



AUDIT OF BANKS: LESSONS FROM THE CRISIS

Part of the *Inspiring confidence in financial services* programme

The ICAEW Financial Services Faculty, in light of the financial crisis, undertook to research lessons to be learned and ways in which bank auditors can more effectively support confidence. This '*Audit of banks: lessons from the crisis*' project follows up on the work of the UK House of Commons Treasury Committee which, in its Ninth Report of Session 2008-09, questioned the value of audit.

The faculty, in its evidence to the committee, suggested ways in which the role of auditors might be strengthened. The '*Audit of banks*' project involves further investigation of these and other ideas through a three phase research process.

Phase 1: Development of a paper for discussion with bank finance directors, audit committee chairs, investor representatives, regulators and other interested parties

Phase 2: Stakeholder interviews

Phase 3: Analysis of research and publication of report on lessons from the crisis

The faculty has now completed the second phase of the project. We have summarised the opinions expressed in our stakeholder interviews in this short feedback statement as interim findings. We expect to publish the final report in May 2010, reflecting on this feedback, including lessons we have learned and any further recommendations.

Stakeholder feedback

The stakeholders interviewed can broadly be split into three groups: investors, bank representatives and policymakers (including the FSA, Treasury Committee and European Commission). Investors expressed the strongest opinions and focused on public reporting areas. Bank representatives recognised that there are lessons that can be learned and suggested improvements but indicated that the current auditing system was not top of their list of issues to be addressed, and was not thought to be significantly broken. Policymakers were more guarded in making specific recommendations but provided useful input and reflections, while stressing that these should not necessarily be taken as official policy decisions and expressing caution about what we should report on their views. None of these characterisations are perhaps surprising.

1. Audit process highly valued but audit reports seen as compliance statements

The skills of auditors are highly respected and the audit process regarded as essential in imposing discipline upon directors' presentation of financial information. Financial statements are provided by directors. The audit process involves validating the information in the income statement, cash flow statement, balance sheet and notes to the accounts. The audit report is an opinion on whether the directors have presented that information fairly.

The audit report itself, however, was not viewed as providing useful information to users. It was variously described as a statement of compliance with accounting standards and lacking in information content, since unqualified audit reports use standardised wording. This can make it difficult for investors to assess the quality of individual auditor performance and differentiate between audit firms.

This apparent contradiction between audit processes being valued but audit reports being seen as compliance statements may reflect increasing complexity of financial statements. With the growth in size of annual reports and financial statements, it has become more difficult for users to identify the key areas of judgement or risk. Audit reports have always been an opinion on directors' presentation of the financial statements, rather than a wider business commentary.

Some investors wished to see more regular use of emphases of matter in audit reports to draw users' attention to the most difficult areas. Auditing standards, by contrast, point towards only occasional use of emphases of matter, to avoid reducing the impact of such statements.

One investor expressed an alternative view, suggesting that the real value of audits is in changing behaviour, and that bland audit statements could be seen as a positive outcome. They require a significant amount of effort to achieve and it may be a bad thing if auditors provided more information since it could suggest inadequacies in the information presented by directors. This view tends to support the current approach of auditing standards towards the use of emphases of matter statements. Bank representatives shared this view that the value of audit lies in what goes behind the audit report and did not agree that more descriptive audit reports would necessarily be a positive development.

2. The presentation of risk information requires a fundamental review

While there is no particular appetite from stakeholders or auditors for audit reports to be expanded to cover the whole of the front half of the financial statements or regulatory disclosures, there was a view that auditors could do more reporting on risks. Investor representatives wanted to know the subjective opinions of auditors, in some ways something akin to an insider's analyst report on the company. This was considered by bank representatives to be an unrealistic goal, particularly as there are no objective standards against which judgements could be measured. There would also be a risk of creating an expectation gap about what auditors can and cannot achieve, not least around predicting future economic circumstances.

One investor representative suggested that institutional investor representatives should be included in discussions between management, the audit committee and the auditors, and even to some of those involving the regulator. It is clear that these discussions often would be of interest to investors, but this suggestion is unlikely to be supported by regulators, audit committees, CFOs or auditors since the investor presence may inhibit the degree of challenge. It also risks favouring some investors over others, creating insiders (potentially requiring restrictions to be placed on the actions that could be undertaken by those party to such discussions) and undermining market confidence. For this idea to be taken forward, it would require wider consultation.

There was a common view among bank representatives and investors that more could be done on risk reporting. Banks in particular may need a different form of public statement in the front of the accounts to give a better short story of a bank, its business model and the risks it faces. There were different views on what that statement might cover, including short statements of:

- Business model and key business risks.
- Source and application of capital statement showing which parts of the business require large amounts of capital.
- Detailed going concern statement, including risks and why the directors are satisfied.
- Benchmarking certain areas of activity (eg, loan ratios) against the market to highlight areas where an aggressive business model is being followed.

These suggestions were provided by bank representatives, with investors being less specific about the nature of the information they would wish to see reported. Some investors suggested that the additional statement might be provided by auditors, while bank representatives strongly felt that such statements should be provided by directors. Those suggesting that auditors provide the statements generally agreed that it would be acceptable for them to be prepared by directors if the statement was explicitly covered by an audit report. Because it would cover more subjective material than the current audit report on financial statements, it would involve greater judgement by auditors. Investors and bank representatives agreed that a different form of audit opinion would need to be developed. A set of standards against which the auditor reported would also need to be agreed.

