ICAEW
FINANCIAL SERVICES FACULTY

Audit of banks: 5 years on

INSPIRING CONFIDENCE IN FINANCIAL SERVICES INITIATIVE

ABOUT THE ICAEW FINANCIAL SERVICES FACULTY

The ICAEW Financial Services Faculty was launched at the start of 2007 to provide professional support to ICAEW's members working across the financial services sector, to influence public debates on regulation and standards affecting the sector and to become a world-class centre for thought leadership. The *Inspiring Confidence in Financial Services* initiative was established in early 2007. It aims to provoke new thinking and identify better ways of tackling long-term challenges in the financial services sector.

Confidence is vital to financial services. A stable financial system is important to the economy and sustainable levels of confidence in financial services are needed for this stability. Our work is based upon four themes, which are interdependent and cannot be considered in isolation.

These themes are:

- responsible providers
- responsible consumers
- better information
- better regulation.

Our work involves developing reports and provocative issues papers, holding high-profile conferences and having discussions with stakeholders. We aim to bring together the financial services sector, industry professionals, consumers, regulators and policymakers. We believe that financial services will only inspire confidence if the sector engages with all of its stakeholders.

For more information about the *Inspiring Confidence in Financial Services* initiative, visit icaew.com/inspiringconfidence. For more information about the Financial Services Faculty visit icaew.com/fsf. Alternatively contact Iain Coke at iain.coke@icaew.com.

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1. Introduction

ICAEW's Financial Services Faculty published *Audit of banks: lessons from the crisis* in 2010 (the 2010 report) in response to the global financial crisis, which started with the 2007 credit crunch. It responded to questions from among others, the UK Parliament's Treasury Committee about the value of audit, given that auditing did not provide forewarning of the banking crisis. One of the challenges laid down by the Treasury Committee was that, although auditors had apparently met their legal obligations, they had fallen short of public expectations.

Audit of banks: lessons from the crisis sought to identify actions that banks, auditors and other parties could take to strengthen the banking system without the need for legislative or regulatory changes. This was not because no changes were needed to regulation, but because such matters were being considered by other public enquiries, law-makers, regulators and standard-setters themselves. We identified a number of practical proposals which we believed would improve bank reporting, auditor reporting and the relationship between auditors and bank supervisors. These proposals included recommendations for banks, auditors, regulators and standard-setters, as well as commitments from ICAEW to undertake certain actions.

Five years on from its publication, this report looks back at various initiatives that have taken place since then which address the issues we have identified. Secondly, it summarises the most important of the legislative and regulatory initiatives that have taken place around auditing which address issues not covered in our report. While some of these address banking specific issues, many apply across different sectors. Finally, this report identifies potential areas for future work as part of an ongoing need for continual improvement to maintain and enhance the quality and relevance of auditing.

Context

The developments highlighted in this report are set against a context of increased scrutiny of the performance of bank audits and bank financial reporting. Audit supervisors such as the Financial Reporting Council (FRC) have increased the number of bank audits it reviews as part of its annual audit monitoring, taking a particular focus on judgemental areas such as loan loss provisioning and undertaking thematic reviews on bank audits. Audit supervisors have also become more internationally co-ordinated through the work of the International Forum of Independent Audit Regulators (IFIAR), which has worked with the Financial Stability Board to examine issues over the consistency and quality of the audits of globally systemically important banks across different jurisdictions.

Audit regulators, while recognising that improvements have been made in the quality of bank audits, have identified areas where they feel auditors could still do better. The 2010 report did not make particular recommendations around audit monitoring as the FRC had only recently implemented major reforms in this area. IFIAR was set up in 2006, shortly before the start of the financial crisis, and the FRC had already increased its targeted monitoring of bank audits before the 2010 report was published. This report does not, therefore, detail these developments, but they set an important context to the other developments which are covered in the report.

Summary of key developments

There have been significant improvements in bank reporting and auditing since the publication of *Audit of banks: lessons from the crisis*.

The most ground-breaking are probably the enhanced auditor and audit-committee reports, which for the first time provide information about the matters and risks considered during the audit process. Equally important has been re-establishing better quality, regular dialogue between bank auditors and supervisors, which had stopped working as effectively as it should have in the run-up to the financial crisis.

