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Dear Pat

DP 10 / 3 Enhancing the auditor's contribution to prudential regulation

ICAEW is pleased to respond to your request for comments on discussion paper 10/3 *Enhancing the auditor's contribution to prudential regulation*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ENHANCING THE AUDITOR'S CONTRIBUTION TO PRUDENTIAL REGULATION

Memorandum of comment submitted in September 2010 by ICAEW, in response to the Financial Services Authority's discussion paper 10/3 *Enhancing the auditor's contribution to prudential regulation* published in June 2010.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper 10/3 *Enhancing the auditor's contribution to prudential regulation* published by the Financial Services Authority.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.
4. Our Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest. It draws together professionals from across the financial services industry and from the 25,000 members specialising in the sector. This includes those working for regulated firms, in professional service firms, intermediaries and regulators.

BACKGROUND

5. While it will take a number of years before the causes of the financial crisis are fully understood, evidence to date indicates that it was caused by a combination of sub-prime lending and a dramatic fall in property prices in the US. The collapse in confidence across capital markets that followed was fuelled by doubts about the viability of financial institutions holding significant assets that depended directly or indirectly on property lending or wholesale market funding.
6. Concerns about the relative strength of the capital base of these institutions led to a meltdown in the liquidity available to them, which cumulatively resulted in a sharp contraction of funds available to the banking system generally and the ability of banks to provide credit to consumers and businesses. As financial institutions have come under pressure from regulators to restore capital ratios to prudent levels this has continued to limit the amount of lending that is taking place, resulting in a significant decline in economic activity.
7. The speed at which all this happened was dramatic. A number of well known financial institutions were swept away, amalgamated or nationalised. Governments across the world were forced to underwrite failing industry sectors at a cost of many billions. Orthodoxies that governed economic behaviour over the previous decade were thrown into question. The real economy is only beginning to move from recession to fragile recovery.
8. In these circumstances it is right that our financial systems be scrutinised. All market participants need to think hard about the lessons of the past two years and be prepared to take the necessary steps to ensure that the risk of this happening again is mitigated.
9. The audit profession, which plays an integral part in the effective operation of capital markets and the wider economy, is no exception.

10. The past 24 months have tested auditing reforms adopted in the UK after Enron as well as the work undertaken through avenues such as the Audit Quality Forum. The evidence to date suggests that in the main, auditors have been performing an important role with diligence in the face of challenging economic circumstances and that recent reforms are holding up well.
11. Part of the auditors' contribution has been to challenge asset valuations, which has contributed to companies having to revalue their assets, in certain cases requiring a considerable reduction in values in order to give a true and fair view in accordance with the relevant financial reporting framework. These revaluations have contributed to the falling financial performance of the financial services sector, reductions in share price and criticism of directors in general meetings of shareholders as well as the media.
12. However, over the past 18 months ICAEW has been examining what lessons can be learnt from the crisis and how audit needs to evolve to meet changing market expectations. Our Financial Services Faculty has led on this work. Key recommendations are included in the report *Audit of banks: lessons from the crisis* which we have appended to this submission. In particular, we believe that improvements can be made in terms of the way risk is reported by financial services firms. We also think there is a need for better dialogue between auditors and supervisors. To this end and at the request of the Bank of England we are participating in a Working Group to look at the flow of critical information on banks between the regulator and auditors.
13. Three key points inform our consultation response:
 - This has not been an audit driven crisis – UK audit quality remains world leading.
 - The audit profession, along with other market participants, must nonetheless reflect on what lessons can be learned from what has happened over the past two years.
 - This has been a global crisis and reform proposals must therefore be capable of implementation across markets.
14. UK audit firms belong to international networks and audit UK businesses that are international in their operations. We urge the committee to ensure that hasty responses to the current crisis at the national level do not inadvertently sow the seeds of future crisis.

MAJOR POINTS

15. We welcome the fact that the FSA and FRC are reflecting on how the auditor's contribution to prudential regulation can be enhanced. As our submissions to the House of Commons Treasury Committee last year indicated, there is scope for the FSA to derive more benefit from auditors' work. Our subsequent work in our *Audit of banks: lessons from the crisis* (hereafter 'our Report') indicates our current thinking on this issue.

