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29<sup>th</sup> September 2010

Dear Ms Sucher and Mr Grabowski

**Discussion Paper 10/3 Enhancing the auditor's contribution to prudential regulation**

PricewaterhouseCoopers welcomes the opportunity to comment on the above discussion paper. Our response below is divided into two sections, this letter which deals with our general observations and the Appendix in which we respond to the specific questions posed in the discussion paper.

**Lessons from the crisis**

We believe that in the wake of the financial crisis it is important for all stakeholders to understand the lessons to be learned and this includes auditors. It is important that those to whom an audit report is addressed have confidence in that report. We recognise that, in the aftermath of the crisis, stakeholders and policy makers are questioning whether the audit, in common with other important elements in the corporate reporting chain and corporate governance framework, should make a greater contribution to the strength and stability of the markets. We therefore welcome the initiative of the FSA and FRC in launching this consultation as a significant contribution to the debate.

The paper covers a wide range of issues and there are a number of proposals in the discussion paper which we support. These include a greater level of dialogue between firms, auditors and regulators, though we believe that the dialogue between the auditor and the regulator should be a two-way dialogue with the FSA also sharing its insight and current concerns regarding the firm and the industry.

There is a significant degree of overlap with the ICAEW's recent paper entitled 'Audit of Banks: Lessons from the Crisis.' We contributed to that paper and support its recommendations in full. Hence, we believe that more can be done by auditors to explain at a

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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.<sup>1</sup> Provision of this information to investors will increase transparency around audits and give investors more confidence in audited information.

In addition, the ICAEW report discusses whether auditors could provide greater assurance on matters outside the statutory audit framework, for example, on aspects of the front half of annual reports. We would welcome a wider public debate to help establish a coherent corporate reporting framework designed to provide high quality disclosures that will further enhance users' understanding of an entity's financial position, risk profile and future viability. Any debate on an enhanced reporting framework should include discussion of how audit may also be enhanced to provide assurance over additional disclosures where appropriate.

Whilst the FSA/FRC paper raises important issues, there are areas where we have significant concerns with the proposals. We would also like to understand better the basis and evidence supporting some of the assertions underlying the paper.

### **Professional Scepticism**

Professional scepticism is central to what auditors do. We believe that the paper illustrates that there is a need for a public debate on professional scepticism and we welcome this. This debate has been initiated by the APB in its recent Discussion Paper, 'Auditor Scepticism: Raising the Bar'. There seems to be an emerging view amongst regulators that insufficient scepticism was demonstrated by bank auditors during the crisis, despite the lack of any compelling evidence to support this view, and despite the fact that in the early months of the crisis the profession was publicly commended for being swift to put out additional guidance on difficult areas such as asset valuation and impairment.

Scepticism is difficult to demonstrate. In reality, it is applied real time in an audit and is both a cultural and behavioural issue.

We believe that the auditor's role is to ensure that management has appropriate robust evidence to support its assumptions - not to present an alternative view with the aim of persuading management to accept it as better than theirs. It is also not our role to approve transactions, only to ensure they are properly accounted for and appropriately disclosed in the context of the financial statements as a whole. The Companies Act only requires that financial statements show a true and fair view not the true and fair view. We will respond to the APB consultation in due course but wonder if the specific concerns of the FSA which are noted in this paper can, at least partially, be addressed through bilateral meetings with the auditor.

### **Disclosures**

Similar to the FSA Discussion Paper 09/5 Enhancing Financial Reporting Disclosures by UK Credit Institutions, a number of concerns are expressed about the quality of disclosures in bank annual reports. It is not entirely clear from the paper whether these concerns stem from a belief that:

- Existing accounting standard disclosures are inadequate;

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<sup>1</sup> ICAEW Paper 'Audits of Banks: Lessons From The Crisis' - Section 2,2

- The major UK banks are not adequately complying with IFRS disclosure requirements for material issues/transactions;
- Generic accounting standards are insufficiently detailed for a specialised industry like banking and therefore IFRS should be supplemented by some form of industry guide; or
- The disclosures required by accounting standards are not providing the market with sufficient information to enable it to determine what actions it wants to take.

The paper would benefit from greater clarity as to how the FSA sees its concerns fitting into the overall framework of financial reporting standards and guidance.

### **Valuations and impairment**

We also have concerns regarding the assertions made relating to valuations and impairments. The paper sets out the FSA's concern that the dispersion in valuation is too high whilst acknowledging that the differences highlighted are generally not material to the financial statements as a whole. The FSA/FRC seem to be looking to auditors to force firms to amend valuations to what can only be assumed to be a consistent and more conservative position. We have highlighted in detail in the Appendix to this letter why this is not appropriate and believe this is more an issue for prudential standards than financial statements.

### **Regulatory oversight of auditors**

Our final key area of concern is regarding the proposal that the FSA needs an enhanced range of enforcement tools in relation to auditors. The oversight of audit firms has been the subject of much debate in the recent past and we believe that there is an existing framework which is robust and working well. We do not see the need to amend this framework to a regime which may produce uncertainty regarding who will be overseeing the work of auditors.

