THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

10 February 2009

Rt Hon John McFall MP
Chairman
Treasury Committee
House of Commons
Committee Office 7
Millbank
London
SW1P 3JA

treascom@parliament.uk

Dear John

IDEAS FOR ENHANCING CONFIDENCE IN BANK REPORTING

I am writing to follow up on matters raised at the Treasury Committee's panel sessions on 28th January 2009 on the role of auditors of UK banks. The Financial Services Faculty at the Institute of Chartered Accountants in England and Wales (ICAEW) is pleased to submit ideas, set out in the attached note, as to how the role of auditors might be extended to enhance confidence in bank reporting.

The ICAEW Financial Services Faculty was established in 2007 to address, in the public interest, issues and challenges facing the financial services industry. In developing these ideas for the Committee, the Faculty has consulted with practitioners in six audit firms engaged in the audit of banks in the UK: BDO Stoy Hayward, Deloitte, Ernst and Young, Grant Thornton, KPMG and PricewaterhouseCoopers.

We look forward to exploring these ideas further with the tripartite authorities and the representatives of banking industry. In the meantime, if you have any queries please contact me or Iain Coke, Head of the Financial Services Faculty at iain.coke@icaew.com.

Yours sincerely

Robert Hodgkinson
Executive Director, Technical
T+ 44 (0) 207 920 8492
E robert.hodgkinson@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

IDEAS FOR ENHANCING CONFIDENCE IN BANK REPORTING

Introduction

The Treasury Committee, at its hearing on the role of auditors in the banking crisis on 28 January 2009, invited the major auditing firms to suggest areas where the role of auditors might be strengthened in the audit of banks. The ICAEW Financial Services Faculty is responding to this invitation after consulting with practitioners in the six largest UK auditing firms.

In summing up these sessions, the Chairman, the Rt Hon John McFall MP, said that auditors had done a decent job of fulfilling the duties expected of them in statute but questioned whether that role was appropriate. The relationship between auditors and the Financial Services Authority (FSA) is central to that question. To help the Committee consider these matters, we set out five areas where the role of auditors could be extended:

1. Financial information outside the accounts
2. 'Pillar 3' risk disclosures
3. Regulatory returns to the FSA
4. Control activities chosen by the FSA
5. Bank-specific meetings with the FSA

The aim of these ideas is to contribute to enhanced public confidence in banks by increasing trust in the information that banks report to the public and to the regulator. Currently, auditors focus on banks' financial statements specifically and work in the interests of shareholders. The wider public may not understand that auditors have only limited involvement with other financial information provided by banks.

The audit profession can contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks, so that those relying on that information can be confident that it has been properly prepared. In assessing each of the suggestions we make for extending the auditor's role, the following would need further consideration:

- the exact nature of work to be performed, how this fits with current professional standards and whether new guidance would need to be developed;
- consulting stakeholders to ensure that any new measures are practical and add value;
- identifying the costs of implementing change, ongoing costs and how they compare to benefits;
- avoiding the creation of expectation gaps which could damage confidence. For example, assurance work does not provide guarantees and it focuses on the quality of the reported information rather than the appropriateness of the underlying reporting requirements; and
- the international context, including maintaining UK competitiveness and drawing on the best of current thinking.

The following paragraphs set out our ideas in more detail.

1. Financial information outside the accounts

Some of the financial information reported by banks does not form part of the audited accounts. For example, banks normally provide capital ratios, which are the regulatory measure of the amount of capital they hold, in their annual report. At the moment, auditing standards require that where information is in the annual report but not part of the accounts 'the auditor should read the other information to identify material inconsistencies with the audited financial statements'. Auditors are not, however, required to obtain additional evidence to support the other information. The UK Government has previously taken the view, after extensive consultation, that it is not necessary to extend the audit scope beyond the financial statements. The FSA and Government should consider doing so for banks, at least in relation to financial information such as capital ratios.

2. 'Pillar 3' risk disclosures

In 2009, banks will be required to report greater detail of their risk positions under new regulations introduced by Basel II, called 'Pillar 3' disclosures. Basel II includes an option to require Pillar 3 disclosures to be audited. After consultation, the UK government and FSA took the view that it would not take up this option to require an audit of the disclosures. Many banks are likely to make these disclosures in their annual report, but outside the accounts. In this case auditors will only need to read the disclosures for inconsistency with the financial statements as in 1 above. The rules also allow banks to make Pillar 3 disclosures outside the annual report, for example on their web-site, in which case there is no requirement for auditors to check them. The FSA should reconsider the decision not to require an audit of Pillar 3 disclosures in the light of changed circumstances.

3. Regulatory returns to the FSA

Banks' regulatory returns to the FSA include a range of financial information, for example on liquidity, large exposures, a bank's balance sheet and capital. At present, these returns are not subject to review by auditors. The present regime for banks arose under the Financial Services and Markets Act 2000 (FSMA). It differs from the insurance sector, where regulatory returns are reported on by auditors. Before the introduction of FSMA, banks' returns were subject to periodic review by auditors. The FSA should consider whether reintroduction of a review of key bank regulatory returns by auditors would be useful.

4. Control activities chosen by the FSA

The FSA has powers under section 166 of FSMA to commission reports by auditors on specific issues. These reports are used mainly when a specific problem has been identified and tend to be forensic in nature and relatively expensive. While it is for the FSA to decide what type of information best supports its supervisory approach, more general reports looking at banks' controls used to be commissioned under the previous regime, when section 39 of the old Banking Act applied. The FSA could make greater and more regular use of their existing powers under section 166 to obtain more information about the operation and application of controls or compliance with regulations.

5. Bank-specific meetings with the FSA

Bank auditors are required to communicate with the FSA in specific circumstances, including when they suspect management fraud, consider there are going concern issues or for significant rule breaches. Depending on the nature of the concern, some communications will involve banks' management while others will not. Written communications may be followed up by meetings. Outside these prescribed circumstances, the need for additional contact between auditors, management and the FSA is up to the judgement of the supervisor.

The current situation differs from the old regime where there were regular bipartite and tripartite meetings to discuss the financial statements audit and section 39 reports. It is worth looking at whether more regular meetings with auditors would help the FSA gain additional insights into the banks they regulate. The knowledge that such meetings were taking place ought also reassure the public. Indeed, it could even be made a requirement that periodic meetings are held with the auditors for particularly important regulated banks, so that it is not left to the discretion of the supervisory team. In support of this, we note that the FSA is advocating annual bilateral meetings with the auditors of all high impact firms.

ICAEW Financial Services Faculty
10 February 2009