exceptions to be noted in the opinion. This has led to client assets reports varying significantly in format and in the amount of detail provided in relation to any qualifications or exceptions. This has made it difficult for the FSA to

52 SUP 3.10.5
53 CASS 6.5.5R and CASS 7.6.8R
54 CASS 7.4.15R

assess the significance of a firm's breaches and to compare reports, so as to decide whether a firm needs specific attention.

4.30 However, some auditor reports include comments from firms' senior management on remedial actions they are conducting following material breaches. This has been useful in notifying the FSA that the firm's senior management are taking actions to remedy the issue, and in assisting the FSA to assess the likelihood of any repetition.

4.31 As noted above, it is the FSA's intention to consult by the end of September 2010 on proposals to enhance the auditors' reporting on client assets.

Enhanced powers for the FRC and the FSA in respect of auditors

4.32 It is possible that recent revisions to the relevant auditing standards, developing further guidance in PNs, sharing insights from the FSA's more intensive supervision with the AIU, and the FSA directly communicating with audit committees may not be sufficient to address all the concerns identified. Similarly, the FSA's closer engagement with auditors (described in Chapter 5) may not be enough to ensure that auditors will always report to the FSA when they encounter information relevant to the FSA's functions in the course of their audit work. Enhanced regulatory powers may therefore be needed to better align auditors' incentives with those of the regulator.

The FRC's independent monitoring and investigation powers

4.33 While the AIU monitors the statutory audits of major entities, the monitoring of the statutory audits of other entities and of all non-audit work undertaken by the auditors of major entities are undertaken by the professional accountancy bodies as Recognised Supervisory Bodies (RSBs). There is, therefore, no independent monitoring by the AIU of work performed by the auditors of major entities on, for example, interim financial information, investment circulars, regulatory returns or other reporting on which the FSA relies (such as in respect of client assets). Consideration could be given to widening the scope of the AIU's independent monitoring arrangements to include other work undertaken by the auditors of major entities and enhancing the powers of the AIU to take follow up action independent of the RSBs in response to their findings.

> 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?

4.34 Currently, the AIU has a prescribed framework for monitoring the application of auditing and independence standards which is constructed around the annual audit inspection cycle. Although the FRC has some powers to investigate specific audit issues at short notice outside the annual inspection cycle, or to conduct enquiries into the circumstances where a major entity 'fails' after an audit has been undertaken or indications emerge of a possible audit failure, this has not been a routine element of their work and would have resource implications. There could be merit in considering improving the clarity and scope of the FRC's powers, and increasing its resources, so it could conduct such investigations with a clearer statutory remit in a short timeframe in relation to areas of concern. This could, for example, be relevant if the FSA identifies a specific area of potential concern over audit work which the FRC could then assess and investigate in a timely manner.

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 in relation to areas of concern?

The FSA's enforcement powers

4.35 Under the current regulatory regime, if the FSA has specific concerns about an auditor, it can refer that auditor to the AADB and the auditor's professional body. In addition under FSMA, the FSA has the power to disqualify an auditor from acting as the auditor of an authorised person if it appears to the FSA that the auditor 'has failed to comply with a duty imposed on him under [FSMA]'.[55] This means that if an auditor failed to provide adequate assurance reporting on client assets or to report appropriately in accordance with the duty to report to the FSA, the FSA can disqualify the auditor.

4.36 A failure to discharge duties under FSMA could take a wide variety of different forms. It could vary in seriousness or significance. The failure could also be attributable to different parts of an audit firm (e.g. the individual partners or other members of the audit team, or a decision that is more 'diffused' within the firm – for example, where the lead audit partner has taken advice from technical specialists within the firm and implemented their recommendations).

4.37 The FSA needs the right range of enforcement powers to enable it to make a fully calibrated response to the level of regulatory concern in any given case. The provision of further powers would require amendments to FSMA. The appropriate package of enforcement powers could include some or all of the following:

- the power publicly to censure the audit firm or relevant individuals within the audit firm;
- the power to impose financial penalties against the audit firm or the relevant individuals within the audit firm; and
- the power to disqualify the audit firm or relevant individuals within the audit firm from acting as the auditor of an authorised person or class of authorised person (either by temporary suspension or indefinite disqualification).

55 Financial Services and Markets Act 2000 section 345(1). The reference to duties imposed under FSMA includes duties contained in FSA rules made under FSMA (e.g. requirements in rules relating to auditors' functions in relation to client assets).

Q7: Do you think the FSA should seek an enhanced range of enforcement tools in relation to audit firms as described above? 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?

Implications of enhanced powers for the FRC and the FSA

4.38 Enhanced powers for the FRC and FSA as described above would help improve compliance by making monitoring and enforcement by the FRC and the FSA a more credible deterrent. However, for the benefits of these proposals to materialise we need to monitor the auditors' work effectively so as to detect inadequate audit practices. The proposed approach to more intensive supervision by the FSA (described in the next chapter), and more sharing of information between the FSA and FRC as described in this chapter, would help this.

4.39 There would be no additional direct costs to firms from the more targeted range of enforcement powers as described above, on the assumption that firms already comply with the FSA's rules and conduct their work without deficiencies. There could be increased costs of monitoring and investigations. Indirect costs, for example those due to potential changes in the nature or supply of audit services, may also arise. Such indirect economic costs are less likely the more targeted the enforcement measures.

Summary

4.40 In this chapter we described how, within the current UK regulatory framework for monitoring and enhancing audit quality, the FSA and the FRC are working and could work to deal with the identified concerns about some aspects of work by auditors. The measures described in this chapter –revised auditing standards which come into effect this year; proposed further guidance in APB Practice Notes; enhanced cooperation between the FSA, the AIU and other FRC bodies; the FSA providing feedback to audit committees of larger firms; clarification on how auditors can fulfil their duty to report to the FSA and enhancing auditors' reporting on client assets – should help to address these concerns. We concluded by noting that, although it may require changes to primary legislation, there may be scope for enhancing the FRC's monitoring and investigation powers and the FSA's enforcement powers.

4.41 Nevertheless, there is also substantial scope for enhancements in the way in which auditors and the FSA collaborate that could help mitigate some of the concerns expressed in chapter 3. In the next chapter, we explore in more detail how the FSA is already enhancing its engagement with auditors and what else can be done.

5 FSA engaging more effectively with auditors in its supervision

5.1 In earlier chapters we identified issues about how auditors fulfil their statutory audit obligations, carry out their assurance work on client assets and how they fulfil their duty, and exercise their right, to report matters to the Financial Services Authority (FSA). However, there is also significant scope to improve the way the FSA engages with auditors. In particular the FSA needs to:

- hold more, and earlier, meetings with auditors; and
- enhance information sharing between itself and auditors.

5.2 These issues are discussed further in this chapter.

More, and earlier, meetings with auditors

High impact firms

5.3 Supervisors are already required, under the Supervisory Enhancement Programme (SEP), to meet with the auditors of high impact firms at least annually to discuss firm-specific issues. These issues may include the financial results, key accounting or audit judgements, systems and controls, and the auditor's view of management.

5.4 The FSA envisages those meetings becoming more frequent and occurring earlier in the audit process. Currently, the FSA typically meets with auditors when the year-end audit is substantially complete. By this time management will usually have reached conclusions as to the key accounting treatments, methodologies and assumptions to be adopted and the auditors will usually have formed a view on them. It could be problematic for the FSA to challenge these conclusions for the purposes of statutory reporting at such a late stage in the process. So, for the largest institutions, the FSA increasingly expects to meet auditors at a much earlier stage in the process as well; i.e. when areas of accounting judgement can be discussed and views expressed on a timelier basis, so they can be taken into account by management and auditors in reaching final conclusions. Several meetings over a short period might sometimes be necessary to tease out and explore the key issues fully. In relation to one-off structured transactions, this could also mean the FSA being involved at an earlier stage prior to the transaction being undertaken.