There have also been major developments in bank reporting, with banks working together with investors, analysts and auditors to identify what information readers of annual reports want and what can be realistically delivered by banks. While not all of these new disclosures are covered by the scope of audit, ICAEW is exploring developing an assurance model for bank capital ratios. In addition, when issues were uncovered over the manipulation of LIBOR and other important benchmarks, one of the solutions was to introduce new assurance requirements for these and ICAEW has developed guidance so that this can be provided on a consistent basis.

2. 2010 recommendations and subsequent actions

This section summarises the findings of the 2010 report and reviews the subsequent developments against these proposals.

Auditing does not happen in isolation. In considering the role of bank auditors and what could be improved, it was important to also consider the role of bank reporting and the relationships between auditors and stakeholders, including audit committees, investors and bank supervisors. The report made a series of proposals for improving bank reporting, auditor reporting, the relationship between auditors and supervisors and in how the supervisors could use the skills of auditors better by using their powers to commission special reports by skilled persons more effectively.

2.1 Bank reporting

2010 proposals	Subsequent actions
Banks should:	
• develop new risk reporting statements; • enhance confidence in risk statements by obtaining public assurance from auditors; • provide greater prominence to critical accounting estimates disclosures; and • place greater emphasis on the ordering and presentation of information in annual reports as a whole.	• The EDTF brought together banks, analysts, investors and auditors to develop principles for better disclosure which have been voluntarily implemented by large international banks.
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.	• ICAEW issued guidance to enhance the dialogue between bank auditors and audit committees. • The FRC updated ISA 260 to strengthen the communication between auditors and boards. • ICAEW is consulting on a model for assurance on bank capital ratios.
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.	• The FRC introduced a requirement for annual reports to be fair, balanced and understandable. • IFRS 9 introduced new disclosure requirements for financial statements. • The Basel Committee has updated its disclosure requirements.

Improving risk reporting

The 2010 report found that, while banks provided a lot of information in their annual reports, the way that it was presented made it difficult for readers of the accounts to obtain a clear understanding about a bank and its business model. In particular, it found that risk information was presented in a piecemeal manner, split between unaudited sections in the front half of annual reports and in the audited financial statements.

The work of the Enhanced Disclosure Task Force (EDTF) is the most significant private sector initiative to improve bank disclosures. It was set up at the request of the Financial Stability Board as an international initiative to bring together bank executives, investors, analysts and auditors to develop recommendations for new bank disclosures, including considering how to present risk information. The EDTF issued principles and recommendations for improved disclosures in October 2012, which large banks have adopted on a voluntary basis. It issued an update to this report in September 2014. One of the most positive aspects of the EDTF was that it brought together different groups which had not previously worked together to address common problems in a pragmatic way.

The EDTF proposed some additional disclosures, how to better order and present disclosures and whether any disclosures provided by banks could be removed as they were not well used. It included recommendations for more granular information, for example on credit risk, and more information to be provided about bank capital ratios and the risk-weighted assets calculations that form part of those ratios.

The EDTF perhaps had less success in identifying disclosures which could be removed from bank annual reports. Some of this might reflect the fact that specialist analysts in particular like granular data which can add to the complexity of annual reports, and most disclosures made by banks were introduced due to demand from somewhere. The EDTF also found that some of the disclosures that were considered less useful may be required under legal or other requirements. For example, while cash-flow statements are very important for non-banks, they were not considered helpful for banks. However, companies legislation requires that these disclosures are provided.

Fair, balanced and understandable

The UK FRC introduced a new requirement on boards for the annual reports as a whole to be fair, balanced and understandable. Previously boards were required to ensure that these were free from material misstatement. The new requirement extends this to require that annual reports also present a complete picture so that boards more accurately presented the financial position, performance and prospects of their business. Auditors' responsibilities have not been extended beyond the financial statements, but as before they are required to read the other information in annual reports and report if it is inconsistent with their knowledge of the business. However, auditors are now expected to consider, when reading this, if it is fair, balanced and understandable, not just whether there are any material misstatements.

