



ENGAGEMENT BETWEEN EXTERNAL AUDITORS AND SUPERVISORS AND COMMENCING THE PRA'S DISCIPLINARY POWERS OVER EXTERNAL AUDITORS AND ACTUARIES

INTRODUCTION

ICAEW welcomes the opportunity to comment on the consultation paper (CP) *Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries* published by the Prudential Regulation Authority ("PRA") on 27 February 2015, a copy of which is available from this [link](#).

WHO WE ARE

This response of 27 May 2015 has been prepared on behalf of ICAEW by the Financial Services Faculty. As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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MAJOR POINTS

- 1) ICAEW fully supports the objective of improving the engagement between external auditors and supervisors and believes that this can deepen and enrich both auditors' and supervisors' risk assessments. We agree that there is the opportunity for regulators to derive more benefit from the knowledge and experience auditors have about the financial institutions they audit. We welcome the continuing consultation on how this can be best achieved through sharing information.
- 2) We are aware that the PRA is proposing a dry run of the new private reports during the course of the 2015 year-ends for a significant proportion of the scoped in population. This would appear to suggest that the regime will go ahead regardless of the outcome of this consultation. We recommend that the consultation period for the regime is not concluded until the results of the trial can be assessed, discussed and debated.
- 3) We have set out our response below addressing:
 - The potential cost-effectiveness of the private reporting regime in meeting regulatory objectives,
 - If the regime proceeds, suggestions as to how it could be made most efficient,
 - The PRAs responsibilities over audit quality, and
 - The new disciplinary powers of the PRA.

Cost-effectiveness of the proposed private reporting

- 4) The primary objective of the proposed private reporting regime is stated as enhancement of the auditor/supervisor dialogue (1.7) and we agree that while progress has been made in this area, further improvement is still possible. We believe that the proposal to require auditors (currently of the UK's largest banks and building societies) to provide written reports to the PRA annually on aspects of audit work performed could facilitate further improvements by making the information auditors provide more relevant to users. However, we believe that there are also alternative means to achieve those goals which might be more cost effective.
- 5) The direct costs of the regime (excluding the indirect cost to regulated institutions themselves) are estimated to be between £7m and £22m by the CP. These costs are expected to be passed on to the Relevant Firms. We note that such estimates are subject to change and the actual cost of the regime will only be known once the first reports are written, submitted and discussed.
- 6) Notwithstanding this, the estimated costs are considerable. We believe that significant improvement can be made in the auditor/supervisor relationship by greater use of both bilateral and trilateral meetings that are longer, with more detailed agendas and undertaken more frequently at a fraction of the cost of the regime.
- 7) We believe greater use can be made of existing reported information such as CoREP returns, FinREP returns, Pillar III data and existing outputs of the audit process such as management letters, highlights memoranda and Audit Committee presentations in preparing for such meetings in a detailed way. We believe that these enhanced meetings could significantly improve the knowledge of the supervisor in respect of the findings and understanding of the issues possessed by the audit team.
- 8) Further, detailed questioning as to the nature of judgements made in financial statements (for example on what basis such judgements are made, with what evidence, under what governance process etc.) can be addressed directly by supervised firms, eliminating the cost of audit firms reporting information that can be obtained directly from management. It is the

responsibility of the Directors of those firms to form those judgments and as a result the most data as to their rationale will sit with management.

- 9) Should the regulator have specific concerns at a detailed level regarding some element of a bank's financial reporting, it has the ability to request a S166 Skilled persons review and set a scope for either the auditors or another firm to report to it on that area. Use of data from the ordinary course of the auditor's activities will provide limited benefit in addressing specific concerns. By its nature, that work will not be performed with the primary objective of reporting to the regulator in mind.