5.5 The Accounting Review Team (ART) supports supervisors in their meetings with auditors. This typically involves helping to scrutinise the various documents that arise out of the audit process – including reports to the firm's audit committee – and participating in many of the meetings.

Relationship-managed firms

5.6 It is also envisaged that supervisors of each relationship-managed firm[56] will meet periodically with the firm's auditor, even though engagement with auditors for all relationship-managed firms is not required under the SEP. The ART will attend the meetings to support supervision if, for example, a specific accounting issue has been identified or if any qualification or other modification of the audit report is likely.

Trilaterals between the FSA, auditors and firms' audit committees

5.7 As explained earlier in this paper, audit committees are a very important part of the corporate governance structure and an effective audit committee is a great help to the FSA in its supervisory work. However, although the FSA generally expects to see the auditor's reports to the audit committee and sometimes asks to see copies of audit committee minutes, it does not currently meet the audit committee.

5.8 One proposal being considered is for the FSA to hold regular meetings with the audit committees of high impact firms. A variation on this might be to hold trilateral meetings between the FSA, a firm's auditors and the firm's audit committee. Such meetings could be used for the FSA to share its insights on accounting and regulatory concerns so the audit committee is better informed about the FSA's areas of interest and how these may affect the firm. The timing and frequency of meetings, as well as the resources required, would need to be considered against the potential benefits.

5.9 The main benefits of more and earlier meetings with auditors and/or trilaterals with audit committees will be that the FSA will be in a better position to communicate its views and raise relevant challenge at an early stage, so as to allow relevant changes to firms' reporting and practice where that is warranted. There may be additional costs for auditors – and as a result to firms – in attending and preparing for additional meetings with the FSA. We consider that these costs are likely to be proportionate to achieve enhanced reporting and practice.

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

56 Relationship-managed firms are firms that, either due to their size, nature or regulatory history, are supervised by designated teams within the FSA.

More information sharing between auditors and the FSA

5.10 Meetings with auditors are of course not an end in themselves. A willingness to share information is key to making the meetings as useful as possible. We believe that both auditors and the FSA have lessons to learn in this area.

5.11 Higher quality audits and audited financial statements make it possible for the FSA to do its job better, and more effective information sharing between the FSA and auditors can contribute to higher quality audits. While there are restrictions that need to be adhered to on what information the FSA can share with auditors and the circumstances in which it can be shared, the 'default mode' should be that the FSA shares with auditors key information it has that may contribute to higher quality audits.

5.12 The FSA therefore intends as a matter of priority to develop guidance internally to help supervisors distinguish between disclosable and non-disclosable information and to encourage them to share with auditors disclosable information where relevant.

5.13 Although the FSA receives a lot of useful information from its meetings with auditors, experience has shown that sometimes information that would have improved its supervisory work has not been shared with the FSA. There have also been occasions where the FSA and a firm's auditors have been separately encouraging the firm to reconsider an accounting estimate it was proposing to use; had the parties been aware that they shared each other's concerns, they both might have raised those concerns more forcefully with the firm. This is a good example of how more can be achieved working together rather than working separately. Both parties need to learn that, where there is a concern, the default should be to share the information unless there are restrictions that would prohibit this.

5.14 The FSA expects that the costs, if any, to stakeholders or the FSA as a result of the above proposals on information sharing between the FSA and auditors will be minimal.

5.15 A question has arisen whether there should be a legal duty on the FSA to report matters to auditors (through an amendment to FSMA).[57] The FSA does not believe that an obligation for it to report to auditors would be appropriate or an optimal use of resource, for a number of reasons.

5.16 First, the duties of the FSA are different from the duties of auditors. The FSA's duties are far broader[58] than those of auditors, whose focus is to provide an opinion on the truth and fairness of the financial statements. While the FSA should, as indicated above, share information with the auditors that may assist it in fulfilling its statutory duties, any such information should not negate the responsibility of the auditor to obtain sufficient appropriate audit evidence to support the audit opinion.

5.17 Second, any major concerns that the FSA has with a firm would usually have been communicated to the firm in writing, and the auditor already has access to such communications, given the obligations on firms to disclose all relevant information to their auditors.

57 ICAEW (2010)

58 The FSA's responsibilities are set out in FSMA and give the FSA five statutory objectives, being (i) market confidence in the financial system; (ii) promoting public understanding of the financial system (which is to be repealed on the full commencement of the Financial Services Act 2010); (iii) contributing to the stability of the financial system; (iv) securing the appropriate degree of consumer protection; and (v) reducing financial crime.

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?

Summary

5.18 The chapter has considered measures to ensure that more effective engagement between the FSA and auditors can be achieved. These measures – more and earlier meeting between the FSA and auditors, including trilateral meetings between the FSA, firms' auditors and audit committees, as well as more information sharing between the FSA and auditors – can help the FSA make best use of auditors' skills and knowledge about the firms they audit. This can further enhance the FSA's work in relation to its statutory objectives. The measures described in this chapter are at a relatively early stage of development and there is a need for both the FSA and auditors to continue to build relationships to ensure that the maximum benefit can be gained.

5.19 In the next chapter we focus more closely on how the FSA can utilise auditors through more direct reporting requirements to the FSA.

6 Assurance and skilled person reporting to the FSA

6.1 In this chapter we explore how the Financial Services Authority (FSA) currently uses external assurance for reporting to the FSA and where, how and when such assurance reporting could be enhanced. In particular, we consider how to:

- make more effective use of section 166 Skilled Person Reports;
- find ways of enhancing the quality of regulatory returns; and
- enhance auditor reporting on the financial statements to the FSA.

Making more effective use of section 166 Skilled Person Reports

6.2 In 2001 the FSA acquired a new power to require firms to provide reports by skilled persons under section 166 of the Financial Services and Markets Act 2000 (FSMA) (s.166 Skilled Person Reports or s.166 SPRs). This power replaced various and differing powers that existed previously to commission special reports and meant that, for the first time, the same approach would apply across all sectors and for both the FSA's supervisory and enforcement functions.

6.3 When the FSA requires a s.166 SPR to be prepared, the firm concerned must appoint and pay a 'skilled person' nominated or approved by the FSA to prepare it. This skilled person does not have to be the firm's auditor or indeed any auditor – it could be, for example, a consultancy or legal firm. The reports are addressed to the firm itself. Each decision to use skilled persons is taken on a case-by-case basis according to the FSA's need and each situation's circumstances, considering factors such as whether the need can be met by other tools available, the firm's position and attitude, the cost and benefit to the firm and the resources and expertise the FSA has to do the work itself. In 2009/10, 88 s.166 SPRs were commissioned, covering prudential and conduct issues.

6.4 A number of pieces of work are ongoing across the FSA in relation to the use of s.166 SPRs to try to ensure s.166 SPRs powers are used in a way that results in the maximum regulatory benefit relative to cost. In addition the FSA is currently considering the following:

- whether s.166 SPRs achieve the FSA's desired outcome;
- whether, given the number of firms the FSA regulates, the more intensive regulatory approach that it is now adopting, and the current stressed environment, the FSA should be thinking in terms of commissioning more SPRs each year. (Although the 88 last year was itself a significant increase on the year before – in 2008/09 a total of 56 such reports were commissioned.) That is not to say that there should be a specific target for the number of s.166 SPRs that should be completed every year – rather, it is whether there should be a greater use of s.166 SPRs;
- the impact of work in relation to s.166 SPRs on firms' and the FSA's resources;
- when the use of auditors is appropriate to carry out a s.166 SPR, and when is it not:
    - o It could be argued that the firm's auditors will, because of their ongoing involvement with the firm, sometimes be too close to the matter on which they are asked to report. This is likely to be less relevant when using the firm's own auditors for section 166 Return Assurance Reports (s.166 RARs, described later in this chapter) that are more quantitative in nature. Furthermore, some argue that commissioning the firm's auditors to do a s.166 SPR runs the risk of rewarding them for potentially poor work in the past. On the other hand, using the firm's auditors will often keep costs down, and they may well have a better understanding of the business than a new external firm.
    - o Some would argue that using an accounting firm that is not the firm's auditors would also raise issues because that firm will be tempted to 'pull its punches' in its report because it has too much to lose – in terms of the possibility of winning business from the firm in the future. This might sometimes also be the case when a skilled person other than an accountancy firm is used.
- Currently the FSA generally decides on approving the most appropriate skilled person on a case-by-case basis depending on the subject of the s.166 SPR, whether there seem to be any obvious conflicts of interest (the key issue being that the skilled person should not be reporting on something which they had been involved in developing or reporting on for the firm)[59] and what the FSA's experience has been with the auditor; and
- What further guidance do supervisors need to use s.166 SPRs effectively?