Other disclosures and audit requirements

The Basel Committee on Banking Supervision has updated its Pillar 3 public disclosure requirements (Basel 3 disclosures), issuing the latest revised requirements in January 2015. IFRS 9 *Financial Instruments*, issued by the International Accounting Standards Board after extensive public consultation, has introduced new disclosure requirements in addition to introducing changes to the way that financial instruments are measured.

The EDTF did not recommend that the new disclosures should be audited except where they comprised part of the audited financial statements. Other disclosures could be made in the unaudited sections of the annual report. Similarly, there is no requirement for Basel 3 disclosures to be audited, nor for the disclosures to be included in annual reports. However, ICAEW is consulting on developing a model for assurance on bank capital ratios and published a discussion paper on this in July 2015. ICAEW is not proposing that this is made a mandatory requirement as this is a matter for legislators, regulators and standard-setters. Instead our intention is to develop a consistent model for providing this assurance that can be adopted voluntarily by banks or which could form the basis of a requirement should demand for this emerge.

Auditor–audit committee relationship

Our 2010 report identified the relationship between auditors and audit committees as being important to both good reporting by banks and an effective audit process. ICAEW published *Enhancing the dialogue between bank auditors and audit committees* in March 2012. This was developed in consultation with auditors, bank audit committee chairs, heads of internal audit, senior bank executives, investors and regulators. It recommended clear communication which not only presented conclusions, but also told the story of how they were reached, particularly on judgemental or contentious areas. In addition, the FRC updated International Standard on Auditing (UK and Ireland) 260 *Communication with those charged with governance* (ISA 260) was revised in 2012 and again in 2014, recognising the importance of clear, two way dialogue.

Summary of progress

There has been positive engagement and clear improvements to bank reporting as a result of the various post-financial crisis initiatives. Bank annual reports are still long and not easy for non-specialist readers to follow. This may reflect the complexity inherent in banks and the regulatory environment that they face.

2.2 Auditor reporting

2010 proposals	Subsequent actions
Auditors should:	
• better explain how audits improve the quality of financial information; • develop a framework for an enhanced opinion on the front section of annual reports; and • provide greater assurance outside the audit report.	• FRC introduced the enhanced auditors report to explain key audit risks. This is being extended internationally.
ICAEW will:	
• convene a forum for discussion between auditors and investors; and • develop guidance for public assurance on bank risk statements, should demand exist.	• There was little investor demand for an auditor-investor forum. • The new ICAEW *Audit insights* series of reports into sectors highlights key issues facing sectors.
Bank directors should:	
• provide more information about discussions with auditors; and • disclose how external assurance has supported their governance and risk management processes.	• FRC introduced new requirement for audit committees to disclose the key risks they considered and work they have undertaken to address these.

Auditor and audit committee reports

It was difficult for outsiders, including investors, to assess whether auditors have done an effective job as audit reports provided an opinion on whether the financial statements were fairly presented or provided a true and fair view but did not provide any information on the work that auditors had undertaken to support this opinion. Similarly, audit committee reports previously provided information on the processes they undertook, such as the number of meetings held, but did not provide information on the risks they considered or how they reached their conclusions.

The 2010 report made a series of recommendations for improving the flow of information from auditors and audit committees in annual reports, as well as for opening new channels of communication between auditors and investors on the systemic issues they see across the banking sector.

The UK FRC introduced a new requirement for an enhanced auditor's report in its June 2013 revision to ISA (UK & Ireland) 700 *The auditor's report on financial statements* (ISA 700 revised). This introduced a new requirement for auditors to discuss in their reports the key audit risks they considered, how they addressed them and how they considered materiality. This went significantly beyond the ICAEW 2010 recommendations for auditor reports. The International Auditing and Assurance Standards Board, in January 2015, revised the international version of ISA 700 to adopt the enhanced auditor's report internationally. Changes to the UK Corporate Governance Code (UK Code), introduced by the FRC in 2012, required audit committees to provide more details on the work they do including the key risks they considered. The new auditor and audit committee reports apply across all sectors, not just banking.

Taken together, the new auditor and audit committee reports provide valuable new information. For the first time, readers of annual reports are given summaries of the key audit risks considered by audit committees and auditors and the work they have undertaken to address these. These should give investors and other stakeholders new insights into judgemental and potentially contentious areas of accounting included in the financial statements, and into the work of audit committees and auditors in reviewing and challenging the judgements made by executive management.