Increased dialogue

16. We would like to see a focus on fostering strong and collaborative working relationships. With a view to this, we welcome the proposals for the FSA to engage in more dialogue with both auditors and audit committees, and we think this will be more productive than the FSA or FRC obtaining and exercising more formal powers.

Section 166 reports

17. We are pleased to see that the paper continues to explore whether better use can be made of the FSA's existing powers under section 166 of the Financial Services and Markets Act 2000 (FSMA) to commission reports. As our Report argues, we think auditors' skills could be utilised to good effect, were the FSA to request these reports for a wider range of purposes than it has to date.

Regulatory framework

18. In regard to changing regulatory requirements so that the regulator has more power in relation to other stakeholders in the regulatory process, including auditors, we note that there are already existing structures for regulating auditors and do not think a strong case has been made for introducing new measures.
19. Specifically, the Companies Act 1989 established the concept of Recognised Supervisory Bodies for auditors. All undertaking statutory audit work are required to be registered by a Supervisory Body, such as ICAEW, which has responsibility for the supervision of and, where appropriate, disciplinary action against auditors whose conduct or professional work falls short of standards required.
20. We consider that the existing arrangements are sufficient providing they are properly used by all concerned, and that all bodies with regulatory responsibilities are in regular dialogue with each other.

Benchmarking

21. Regulators could do more to help preparers and auditors achieve some of the outcomes they want to see. Specifically, the FSA could be more active in communicating information about the market's approach to, for example, specific valuation issues. As we explain in our response below, during the financial crisis information was collated on issues of concern, but was not relayed back to preparers or their auditors as fully as it might have been. We suggest the FSA considers providing more information on market practices in particular areas than it has to date. This would help promote a more consistent approach amongst preparers over time, particularly if such information was made available ahead of reporting deadlines.

RESPONSES TO SPECIFIC QUESTIONS

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?

22. The FSA and FRC currently have an approach which properly focuses more on high risk entities and issues than those which pose less of a risk to the operation of the markets and confidence in financial reporting. Any changes to the auditor's role in prudential regulation should have regard to proportionality. Banking, insurance and asset management all differ in nature and by size, so the risks attached to them and the information regulators will need will vary. Similarly, the risks of a publicly listed financial services firm are very different to a start up hedge fund manager or private equity house, and the regulatory approach towards them – including what information is subject to assurance – should reflect these differences.
23. A second general comment we have is that the auditor-regulator relationship which is the focus of this paper is part of a wider set of relationships. In particular, there is a governance framework which includes internal audit and audit committees or those charged with governance. How external auditors can best contribute to prudential regulation will depend on what roles are accorded to them, so in developing any future actions it will be important that due regard is paid to the overall picture.
24. We set out further thoughts on the auditor's contribution to prudential regulation in our Report.

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?

25. The paper does not provide sufficient evidence to support the assertion that there is a lack of scepticism. We have not been made aware of evidence of a lack of professional scepticism in the course of bank or other financial services firms audits, including the audit of key areas of judgement in relation to accounting estimates and related disclosures, by either financial services firms or their auditors.
26. The application of scepticism is a central part of the auditor's role and indeed of chartered accountants' work outside of the audit context. Students working for the ACA are taught that being sceptical is part of being a professional accountant. Following qualification, we attach great importance to our members acting with integrity, and having a sceptical approach is part of this.
27. We are open to considering evidence that improvements are needed, and we welcome the publication of the Auditing Practices Board paper, *Auditor scepticism: raising the bar* and will be responding to this in due course. As this paper indicates, a sceptical approach on the part of auditors is not visible to most stakeholders in the audit process.
28. To increase visibility we suggest that the application of professional scepticism could be addressed by audit committees, who could report at a high level on discussions they have had during the year with their auditors in the annual report. This is a suggestion we explore in more detail in our Report. We also suggested that audit committees could confirm that matters highlighted in the critical accounting estimates section of the financial statements had been discussed with auditors along with judgments.
29. We are aware that the different responsibilities of the prudential regulator and of auditors may lead to different interpretations of scepticism. Specifically, the prudential regulator may notice the application of auditor scepticism when it encourages preparers to make the financial statements more conservative, but not recognise it when it has the opposite effect, for example, when auditors challenge provisions for being too high.
30. The paper remarks that 'Although [differences...] 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.' (para 3.18). We think this indicates a further area where differences around the application of scepticism arise: materiality. Auditors' responsibility is for assessing the financial statements as a whole. Under existing auditing standards, in performing work to support their audit opinion, materiality is set in relation to the financial statements overall, and not with regard to specific sections of the financial statements. Changes going forward in audit requirements mean that performance materiality for particular classes will also be considered. Nevertheless, financial services regulators are likely to be more interested in certain line items than other users. The paper appears to imply that auditors should change their materiality to reflect the regulators' specific concerns: if this is the case, an explicit argument for the pros and cons of such an approach should be made.
31. Prudence forms part of the International Financial Reporting Framework, as one of the four qualitative characteristics of financial statements, reliability, refers to it (Framework for the preparation and presentation of financial statements). However, prudence is less important to financial statements preparation than to prudential regulators, for example where accounting standards specifically require market values to be used. We think this may contribute to a gap between the FSA's expectations and those of auditors as to what the application of professional scepticism means in practice.

