AUDIT OF BANKS: LESSONS FROM THE CRISIS

BETTER INFORMATION
Inspiring Confidence in Financial Services initiative
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June 2010

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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.
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If there is to be a positive legacy of the financial crisis, it must be in the lessons that market participants have learned from extremely challenging times. As with all stakeholders in the banking crisis, bank auditors must seek lessons to be learned.

Auditors play an important role in financial markets, promoting confidence in financial information provided by banks and other financial institutions and acting as a discipline for directors and management. This report seeks to identify incremental improvements in the functioning of the system in the future.

Auditing and the regulatory framework that supports auditing have generally held up well in the crisis. The necessary reforms to the auditing regulatory framework implemented after the collapse of Enron seem to have stood up to their first major test. However, questions have been asked, including by the UK House of Commons Treasury Committee, about the value of bank audits, since auditing did not provide forewarning of the banking crisis. The European Commission, in its Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies, issued in June 2010, asks questions about the scope of auditor responsibilities, covering areas similar to some of the proposals in this paper. While this report is based on UK experience, we believe that its analysis and proposals will be of wider interest.

The purpose of audits is to provide greater confidence in information provided by directors through an independent opinion on its truth and fairness. This is the same for banks as for other entities presenting audited financial statements. For banks, regulators and supervisors provide an additional defence, albeit with different objectives and different primary stakeholders.

One way for auditors to respond to the crisis is by suggesting changes to regulation, financial reporting standards or auditing standards. Indeed, we suggest some areas where long-term changes could be made in these areas. However, such changes take time and auditors can also take more immediate steps to promote positive improvements through market-based solutions and better communication.

Perhaps more than anything else, politicians ask questions about professional judgement when discussing the role of auditors. An auditor’s work is conducted under a framework of professional standards, covering auditing, ethics and financial reporting, and of legislation and regulation. Much of this work is behind closed doors, therefore the impact of an audit on financial statements and on the discipline provided by internal controls is not visible. This helps to explain why questions may arise about the exercise of professional judgement by auditors.

If there is one big lesson from the crisis for auditors, it may be that more needs to be done to explain the value of audits to those outside the audit process. Making more information available about discussions between auditors and banks could increase the value placed on audit and thereby increase market confidence.

On a personal note, I would like to thank the contributors to this report, including the stakeholders we interviewed for their time and ideas and working party members for their hard work, support and openness. Preparing this report has been challenging. We acknowledge that many of our proposals, if implemented, would lead to additional work for auditors. However, in developing our proposals, we have been guided by the views of banks’ stakeholders. Our aim throughout has been to address their concerns.

Iain Coke
Head of ICAEW Financial Services Faculty

June 2010
The ‘Audit of banks: lessons from the crisis’ project has involved considering the contribution of bank auditors to confidence in markets, and how this can be enhanced in light of the credit crunch and resulting banking crisis. Stakeholder interviews identified a number of challenges. The Financial Services Faculty, working with experienced bank auditors, has considered these and identified a number of proposals for improvement.

These proposals are summarised below. Our report identifies a number of incremental changes that, taken together, should enhance confidence in banks’ reporting.

**Bank reporting**

Risk information is often presented in a piecemeal manner in bank annual reports, spread between the audited financial statements and the unaudited front sections. Banks need to focus on clearer presentation which allows users to understand the big picture, which is currently often obscured by the volume of detailed information. Summary risk statements are a potential way of providing this big picture. Auditors should be asked to provide assurance on new summary risk statements to provide confidence to readers of financial statements.

Audit committees have an important role to play in supporting better reporting. Auditors play a key role in making sure audit committees are equipped with the information they need to perform their role. A guide to good practice in audit committee reporting would help improve performance.

**Auditor reporting**

Insufficient information is provided under the current framework about the work that underpins an audit. This makes it difficult for investors to assess the performance of bank auditors or to understand the key areas of challenge. To address this gap, banks should confirm that key areas of judgement discussed with auditors are set out in the critical accounting estimates and judgements disclosures in the financial statements. The Financial Services Faculty will set up a forum for investors and auditors to help make the audit more transparent. Auditors should also have more involvement in reporting on the front sections of annual reports. Their responsibilities for this are currently very limited.

**Dialogue with supervisors**

Regular exchange of information between auditors and bank supervisors enables both parties to perform their duties more efficiently and effectively. Dialogue between auditors and banking supervisors was not consistently good enough before the crisis, with the regulator not placing sufficient value on such dialogue. There have been improvements in both the frequency and quality of dialogue but this remains variable and is dependent upon the attitude of individual supervisors. Further improvements are needed, including improvements to promote greater consistency between supervisors and ensure that discussions are a two-way process for information sharing.

**Support for supervision**

Auditors and other external experts have particular skills that can support banking supervisors in performing their functions. Supervisors have the power to utilise these skills but have done so rarely, typically only where particular problems have been identified. There is scope for making greater use of external experts on a thematic basis, as part of supervisors’ overall monitoring regime and as preventative or diagnostic measures.
In light of the financial crisis the Financial Services Faculty undertook a project 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 bank audits.

The faculty, in its evidence to the committee, suggested ways in which the role of auditors might be expanded. This project has involved further investigation of these and other ideas through a three-phase research process and in April 2010, we summarised the opinions expressed in our stakeholder interviews in a short feedback statement as interim findings that are reproduced in Appendix 2.