Efficiency of the regime

- 10) The written reports discussed in the CP document the responses to questions that the supervisor can ask in the ordinary course of the auditor/supervisor relationship. It is acknowledged that the objective is to learn new things about the audit and "*not to repeat to the PRA things that they are already putting in writing to their clients*" (3.7). However, in that approach, it is critical that the nature of the questioning is one that follows the conduct of the audit, and not one that directs the approach of the audit. That is, the questions should be capable of being answered as a result of the work performed by the auditors in the normal course of their duties.
- 11) In Appendix 2.2.5 there is a requirement that the auditors should consult with the PRA before the audit is completed to ensure that the supervisor's expectations of content can be met and that the report fully covers the scope. This suggests that the supervisor may redirect the firm to complete new or different audit work during the audit if it is unsatisfied by the draft report that it has seen. The audit is designed to enable the auditor to form a view on the truthfulness and fairness of the financial statements as a whole. Forming views on the sufficiency or otherwise of audit work (in respect of the overall objective) through examination of the responses to a select number of questions risks an inappropriate refocussing of the purpose and design of the audit at a critical stage.
- 12) There is a danger that areas of focus indicated by the regulator may distract from work undertaken on areas of critical audit risk identified by the auditor. The Audit Committee are charged by shareholders to oversee the audit process. It is therefore critical that the Audit Committee is fully consulted and agrees to the reporting proposed before the commencement of the audit in order to address potential differences of view. We also note that agreeing the form and content of such a report with management may lengthen the reporting cycle and a substantial increase in the volume and detail of Board level reporting by the auditor may not be helpful in ensuring the key messages that the auditor wishes to communicate are clear.
- 13) We firmly believe that the purpose of the reporting mechanism should be for the supervisor to learn about the audit work that has taken place, and not to redirect resource or audit work to areas that it believes bear investigation at a late stage of the audit. The objective of setting questions with the auditors earlier in the audit cycle should be sufficient to make clear where the supervisor has concerns. It is then the role of the auditor to design and execute an audit plan that meets all of their statutory objectives. We believe that the approach described in Appendix 2.2.5 undermines the proper execution of the audit by second guessing the way in which the audit is conducted.
- 14) The approach of agreeing the questions with the audit team at the start of the audit cycle has the advantage of being able to close any expectations gap of what it is possible for auditors to report on. The agreement of the questions and scope of the report will be of critical importance in the success of the regime. In particular, agreeing to clear, concise and achievable outcomes will require the agreement of supervisor, auditor and Audit Committee.

- 15) We believe that matters such as materiality (for example an area where the auditor does less work on the grounds of materiality) will be important to clarify at this stage. If the auditor will not be capable of answering a question due to the work it has planned, it should be identified at this stage. Where this is shown to be the case, the question should be removed and no new audit work undertaken in order to address it. As noted above, we believe that this is the opportunity for the supervisor to make use of the work that is performed in the ordinary course of the audit and not a mechanism such as S166 reporting where the supervising authority directs the work performed.
- 16) We note that there is some confusion as to whether the report proposed will be shared with those charged with governance at the institution (3.12 states that the reports are to be made available to audit committees, whereas Appendix 2, 4.1 suggests a firm may want to share the report with audit committees). We believe that such a report should be shared with management at the institution. It would be inappropriate for the regulator to have a greater level of reporting from the auditor than those charged with governance at the institution.
- 17) The CP states that the PRA relies on the audit to be of "sufficient quality". The term "sufficient" is defined as being met only if the auditor "...both (i) considers the risks to individual safety and soundness and financial stability and to the protection of policy holders (as informed by supervisors) in identifying, assessing and responding to the risks of material misstatement, and (ii) reports all findings germane to the risks to these objectives directly to us [PRA] and the client's audit committee". We do not believe that another definition of audit quality is helpful as considerable work in defining and improving audit quality has been ongoing for a number of years by the FRC and others. We believe that a discussion with FRC to align the definition of "sufficient" audit quality should take place.