3. Communication between regulator and auditors needs to be improved

Regular dialogue between the regulator and auditors of major banks is regarded as essential. The frequency of meetings between supervisors and auditors has increased over the crisis, but it was felt by some that it can improve further. It was also felt that the quality of meetings was variable, with some being more useful than others. Quality can depend upon both the individual supervisor and bank auditor, and how open they are. New guidance and protocols may be needed to cover what is to be expected from such meetings to ensure they are effective. This could also help to allay any concerns of management and audit committees over discussions auditors may have directly with supervisors. Investors considered that they can gain reassurance from knowing that auditors and supervisors had regular and constructive dialogue. Bank representatives and policymakers agreed that this is a sensible measure.

The Financial Services Faculty is engaging with the Financial Services Authority (FSA) on improving the level of dialogue and we are encouraged by the FSA's commitment to engage more effectively with external auditors, as stated in the FSA 2010/2011 business plan.

Although auditors have a duty to report certain matters to the FSA, there is no reciprocal duty of the FSA to report matters to auditors. It was felt that it should be an absurdity for the FSA to allow a bank audit opinion to be signed when it was aware of a significant matter that it knew or suspected the auditors were unaware of, for example suspicions of serious fraud or criminal activity involving senior management. One audit committee chair stated that this situation is a 'disgrace'. This position contrasts with the position in the US under the Federal Reserve system, whereby banking supervisors are required to confirm to bank auditors that they are not aware of any matters that might impact upon the audit opinion.

4. Skilled persons' reporting tool is underused

There is scope for more private reporting by auditors, with private auditor reports often providing much more useful information than public statements. Investors and bank representatives all felt that having reports from independent experts to the regulator on selected internal controls or key risks would be a useful supplement to the FSA's own visits. These reports could be from the bank auditor, another audit firm or another independent service provider, such as a professional compliance consultancy, depending upon the nature of the work. Leveraging the existing knowledge of the auditor could be useful in the right circumstances.

There was also general support for utilising existing powers to periodically commission an auditor's report on key regulatory returns to the FSA. This might be done thematically, with the FSA selecting particular returns to be reviewed across the sector at a particular time. This could act as a discipline over the completion of returns, and as a check on the consistency of preparation across institutions, given that often judgement is involved in completing the forms. One bank chief financial officer (CFO), however, felt that there was no value in auditors reviewing regulatory returns, partly because he thought that they were a data collection exercise and partly because of scepticism over how much attention supervisors paid to the information, feeling it was mainly used for statistical monitoring purposes.

The current FSA skilled persons' regime gives the FSA the tools to commission reports on regulatory returns but it has been underused, with a focus on addressing problem areas rather than as a monitoring or control mechanism. Skilled persons' reports are viewed by banks as a punishment, or part of the process of resolving problems, but could be used in more of a preventative or diagnostic way as part of the FSA's normal monitoring processes. While not wanting a return to the previous Bank of England regime when such reports were required every year for every bank, most interviewees would value a broader use of such reports.

It should be noted that the FSA's 2010/11 Business Plan reports its strong commitment to engage more effectively with firms' external auditors, including 'more Section 166 reviews, supervisory meetings with auditors and possible additional assurance on our regulatory returns.'

Process

The project has been led by a working party consisting of experienced bank auditors from 7 of the largest audit firms and ICAEW staff, with an observer from the Auditing Practices Board. We have conducted a series of stakeholder interviews with the CFO or audit committee chairman of 5 of the largest UK banks, 8 senior investor representatives, the FSA, the European Commission and the chairman of the Treasury Committee. These interviews took place between January and March 2010, and were based upon a discussion paper developed by the faculty. We have also hosted a public discussion session, hosted by the Centre for the Study of Financial Innovation (CSFI). We will hold a further discussion on 9 June to discuss the findings and recommendations of the final report, in conjunction with the International Centre for Financial Regulation (ICFR).

If you have any comments on this stakeholder feedback, or other views you would like us to consider in preparing our final report, please send them to Iain Coke, head of the Financial Services Faculty (iain.coke@icaew.com).

About the ICAEW Financial Services Faculty

The ICAEW 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 and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members in the sector, including those working for regulated firms, in professional services firms, intermediaries and regulators.

About the *Inspiring confidence in financial services* programme

The *Inspiring confidence in financial services* programme debates issues affecting confidence in the financial services sector. It develops new insights and ideas by questioning financial services providers, consumers and regulators about how they interact with each other and how information flows between them.

Market conditions were very different when we launched the campaign in early 2007 and confidence in financial services was high. However, we identified four themes that represent challenges in the sector, all related to supporting confidence: responsible providers; responsible consumers; better regulation; and better information. To have stable, efficient markets that support consumer interests and sustain wider economic development, it is necessary to draw together these elements.

The '*Audit of banks: lessons from the crisis*' project forms part of this wider programme, under our better information theme. Other activities in the programme have included hosting major conferences, producing briefing and issues papers, and informing ICAEW policy and representational activity, including evidence provided to Parliamentary committees.

The financial crisis highlighted the importance of debating these issues on a continual basis to allow the system to react and adapt to the dynamic and evolving financial sector.

The financial crisis has highlighted the importance of debating these issues on a continued basis to allow the financial system to react and adapt to dynamic change.

icaew.com/fsfaculty

April 2010

© Institute of Chartered Accountants in England & Wales 2010

As a world-class professional accountancy body, the ICAEW provides leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry to maintain the highest standards.

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. The ICAEW ensures these skills are constantly developed, recognised and valued.

Because of us, people can do business with confidence.

Chartered Accountants' Hall
Moorgate Place, London
icaew.com

T +44 (0) 20 7920 8100
F +44 (0) 20 7920 0547
E fsf@icaew.com