This report marks the final phase of the project and presents lessons for bank auditing from the financial crisis. It sets out how auditors can play an active role in improving the functioning of the banking system to promote confidence over the longer term. The report refers throughout to banks. It is also relevant for large building societies. References to banks should be read to mean banks and building societies.

We have conducted a series of stakeholder interviews with the Chief Financial Officer or audit committee chair of five of the largest UK banks and building societies, eight senior investor representatives, staff from the Financial Services Authority (FSA), the European Commission secretariat and the chairman of the Treasury Committee. These interviews took place between January and March 2010, and were based upon an issues paper developed by the faculty which is reproduced as Appendix 1. We have also taken part in public discussion sessions with the Centre for the Study of Financial Innovation (CSFI) and the International Centre for Financial Regulation (ICFR).

If you have any comments on this report, please send them to Claire Stone, Manager, Audit & Reporting, Financial Services Faculty (claire.stone@icaew.com).
1. BANK REPORTING

The directors of banks are ultimately responsible for the information they present in annual reports, and for the information on which auditors report. Bank reporting is therefore the starting place of any discussion about the role of bank auditors.

Bank reporting has been criticised for not providing sufficient early warning of bank failures. Maturity transformation is a key role performed by the banking system. This makes banks inherently risky as their services involve holding long-dated assets, in the form of long-term loans, and short-dated liabilities, in the form of customer deposits. The size of annual reports has increased significantly over a number of years, both in the quantity and complexity of information provided in the audited financial statements and in the unaudited front half of annual reports. Annual reports already provide a significant amount of information on risks, exposures and business models. In addition significant information is provided outside annual reports, for example through analyst presentations, trading updates and Basel 2 Pillar 3 disclosures which are often presented separately on bank websites. However, the volume and complexity of information and the way it is presented has made annual reports less accessible to non-experts. There has been particular concern that it is difficult to understand risk, business models or going concern assumptions from reading annual reports.

1.1 Presentation of risk information

Increased levels of disclosures are adding complexity to bank reporting. The stakeholders we interviewed agreed that more concise and easier to interpret risk disclosures are needed. The concern is not so much about insufficient amounts of risk information but more about the way it is presented. Reflecting numerous attempts to add to risk disclosures, risk information is currently often presented in a piecemeal fashion, making it difficult to see the wood for the trees. This lack of clarity undermines user confidence in reported financial information.

The level of information banks are providing on risk improved during the financial crisis. Initiatives such as the development of a draft code for financial reporting disclosure by the British Bankers’ Association are likely to help maintain a focus on the quality of reporting.

A particular issue raised is that relevant risk information is often provided in the annual report, but due to the way in which it is presented, the relative importance of different risks is hard to gauge. There is no short statement clearly setting out key issues for users to consider in order to understand the business. Bank directors suggested alternative short statements which might help explain the risks to their business more effectively. While there was agreement on the need for clearer statements, there were different views on what form those statements might take and what they would cover. The main suggestions were the inclusion of the following:

- the business model and key business risks;
- a source and application of capital statement showing which parts of the business require large amounts of capital;
- a detailed going concern statement, including risks and why the directors are satisfied regarding the bank’s ability to continue as a going concern; and
- benchmarking information on certain areas of activity (for example, loan ratios) against the market, so as to highlight areas where an aggressive business model is being followed.

Without developing examples, it is difficult to assess which of the disclosures proposed above would provide the most useful information over the longer term and which might provide the best signalling of future problems. Banks could prepare and publish example statements, or voluntarily include summarised risk disclosures in their annual reports. Auditors should work with the banking industry to assist in the design of these statements but this is an area which the industry should own. A degree of experimentation will be necessary to see which form of disclosure is the most meaningful for investors.
A concern of investors was that risk statements provided by directors might not tell the full story, and that they would have more confidence in the statements if they are reviewed by the auditor. Once new risk statements are developed, auditors could be asked to provide assurance on them. This could be accomplished by extending the scope of the statutory audit report or could form a separate assurance engagement. Auditors should work with banks to develop an appropriate framework, using the existing assurance framework set out in the International Auditing and Assurance Standard Board’s International Standard on Assurance Engagements 3000 as a starting point for the provision of such assurance, as the content of new risk statements is developed.

If a better form of risk reporting emerges and if market demand exists for this reporting to be subject to assurance from auditors, these developments should be formalised through changes to the relevant regulatory requirements.

1.2 Reporting of critical estimates and judgements

One area where investors have said they that they would like more information is around the sensitivity of critical accounting estimates and judgements.

Professional judgement is at the heart of financial reporting. Although accounting standards have become increasingly technical, many areas retain the need for judgement. In particular, one overall test is a subjective judgement over whether the financial statements provide a true and fair view. Indeed, as the sophistication and complexity of accounting has increased, there are more areas where estimates are needed, for example in fair value measurement when there is no active, deep and liquid market and in estimating future pension liabilities for defined benefit (final salary) schemes. These estimates may be based upon objective evidence, but the models and inputs used impact the final measurements. As a result, there will often be a range of acceptable outcomes that directors may present rather than a single true answer. The best estimate is a matter of opinion.

