ICAEW representation

ICAEW REP 49/06

CP 06/11 INTEGRATED REGULATORY REPORTING: CREDIT INSTITUTIONS AND CERTAIN INVESTMENT FIRMS

Memorandum of comment submitted in September 2006 by the Institute of Chartered Accountants in England and Wales to the Financial Services Authority's consultation paper 'CP 06/11 Integrated Regulatory Reporting: Credit Institutions and Certain Investment Firms' issued in May 2006.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') welcomes the opportunity to respond to the FSA on its Consultation Paper 06/11 'Integrated Regulatory Reporting: Credit institutions and certain investment firms'. Our comments relate to the proposals in Chapter 12 on the auditor reporting requirements.

2. The ICAEW is the largest accountancy body in Europe, with over 128,000 members operating in business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.

MAJOR COMMENTS

Approach lacks consistency

3. We support the proposal to remove the requirement for auditors to report on regulatory returns for firms falling under the Prudential sourcebook for banks, buildings societies and investment firms ('BIPRU firms'). This brings the requirements for these firms into line with the existing auditor reporting requirements for banks thereby bringing consistency across firms subject to the Capital Requirements Directive. However, the proposal creates an inconsistency between the auditor reporting requirements of BIPRU and non-BIPRU investment firms.

4. This difference in approach is incongruous with the FSA objective of risk based regulation, since BIPRU firms are generally considered to be of higher risk than non-BIPRU firms. We note that the FSA intends to conduct a review of the audit requirements of regulated firms in 2007 and that any decision on the removal of the audit reporting requirements for non-BIPRU firms has been deferred pending this review. The scope and content of this review is unclear. We understand that the requirement for the FSA to consult on removing the requirement for BIPRU firms is higher priority than for non-BIPRU firms, as the proposals for BIPRU firms relate to the implementation of EU Directives. However, it is strange to retain more onerous requirements for lower risk firms in the interim period than those required for higher risk firms.

5. We recommend that the review of the audit requirements for non-BIPRU firms intended for 2007 is brought forward and conducted as soon as possible, to allow any changes to be made to BIPRU and non-BIPRU firms simultaneously and avoid the risk of the proposed review being undermined or pre-judged by the decision on BIPRU firms.

6. In the longer term, it would be strange if the decision was made to retain the auditor reporting requirements for non-BIPRU firms when they had been removed for BIPRU firms. Although the CP 06/11 does not include any proposals for non-BIPRU firms, the FSA should consider the implications for such firms when making its decision on the requirements for BIPRU firms. We support long term consistency, support the proposal to remove the auditor

reporting requirements for BIPRU firms and would support the early removal of the auditor reporting requirement for non-BIPRU firms as a pragmatic measure.

Inappropriate reference to auditors' management letter

7. Paragraph 12.6 suggests that senior management may obtain confirmation that they have calculated their capital correctly via the annual management letter of the auditor. This reference is inappropriate as it confuses the responsibilities of auditors and management. Furthermore, management letters are not always produced and can take different forms.

8. If the audit requirement is removed, management have the option to engage auditors to review their capital calculations, but this work is not part of the normal audit work. Auditors engaged to conduct any such work would normally issue a separate report rather than reporting through the management letter, however. While this option is available to management, it is not appropriate for the FSA to lead management in that direction.

9. Auditors undertaking a statutory audit might review the capital calculation as part of their normal audit work, for example on reviewing compliance with laws and regulation. However, there is a clear difference in the level of work required and assurance given on these matters and that which would be required if an explicit report was required. For example, a statutory auditor might review the capital calculation to ensure that there was nothing to indicate that capital was overstated whereas an auditor reviewing the accuracy of capital calculations would look in more detail at all aspects of the calculation.

10. The reference to the auditors' Management Letter should be removed. This will avoid the danger of creating an expectation gap over the level of work performed by auditors on capital calculations. It will also avoid creating an expectation among supervisors that firms will engage their auditors as a matter of course to review capital calculations. Such an expectation would undermine the benefits of the removal of the auditor reporting requirements.

POINTS OF DETAIL

Impact of proposals upon quality of prudential capital calculations

11. Auditors often discover adjustments when conducting their audit work on prudential capital calculations. Some of these adjustments can be large. Generally, audits improve the quality of information provided on prudential capital calculations. While we support the removal of the audit requirement, it is not without its risks.

12. One potential downside is the fact that the removal of the audit requirement might reduce the pool of auditors with the skill set to review compliance with the prudential capital rules. The experience of the removal of the old s39 reporting on banks has borne this out, with a concentration in the market for s166 skilled persons reports and consequent increases in costs. One way of addressing this might be the use of s166 reports with a standardised scope on a

risk-based sample of firms, which might allow the assignment to be more cost effective and within the skill sets of a wider range of auditors.

13. Removing the audit requirement may mean that management and supervisors are required to carry out additional work to satisfy themselves as to the accuracy of the capital calculations. Arguably, ICAP assessments might cover part of this risk as supervisors have the opportunity to challenge the risk assessment relating to the accuracy of the calculations depending upon the level of review carried out internally. Supervisors should, however, be aware that their consideration of the quality of capital assessments may be affected by the removal of the auditor reporting requirements.

Treatment of audit adjustments through Integrated Regulatory Reporting

14. The move away from annual returns to quarterly or monthly Integrated Regulatory Reports (IRRs) may create potential issues regarding the treatment of normal audit adjustments. Management prepare the IRRs based upon management information. The audited financial statements may well contain differences due to matters arising in the post-balance sheet period, changes in classifications or other matters picked up in the audit. It is unclear how firms should deal with significant adjustments arising from the audit process, for example whether IRRs should be adjusted and re-submitted or whether the audit adjustments can be dealt with through the subsequent IRR submitted. The FSA should formalise and clarify the informal guidance provided in an e-mail in March 2006 to auditors on this point.

Lack of clarity on cut-off dates

15. The proposals refer to 1 January 2007 and 1 November 2007 as the transitional dates. It is unclear whether these dates refer to accounting reference dates or dates of submission. If the dates are intended to refer to accounting reference dates, it suggests that 31 December 2006 year ends must be audited while they need not be if the cut-off date is the submission date. The cut-off date should be clarified.

16. If it is intended that the cut-off date is the accounting reference date, then clarification is required with respect to the auditors reporting requirements on the expenditure based requirement (EBR). The EBR is replaced by a Fixed Overhead Requirement (FOR) under the CRD with effect from 1 January 07. Auditors of the financial statements to 31 December 06 would still be required to report on the EBR even though the requirement is no longer applicable. Furthermore, we understand that firms will still be required to report their EBR during 2007 even though they will instead be subject to the FOR. Further work should be carried out on the transitional arrangements to remove these anomalies.

IDC 6 September 06