Auditor–investor engagement

Our 2010 report also proposed establishing a forum between auditors and investors to discuss systemic issues across the banking sector. ICAEW's Financial Services Faculty set up an auditor-investor forum to discuss these issues. However, while we held interesting discussions, the take-up from investors and analysts was low so we discontinued this as it was not meeting investor needs. However, ICAEW instead established the *Audit insights* series which involves issuing reports on different business sectors as a way of auditors presenting their observations on issues that they see across these sectors that would be of interest to the wider public. Auditors did not previously have a formal mechanism for presenting these. ICAEW has issued reports on a number of sectors, including retail, manufacturing, construction and banking.

The report *Audit insights: banking* highlighted a number of issues, including:

- the need for banks to examine how their underlying business operations support efforts to restore trust;
- the need for banks to re-examine their business models in light of increased cost pressures and changing societal expectations;
- the fact that many bank key performance indicators are not based on common standards or are unaudited, so may be less comparable and reliable than they should be; and
- the need for major investment in IT infrastructure to meet new customer demands and to replace old and fragile underlying systems.

Summary of progress

There has been significant progress in the reporting about the work of auditors and audit committees and the *Audit insights* series provides a vehicle for the auditing profession to discuss in public the industry-wide and systemic issues they observe during the course of their audit work that would not otherwise be covered in their audit reports.

2.3 Dialogue with supervisors

<table>
<tr><th>2010 proposals</th><th>Subsequent actions</th></tr>
<tr><th>Supervisors and auditors should:</th><th></th></tr>
<tr><td>• meet more frequently; and
• be open in meetings and engage in constructive dialogue.</td><td rowspan="7">• Dialogue between bank auditors and supervisors has significantly improved.
• Code of practice for effective auditors-supervisor dialogue developed by UK regulators, ICAEW and audit firms, issued by the regulators, and subsequently given additional statutory backing.
• Basel Committee and EBA propose extending this internationally.
• Regular meetings now happening with chief executives of regulators, heads of audit at firms and ICAEW to discuss cross-sectoral issues.</td></tr>
<tr><th>Supervisors should:</th></tr>
<tr><td>• 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.</td></tr>
<tr><th>Auditors should:</th></tr>
<tr><td>• 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.</td></tr>
<tr><th>ICAEW will:</th></tr>
<tr><td>• work with the FSA, the FRC and auditors to develop guidance and protocols over auditor-supervisor dialogue.</td></tr>
</table>

Code of practice for auditor–supervisor dialogue

Good communication between auditors and stakeholders is an important element of an effective audit process. Bank supervisors are a particularly important stakeholder in bank audits. Supervisors have access to information that might not be available to the auditor, and also undertake their own risk assessments. The 2010 report highlighted the need to improve this dialogue so that there is genuine two-way sharing of information, for example on risks.

In the UK, there was a mechanism in place for regular meetings between auditors and banking supervisors for many years before the financial crisis. However, that dialogue had become progressively less effective in the years between the FSA taking on responsibility for banking supervision and the start of the crisis. As a result, this mechanism did not work well when it was needed, to allow auditors and supervisors to discuss their respective concerns.

ICAEW worked with the Bank of England, Financial Services Authority and audit firms to develop a code of practice for the relationship between external auditors and supervisors, which was issued by the FSA in 2011. This was adopted by the Prudential Regulation Authority, with a similar code developed and issued by the Financial Conduct Authority, when they assumed their responsibilities. The UK Parliamentary Commission on Banking Standards recommended in its June 2013 report *Changing banking for good* that this should be given statutory powers, with the PRA and FCA required to issue an annual report on communications between auditors and supervisors. This was enacted in the Financial Services (Banking Reform) Act 2013. In 2014, the Basel Committee proposed introducing a similar regime to the UK auditor-supervisor dialogue internationally and the European Banking Authority issued a consultation to introduce this across Europe in 2015. In addition, the FRC updated the guidance in Practice Note 19 on the statutory duty of bank auditors to report significant matters to the regulator, which clarified and emphasised the importance of this. This is a formal reporting requirement, mandated by law when the auditor discovers a significant issue, and in addition to the need for useful ongoing dialogue.