Accounting standard-setters have addressed this issue by requiring disclosure of the critical accounting estimates and judgements in the accounts. Good practice would be to draw them together in one note to the accounts. These disclosures are already within the scope of the audit. This is also an area where the industry has significantly improved its disclosures over the course of the crisis and the British Bankers’ Association code referred to above is a further significant step forward. It is important that these disclosures remain dynamic and are changed each year to reflect the changing circumstances of each bank and the environment it operates in. This should be a collaborative exercise between the industry and auditors.

It also emerged from some of our interviews that critical accounting estimate disclosures may not be widely read by investors. Banks should therefore consider whether they give sufficient prominence to these disclosures.

1.3 Auditor communication with audit committees

Audit committees play an important role in the governance surrounding the finalisation of critical judgements, estimates and presentation affecting the accounts. The primary source of information for audit committees is the executive management. Good quality reporting from auditors to audit committees can add context to that and highlight gaps in management reporting.

Auditors have a duty to report matters of significance to those charged with governance. This normally happens through the audit committee, for whom auditors typically produce a report. The findings, including key areas of the audit such as the critical accounting estimates are then discussed between the auditors and audit committees.

Auditors are expected to highlight in their reports to, and discussions with, audit committees any concerns or areas where estimates are towards the extreme end of ranges of acceptable outcomes. However, practice may vary as to how these issues are reported. Good practice is to use language that makes it clear whether, in the auditor’s judgement, individual estimates fall within an acceptable range, whether there is consistency with estimates made in prior years and if the cumulative effect of, for example, moving from aggressive to conservative ranges of estimates, or vice-versa, could have a significant impact. Auditors can also indicate how comparable the definitions applied in financial statements, for example of particular types of financial instruments, are with those used elsewhere in the sector. Armed with this information, audit committees are more effective, for example because they are better able to challenge executive directors on the judgements, estimates and presentation used in the accounts.
In order to make audit committee reporting more consistent, ICAEW will develop guidance for bank auditors on good practice for reporting to audit committees.

1.4 Presentation of information in annual reports

As financial reporting standards have become increasingly complex, reflecting the growing complexity of financial markets and business generally, the perceived focus of preparation of true and fair financial statements may have shifted away from the big picture towards compliance with the requirements of standards.

Financial reporting standards require various components of information which must be presented in order to provide a true and fair view in the financial statements. They do not and are not intended to cover every eventuality nor how information is put together. Compliance with financial reporting standards is only one part of providing a true and fair view. The way that the information is presented and ordered is also important. We encourage banks to continue to seek further improvements in their reporting.

Directors are already expected to consider the presentation of information in preparing financial statements as would auditors in providing an opinion on whether they provide a true and fair view. However, there is no framework for directors presenting information in the front half of annual reports. Such a framework could prevent key pieces of information from being lost in a surfeit of detail.

Auditors should assist directors in this process by considering more carefully the ordering and presentation of information in annual reports as a whole. This assessment could be clearly communicated to audit committees to ensure that the directors also consider this.

1.5 Other sources of information

Annual reports are only one source of information to investors and users of financial information. Analysts use information presented directly to them by the company as a major source of information. The material included in analyst presentations, despite its heavy use, is not subject to any auditor review, and while it may be provided to auditors, there is no obligation on the company to do this routinely. Consideration should be given to introducing a requirement for auditors to review material in analyst presentations similar to the extended auditor responsibilities over the front-half of annual reports we propose in the Auditor Reporting section of this report.

1.6 Summary of proposals

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<th>Objective</th>
<th>Continuous improvement in reporting by banks.</th>
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<tr>
<td>Challenge</td>
<td>Risk information is presented in a piecemeal manner in many annual reports and it can be difficult for users to get a clear sense of the key risks. The quality of disclosures on key accounting judgements and critical estimates has improved, but there is scope for further work here.</td>
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<tr>
<td>Lesson from the crisis</td>
<td>Concise statements are needed to provide a clear picture of banks’ significant risk exposures.</td>
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<tr>
<td>Banks should:</td>
<td>• develop new risk reporting statements;</td>
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<td></td>
<td>• enhance confidence in risk statements by obtaining public assurance from auditors;</td>
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<tr>
<td></td>
<td>• provide greater prominence to critical accounting estimates disclosures; and</td>
</tr>
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<td></td>
<td>• place greater emphasis on the ordering and presentation of information in annual reports as a whole.</td>
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### Auditors should:
- work with banks to develop assurance reports to go with clear summary risk disclosures; and
- communicate clearly to audit committees.

### ICAEW will:
- produce good practice guidance for reporting to audit committees.

### Regulations and standard setters should in the longer run:
- amend risk reporting requirements to support more concise risk reporting; and
- extend the scope of the audit and auditing standards or draft assurance standards to cover new risk reports.

### Outcome
Clearer communication from banks to investors, customers and wider stakeholders on the key risks faced by banks, and greater confidence in those communications.
Audits provide greater levels of confidence in information presented by directors by providing an independent opinion on its truth and fairness.

Auditing and the regulatory framework that supports auditing appear to have held up well in the crisis. The necessary reforms to the auditing regulatory framework implemented after the collapse of Enron seem to have stood up to their first major test. However, there is room for further improvement. Our stakeholder research has highlighted auditor reporting as a particular area to look at.