32. During the height of the financial crisis, a wide range of valuations were acceptable in the areas of fair value and impairment, and it was the FSA itself that was in the best position to observe the market as a whole. We have heard that the provision of more benchmarking information by the FSA to market participants and their auditors would be useful in helping preparers report in a manner that is more consistent with their peer group and aid auditors in making more informed judgements in these areas. The auditor's clients may be a conservative, neutral or aggressive segment of the whole population in relation to particular estimates, but the FSA, with access to the entire regulated sector, is in a better position to gauge this than are particular regulated firms or their auditors.

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?

33. Whether prepared under IFRS or UK GAAP, accounting standards provide a comprehensive framework for financial reporting. We recognise that disclosures about key judgements are useful and required by accounting standards, but do not agree that further disclosures are necessarily required. We are not certain what accounting disclosures are considered not to capture the economic substance of a transaction, or a firm's financial position and performance more generally since in our view the existing reporting frameworks are fit for purpose.
34. We acknowledge that there is always scope for improvements to be made in the quality of disclosures, but we do not agree that more detail on specific transactions is necessarily required. There is a tension between the provision of detailed information and how easy it is for users to understand the key points. We are not clear where the paper positions itself on this point, as it states that users increasingly expect enhanced disclosures but also says that financial statements should not be too lengthy. Were preparers to address the detailed areas raised in the paper the financial statements we anticipate they would grow rather than shrink, and the paper could be more open in acknowledging this. The FRC's FRRP has highlighted concerns around excessive disclosures and boilerplate. Our work for our Report did not find particular demand for detailed new areas of disclosure, but for clearer presentation of existing information, especially that on risks. Section 1 of our Report has more detail on our findings.
35. Additional information specifically for regulatory purposes will be needed in addition to the financial statements, and this can be - and is - provided by regulated entities directly to their regulator. This is in our view a more efficient approach than using the financial statements to communicate information which may be of limited interest to many users.
36. We note the FRC and FSA's point that improvements to disclosures "should have been achieved earlier and with less intervention on their part". In our view, other initiatives contributed considerably to improvements in disclosures. Companies were responding to pressure from investors for more information on particular matters, and gave financial information outside of the quarterly reporting timetable and annual reports, including in their exposures to sub-prime mortgages.
37. To the extent that more detailed disclosures are being demanded by users other than the FSA, the development of any additional requirements should be the IASB and FRC's responsibility for IFRS and UK GAAP users respectively, with the FSA providing input along with other stakeholders. This would keep a clear separation between the roles of the financial reporting standard-setter and financial services regulator. To the extent that financial reporting changes are led by the IASB, it would also prevent different requirements emerging in different jurisdictions as national regulators go in different directions.
38. We would like to see more evidence around exactly what information users are requesting, as the paper's assertions in this area are not always clearly supported. Preparers would also be

interested in hearing about specific disclosures which users need, as this would assist them in responding to such requests.

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?

39. The proposal to enter into dialogue with firms' audit committees or those charged with governance and auditors is made specifically in relation to the firm's responsibilities for appointing an auditor. We note that audit committees currently receive feedback from their auditors, which is given to the auditors by the FRC's Audit Inspection Unit (AIU) on their audit when it has been subject to review. This will assist those responsible for governance in making decisions about whether to appoint a new auditor or retain their existing auditor. We would encourage the FSA to participate in dialogue with the firm's audit committee and auditor to share experiences of interaction in the context of the supervisory process. We would argue that the emphasis should very much be on dialogue, and that the auditor should also have an opportunity to set out their experience of interaction with the FSA in the context of their audit of the firm.
40. We think that there would be many areas other than the appointment of auditors where the audit committee would welcome more dialogue with the FSA. For example if directors at the FSA were to discuss their current regulatory concerns with the audit committee and auditors, and how this shapes their information needs, that would be useful.