6.5 In Q3 2010, when this 'lessons learned' review has been completed, the FSA will consider the need to revise its existing practice and guidance in this area.

59 SUP 5.4.8G of the FSA Handbook sets out the considerations to be made when the FSA nominates or approves a skilled person.

6.6 Currently, it can be difficult to determine the detailed scope and type of assurance required in a s.166 SPR before the work begins. Under current practice, the FSA issues a draft notice for consideration by the firm and the skilled person before finalisation, which gives firms the opportunity to challenge a scope that appears too broad or likely to result in costs disproportionate to the resulting benefit. Scoping and type of assurance issues still occur and while it is important to retain a level of flexibility in the scope, so as to deal with developments arising as the skilled person's work progresses, this does not negate the importance of setting a clear scope from inception. The FSA is therefore considering how it might change procedures to improve this aspect of the process.

6.7 The FSA has previously directly commissioned external reports on firms (rather than through a s.166 SPR), at the firm's expense. The FSA has found that this can not only make it easier to manage changes in scope and type of assurance, but that it also largely addresses the inherent conflicts that may limit the effectiveness of s.166 SPRs. These conflicts can arise because while the skilled person is nominated or approved by the FSA, the contractual relationship is between the firm and the skilled person rather than directly with the FSA; this may have a qualitative impact on the reports we receive. As such, the FSA also considers that it may be desirable for FSMA to be amended to allow it to commission the equivalent of a s.166 SPR directly, with the report being addressed to the FSA but the cost being met by the firm.

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?

Enhancing the quality of regulatory returns

The current position

6.8 Regulatory returns from firms to the FSA contain a range of information that the FSA uses to inform its supervisory activities including, for example, data on liquidity, capital, capital requirements and large exposures. Firms are responsible for ensuring the data they submit in their regulatory returns is complete and accurate.

6.9 Currently, except in the case of insurance firms and credit unions, there is no requirement for the returns to be audited.[60] The regulatory returns of banks are not required to be audited, and never have been.[61]

6.10 Insurance firms' regulatory returns are in the public domain (because they are available from the firms on request) and are used by investors and other stakeholders to supplement the information in the published financial statements. They also provide accounting information that is currently not necessarily provided

60 The existing approach to requiring regulatory returns to the FSA to be audited was laid out in FSA (2007a) and FSA (2007b).

61 Prior to the implementation of FSMA, banking supervision was the remit of the Bank of England under the Banking Act 1987. Under section 39 of that Act, reports on regulatory returns were commissioned annually on a sample basis, but there was no general audit requirement. FSMA, and hence the FSA, have never required audited regulatory returns for banks and a policy decision was taken to not commission section 39-type reports.

in the audited financial statements. As such, the audit requirement underpins market confidence in the information in the returns.

6.11 The FSA requires the regulatory returns of credit unions to be audited because, relative to other sectors, a greater proportion of the information needed for the FSA's supervisory work is obtained from those returns than from the financial statements.

The concern

6.12 In 2008, the FSA implemented a new regulatory reporting regime and an on-line regulatory reporting system (Integrated Regulatory Reporting and GABRIEL[62]). The FSA's analysis and use of the information provided since has raised some concerns about its quality. Those concerns are arising across sectors and for large firms as well as small. Experience to date suggests that certain forms – for example FSA001 (balance sheet) and FSA015 (arrears data) – are causing particular problems.

6.13 While incorrect reporting occurs in the minority of firms, many of the errors occurring have not been minor, as the examples in Box 6.1 illustrate.

Box 6.1 – Examples of errors in regulatory returns

A credit institution incorrectly netted down derivatives in the balance sheet (FSA001) leading to a misstatement of c. £900 bn.

A thematic review recently undertaken on arrears reporting (FSA015) revealed errors by 29 out of 30 of the credit institutions investigated.

A credit institution misreported on the expected loss on the Internal Rating Based (IRB) portfolio risk (FSA045) as a result of a decimal point error in the Loss Given Default (LGD) and a coding error for Exposure At Default (EAD).

A credit institution misreported its securitisation positions in its credit risk reporting (FSA004) as it did not match entries in the separate return for securitisation (FSA046).

A number of firms made errors in their calculation of the Basel I capital floor. IRB firms' capital requirement is the higher of their Basel II capital requirement and 80% of their Basel I capital requirement.

6.14 Some of the issues identified may be caused by the introduction of the new regime and system – when new systems are introduced, there is often a lead time before the data is of the required accuracy. In the light of experience of data analysis since 2008, the FSA has enhanced the notes and guidance for completing returns.[63] This aids more consistent, meaningful data reporting. However, the problem of data errors appears to be more significant than systems issues and gaps in guidance and other action is needed.

6.15 The FSA is therefore considering whether the quality of data would improve were returns to be subject to external review and, if so, what form this external review might take. If it is concluded that such a change would result in improvement in the

62 GABRIEL (GAthering Better Regulatory Information ELectronically) is the FSA's online regulatory reporting system for the collection, validation and storage of regulatory data.

63 See, for example FSA (2009f), FSA (2010e) and FSA (2010f).

quality of data, it would also be important to consider whether the benefits of such a change would exceed the costs that would be incurred by firms.

Possible solutions

Requiring regulatory returns to be audited

6.16 One possible way forward is to require all regulatory returns to be audited. However, many firms that are required to submit regulatory returns to the FSA are not currently required to appoint an auditor, and therefore imposing an audit requirement for the returns may be a disproportionate response for such firms. Therefore it may be preferable to require audited regulatory returns only from those firms that are required, by legislation, to appoint an auditor. Other firms are relatively less significant, on an individual basis, in terms of the risks they pose to the FSA's statutory objectives.

6.17 Those in favour of such an approach point out that, if returns were audited, the likelihood of errors arising in them would be significantly reduced. It is also true that it is rare for us to find significant errors in returns from insurance firms which, as noted earlier, are audited. On the other hand, although the FSA is seeing far too many errors in the returns it receives, they represent only a minority of the returns received and some would argue that requiring them all to be audited because of problems with a minority would be excessive.

6.18 The FSA could require an annual statement on firms' systems and controls around regulatory reporting (to be supplemented by s.166 RARs where necessary). This work could be undertaken at the same time as the audit, and could provide additional comfort over the quality of regulatory reporting. This may entail additional costs, albeit lower than the costs of requiring a full audit of all regulatory returns for firms subject to statutory audit.

6.19 The costs and benefits in establishing a requirement for external assurance over regulatory returns would depend on the type of assurance required. An audit of all regulatory returns would provide a reasonable, but not absolute, degree of assurance over the information in the returns, but the cost to firms is likely to be high, potentially disproportionately so. Furthermore, an audit of regulatory returns might not resolve issues where accounting judgement or complex valuation techniques are involved. An audit of firms' systems and controls around regulatory reporting for firms that already appoint auditors may be relatively less costly, and may potentially address the concerns noted above around errors in regulatory returns.