2.1 Audit reports

Our stakeholder engagement highlighted the fact that the audit process is highly valued by investors and banks, and seen as essential in providing discipline to directors in their presentation of information, and to the control environment around their financial processes.

The audit report itself, however, was not viewed as providing useful information since it uses standardised language. This is a challenging finding for auditors and more effort needs to be put into explaining how the overall audit process, including the audit report, enhances confidence and into demonstrating how audit quality is maintained.

There were divergent views as to whether auditors should provide a commentary on areas such as management performance, risk and key accounting judgements or whether it was better to retain the clarity of a standard audit report. Those in favour of retaining the standard audit report were concerned that any commentary would be highly subjective, that it is the directors’ responsibility to provide information to investors and that it might impair the quality of evidence available to auditors if it made bank management more guarded in their dealings with auditors.

Whichever view is correct, current practice is that the audit report does not include such a commentary and reserves additional comments to emphases of matter where significant issues are highlighted, or to situations where auditors qualify or disclaim their opinion. To allow or require an auditor commentary would represent a significant shift in auditor responsibilities and may require changes to International Standards on Auditing. We do not currently advocate this as a solution without further investigation as it carries the potential for unintended consequences.

It is also an issue that is wider than just one of bank auditing and we welcome the fact that the Financial Reporting Council and the International Auditing and Assurance Standards Board have already started research on this topic.

However, there are a number of alternative measures that may be taken to address the concern that there is insufficient information about the views of auditors or recommendations they have made.

2.2 More information about how audits enhance bank reporting

Concerns about a lack of transparency show that more can be done by auditors to explain how audits improve the quality of reporting by banks and impose discipline upon directors and executives. A first step would be for auditors to provide this information across the sector, and the Financial Services Faculty would be willing to assist in this. While auditors have in recent years worked to explain their responsibilities and to reduce the audit expectation gap, including through the Audit Quality Forum, there is scope for more information about audits to be made public.

In particular, more could be done to explain at a thematic level the practical issues and concerns that auditors have, and areas they expect to pay particular attention to across the banking sector in a particular year’s reporting season. Auditors should be willing to share these systemic concerns with investors. Provision of this information to investors will increase transparency around audits and give investors more confidence in audited information.
To facilitate this information sharing, the Financial Services Faculty will establish a forum for auditor/investor dialogue to discuss the key areas of audit focus across the industry for each reporting season. Subject to the level of investor interest, these would be held annually in November, or bi-annually with an additional meeting in May.

2.3 Auditor responsibilities for front section of annual reports

One of the reasons given by investors for wanting more commentary from auditors is a feeling that the information provided by directors in the front section of annual reports is presented in a favourable light or tends to be standardised boilerplate.

The responsibilities of auditors for reporting on the front section of the financial statements are currently limited. Auditors read this information and must report if the information provided is inconsistent with the financial statements or contains material the auditors know to be untrue. Annual reports have expanded over the years and banks and other reporting entities provide significantly more information in the front section of annual reports. The scope of the audit report, by contrast, has remained relatively static, being largely focused on the financial statements. It may be time to reassess this.

There was no particular demand from the stakeholders we interviewed for auditors to provide a true and fair opinion over the front section of annual reports. However, there was some surprise from investors that auditors’ responsibilities were so limited, and particularly that audit reports do not provide comfort on the completeness of information presented in the front section of annual reports.

In our view, auditors should report not only on whether there are any inconsistencies between the information in the front section of annual reports and the financial statements, but also whether there are any material omissions in the information provided in the front section of annual reports, based upon the auditors’ knowledge of the bank they are reporting on. Alternatively, the auditor could report on whether the balance of the information is appropriate. This would require the development of a new auditing or assurance standard to define the terms to be used so that users are clear about the level of assurance they receive. Without this there is a danger of a widened expectation gap over the role of the auditor but we see no reason why an appropriate standard could not be developed.

2.4 Auditors could provide greater assurance outside the audit report

There is an existing international assurance framework which allows auditors to provide public reporting on matters outside the audit report and outside the statutory audit framework. This might be utilised to provide external public assurance on aspects of the front half of annual reports, notably any enhanced summary risk disclosures that are provided by banks as discussed in the previous section. Public assurance reports can be commissioned by banks on a voluntary basis without requiring any change to the statutory framework or auditing standards.

There are some areas where additional auditor reporting could be of value, for example, on regulatory capital ratios, which could be incorporated into the audit report under existing auditing standards. In other areas, such as innovative risk reporting by banks, auditors may be able to provide a different form of assurance, using the International Auditing and Assurance Standards Board’s existing International Framework for Assurance Engagements (‘assurance framework’) as a starting point for their reporting. Auditors would need a set of criteria or procedures against which to report, but these could be agreed between auditors and banks. Related guidance could be developed for these reports if patterns emerge for a consistent type of report. In time, such additional reporting could be brought within the statutory reporting framework.

Auditors should explain better to investors and banks how the assurance framework can be used to provide additional comfort on risk disclosures, or other areas of the front half of annual reports where demand for assurance services exists. Auditors should also explain the nature of services and the form of reporting they would be willing to provide.