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?

41. This is a complicated area. The paper does not set out why and to what extent the FSA relies on such matters as investment circulars. This is a key issue to determining if special monitoring is needed of those who report on such documents. The AIU derives its functions from arrangements entered into with the Recognised Supervisory Bodies under schedule 10 of the Companies Act 2006. It cannot assume additional responsibilities as regards registered auditors of its own volition. Under ICAEW's audit regulations, work can be included in a monitoring visit if it is work that requires registered auditor status to undertake. There is no need to enhance the powers of the AIU, but, as noted before, a case needs to be made to include such work.

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?

42. We do not believe that there is any need to increase the FRC's powers in this way. As noted above, the AIU derives its functions from the Recognised Supervisory Bodies who do have powers to visit a firm for monitoring purposes at short notice. If this is required, then other planned visits are delayed so that the visit can be undertaken at short notice. As set out below in our answer to question 7, this is an area on which we would welcome discussion with the FSA to better understand their concerns and determine how matters could best be taken forward.

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?

43. The auditor's central role is to perform the statutory audit which provides assurance to the shareholders that the financial statements are true and fair. Whilst auditors can and do provide information to the financial services regulator, arrangements in the UK do not currently see the

auditor act as an arm of the regulator. Transforming the auditor to an extension of the regulator would be a major shift, which would require support from a wide range of stakeholders, extensive consultation, and a cogent argument as to why this would be an improvement on either existing arrangements or incremental changes to those arrangements.

44. The regime the paper proposes would represent a significant shift in the authority of the financial services regulator over auditors which we do not consider appropriate. The FRC also has responsibilities in regard to audit work and duplication of these would create confusion when disciplinary proceedings were necessary.
45. We do not think that the additional powers suggested are needed. As is noted, the FSA can act to stop an audit firm acting in relation to the audit of an authorised person. That should be sufficient. There are already established procedures within the Recognised Supervisory Bodies who register individual auditors to discipline them if they fall short of the required standards. Those powers include the ability to discipline individuals within a firm. The Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 permits the FSA to disclose information to a Recognised Supervisory Body and specifically mentions that this could be in relation to its functions in respect of disciplinary proceedings against auditors. Such proceedings are subject to the oversight of the Professional Oversight Body. These disciplinary powers include the ability to remove an auditor's registration and impose unlimited fines. To create additional powers, in another place, would not be an efficient use of resources given that the current regime is fit for purpose.
46. Rather than extending its enforcement tools, we would like to see improved use of existing tools and a shift in culture. We support the idea that the FSA should engage more in an informal two-way dialogue with auditors and fellow regulators. Internal communications at the FSA could be reviewed to ensure that relevant information from auditors is passed by supervisors to their FSA colleagues. If the FSA were to cultivate better relationships with auditors, it might feel less in need of new enforcement tools. As a Recognised Supervisory Body for auditors we would be more than happy to work with the FSA to adopt some general procedures for cooperation and to discuss any specific concerns.
47. The FSA should make better use of its powers under section 166 of the Financial Services and Markets Act 2000 to commission skilled person reports on a thematic basis from a group of firms or on a case-by-case basis, which will be used preventatively rather than for enforcement. See our comments below on chapter 6 of the discussion paper.

Chapter 5

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

48. We think that closer dialogue between auditors and the FSA, and trilateral meetings involving management will be useful in strengthening the FSA's engagement with the entities it regulates, including in the area of accounting. On a related point, the growing accounting unit at the FSA will help improve the technical expertise at the FSA and improve the quality of dialogue on accounting matters.
49. Relationships between supervisors and auditors are currently variable in quality, and we would wish to see the FSA do more to standardise and operationalise close relationships as part of its policy.
50. The FSA's engagement with firms' accounting and with auditors will be most effective if the FSA consistently respects confidentiality and does not unnecessarily disclose the information to the market or other bodies. As part of developing its policies around relationships with auditors and preparers, the FSA might consider confidentiality requirements.