6.20 Therefore, external assurance over regulatory returns may be most beneficial and cost-effective if narrowly defined – one example is an assurance engagement considering systems and controls for data feeding into the returns. The FSA could also implement an 'agreed-upon procedures' engagement, which could, for example, require an auditor to perform agreed-upon procedures on a list of assumptions for those assets where valuation ranges exceed a certain number or percentage. Should the FSA decide to take any of the above proposals further, it would consult and conduct a full cost benefit analysis of any proposals.

S.166 Return Assurance Reports

6.21 An alternative to requiring all regulatory returns to be audited would be to carry out a review of a specific firm's regulatory returns. In past consultations,[64] the FSA introduced the concept of s.166 Return Assurance Reports (s.166 RARs). This involves the FSA using powers under section 166 of FSMA to review a specific firm's regulatory return where there is a perceived risk. These reviews can therefore be used to gain assurance that the regulatory return has been properly prepared in accordance with the relevant FSA rules.

6.22 The FSA is already committed to making greater use of s.166 RARs to provide greater assurance that regulatory returns submitted to the FSA have completed in accordance with the relevant rules.[65] The FSA believes that this would include firms with problematic regulatory returns and firms where the regulatory returns have not been subject to external assurance in the past. In view of the concerns mentioned earlier, the FSA believes that making even greater use of s.166 RARs would be of regulatory benefit. The FSA would select specific firms and specific returns based on their risk characteristics for a s.166 RAR review; this is likely to be preferable to requiring all regulatory returns to be audited.

6.23 In order to make the commissioning of such work more straightforward than it is presently and to provide more certainty over costs, the FSA intends to work with the FRC and the accountancy profession to develop a selection of pro-forma scopes and opinions for s.166 RAR work and to find a suitable mechanism to implement this guidance, such as an APB Practice Note or enhancements to the current technical release from the Institute of Chartered Accountants in England and Wales (ICAEW).[66]

6.24 Whilst the total costs of s.166 RARs will increase as the FSA increases its use of these reports, the suggestions to establish pro-forma scopes and reporting formats should help to reduce the costs to individual firms. Furthermore, as s.166 reporting becomes more common, auditors and other skilled persons will establish work methodologies that they can then apply across a range of s.166 work, thereby bringing down costs further.

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 RARs be preferable to introducing an audit requirement for all returns?

Enhanced auditor reporting on financial statements to the FSA

6.25 One of the areas the FSA is exploring is whether auditors should be required to report to it on additional specified areas, for the firms they audit, either where the FSA would like more insight into findings from audit work undertaken or where it

64 FSA (2007a) and FSA (2007b)
65 FSA (2007b)
66 ICAEW (2008)

would like the auditors to undertake and report on additional assurance work. This would be separate from commissioning auditors under s.166 where the appointment of a skilled person under s.166 is usually to identify, assess, measure, monitor or limit identified risks specific to that firm. This enhanced auditor reporting would provide reports to the FSA which would cover a range of firms and could provide more detail to the FSA over key aspects of the audit, or other work undertaken at the same time as the audit.

6.26 However auditors are already required under auditing standards to report to those charged with governance on, among other matters, significant findings from their audit work.[67] The FSA has access to these reports and therefore before reviewing the case for enhanced auditor reporting to the FSA, it is helpful to understand the areas covered by these written reports to those charged with governance.

6.27 In these written communications to those charged with governance, the auditor is required to convey views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor should explain to those charged with governance why the auditor considers a significant accounting practice, though acceptable under the applicable financial reporting framework, not to be most appropriate for the particular circumstances of the entity.[68]

6.28 These reports of significant findings are provided to the FSA by the firms themselves and they help the FSA to obtain greater understanding of, and comfort about, the audit work performed on key areas of accounting judgement. However, though there may be some overlap with the FSA's areas of interest, these reports are not tailored to FSA concerns about, for example, inconsistent treatment in some areas of fair value and impairments. To enhance prudential supervision and market confidence, through auditors focusing to a greater extent on these areas in a consistent manner, the FSA believes it is also worth considering whether auditors could therefore provide additional information on the audited firm to the FSA on the following areas:

- **Reporting on areas of significant accounting judgement** which materially affect the firm's results and financial position. For example, a granular analysis of the appropriateness of a firm's impairment policy and/or provisions and the audit work which the auditors undertook to get comfortable with the impairment balance. Other examples could include credit valuation adjustments and the judgements involved in individual or classes of significant or unusual transactions which resulted in special purpose entities not being consolidated, or securitisations leading to the derecognition of assets.

- **A post audit report to the FSA**, setting out the main findings arising from the audit that could be relevant to the FSA such as identified weaknesses in the internal control environment or policies and practices at the firm that differ significantly from its peers.

6.29 The FSA could also ask for reports on areas which are not traditionally core to the conduct of the audit such as the main dependencies and vulnerabilities inherent

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67 ISA 260 (UK and Ireland), *Communication with those charged with governance.*
68 Ibid

in the firm's business model, or the effectiveness of governance, risk management processes or internal controls. Before each reporting period the FSA could prescribe which financial reporting areas it expects to be covered in the period.

6.30 Over time, as well as enhancing the FSA's supervision, the forms of reporting described above could help support reliable public financial reporting, underpinning market confidence. Such reports might not be required for all firms, but maybe a range of firms such as all high impact firms.

6.31 In each case, consideration would also need to be given to whether the APB and FSA should work together to enable the APB to develop appropriate auditing standards and guidance for the assurance work in these areas, and whether it would be appropriate for the AIU to inspect the work undertaken by the auditors and for such work to be in the scope of the AADB.

6.32 The costs of the type of reporting outlined above would be met by the firms being reported upon. The balance of costs and benefits of such reporting will vary depending on what is reported. At a minimum it is anticipated that any such communications would be derived from work already undertaken as part of the audit engagement and therefore the additional cost would be limited. In moving away from auditors' reports that could be derived from audit work already undertaken, the costs of such reporting would increase. The power for the FSA to require such enhanced auditor reporting would necessitate an amendment to FSMA.

6.33 A key benefit for the FSA could be that any such additional information would provide it with more complete information relevant to judge the adequacy of amounts in the annual accounts which are relevant to the FSA's functions and could be presented in a consistent format which would aid comparison across firms. Reporting on the firm's business model and other matters such as governance, risk management processes, accounting systems and internal controls could provide key information to the FSA which would contribute to effective supervision.

6.34 The scope of such work would need to be carefully defined to ensure it would result in relevant, complete and accurate reporting. It might not always be possible to design such reporting to provide sufficient additional benefit. The costs could also be unduly high for the firm, especially if the auditor undertook the work and the firm had no choice over this. Under the FSA's more intensive approach to supervision, in many areas, such as an assessment of the firm's business model, this is already part of its supervision activities. Granular analysis of key areas of a firm's accounts, such as credit risk, is also already carried out on a thematic basis by the FSA's own experts.

6.35 If enhanced auditor reporting was thought desirable in principle, further consideration would need to be given to issues of implementation and to who would pay. We would therefore particularly welcome views on whether the auditor should provide enhanced reporting to the FSA, if this is a fruitful area for development and the likely costs and benefits of such reporting.

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?

Summary

6.36 In this chapter we considered ways in which the FSA could better use auditors' skills and knowledge through more direct reporting to the FSA. This included considering how s.166 SPR reporting might be more effective, and we noted that the FSA's existing guidance and practice for s.166 SPRs may be revised after completing its 'lessons learned' review in Q3 2010. We also described the current position in respect of firms' regulatory returns and explored ways in which auditors could be used to enhance the quality of such returns. Finally, we considered the possibility of implementing a requirement for auditors to report directly to the FSA on additional specified areas, noting how this would be distinct from s.166 SPRs.