If there is widespread demand for public external assurance on summary risk statements or any other aspect of the front section of annual reports, ICAEW will work with auditors, supervisors, standard-setters, investors and banks to develop guidance on such reports.
2.5 Information from banks about discussions with auditors

Banks could help to explain the important role that their auditors play by providing more information about the governance process over the financial statements and their discussions with auditors. Auditors should encourage such disclosures. There may be three benefits in providing this information all of which would enhance confidence in bank reporting:

- it may enrich the quality of information in annual reports about key risks, uncertainties and areas of judgement;
- it could provide better information about how auditors are discharging their responsibilities; and
- it could demonstrate how auditors and other external parties are strengthening risk management processes through additional assurance services.

Audit committees could, for example, confirm that all of the matters highlighted in the critical accounting estimates section of the financial statements have been discussed with the auditors, and also that this section covers all of the main areas of discussion they have had with auditors over judgements in the financial statements.

Assurance services can enhance risk management and the control environment. Such assurance services may be provided by the auditor or another audit firm or may be in the form of input from another external expert. Limited information about such assurance services provided by auditors is currently provided in auditor remuneration disclosures but without any explanation of how such additional assurance services have enhanced bank risk and control oversight. There is no disclosure of assurance provided by parties other than the external auditor.

Banks could provide more information about how they use private assurance reports to enhance their governance and risk management whether provided by the auditor or another external party. Auditors and other providers of assurance should express their willingness for this information to be provided, so long as an appropriate context is given for the work.

2.6 Audit oversight and inspection

The audits of listed companies and public interest entities are supervised by the Financial Reporting Council’s Professional Oversight Board, who draw on the work of the Audit Inspection Unit (AIU). The AIU has recently increased its focus on bank audits and also expanded its reporting on individual audits reviewed so that this is now provided to the reporting entity’s audit committee. This work, and reports from the Financial Reporting Council about this work, represent a safeguard over audit quality and should provide confidence to investors and other external stakeholders that auditors are performing their duties with due rigour.

2.7 Summary of proposals

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<th>Objective</th>
<th>Increase confidence in auditors’ work on banks’ financial reporting.</th>
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<tr>
<td>Challenge</td>
<td>Audits exist to increase investors’ confidence in information provided by directors. The audit process is seen as useful but the value of individual audits is difficult for investors to assess since audit reports use standardised wording. There is a lack of understanding as to how the work of auditors helps increase the quality of information reported by banks.</td>
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<tr>
<td>Lesson from the crisis</td>
<td>More work needs to be done to show investors how auditing and the work of auditors improves the quality of reported financial information.</td>
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<td>Auditors should:</td>
<td>• better explain how audits improve the quality of financial information;</td>
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<td>• develop a framework for an enhanced opinion on the front section of annual reports; and</td>
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<td>• provide greater assurance outside the audit report.</td>
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<td>ICAEW will:</td>
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<td>• convene a forum for discussion between auditors and investors; and</td>
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<td>• develop guidance for public assurance on bank risk statements, should demand exist.</td>
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<th>Bank directors should:</th>
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<td>• disclose how external assurance has supported their governance and risk management processes.</td>
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<th>Outcome</th>
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<td>The measures above will increase transparency around the audit process, and lead to a sounder appreciation by investors of the benefits of the statutory audit and non-statutory assurance services. This will support higher levels of confidence in information reported by banks.</td>
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</table>
Auditors and bank supervisors have different roles. The supervisor’s job is to check a bank’s soundness, that it is operating within the regulatory rules and to consider the overall risks to the banking and financial system, as well as to discharge any consumer protection responsibilities they are given. The auditor’s role is to provide an opinion to shareholders on the information provided by the bank in its financial statements.

As part of their responsibilities, the supervisor and auditor each considers the risks relating to that bank and the implications of the evidence they receive for their own objectives. The supervisor and auditor have different focuses but there are areas of common interest in their risk assessments. Each has an interest in the other party performing their duties effectively. Constructive, two-way communication between auditors and supervisors can help each party, by enriching their knowledge and risk assessment processes and sharing any concerns.

### 3.1 Communication between regulator and auditors

The banking crisis has highlighted weaknesses in the level of dialogue between auditors and supervisors. In the run-up to the crisis, for a number of large banks there were no meetings between supervisors and auditors for over a year. Evidence from bank auditors suggests that the level of dialogue was much better under the previous Bank of England supervisory regime. This is both in terms of frequency of meetings and the willingness of supervisors to share information with auditors.

The need to improve the level of engagement has been acknowledged by the FSA and this has been improving since the start of the crisis. However, evidence from bank auditors suggests the frequency of meetings and quality of discussions still vary significantly, largely according to the level of engagement on the part of individual supervisors. Some supervisors take an active interest in the external audit, for example attending audit planning meetings, while others do not engage fully with the external auditor. Similarly, while some bilateral meetings provide a frank exchange of views, auditors report other meetings with the FSA where the information flow is one way, with the supervisor listening to insights from the auditor but providing little in exchange. There is therefore room for further improvement.

Clearly, both supervisors and auditors share the responsibility for good dialogue; it is dependent upon the openness and willingness of both sides to share information, particularly with regard to significant risks. New guidance and protocols may be needed between auditors and supervisors to set out the terms of engagement. This may need separate guidance for auditors and for supervisors, although the guidance should be complementary. There may be occasions when both the auditors and supervisors have information to share which they wish to keep confidential from the bank directors. We would expect these occasions to be rare, but they would cover serious matters. The protocols between supervisors and auditors should be capable of dealing with these situations and ensuring that confidentiality is maintained.