The issue around auditor-supervisor dialogue was not just over the frequency of meetings but the quality of discussions at those meetings. The code of practice addressed both matters and feedback from both sides suggests that there have been significant improvements. For the largest banks, there will be several meetings over the year, including at audit planning stage, during the course of the audit and after the audit report has been finalised.

Maintaining the quality of this dialogue requires continued attention to ensure that it does not relapse into its previous state of ineffectiveness. This is a particular danger when markets seem benign and there may appear to be little to discuss. Keeping regular and open dialogue in these times should mean that, when issues do arise, they are discussed more quickly. The statutory requirement for a regular report by the regulators on the quality of the dialogue provides a mechanism to ensure a continued focus on the effectiveness of this dialogue.

Wider engagement between the auditing profession and supervisors

In addition to meeting auditors of individual banks, supervisors also have regular meetings with individual audit firms to discuss issues across their banking clients. This allows sharing of confidential comparative information and for the supervisors to raise any concerns they may have over the performance on individual bank audits, or across a firm, with senior partners at the audit firm.

From 2014, ICAEW has also arranged regular meetings between the chief executives of the PRA and FCA and heads of audit of the largest auditing firms to discuss emerging issues and any areas of common, concerning the banking and insurance sectors. These meetings ensure regular engagement between auditors and the most senior level of the regulators and provides an opportunity to identify areas which the profession needs to work together to address. An example of this is ICAEW's work on assurance on bank capital ratios. We were asked to consider how assurance could contribute to increasing confidence in the system of capital ratios and over their operation. ICAEW is currently consulting on developing a consistent framework for providing this assurance.

Summary of progress

There is now regular dialogue between the auditors and supervisors of the largest banks and insurers. There was positive engagement between the auditing profession and regulators to agree a code of practice focused on how to make the dialogue more useful. There is also now regular senior level dialogue with audit firms and with the auditing profession collectively.

2.4 Support for supervision

<table>
<tr><th>2010 proposals</th><th>Subsequent actions</th></tr>
<tr><th>Supervisors should:</th><th></th></tr>
<tr><td>make better use of the s166 reporting tool to support its supervisory objectives; and
periodically require auditor reports on key regulatory returns.</td><td rowspan="5">Regulators have increased their use of the skilled person's reporting tool.
A new power was introduced for the regulators to directly commission skilled persons' reports.
ICAEW updated its guidance on reports by skilled persons in March 2012, and again in December 2014.
The PRA is developing a new written report for bank auditors to provide privately to the regulator.
The FRC issued a bulletin on auditing client assets in 2012 and an assurance standard in November 2015.
ICAEW issued guidance on assurance and benchmarks and indices in 2014.
ICAEW is consulting on a model for assurance on bank capital ratios.</td></tr>
<tr><th>Auditors should:</th></tr>
<tr><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></tr>
<tr><th>ICAEW will:</th></tr>
<tr><td>review and, if necessary, update its guidance on s166 skilled persons reports.</td></tr>
</table>

Updating skilled persons reporting

In the UK, the FSA had the power to require banks and other regulated firms to commission a special piece of work by a skilled person under s166 of the Financial Services and Markets Act 2000. These assignments could be used for a variety of purposes but were intended for areas where supervisors did not have sufficient specialist skills or capacity to undertake more detailed investigations themselves. This flexible tool was only used infrequently compared to both the number of firms regulated by the FSA and in comparison to the similar tool previously available to the Bank of England when it regulated banks prior to the FSA's formation. The 2010 report found that the FSA had not used this tool as effectively as it might have done, and in particularly might have made more extensive use of assurance to support its objectives.

The skilled persons reporting tool has increased in use since before 2010, when 20-25 reports were commissioned a year, to 95 which were commissioned in 2014/5 (the latest full year available). The Financial Services Act 2012 introduced a new power for supervisors to directly appoint a skilled person, which is in addition to the existing powers to require a regulated firm to appoint a skilled person. The regulated firm pays the fees of the skilled power under either type of assignment, but the difference is that, under the new power, the supervisor selects and contracts with the skilled person, rather than the firm doing this.