6.37 In the next chapter we examine whether auditors have a role to play in firms' Pillar 3 disclosures and prudential information included in their annual reports.

7 Audit of Pillar 3 and prudential information in the annual report

7.1 In this chapter, we consider whether auditors should have a specific role in relation to:

- disclosures published under Pillar 3 of the Basel II capital framework (as raised in the Treasury Committee's report on the banking crisis); and
- disclosures of prudential information in the annual report, but outside of the audited financial statements.

Pillar 3 disclosures

7.2 BIPRU firms[69] are required to make disclosures on capital and risk management under Pillar 3 of the Basel II capital framework. These disclosures aim to complement Pillars 1 (minimum capital requirements) and 2 (supervisory review) by facilitating market discipline and encouraging the spread of best practice. The disclosure requirements were implemented in European Union (EU) law via the Capital Requirements Directive (CRD), and implemented in the UK via BIPRU 11 of the Financial Services Authority (FSA) Handbook.

7.3 Disclosures made under the Pillar 3 requirements must be subject to internal verification.[70] However, the CRD makes provision for competent authorities to require firms to use 'specific means of verification for the disclosures not covered by statutory audit'.[71] The FSA's approach to implementing Pillar 3, which the FSA consulted upon and discussed with the industry in 2005/6, did not make use of this national option to require external audit. This is in line with the FSA's overall approach to implementing Pillar 3 disclosure requirements, which is by copy-out from the CRD with no additional guidance. The FSA consulted on continuing this approach last year[72] and, in line with stakeholders' responses, believes it remains appropriate.

69 Generally, BIPRU firms are banks, building societies and investment firms. A detailed definition is set out in BIPRU 1.1.6 R of the FSA Handbook.

70 This is determined by the firm following BIPRU 11.3.3 R (implementing Article 145(3) of Directive 2006/48/EC of the European Parliament).

71 Article 149 (d), Directive 2006/48/EC of the European Parliament

72 FSA (2009e)

7.4 Only one EU member state has made use of the option to require external verification of all Pillar 3 disclosures, with one other requiring external verification of a selection of Pillar 3 information. Two other member states have required limited external verification of compliance with Pillar 3 (without certifying the content of the disclosures). In practice, therefore, the vast majority of disclosures made under Pillar 3 in the EU are only audited where a firm chooses to rely on information in its financial statements to fulfil particular requirements. This is most common for credit risk disclosures on impaired assets and provisions,[73] since similar information is also required by disclosures on credit risk under IFRS 7,[74] *Financial Instruments: Disclosures*.

7.5 In written evidence to the Treasury Committee,[75] the ICAEW suggested that the FSA reconsider its decision not to require external audit of Pillar 3 disclosures in light of changed circumstances. The Treasury Committee asked the FSA to respond to this recommendation.[76]

7.6 Additional assurance reporting, if made public, could increase the decision-usefulness of Pillar 3 disclosures to market participants by increasing the extent to which they can rely on the disclosures made. This could increase the effectiveness of market discipline if market participants then felt more inclined to act on the information provided.

7.7 The Solvency II regime for insurers includes a publicly-disclosed Solvency and Financial Condition Report (SFCR), containing similar information on capital resources and risk management to that provided by BIPRU firms under Pillar 3. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) believes some of the information that needs to be included in the SFCR should be subject to external audit, and this is supported by the FSA. Items which could be subject to an external audit as listed in CEIOPS' *Advice for Level 2 Implementing Measures on Solvency 2: Supervisory Reporting and Public Disclosure Requirements*,[77] to the European Commission, include own funds (together with an accounting reconciliation), life and non-life technical provisions and quantitative assumptions used in valuation processes. CEIOPS are developing more detailed proposals for consultation as Level 3 Guidance. This is likely to be mirrored by a requirement for external audit of particular items in regulatory returns (which will consist of a report to supervisors and certain quantitative templates), albeit on an annual rather than quarterly basis.

7.8 However, there are several other instances (besides Pillar 3 disclosures) where information is routinely provided to market participants without being subject to audit. For example, there is no requirement for interim accounts to be audited or reviewed.

7.9 In the FSA's response to the Treasury Committee[78] on Pillar 3 disclosures for BIPRU firms, it was noted that there was no demand from investors for an audit requirement to be imposed. Although this is kept under review, any change in

73 For example, when complying with BIPRU 11.5.8 R
74 IFRS: International Financial Reporting Standards
75 ICAEW (2009a)
76 House of Commons Treasury Committee (2009)
77 CEIOPS (2009)
78 FSA (2009d)

policy would have to be subject to a cost-benefit analysis and developed bearing in mind any ongoing policy developments at EU level. Pillar 3 disclosure requirements are currently developed at international level, through the Basel Accord, and are subsequently implemented via EU legislation. The FSA will continue to work with international supervisory colleagues to maintain a harmonised approach.

7.10 A recent stakeholder feedback paper from the ICAEW also concluded that 'there is no particular appetite from stakeholders or auditors for audit reports to be expanded to cover … regulatory disclosures'.[79]

7.11 Since Pillar 3 disclosure requirements have only been implemented recently, it is difficult to draw firm conclusions on their effectiveness. Many firms only published full Pillar 3 disclosures for the first time in 2009. The FSA understands that market participants showed limited interest in the reports produced in 2009. Through the Committee of European Banking Supervisors (CEBS), the FSA is continuing to monitor implementation of Pillar 3 by EU banks, and are engaging with users as part of these efforts.

7.12 However, the lack of demand by users, combined with the limited evidence available to date of the use made of Pillar 3 disclosures, raises doubts about whether external audit would have a significant impact on the effectiveness of Pillar 3 disclosures in reinforcing market discipline. External audit could create extra costs for firms and an increase in the time taken to prepare and publish the disclosures, without significant additional benefits.

> Q13: Would external audit increase the decision-usefulness of Pillar 3 disclosures made by BIPRU firms? Would the benefits justify the costs?
>
> Q14: Are the different approaches to external audit of Pillar 3 information between BIPRU firms and insurers justified, or should there be a common approach?

Prudential information in the annual report

7.13 Some information on capital is available in a firm's annual report. This information may or may not be audited, and may be included in the following circumstances:

- when a firm uses its annual report to comply with some or all of the Pillar 3 disclosure requirements (as noted above);
- when disclosures on capital are required by accounting standards; or
- when a firm includes information voluntarily or to follow best practice recommendations.

7.14 For firms reporting under IFRS, IAS 1,[80] *Presentation of Financial Statements* requires information relevant to an understanding of the financial statements to

79 ICAEW (2010)
80 IAS: International Accounting Standard

be presented in the notes to the financial statements which are covered by audit. In particular, IAS 1 requires a firm to 'disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital'. This should include summary quantitative data about what it manages as capital and whether the firm has complied with externally imposed capital requirements during the period. A firm should also disclose capital requirements in different jurisdictions where aggregate disclosure would not give a fair reflection of an entity's capital resources.

7.15 Under UK generally accepted accounting principles (UK GAAP), firms applying Financial Reporting Standards (FRSs) 25, 26 and 29 are required by FRS 29 (paragraph 42A) to make disclosures about their capital in accordance with Appendix E of that standard. Although there is no direct equivalent to IAS 1 under UK GAAP for other entities, the Companies Act 2006 section 417 requires the directors' report of a company (other than a company entitled to the small companies exemption) to contain a business review. The business review must give a fair review of the company's business and a description of the principal risks and uncertainties facing the business (section 417(3)). The review required is 'a balanced and comprehensive analysis of (a) the development and performance of the company's business during the financial year; and (b) the position of the company's business at the end of that year' (section 417 (4)). Additional requirements apply in the case of quoted companies. The ASB's Reporting Statement, *The Operating and Financial Review*[81] provides applicable best practice guidance in this area, and notes that the review 'should contain a discussion of the capital structure of the entity'.