The natural place for guidance for auditors is the Auditing Practices Board’s Practice Note 19 *The Audit of Banks and Building Societies in the United Kingdom* (PN19). Guidance for bank supervisors must come from the FSA, and the protocols should be agreed between the FSA and bank auditors. ICAEW is already working with the Auditing Practices Board on an update of PN19 and will commit to working with the FSA and bank auditors to develop new protocols for dialogue between auditors and supervisors.

Auditors could also be more proactive in holding supervisors to account for the quality of dialogue, both in terms of frequency of meetings and the openness of the supervisors. If auditors have concerns about the quality of engagement with individual bank supervisors or more generally and the potential impact on their work as auditors, they could raise these concerns at a higher level within the FSA.
Supervisors should have corresponding responsibilities for the quality of dialogue. If supervisors have any serious concerns over the openness of auditors of individual banks or more generally, they should be prepared to raise those concerns at a more senior level within the audit firm, with the bank itself and, if serious or persistent, with audit regulators.

### 3.2 Duty to report

One particular issue highlighted by both bank auditors and a number of bank representatives interviewed in our research is the imbalance between the duty of auditors to report matters to the FSA which may be material to their supervisory responsibilities, but no corresponding duty on the FSA to pass on information to auditors that may be material to the audit. The FSA currently interprets their powers in this respect as being able, but not required, to share information with auditors that may be in the FSA’s interests as supervisor. Often the FSA will advise banks to pass on certain communications or letters to bank auditors, but do not copy them directly to the auditor. It is our understanding that bank supervisors have a duty to inform auditors of significant matters in certain other jurisdictions, notably the US.

One consequence of this imbalance is that it may impair the quality of regular dialogue between supervisors and auditors.

A potentially more serious consequence is that the FSA would not be required to inform an auditor that they were about to take significant action against a bank, even when the auditor was about to sign an audit report. Although this is only likely to be an extremely rare situation, allowing an unqualified audit opinion to be issued when the FSA was about to take serious action is unlikely to aid market confidence or promote financial stability.

Internal guidance from the FSA may be able in part to address the concern, but we would advocate a change to the legislation to impose a reciprocal duty upon bank supervisors to share information directly with auditors. This legislative change could include legal obligations over confidentiality.

The FSA has expressed surprise that auditors do not make as many reports under the Duty to Report as they would expect. However, in practice it is extremely unusual for an auditor to be aware of information that the supervisor does not already have. In most situations that an auditor becomes aware of, a bank would already be in discussion with the supervisors. When this is not the case, as part of its investigation or evidence gathering, the auditor would normally discuss the matter with bank executives or, if it involves fraud involving senior management, with non-executive directors. If significant, the auditor would advise the bank to inform the supervisor directly. The auditor must then also inform the FSA about the matter, but in practice, auditors would only expect to be the first to inform the FSA of serious matters when they had significant concerns about the integrity or competence of management. More pro-active dialogue between auditors and supervisors should ensure such matters are reported by auditors. Nonetheless, the guidance in PN19 should be updated to remind auditors that they must still make reports when they are aware that the supervisor has already been informed of a matter.

### 3.3 Responsibility for dialogue

The responsibility for setting up meetings between auditors and supervisors has generally been thought of as a responsibility of supervisors. This has been partly because the supervisors have a power to request meetings and the auditors have a duty to engage, whereas the auditors have concerns about breaching client confidentiality if they initiate meetings where they have no material matters to report. It was also partly because of the asymmetric duty of auditors to provide information to supervisors without there being an obligation on supervisors to provide information to auditors.

In practice, auditors could request meetings with supervisors to help them discharge their responsibilities as auditors and take a more proactive approach to engagement with supervisors. In particular, when the supervisor has not requested a meeting for some time, auditors could request a meeting.
### 3.4 Summary of proposals

<table>
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<tr>
<th>Objective</th>
<th>More constructive dialogue between the FSA and auditors, to better serve depositors’ and investors’ interests.</th>
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<td>Challenge</td>
<td>Bilateral meetings between auditors and the FSA have been too infrequent and sometimes the quality of information shared by bank supervisors with auditors has been limited. In addition, there is no obligation on the FSA to share relevant information.</td>
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<tr>
<td>Lesson from the crisis</td>
<td>Dialogue between supervisors and auditors was insufficient.</td>
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| Supervisors and auditors should: | • meet more frequently; and  
  • be open in meetings and engage in constructive dialogue. |
| Supervisors should: | • commit to make communication with auditors a two-way process;  
  • be willing to share information with auditors; and  
  • be subject to a reciprocal requirement to report material information to auditors. |
| Auditors should: | • be proactive in setting up regular meetings with supervisors;  
  • be open in dialogue with supervisors; and  
  • raise concerns at a higher level within the regulator if they consider the level of engagement from supervisors is inadequate. |
| ICAEW will: | • work with the FSA, the Financial Reporting Council and auditors to develop guidance and protocols over auditor-supervisor dialogue. |
| Outcome | Regular exchange of relevant information between auditors and regulators will enable both parties to perform their roles more effectively, and better serve the interests of depositors and investors. |
The FSA needs a range of tools and a variety of skills to undertake its supervisory duties. Although the FSA has well qualified staff in its supervision department, there is often a need for additional specialist skills and expertise which are not available within the FSA’s own staff. Because the nature of specialist skills needed by the FSA changes over time, it may be more efficient to make use of external expertise to cover particular issues of concern. This can add to the flexibility of the FSA’s supervision department and its responsiveness to particular issues.