51. The FSA should do more to relay back accounting information it obtains on the market as a whole, to support a more consistent approach by directors in preparing their accounts. As the financial crisis unfolded in 2007, the FSA obtained information on super senior subprime exposures; in 2008 on credit valuation adjustments in respect of monolines and in 2009 on impairments. Although the FSA obtained information on these subjects in advance of statutory reporting year ends, it did not provide adequate feedback to preparers or their auditors on these issues.
52. Our interviews with finance directors earlier this year, as part of our work for developing our Report, indicated that more benchmarking information from the FSA would be useful to preparers, rather than being told that they are an outlier but not being provided with supporting evidence for this assertion.
53. Our comment at question 1, on proportionality, will be relevant as the FSA should seek more intensive engagement only when the risks mean it is merited.
54. There is scope for more transparency around the role of overseas regulators and how the FSA interacts with them in relation to specific regulated entities. For the higher risk firms, it might be useful for meetings involving auditors, management and both UK and overseas regulators to take place from time to time, to improve communication around the respective responsibilities of the different regulators.

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?

55. We are aware that the FSA has felt constrained by its statutory position, and would urge that attention be given to revising these legislative barriers. We understand from the FSA's paper 'The protection of regulatory information under English law' (2004) that part of the legislation derives from EU directives and may not be easy to change. However, the FSMA does allow disclosure in specified circumstances, for example where the information is in the form of a summary and it is not possible to ascertain from it information relating to any particular person. We believe much greater use could be made of this provision without offending EU directives, which in our view are not designed to stand in the way of sensible regulation.
56. Auditors have been willing to share and we are pleased that the FSA has recently revised its approach and understand from auditors that the quality of information sharing is starting to improve. There is scope for the quality of dialogue to improve further as previously mentioned. There is a duty for auditors to share certain information with the regulator. There should be a reciprocal obligation on the regulator to share information of material significance to the audit with the auditor. We explain this in more detail in section 3.2 of our Report.
57. We do not agree with the FSA's reasoning for not reporting significant matters to auditors (5.16-5.17). We agree that the FSA and auditor have different duties, and think that this separation works well. Nevertheless, there is clearly an overlap between them and we think there is a strong case for a more open approach to information sharing than the FRC and FSA propose, including changing legislation if this is necessary to achieve it.
58. The FRC and FSA's argument that auditors have access to its concerns by way of management will not be true for certain types of information. Specifically, the FSA may occasionally be aware of information relating to management fraud or to action it plans to take which will affect an entity, which it has not yet communicated to that entity. If not made known to the auditor these types of information could result in an inappropriate audit opinion being given. We think it is in the public interest for confidence in the audit to be maintained, and do not think that withholding such information would be appropriate. We recognise that suitable safeguards will be needed to protect the integrity of the regulatory system in such circumstances, and consider the existing framework will be fit for purpose.

59. We strongly agree that whilst the FSA should share information with auditors, this does not in any way relieve the auditor of obtaining sufficient audit evidence to support the audit opinion. We think the reverse argument can also be made: whilst the auditor can and should provide relevant information to the regulator, this does not relieve the regulator of its duties for making judgments and acting in a way that best fulfils its regulatory responsibilities. In this context, it is worth reiterating that over-reliance on historic financial statements which are not designed to meet the needs of prudential regulators should be avoided.
60. A reciprocal obligation would not, in our view, consume significant FSA resources, given the FSA's move towards better information-sharing with auditors. We also think that it is consistent with the FSA's objective of maintaining market confidence.

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?

61. We consider the FSA could make more use of section 166 skilled persons' reports as a preventative rather than enforcement tool. For example, reports could be commissioned on a particular area that firms may be having difficulties with, to identify what the issues are and rectify them at an early stage. Commissioning detailed reports on particular firms when significant failings are suspected is expensive; we acknowledge that it will sometimes be necessary but would prefer to see the balance of reports shifting further from enforcement towards a monitoring function.
62. Clear scoping at the outset is essential if the work is to be performed in a timely and cost-effective manner. We recognise that scoping is difficult and agree with the FSA that this is an area requiring further work. Those responsible for scoping skilled persons' report will need to receive suitable training.
63. We would be willing to review and amend our Technical Release on section 166 reports if that would be of value to the FSA.
64. Some firms may regard a request to have s.166 reports prepared as an indication that there has been a failing: as the use of the reports becomes wider and less closely related to potential enforcement action, it will be useful if the FSA communicates to regulated entities what it sees as the purpose of reports, and how it ties in with other tools it has available.