7.16 For many financial services firms and particularly for credit institutions, capital ratios and other information on capital management are likely to be essential in understanding the position of the firm. Therefore, the business review often contains additional capital information. A separate capital management note or risk management section may also include information which links back to capital adequacy and resources, such as risk weighted assets.

7.17 Where this information is included outside the financial statements, it is not subject to audit unless it covers information required by accounting standards[82] although the Companies Act 2006 requires particular sections of the annual report to be reviewed for consistency with the financial statements. This is also true for Pillar 3 disclosures where these are included in the annual report (rather than in a separate document) but outside the notes to the financial statements.

7.18 Following the financial crisis and the increased focus on the capital adequacy of major financial institutions, there could be an argument for increasing the scope of audit to encompass all disclosures on capital and liquidity published within the annual report, to enhance the credibility of the data and therefore market confidence. However, as well as increasing the costs of the audit, unless coupled with more specific disclosure requirements, this could create incentives for firms to publish less information on capital adequacy or to publish information in different places, which would not lead to increased benefits for market participants.

81 ASB (2006)

82 E.g. for those reporting under IFRS, the disclosures under IFRS 7, *Financial Instruments: Disclosures*.

7.19 Even if there is no increase in coverage by the audit, there could be merit in increasing the transparency of the link between accounting figures and regulatory capital by requiring some specific disclosures on capital adequacy within the audited financial statements. The Basel Committee's consultative document on strengthening the resilience of the banking sector proposed that banks should disclose 'a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements'.[83] A natural complement to this could be a 'regulatory income statement', as recently suggested by the Chairman of the IASB, showing the extent to which accounting income feeds through to regulatory capital resources.

7.20 Another approach could be to identify particular measures where their inherent uncertainty or relevance to key decision-making meant the audit could create added value. If this approach was considered desirable, it could be further enhanced so the need for an audit is considered routinely as part of the process for developing new regulatory measures and associated disclosures.

> 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?

Summary

7.21 In this chapter we considered the potential for auditors to have a specific role for firms' Pillar 3 disclosures and for prudential information included in firms' annual reports. With regard to the former, we noted that there appears to be limited appetite from many stakeholders for the imposition of an audit requirement for Pillar 3 disclosures and that across the EU, few countries have implemented additional audit or assurance requirements for these disclosures. With regard to the latter, we explained the importance and relevance of prudential information disclosure for financial services firms and raised a question as to whether an explicit audit requirement for such disclosures could be helpful.

83 BCBS (2009)

Market and regulatory failure analysis

A1.1 This annex provides an overview of the economic theory and empirical evidence relevant to the issues identified in this paper. In particular it examines the:

- economic rationale for financial reporting, audit and disclosure;
- determinants of audit quality; and
- risks to the FSA's objectives arising from the specific areas of interest regarding the audit process and the data it relies upon.

Economic rationale for financial reporting, audit and mandated disclosure

A1.2 Financial reporting reduces the information gap between a firm's shareholders, potential investors and debt holders and its management, relating to the activities and performance of the firm. It therefore facilitates corporate governance, the efficient functioning of capital markets and increased liquidity,[84] and tends to reduce firms' cost of capital.[85]

A1.3 Economic literature has identified a number of factors that have the potential to cause market failures arising from a lack of alignment of incentives between a firm's management and its shareholders. These factors include:

- asymmetric information, where management know more about the firm and its performance than its shareholders; and
- the 'principal-agent' problem, which arises when the interests of shareholders (the principal) and firms' management (the agent) diverge.

A1.4 These factors mean that shareholders tend to have less, and lower quality, information about the firm than its management. This in turn makes it difficult for shareholders to hold management to account for their stewardship of the firm and

84 Glosten & Milgrom (1985)
85 Healy & Palepu (2001) and Ball (2001)

can render monitoring of management actions costly. Ultimately, it may also result in ineffective sanctioning of poor management performance.[86]

A1.5 The presence of these factors, if unaddressed, would lead to sub-optimal levels of investment. However, both market incentives and existing rules taken together (including securities market regulation, accounting and audit standards, and corporate governance requirements) are likely to contribute to more efficient outcomes.

A1.6 Firstly, it is in management's interest to attract funding at competitive rates. Empirical findings suggest that capital markets generally value 'reliable' accounting. High quality financial reporting has been found to increase the liquidity of a firm's shares and its access to capital, as well as to reduce its cost of capital.[87] Complementary to that are findings that management use voluntary disclosures in order to attract capital at more favourable rates, provided that the benefits (in terms of cheaper capital) do not exceed the costs (an indirect cost of disclosure may be that it may help a firm's competitors,[88] or cause a regulator to act in a manner contrary to the firm's private interests, for example).

A1.7 Secondly, theoretical and empirical studies of major regulatory events suggest that reporting and disclosure regulation can, depending on the case, positively affect individual firms' cost of capital and market liquidity and efficiency.[89] Examples include two studies of Securities and Exchange Commission (SEC) disclosure regulation in 1964 (noting benefits such as reductions in volatility among over-the-counter stock and increased returns).[90] However, disclosure regulation may result in net costs for individual firms.[91]

A1.8 The rationale for mandating disclosures is that firms may not face all the costs and benefits that could result from disclosure. Disclosures by individual firms may have market and economic impacts going beyond those experienced by the disclosing firms themselves. Whether mandated disclosure is a net benefit to society will depend on the facts of the case at hand. Furthermore, whether the perceived benefits are likely to materialise depends on effective monitoring and enforcement.[92]

Audit and determinants of audit quality

A1.9 Audit and assurance reports are designed to provide stakeholders with an independent view of the reliability of information provided to them by management (and potentially other aspects of management activities). They tend to enhance the quality and credibility of disclosed information and, as such, may be required by capital providers if not by regulators. Auditors are agents of shareholders[93]

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86 Shleifer & Vishny (1997). The seminal book by Berle & Means (1932) showed that ownership dispersion worsens principal-agent problems between shareholders and managers and that management controlled firms can deviate from profit maximization. The latter issue was further developed in Baumol (1959).

87 Leuz & Verrechia (2000)

88 Feltham, Gigler & Hughes (1992)

89 Rajan & Zingales (1998)

90 Ferrell (2003) and Greenstone, Oyer & Vissing-Jorgensen (2006)

91 Bushee & Leuz (2005)

92 The latter includes the institutional framework available for enforcing disclosure standards, including both the availability of private litigation and public enforcement – Ball (2001).

93 Under the Companies Act 2006 auditors are appointed by and report to the shareholders of the company.

and, whilst their appointment must be approved by shareholders each year, they are nonetheless likely to develop a close working relationship with the board of directors over time. Furthermore, an auditors' reappointment often hinges on the quality of their long-term relationship with the board.[94] In addition, particularly in the case of complex firms, the auditor may require the close cooperation of management in order to carry out the audit process in a timely way and at reasonable cost. The closeness of the relationship may be further strengthened where the auditor provides services other than the audit to the firm.[95] These relationships may adversely affect the auditor's oversight (on behalf of shareholders) of management (acting as agents for shareholders when managing the assets of the firm) and auditors may face potential conflicts of interest between their duties to shareholders and their relationship with the firm.