In addition, the FSA could make better use of the knowledge and work of auditors by the supervisor requesting particular areas to be looked at in greater detail during the audit. This might extend the audit tests to areas not considered significant audit risks, or involve using a different level of materiality than that which would be necessary to provide an opinion on the financial statements. This type of discretionary auditing could be a powerful tool for supervisors in obtaining information.

4.1 Skilled persons’ reporting tool

Under section 166 of the Financial Services and Markets Act (FSMA), the FSA can commission a report to be prepared by a ‘skilled person’ paid for by the regulated firm (s166 reports). Skilled persons may be the auditor of the bank, another auditing firm or another person with a particular skill or expertise not available to the auditor, such as a lawyer, actuary, independent valuer or compliance consultant.

The number of s166 reports in the years leading up to the crisis was very low, with an annual total of about 20–25 across the regulated sector, and the auditor was used very rarely. This was described by the Treasury committee as a wasted opportunity.

Infrequent use of external expertise is not, of itself, a weakness in supervisory processes. The types of work that external experts might undertake could be carried out directly by supervisors. However, the FSA supervision team is not geared up to have the scale of resources that would allow it to undertake all of this work directly. In Spain and the USA, for example, there are larger supervision teams focused on individual banks and more in-house expertise in the supervisors to undertake their own supervisory audits. Bank directors interviewed in our research highlighted concerns over the effectiveness of the FSA’s thematic work.

The FSA has acknowledged the scope for greater use of its powers to utilise the s166 tool, and has already increased the frequency of the approach by approximately tripling the number of engagements. However, their frequency of use is still small compared to the number of regulated firms and they are only commissioned when a specific concern has arisen. Because the work may eventually lead to enforcement action, skilled persons are often asked to provide a high standard of evidence to support their work, which has led to a forensic approach often being taken. The FSA’s Supervision Sourcebook and internal processes needed for supervisors to commission s166 reports may have supported this infrequent use. The reports themselves are generally seen by banks as a form of punishment for perceived weaknesses. The FSA may need to review its internal guidance to supervisors on the use of s166 reports and, if necessary, revise its procedures and rules governing their use to address these concerns.

There is a potential gap in the current supervisory toolbox whereby expert reports could be used by the FSA on a thematic basis, or as a diagnostic and monitoring tool where the FSA is seeking to identify risks or problems in the system, or in assessing performance or compliance. Banks and investors interviewed by us supported the potential value to supervisors of requesting additional assurance from auditors, or other suitable independent experts. This could cover aspects of the internal control or risk management environment or other areas considered important to supervisors. By using the reports thematically across a number of banks the FSA could obtain useful information both about individual institutions and across the market to identify wider issues. There is a particular value in using the auditors for this type of report as the work can often be combined with the audit itself.
The Bank of England previously used its section 39 powers to commission work from auditors in this way. Arguably the tool was overused on occasion by the Bank, with supervisors almost automatically commissioning such reports on an annual basis without sufficient thought about how they were targeted. However, the pendulum has swung too far in the opposite direction.

4.2 Audits of regulatory returns

Section 166 or other expert reports could also be used to check periodically on the completion of key regulatory returns. Investors and some bank representatives saw value in auditors periodically reviewing key returns. The past experience of auditors of reviewing bank returns, and current experience of reviewing insurance returns, reveal that there are frequently errors of varying degrees of seriousness. Some bank Chief Financial Officers considered that there was little or no value in an audit review of regulatory returns since the returns were seen largely as a box-filling exercise, and they are sceptical about how much these returns are relied upon and used by supervisors. In our view, if regulatory returns are used and relied upon by supervisors, periodic external assurance on their completion should enhance the supervisory process by making the information more reliable.

ICAEW has issued guidance for auditors undertaking s166 reports. This can also be used by other skilled persons. We will continue to review the appropriateness of this guidance and will expand it if necessary if the use of experts’ reports is increased.

4.3 Summary of proposals

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<tr>
<th>Objective</th>
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<tr>
<td>Supervisory processes are strengthened to promote financial stability and provide improved protection to bank customers.</td>
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<tr>
<th>Challenge</th>
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<tr>
<td>The FSA has the power to utilise the skills and knowledge of auditors to strengthen its supervisory processes through skilled persons’ reports. This tool is currently under-utilised by the FSA, as it makes limited use of its powers to request thematic reviews and tends to use its existing powers to require reports on an enforcement, rather than a preventative or monitoring, basis.</td>
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<tr>
<th>Lesson from the crisis</th>
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<tr>
<td>Supervisors have made insufficient use of the skills of auditors in the supervisory process.</td>
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<th>Supervisors should:</th>
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<tr>
<td>• make better use of the s166 reporting tool to support its supervisory objectives; and</td>
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<td>• periodically require auditor reports on key regulatory returns.</td>
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<th>Auditors should:</th>
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<td>• engage in dialogue with the regulator about the type of work that auditors could perform efficiently, including tasks which could be done alongside statutory audit work.</td>
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<tr>
<th>ICAEW will:</th>
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<td>• review and, if necessary, update its guidance on s166 skilled persons reports.</td>
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<th>Outcome:</th>
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<tr>
<td>Greater use of external experts, including auditors, could strengthen supervisory processes and widen the resources and range of skills available to supervisors.</td>
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Areas where auditors could support the regulatory process:

1. More frequent bilateral or trilateral meetings aimed at informal sharing of views on:
   a. Risks and quality of risk management, including internal audit?
   b. Quality of financial control environment?
   c. The bank’s culture and management style?