ICAEW updated its guidance on reports by skilled persons in March 2012, working with the FSA, FRC, regulatory consulting firms, actuaries and auditing firms. This update aimed to make our guidance applicable to all types of skilled persons, suggesting, for example, minimum quality control and ethical requirements. It also introduced new guidance for types of report previously not covered by professional guidance, introducing the 'review and recommend' assignment. These updates were intended to improve the consistency of approaches taken to these assignments by different professionals and make the skilled persons' reporting tool more practically useful for supervisors. ICAEW further updated this guidance in December 2014 to include, among other things, guidance on the new power for regulators to appoint skilled persons directly.

In 2015, the PRA issued a consultation to introduce a new written report from bank auditors to the supervisor, to answer questions prescribed by the regulator. This is different to the skilled persons' tool, in that the auditors of all large banks are asked the same set of questions and are required to provide a report based upon the findings of their normal audit work. Its stated intention is not to require auditors to carry out additional procedures or consider areas that would not be covered by the scope of the statutory audit.

Assurance on client assets

One area where auditors were asked to provide additional assurance in the years leading up to the crisis was over compliance with the FSA's client assets rules. The 2010 report did not identify potential improvement around client asset audits. After our report was issued, the FSA identified a number of weaknesses in the controls over client assets following the financial crisis, in particular over whether client assets were properly segregated. They also raised concerns over the quality of client asset assurance engagements and referred a number of cases to the FRC and the Recognised Supervisory Bodies for audit (which include ICAEW), which have given rise to disciplinary procedures.

The FSA and the FCA have significantly tightened the rules for regulated firms over client assets. The FRC also updated its guidance for assurance on client assets, issuing a Bulletin in 2011 which required auditors to approach their work in this area as if an entity was insolvent, rather than a going concern, emphasised the need for specialist skills and required auditors to report all breaches without considering materiality. The FRC subsequently developed a new assurance standard for reporting on client assets to the FCA, which was issued in November 2015. This new guidance makes a client assets assurance engagement significantly more demanding and now involves a significant amount of assurance work in its own right.

Assurance on bank capital ratios

The 2010 report noted that bank capital returns are not audited and that past experience of skilled persons reviewing these returns found frequent errors of varying degrees of seriousness. It suggested that auditors could be periodically asked to review these under the s166 regime. Since then, bank capital ratios have become an even more important performance indicator for banks but they remain unaudited with little use of the s166 tool in this area. Disclosures have improved over risk-weighted assets calculations and capital ratios. Various regulatory exercises have tested whether different banks' capital model would produce similar risk-weightings from the same theoretical asset portfolios. They highlighted much wider differences than expected.

Many of these are likely to be due the level of discretion allowed within the capital rules and the fact that international supervisors may be inconsistent in what they allow or require banks to use in their model designs. However, it is possible that some of these may be due to weaknesses in the operation of the capital models.

ICAEW's Financial Services Faculty was asked by the chief executive of the PRA in 2014 to consider how assurance on risk-weighted assets or capital ratios might contribute to greater confidence in capital ratios. In 2015, we published a discussion paper on this after conducting stakeholder research into what form of assurance would be useful. We are considering the responses to this consultation and, while there are some concerns over the potential costs of public assurance on capital ratios by external auditors, there was support for the development of a framework for delivering private assurance to audit committees on this important area on a voluntary basis.

Assurance on benchmarks and indices

The 2010 report recommended extending the use of assurance into new areas to support the work of supervisors. One area not anticipated at that time was the processes banks use to contribute to benchmarks and indices. The LIBOR scandal highlighted major problems in this area. The manipulation of bank submissions to LIBOR did not directly affect the books and records of those banks. As such, these processes were not covered by the financial statements audit. However, one of the solutions to the LIBOR scandal was to introduce a requirement that banks obtain assurance from external auditors on their submissions to interest rate benchmarks. Similar assurance requirements have been introduced for other benchmarks and indices, such as those produced by oil price reporting agencies.

ICAEW's Financial Services Faculty responded to this crisis by developing a framework for assurance on benchmarks and indices and issued guidance on this in February 2014 after public consultation and engagement with regulators and benchmark and index participants. This assurance provides users of benchmarks and indices with more confidence that they are subject to effective controls, governance and oversight.