A1.10 Key to managing this potential conflict is to ensure that the incentives for delivering high quality audit exceed the incentives for other behaviours. Economic literature considers the key incentives for audit quality to be the likelihood of litigation against the auditor and the reputation of the auditor. There is mixed evidence as to which of the two is more relevant, although a review of the literature suggests that they may be complementary. In particular, in regimes where there is no, or limited, auditor liability, the reputational effects described in the literature tend to be established more convincingly.[96]

Reputation

A1.11 Auditors have reputational incentives to avoid audit failures because the market may punish firms whose auditors' reputation is tarnished – firms are less likely to appoint or reappoint such an auditor. More generally the larger audit firms have substantial 'brand' or franchise value which they wish to protect. Several studies have investigated this by considering share price movements of a firm's clients following an audit failure. These studies also consider whether a firm's clients switch auditor as a result. Evidence is mixed because it is difficult to distinguish between clients' choosing a different, more reputable auditor, or changing simply because their existing audit firm is failing (as was the case with Arthur Andersen).[97]

Litigation

A1.12 In theory, legal liability arising from audit failure ensures that the auditor shares in the cost of an audit failure. This may increase auditor incentives properly to 'obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework'.[98]

94 Although reappointment requires the approval of the audit committee. See FRC (2010).
95 Oxera (2006), page 26
96 For a review of the literature see Skinner & Srinivasan (2010).
97 Firth (1990)
98 ISA (UK and Ireland) 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland).*

A1.13 However, below a certain level of liability it may have the opposite effect (that is, the cost of shirking may be acceptable to auditors if the chance of being discovered, and the level of liability if discovered, is sufficiently low).[99]

Other determinants of audit quality

A1.14 Reputation and litigation risk incentives for auditors are not, in practice, the only determinants of auditor objectivity and of a high quality audit. In the wider literature, audit quality is also considered to be influenced by factors such as the role and composition of firms' audit committees, the type and amount of non-audit services provided by auditors,[100] the culture and reward structure in which audit partners operate,[101] and the individual relationships between the lead audit partner and the firm's Finance Director.[102] A firm's audit committee may be effective in contributing to a high quality audit, depending on its composition and role. Key factors are likely to include the degree to which it is independent of management and its role in the appointment of auditors, monitoring their independence and objectivity and the effectiveness of the audit.

A1.15 Regulatory responses have been introduced to mitigate the threats to auditor objectivity and audit quality.[103] Examples include measures to monitor audit quality (such as by the AIU for certain entities), measures to investigate and discipline auditors (such as through the AADB), guidance in the FRC's UK Corporate Governance Code regarding the role and composition of audit committees,[104] and Ethical Standards for auditors issued by the APB,[105] which address the auditor's integrity, objectivity and independence.

A1.16 Amongst other matters, the Ethical Standards address threats to the auditor's objectivity and independence posed by financial, business and other relationships, long association with the audit engagement, fees, the auditor's remuneration and evaluation policies, litigation, gifts, hospitality and the provision of non-audit services. The Ethical Standards, which include a number of prohibitions, require auditors to assess these and other threats to their objectivity and independence and to either eliminate them or reduce them to an acceptable level. Such measures are designed to mitigate perceived and actual concerns regarding the closeness of relationship between the auditor and the board of directors. They are expected to eliminate all material threats to the auditor's objectivity and independence.

A1.17 Audit quality is also influenced by many other factors. Some of these factors are controlled by the auditor, such as the audit firm's culture, the skills and personal qualities of audit partners and audit staff and the effectiveness of the audit process. Others are outside the auditor's control, such as the audited firm's corporate governance arrangements, the effectiveness of the audited firm's audit committee,

99 See for example Lennox (1999) and Shu (2000).
100 FRC (2006a)
101 Coffee (2006)
102 Beattie, Fearnley & Brandt (2001)
103 Underpinned by requirements of European Union law: see Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.
104 FRC (2010)
105 See http://www.frc.org.uk/apb/publications/ethical.cfm

reporting deadlines and an audit regulatory environment that focuses on the drivers of audit quality.[106]

A1.18 Many of those under the control of the auditor are addressed in the APB's International Standard on *Quality Control (UK and Ireland) 1, Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* (ISQC 1), and are the subject of monitoring by the AIU for those entities within its scope.

A1.19 Whilst measures such as those set out in the Ethical Standards (described above) and in ISQC 1 may mitigate some of the concerns regarding the closeness of relationship between the auditor and the board of directors, they may not fully resolve all the issues. For example, being conscious of their potential liability, auditors may introduce risk management processes that result in limitations in the scope of their work and caveats in their reports. This can affect the value of the audit work performed.

A1.20 It is worth noting that the consequences of threats to the objectivity of an auditor, if realised, are likely to be more acute in times when the incentives for management to misstate information for stakeholders are greater, such as when the firm's performance is under stress. For example, where fair value models could provide a range of possible values dependent on the interpretation of market inputs, management may exhibit more bias in their judgements where they feel under pressure to meet performance targets or the expectations of stakeholders. If there are threats to the auditor's objectivity and management seek to exploit these to influence the conduct of the audit, the auditor's objectivity and safeguards in place may be particularly challenged. Such challenge could be even more marked where the underlying pressure on management are a feature of the market as a whole. For example, it could be more difficult for auditors to insist on more prudent market valuations when the firm's competitors are taking a less prudent view, potentially for higher short-term gains. Similarly, in times of sharply falling asset prices or low market liquidity, pressure on auditors to accept a less cautious interpretation of market signals is likely to be higher.[107]

A1.21 In these circumstances, the auditor's ability to resist such pressures will depend not only on the regulatory measures discussed above and the safeguards in place but also on the availability of effective levers over management. The ultimate sanction available to the auditor is to qualify the audit report. However, depending on the seriousness of the matter, this may be disproportionate and may not therefore be a credible threat. Other levers available to the auditor are then more important, such as effective mechanisms for the audit engagement partner to seek independent support within the audit firm and for the auditor to draw the matter to the attention of a supportive audit committee and regulator with the ability to influence management's behaviour.

106 FRC (2008a)
107 Huizinga & Laeven (2009)

Risks to FSA objectives

A1.22 This paper identifies specific areas of concern regarding the audit process and the data that the FSA relies upon, which may have an impact on the FSA's ability to fulfil its regulatory remit. These may pose a risk to all FSA objectives but most importantly to the objectives of market confidence, financial stability and consumer protection.

Market confidence

A1.23 Inadequate financial reporting may affect market confidence by increasing costs to investors and reducing market participation. This may also increase the overall cost and reduce the availability of capital.

A1.24 A particular issue relates to concerns about the quality of auditors' work in the context of client assets. The quality of client asset protection can affect both market confidence and financial stability. The failure of Lehman Brothers' European subsidiary, Lehman Brothers International (Europe) Limited (LBIE) revealed a lack of information available to customers, regulators and administrators about client assets handling, record keeping and the location of assets. This resulted in, amongst other things, instances where client assets were not segregated from the firm's assets as appropriate. This problem is very likely to have increased some firms' ability to take on inappropriate risks prior to the recent crisis. Apart from losses to affected clients, this can contribute to systemic risk and increase the costs of a financial crisis, as uncertainty about the solvency of major financial firms, accompanied by concern about the security of client assets, can spread and cause liquidity in wholesale markets to dry up.[108]

Financial stability

A1.25 Whilst the purposes of financial reporting and prudential reporting may be different,[109] financial stability may be also affected by ineffective financial reporting and ineffective audit. Firstly, inadequate financial reporting may be one factor which prolongs unsustainable growth in asset values. That is because, as noted in paragraph A1.21, it may be more difficult and/or inappropriate for auditors to challenge management assumptions about the future (which have a significant impact on valuations) when market signals appear to support a wide range of possible values. It may also be difficult because the auditor may not have appropriate levers to enable effective challenge. In an engagement to report on compliance with a financial reporting framework such as IFRS or UK GAAP, it would be inappropriate for the auditor to seek to impose a degree of prudence in the audited financial statements that goes beyond an unbiased position consistent with the requirement to give a true and fair view. Nonetheless, the auditor may have relevant insights from the audit work that could assist the FSA in establishing appropriate, potentially more prudent, regulatory requirements.