   Feedback: There was support for more frequent and effective meetings

2. Revisit communication protocols between profession and the FSA:
   a. Should regulators have a duty to share relevant information with auditors?
   b. Should the protocols that allow auditors to initiate discussion with the FSA be expanded?

   Feedback: Most stakeholders thought the FSA should be obliged to share relevant information with the auditor, but that revising other protocols was less important.

3. Focused reports on aspects of a bank’s control framework:
   a. Commissioned by FSA, for example in support of a themed review?
   b. Similar to s166 report but without the enforcement connotations these have – more like the old s39 reports?

   Feedback: There was support for greater use of s166 reports on a thematic basis to support regulatory objectives.

4. Audits of key regulatory returns:
   a. Some of the returns are difficult to prepare. Should the regulator be seeking to gain more assurance on the quality of the data?
   b. Selected by FSA – on a rotational basis or on a risk basis?

   Feedback: There was no demand for the routine audit of regulatory returns, although periodic reviews under s166 were seen to be potentially useful.

Areas where auditors could do more public reporting:

5. Financial information outside accounts:
   a. Capital ratios only? Or whole of OFR? Or something in between?
   b. Level of assurance and type of opinion to be provided.
   c. Cost/benefit.
   d. Need for additional guidance (from APB?)

   Feedback: There was no strong demand for a general extension of audit scope to provide a ‘true and fair’ opinion on the full annual reports.
6. Pillar 3 disclosures:
   a. Scope of audit work (all disclosures or only some).
   b. Level of assurance and type of opinion to be provided.
   c. Cost/benefit.

   Feedback: There was no current demand for Pillar 3 disclosures to be brought under the scope of audit.

7. Reporting on controls
   a. A control framework exists for financial reporting (COSO/SoX).
   b. Would need an external framework for reporting on risk management, should investment be put into developing one? By whom?
   c. Cost/benefit.

   Feedback: There was no strong demand for public reporting on financial controls or risk management, but a view that private reporting by auditors to management may be useful.

8. Reporting on governance:
   a. Should the Board report on the effectiveness of its governance in its annual report?
   b. Should auditors report to the Board on effectiveness of governance processes? What framework would be required for such reports?
   c. Cost/benefit.

   Feedback: There was no strong demand for public reporting by boards, but some interest in private reporting by auditors on governance processes.

9. Identification of what is and is not audited:
   a. Do readers of the financial statements understand what work is undertaken or does it need to be clearer?

   Feedback: What is audited is generally understood although there is some uncertainty among users as to what reviewing for consistency means in practice.

Other thoughts:

10. Current discussions between FSA and firms are focused on micro risks and accounting issues – should there be a higher-level forum discussing systemic issues?

    Feedback: A higher-level forum was felt to be useful.

Additional matters raised by stakeholders:

Audit reports should be more informative.

The quality of risk disclosures could be improved, including by adopting new formats for reporting which would be subject to audit.
Stakeholder feedback

The stakeholders interviewed can broadly be split into three groups: investors, bank representatives and policymakers (including the Financial Services Authority, 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, chief financial officers 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; and
- 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 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, 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.'
About the *Inspiring Confidence in Financial Services* initiative

The *Inspiring Confidence in Financial Services* initiative 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, principally 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 has highlighted the importance of debating these issues on a continued basis to allow the financial system to react and adapt to change.
Financial Services Faculty Corporate Membership

The Financial Services Faculty’s corporate membership programme provides funding to support the Inspiring Confidence in Financial Services initiative. This report is an example of our ability to lead and influence public debate on long-term issues relating to financial services.

We are proud to acknowledge our corporate members and thank them for their support and contribution. Our corporate members include:

- BDO
- Deloitte
- Ernst & Young
- KPMG
- PricewaterhouseCoopers

How can my organisation get involved?
Corporate membership of the Financial Services Faculty is available for financial institutions, professional firms, regulatory authorities, industry bodies and support service providers wishing to demonstrate a commitment to promoting long term confidence in the financial services sector.

Corporate membership allows you to engage fully in the thought leadership and policy work of the faculty at a corporate level. As a corporate member of the Financial Services Faculty, your support will be publicly acknowledged in publications and conferences relating to the Inspiring Confidence in Financial Services initiative, as well as on the faculty website.

Further information
Please contact our client relationship manager Thomas Gannage-Stewart for further information about corporate membership of the Financial Services Faculty (020 7920 8659 or thomasgannage-stewart@icaew.com). Alternatively, visit the faculty website icaew.com/fsfaculty.
As a world-class professional accountancy body, 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. ICAEW ensures these skills are constantly developed, recognised and valued.

**Because of us, people can do business with confidence.**

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