Summary of progress

While there has been a small increase in the use of the s166 reporting tool, the assurance requirements over compliance with the FCA's client assets rules have been significantly strengthened and new assurance requirements have been introduced for areas such as the controls over submissions made by banks to benchmarks and indices.

3. Other reporting and auditing developments

In addition to the improvements highlighted in section 2 which take forward the issues identified in *Audit of banks: lessons from the crisis*, there have been other developments in auditing and financial reporting in response to issues identified in the financial crisis and subsequently. We highlight some of the more significant of these below.

3.1 Accounting for financial instruments

Accounting for financial instruments has been one of the most controversial and highly debated areas of financial reporting for many years. The International Accounting Standards Board and its US counterpart the Financial Accounting Standards Board reconsidered this issue in light of the financial crisis. In particular, they considered the measurement basis for financial instruments and how to introduce a more forward looking way to recognise expected losses on loans. Achieving consensus on aspects of this was not easy. The boards have clarified the basis of selection between historical cost and fair value to take more account of the business model of banks. They also considered different approaches to introducing an expected loss basis of making loan loss provisions and, ultimately, the two boards reached different conclusions based upon the feedback they received from different constituents.

The IASB lowered the test for making a provision to there being evidence of a deterioration in credit quality rather than evidence that a loss has been incurred. It also required banks to provide for losses expected in the next 12 months. By contrast, the FASB proposes to recognise immediately the full expected losses over the lifetime of loans. The IASB rejected the lifetime expected loss model as it creates notional accounting losses when loans are advanced when banks actually expect to make profits due to future income on performing loans.

The final version of IFRS 9, the new IASB standard for accounting for financial instruments, was issued in July 2014 and comes into force in 2018. The long implementation time was needed as banks need to incorporate a wider range of information into their accounting provisions including, for example, new data from their credit and risk functions. While it is unfortunate that the two boards could not agree a common solution, it shows how widely opinions varied on this topic.

3.2 EU audit reform

The European Commission, recognising the important role that auditing plays in capital markets, updated the auditing directives and regulations. The most significant of these updates were intended to improve the quality of the audits of public interest entities, including banks. They focused on concerns that conflicts of interest provided by the provision of non-audit services or very long tenures for auditors might undermine the independence and objectivity of auditors. The reforms also considered competition and choice in the audit market, particularly for the audits of the largest businesses and the potential systemic risks created in a market dominated by four large firms. The new audit regulation came into force in June 2014, with member states having a further two years from that date to implement the directive.

More restrictions on non-audit services

Independence is considered a key ethical requirement for auditors. Auditors have been subject to restrictions on the types of services that they are allowed to provide to their audit clients for many years. These were strengthened in the years before the financial crisis as a result of reforms made after various accounting scandals in the early 2000s such as Enron, WorldCom and Parmalat. These include requiring all non-audit services provided by the auditor being subject to approval from the audit committee.

The EU audit reforms impose further restrictions on the non-audit services that may be provided by auditors to their audit clients. There is an outright prohibition on certain non-audit services being provided to public interest entities an auditor audits, including providing specific tax advice, consultancy and advisory services and being involved in the management of the entity.

Auditors are still able to provide other non-audit services to entities they audit, but these are subject to a cap of 70% of the audit fee, averaged over three years. Defined permitted audit services, such as those auditors are required to provide by legislation, do not count towards this 70% cap.

Mandatory auditor tendering

The European Commission considered various potential changes to address concerns over the structure of the audit market. The options considered but not adopted included joint audits (where two audit firms jointly issue an opinion), co-audits (where two audit firms audit different parts of a business and issue individual opinions), and mandatory rotation of audit firms. Instead, the Commission introduced a requirement for public interest entities to put their audits out to tender at least every 10 years.

The FRC, in its 2012 update to the UK Corporate Governance Code, introduced 10-year audit tendering in advance of the EU. This is on a 'comply or explain' basis, where boards which choose not to follow this principle are required to explain publicly why they have not done so.

Although businesses were given a number of years to have their first tenders, in practice a number of the largest banks put their audits to tender early. While incumbent auditors are allowed to take part in audit tenders, none of the largest UK banks have retained their auditors after a tender process. Changing auditors creates some practical challenges for banks and their auditors. For example, maintaining audit quality through a transition requires cooperation between incoming and outgoing auditors.