108 FSA (2010a)

109 See, for example, paragraphs 23 to 30 of the FRC memorandum to the Treasury Committee Banking Crisis Inquiry (FRC 2008c).

A1.26 Secondly, at the onset of periods of reduced market liquidity and falls in asset prices, inadequate financial reporting may cause markets to overshoot as little information is available on the underlying value of assets, and/or the information available may not be trusted by markets. This could also prolong volatility as it will take longer for markets to obtain adequate and trustworthy information on asset values so that liquidity can recover on the basis of relatively clear information about the value that the market places on particular financial instruments.[110]

A1.27 Furthermore, financial stability will be directly affected if the quality of financial reporting negatively affects regulatory capital reporting.[111] This risk is greater the larger and more interconnected firms are. However, misreporting by small and medium size firms may have systemic impact too, if that misreporting is sufficiently widespread. This effect is not necessarily limited just to banks. Insurers played a crucial role in the most recent financial crisis through, for example, their provision of credit protection for various types of sophisticated credit instruments.

Consumer protection

A1.28 Whilst consumers are unlikely to be in a position to assess a firm's compliance with the client asset rules, a lack of proper compliance with these heightens the risk of losses to consumers. As noted above, apart from losses to consumers directly affected, this can contribute to systemic risk and increase the costs of a financial crisis as uncertainty about the solvency of major financial firms can spread.

The need for reliable regulatory data

A1.29 For the FSA to be able to fulfil any of its objectives, the information and data available to the regulator must be reliable. Regulation can only be effective in achieving its stated aims if regulatory analysis and action is founded on information and data that are accurate, complete and relevant. Where regulatory constraints are binding – and therefore costly – regulated entities have an incentive to cheat to save the costs of raising more capital (or of making other changes to their portfolio, such as increasing liquidity) if they believe their actions can remain undetected and unpunished.[112] Behaviour to avoid the costs of regulation has – in the context of regulated utilities – resulted in suggestions that a company's auditors should not be also performing the audit of its regulatory accounts (in cases where such accounts are audited).[113]

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110 Joint FSF-CGFS Working Group (2009); Brunnermeier (2009); Huizinga & Laeven (2009); Plantin, Sapra & Shin (2008).

111 FSA (2009a); Joint FSF-CGFS Working Group (2009)

112 The WorldCom accounting fraud, which led to the bankruptcy of the company in 2002, is a very high profile example where a firm was – albeit only temporarily – successful at influencing regulatory policy through accounting fraud, is described in Sidak (2003). The primary aspect of the fraud was due to misclassification of costs (capitalising rather than expensing) and inflating revenues. However, for regulatory purposes it was WorldCom's claims of internet traffic which ultimately caused harm to its competitors and to US consumers. This is because WorldCom – where it had monopoly power over telecommunications infrastructure – had to obtain agreement from the regulator over how much to charge for access to their infrastructure on the basis of actual and projected internet traffic. As a result of these exaggerated figures, WorldCom's downstream competitors (such as Internet Service Providers and other, smaller, telecoms operators) had to pay high access prices to an under-used telecoms infrastructure. These costs were ultimately passed on to consumers of telecoms companies (including WorldCom's) own retail customers.

113 Regulatory Accounts Inter-Regulatory Working Group (2000), page 9.

A1.30 Avoidance may also take the form of firms saving 'compliance' costs by not devoting the resources that would be required to ensure that regulatory information is of high quality. Such behaviour may also reflect firms' view of the likelihood, and costs, of their behaviour being discovered and sanctioned by the regulator

A1.31 As noted above, there are already various structures in place which are designed to deal directly with the issues identified in this chapter, such as auditing standards; ethical standards covering the integrity, objectivity and independence of the auditor; the role of audit committees; and external monitoring and investigation bodies to ensure the risks are mitigated. For example, the AIU continues to monitor whether statutory audits of major entities[114] have been conducted in accordance with audit regulations.

A1.32 Many of the measures proposed in this paper aim to improve the alignment of incentives between shareholders, investors and auditors on the one hand, and between the FSA and auditors on the other.[115] In addition, later this year the FSA will be consulting on reforms to strengthen the auditor reporting requirements of its client assets regime.

114 The audits of all UK incorporated companies with listed securities and other entities in whose financial condition there is considered to be a major public interest are within the scope of the AIU's work.

115 This distinction between shareholders/investors, auditors and the FSA is necessary because the FSA's role is to internalise the costs of risks to the financial system that individual firms and shareholders do not have to take into consideration – investors and auditors are concerned primarily with private benefits and costs, whereas the FSA is concerned with social benefit and cost.

Governance and reporting responsibilities of firms and their auditors

The Board of Directors

A2.1 Directors are responsible for establishing and monitoring the effectiveness of the corporate governance arrangements under which the regulated firm operates, including the establishment of an effective audit committee. Good governance should enable the directors to discharge their duties in the interests of the firm's shareholders.

A2.2 As part of an effective governance framework, the directors are responsible for establishing effective processes for identifying and responding to risks to the objectives being pursued by the firm in furthering its strategy. They are also responsible for establishing effective accounting systems and internal controls.

A2.3 They are also responsible for preparing financial statements which give a true and fair view and comply with the applicable financial reporting framework. As part of this responsibility they exercise judgement in selecting accounting policies and methodologies, in making accounting estimates and providing disclosures that are reasonable in the circumstances and achieve a true and fair view. For those complex financial instruments or transactions where there are few external observable prices, this poses challenges for management and significant audit risk for the auditor.

Audit committees

A2.4 The audit committee of a UK company has a responsibility to act independently of the executive to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control. The FRC's Guidance on Audit Committees[116] describes the audit committee's specific responsibility 'to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them'. The guidance also explains that the audit committee has an oversight function that may lead to detailed work '[f]or example, if the audit committee is uneasy about the explanations of management and auditors

116 FRC (2008b)

about a particular financial reporting policy decision, there may be no alternative but to grapple with the detail and perhaps to seek independent advice'.

Auditors

A2.5 The role of the auditor is to assess whether the financial statements are free from material misstatement and express 'an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework'.[117] The report of the auditor must clearly state whether the annual accounts give a true and fair view.[118] Auditors will often need to utilise experts to assist in obtaining sufficient appropriate audit evidence to support their opinion, particularly in the area of fair values and other accounting estimates.

A2.6 In undertaking the audit of financial statements, the auditor considers aspects of the governance, risk management processes, accounting systems and internal controls to the extent that these are relevant to the audit. At least on an annual basis, the auditors' observations on these matters are reported to those charged with governance.

A2.7 Following the financial crisis, assessing the valuation of some financial instruments became more difficult. In many cases there has been an increase in the volatility and range of possible values for the instruments affected. In these circumstances, the role of the auditor in providing a high quality audit has become even more important in the context of assessing managements' assertions as to the credibility and appropriateness of the related valuations and disclosures in the financial statements.

117 ISA (UK and Ireland) 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (UK and Ireland).*

118 Companies Act 2006, section 495

List of questions

Chapter 1

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?

Chapter 3

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?

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?

Chapter 4

Q4 Do you agree with our proposal to enter into dialogue with firms' audit committees and auditors as set out above? If not, why not?

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?

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 in relation to areas of concern?

Q7 Do you think the FSA should seek an enhanced range of enforcement tools in relation to audit firms as described above? 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?

Chapter 5

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

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?

Chapter 6

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?

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 RARs be preferable to introducing an audit requirement for all returns?

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?

Chapter 7

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

Q14 Are the different approaches to audit of Pillar 3 information between BIPRU firms and insurers justified, or should there be a common approach?

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?

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: http://www.fsa.gov.uk
Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.

The Financial Reporting Council
5th Floor Aldwych House 71-91 Aldwych London WC2B 4HN
Telephone: +44 (0)20 7492 2300 Website: http://www.frc.org.uk
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