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?

65. We support the proposals at 6.22 to use section 166 reports to gain assurance on regulatory returns when it is considered necessary. The information in regulatory returns can be complex, not least as information from different systems frequently has to be brought together for the purposes of reporting. We think that external assurance on regulatory returns would be helpful in improving the quality of data in returns. We explore this matter further in our 'Audit of banks: lessons from the crisis' report.
66. An annual audit requirement for all returns would be the most costly approach and we are not certain it is justified. The thematic reviews formerly undertaken under the section 39 legislation, which focussed on different returns each year, may be a more proportionate approach to obtaining assurance, and section 166 powers could be used to obtain these.
67. We note that different interpretations may be made on terms used in regulatory returns, which would undermine comparability across financial services institutions' regulatory returns. An indirect outcome of reporting accountants reviewing regulatory returns might be that a more consistent approach emerges.

68. There may be scope for management to perform more reconciliations from the regulatory returns to the accounting information, and this may provide useful information to the regulator. For smaller financial services firms, this may be a proportionate approach.

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?

69. We think improvements in dialogue will be a more cost effective method of communication between auditors and the FSA than formal reports. Where the FSA needs more information on a particular issue or in relation to a particular regulated firm, existing section 166 powers can be used and the auditor could perform the work, if appropriate. The use of section 166 powers would mean that additional regulatory costs are more restricted than if requirements were to be made of industry as a whole.
70. Whatever reporting lines are set up, we think it important that a constructive, collaborative relationship between the regulator, auditor and regulated entity is fostered. In this context, openness around what the regulator and auditor are discussing will in most cases be appropriate.

Chapter 7

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

71. In developing our Report, earlier this year we conducted interviews with a range of stakeholders in bank audits, and the audit of Pillar 3 information was one of the issues raised. There was little demand for audit of this information at the present time. It was noted that more use may be made of Pillar 3 information in future, and that the provision of assurance may then become more useful, for parts of the financial services industry. For further analysis, see our Report.

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

72. The financial and regulatory reporting requirements for BIPRU firms and insurers have developed incrementally and not in tandem: this has given rise to more assurance requirements being placed on insurers than on BIPRU firms.
73. We note that the difference is sometimes justified with reference to the varied approaches taken in insurance accounting under IFRS, which has made other sources of information about insurers more important than would otherwise be the case. The publication of the International Accounting Standards Board's exposure draft 'Insurance Contracts' should, when developed into a final standard, serve to increase the comparability of insurer's financial information, and will weaken the argument that different approaches are justified.
74. Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) has recently been consulting on its advice to the European Commission on audit of Solvency II information. We have argued that some assurance to the regulator is likely to be useful, and that flexibility in the requirements can support a risk-based approach.
75. Whilst the different approaches are not the most logical approach, from a pragmatic point of view if the current arrangements provide useful assurance, the differences need not be eliminated.

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?

- 76.** As we explain in our Report, there was an expectation amongst some investors that quantitative information in the annual report, such as capital ratios, had been subjected to a higher level of independent review than is in fact the case. Given the existing expectation that such information will have been checked by the auditor in more detail than the test for 'consistency' with the financial statements required, we think there is a case for additional assurance around these numbers. This could take different forms, for example agreeing them back to regulatory returns or reviewing the entire calculation, and the cost implications of these will vary enormously.
- 77.** The calculation of risk weighted assets used in capital ratio workings can be complex to determine. The risk and accounting systems used to generate this information are frequently separate within a bank, so auditing the risk weighted assets would not be a simple task. A requirement for the regulatory capital numbers to be subject to external review might increase discipline around the production of this data and highlight errors, but should be regarded as a long-term project.
- 78.** We note that there is a link between this question and question 11 above, as additional assurance work on capital numbers in the annual report would be an indirect way of providing external assurance on regulatory returns. We think that if assurance is sought specifically by the regulator, the regulatory returns themselves should be the subject of the assurance work, rather than the capital information in the annual report.

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