3.3 New disciplinary powers over financial services auditors

The Financial Services Act 2012 introduced extended disciplinary powers in the UK for the FCA, PRA and Bank of England to directly impose sanctions on auditors for failure to comply with rules set by those regulators. These were in addition to the disciplinary powers already held by FRC and the Recognised Supervisory Bodies (RSBs) including ICAEW.

Prior to the 2012 Act, the FSA had the power to disqualify an audit firm from auditing regulated financial businesses. This was seen as too blunt a tool to be useful, particularly for the four largest audit firms which conduct all of the largest audits. In practice, the regulators instead had to refer any concerns they had to the FRC or relevant RSB. The extended powers allow the regulators to directly apply a range of sanctions to auditors, including censure, fines and disqualifications from auditing classes of regulated businesses. These new powers have yet to be used and their use will need to be coordinated with the FRC and RSBs to avoid double or triple jeopardy over multiple disciplinary cases being brought on the same concern.

4. The future of bank reporting and auditing

The accountancy profession needs to continue challenging itself to ensure that bank stakeholders have the information they want and the assurance they need to instil confidence in the sector. This not only involves looking for continuing enhancements in the quality of reporting and auditing, but also a focus on relevance.

The profession must continue to reflect upon and respond to the concerns of audit regulators. Although there have been improvements to the auditing process, the results of audit monitoring reports from the FRC and IFIAR show there are still areas for further improvement, particularly around the international consistency of the quality of auditing. Given that the audits of the largest global banks are undertaken by global audit networks using international standards, consistency should be achievable.

Addressing technological developments

Banks and other companies are asked to provide more and more information. This reflects the phenomenon 'big data'. Technological advances which allow more granular information to be produced and analysed by companies. These advances also allow efficient processing of more detailed data by analysts and readers of financial information, and for different types of information to be combined in new ways.

While there has been a steady increase in the number of disclosures contained in audited financial statements, there has been a much more rapid increase in the disclosures made outside financial statements, either in other sections of the annual report or as separate, standalone disclosures. This is particularly true of banks.

Technological and disclosure developments create two challenges. The first is to make sure that annual reports remain understandable to the general purpose users. The second is to question whether the concept of audited annual reports remains relevant to user needs. The annual report was developed at a time when accounting ledgers were hand-written and when processing accounts was a manual process. In a digital age when financial markets can process and trade on information in a fraction of a second, a different model may be needed.

New technologies also open up new techniques for auditors. Computer-based auditing techniques have existed for many years but advances in processing power and techniques create opportunities for new auditing tools. For example, they may allow an auditor to test 100% of a large number of transactions for the same effort as more traditional techniques which only tested a sample.

Remaining relevant to user needs

Reporting and auditing need to evolve to respond to these challenges and opportunities if they are to remain relevant. Stakeholders will still need high-quality information on the financial performance, position and prospects of companies, as well as on other matters such as their social and economic impacts. However, they may demand that information more quickly and in a form that more readily facilitates speedy analysis. There is also likely to be demand for external, independent checks that the information provided is complete and accurate, until we reach the point that external stakeholders can easily check this themselves.

In the future, user demand may be for companies to provide real-time information and for auditors to provide ongoing assurance on the quality of that information. We have not yet reached the point where it is possible either for banks to provide the level of information required on a real-time basis at a sufficiently high quality, or for auditors to provide assurance on this. However, it is likely that this will become possible in the not too distant future.

While looking ahead to future needs, the profession also needs to respond to more immediate challenges around maintaining and enhancing audit quality. This report does not seek to identify particular areas for improvement in bank reporting and auditing. It reports instead on what has happened since 2010. However, ICAEW will be carrying out further work in this area and, in 2016, the Financial Services Faculty will start a project to identify key questions that the accountancy profession should be considering and then developing proposals to answer those questions.

Our 2010 report identified areas for improvements that were specific to banks. The matters noted above apply equally to many other business sectors. We will therefore explore whether there are further bank-specific matters for development or whether the most important questions are broader ones calling for common solutions across different sectors.

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