Role of new report in enhancing audit quality

- 18) The CP claims that written reporting to the regulator offers additional benefits where we believe that evidence to support the claim is lacking, for example "support improvements in the quality of audit firms" and "leading to more robust audits". We fully support the objectives of seeking continual improvements in audit quality and note that the Financial Reporting Council (FRC) Audit Quality Review Team's thematic review of 2013 bank audits found improvements in this area. It is not clear, however, how the form of reporting proposed will lead to those outcomes.
- 19) While we agree that clearly the PRA has an interest in the quality of the audits of the largest banks and building societies, the PRA is not itself an audit regulator. Notwithstanding the commencement of its new disciplinary powers, these were granted in respect of duties imposed by the regulator and duties of auditors to the regulator. They were not intended to cover the audit of bank financial statements as these are covered by separate statutory responsibilities.
- 20) We are concerned that, by making an explicit link to the objective of improving audit quality and implicit one to its new disciplinary powers, the PRA may be seeking to extend its remit into monitoring and discipline over bank financial statement audits. While there may be benefits of creating a new reporting requirement for bank auditors to regulators, these should not include allowing the PRA to monitor, and take disciplinary action if the PRA felt that there were issues around the quality of bank financial statement audits. If it has such concerns, it should refer them to the FRC or relevant RSB. We believe that the PRA seeking to supervise and take enforcement actions on financial statement audits would be contrary to the wishes of Parliament when it extended the PRA's disciplinary powers.
- 21) We also note that the BIS "Discussion Document on The Implications of the EU and Wider Reforms" proposes a new structure with the FRC acting as the Single Competent Authority to

regulate the audit profession. It is worth noting that under the new EU Directive and Regulation, the current approach, where all investigations and disciplinary functions are allocated to the Recognised Supervisory Bodies will no longer be possible for the audits of PIEs (and no distinction is made for banks)¹. We believe that it is therefore of utmost importance that the proposed changes to the governance of the audit profession in the CP are made in full consultation with the FRC and ICAEW with the new environment foremost in mind.

Need for co-ordination of disciplinary powers

- 22) We believe that existing disciplinary powers over auditors are sufficient and fit for purpose and have previously noted that the regulators had only very rarely referred matters to the statutory audit regulators the Financial Reporting Council ("FRC") and the Recognised Supervisory Bodies (including ICAEW). We also note, however, that the FCA already has these disciplinary powers in place so accept that it is reasonable for the PRA to have equivalent disciplinary powers. It is essential, however, that the regulator works with the FRC and Regulated Supervisory Bodies to ensure there is effective coordination. All bodies must coordinate any disciplinary action to ensure auditors do not face double or triple jeopardy as a result.
- 23) We also note that the disciplinary procedures and powers are wide ranging and the penalties severe. In 2.12 (b) feedback from supervisors indicates that it would have been more helpful if auditors were less defensive in their views in relation to audit judgements. It is difficult to see how the severity of the disciplinary regime will make this process more open and lead to less defensive positions being taken. On the contrary, we believe that reporting to a body that has such powers cannot fail to be informed by the severe threat of sanction that may be wielded by those to whom the firm is reporting to.
- 24) The proposed disciplinary powers are centred on the audits of banks and building societies of considerable size. Generally, the lead audit partners of such engagements are experienced partners who may act as lead partners on other financial institutions such as Insurers or Investment Managers. The fact that the disciplinary regime potentially only applies to one type of engagement (that of a large bank) leads to a singular disincentive to be the lead audit partner for a large bank. Similarly experienced partners who lead the audits for global multinationals and FTSE 100 entities that are not banks bear no such risk.
- 25) We found the Draft Statement of Policy on Penalties (Appendix 3) to be unclear as to when disciplinary action and penalties would be applied to individuals and when they would be applied to a firm. In the latter case, it was unclear how the audit/actuarial firm would be defined if there were multiple legal entities within the overall firm.

¹ Page 18, BIS Discussion document on the implications of the EU and wider reforms - "In future, for audits of PIEs, all investigations and discipline resulting from audit inspections and referrals from other authorities will need to be allocated to the single competent authority."