We would be happy to discuss our comments further, as well as any other matter included in the paper that we have not commented on. Please contact Richard Oldfield (020 7804 4788) or Anne Simpson (020 7804 2093) should you wish to discuss or clarify any matter in this response.

Yours sincerely

*PricewaterhouseCoopers LLP*

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**Appendix: Responses to specific questions**

**Chapter 1**

**Q1 In addition to the matters set out in this paper, are there any other matters you would like to raise concerning the auditor's contribution to prudential regulation?**

We believe that the paper sets out many of the matters which should be discussed when considering the auditor's contribution to prudential regulation. The ICAEW paper entitled 'Audit of Banks: Lessons from the Crisis' provides a comprehensive look at the relevant matters concerning the audit of banks. We participated in this study and we support its conclusions. The ICAEW paper highlights matters in addition to those included in this paper. These include matters such as the presentation of risk information, audit reports, information included in the front section of annual reports and greater assurance outside the audited financial statements (for example over the front section of the annual report). We encourage the FSA and the FRC to consider the recommendations of the ICAEW paper in developing the framework for auditor contribution to prudential regulation.

**Chapter 3**

**Q2 Given that professional scepticism on the part of firms' auditors is especially important in their audit of key areas of judgement in relation to accounting estimates and related disclosures, how could the requirement for professional scepticism and its application in practice be enhanced in these areas?**

It is well recognised that professional judgement permeates the auditing process. For many years, auditors have been required to adopt a sceptical mindset when exercising that judgement in planning and performing an audit.<sup>2</sup> Our belief is that professional scepticism has been applied and whilst practical application of this requirement is inevitably judgemental and will vary according to circumstance, we are not aware of a significant body of evidence which would indicate that professional scepticism has not been applied by bank auditors.

We agree the application and interpretation of professional scepticism is a critical component of an audit and, even though we do not consider there to be an issue in practice, given the fact that concerns have been raised by regulators we believe it is appropriate to have a debate about what professional scepticism means in the current accounting and auditing environment.

A broad debate has been initiated by the APB. We believe it to be the appropriate coordinator for this discussion. The application of professional scepticism applies to all UK audits not just those which are for firms regulated by the FSA. Any changes to audit guidance should be determined in that forum and then further discussed with the IAASB to determine whether changes to the auditing standards are required. A consistent global approach should be maintained on matters relating to auditing standards.

The financial statements, and audit thereof, are a key input to prudential returns in which the FSA has an obvious interest. It is therefore important that the FSA makes its views known to

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<sup>2</sup> ISA 200 (revised and re-drafted) Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing – Paragraph 15

the APB to allow them to formulate the debate and response. For the audit of banks we believe bilateral meetings with auditors provide an appropriate forum for the FSA to raise any questions or concerns it has in relation to the audit approach and professional scepticism of the auditor. Accordingly, the FSA already has an excellent opportunity to challenge the application of professional scepticism in the audit process.

**Q3 Do you agree that management and auditors should pay particular attention to the provision of disclosures about management's key judgements, especially in cases where other specific disclosures required by the accounting standards may not fully inform users about the economic substance of a transaction, or about a firm's financial position and performance more generally?**

We first set out some context to our response. We have then considered the individual parts of the question and finally set out some additional thoughts regarding the FSA's background information and assumptions included in chapter 3.

**Context**

The statutory requirement that UK financial statements show a true and fair view has been an overarching concept for many years. Accounting standards provide that the substance of the transaction is more important than the legal form, when this is material. We believe these obligations are generally applied in practice.

We have concerns that, the FSA in particular, is looking for a level of detail which may be appropriate in the context of prudential regulation but which may not be of use to shareholders and other stakeholders if it is not material to the picture presented by the financial statements taken as a whole – including the business review. Should the FSA wish to obtain detailed information to discharge its supervisory responsibilities then the regulatory framework already exists for it to obtain that information.

We are also concerned that the focus on disclosures during the financial crisis in some way implies that with greater levels of disclosure, the crisis would have been averted or lessened. We do not support this view and would highlight that financial statements provide an historical perspective on performance and do this only twice a year (with the half year regime being less onerous).

**Financial Statement Disclosures**

We fully agree that management and auditors should pay particular attention to the provision of disclosures about management's key judgements. We also support the disclosure of the economic substance of a transaction and believe that this is currently required by accounting standards. Therefore, we do not believe that there should be any situations under the existing framework where the users will be lacking any material information regarding the overall nature of transactions. This is particularly the case given the requirements in IAS 1 regarding the fair representation of accounts which requires 'additional disclosure when necessary'<sup>3</sup>. We believe this is generally applied well in practice as evidenced by the many pages of additional disclosures made by the major banks in 2008 and 2009.

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<sup>3</sup> IAS 1 - Presentation of financial statements – Paragraph 15

This principle is further endorsed within the Clarity ISA framework<sup>4</sup> as it specifically states that the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved even where the disclosures are in accordance with the applicable financial reporting framework. It must, however, be remembered that the audit report is not a report on individual transactions or balances rather a report on the truth and fairness of the financial statements taken as a whole.

Throughout the financial crisis, banks significantly increased the disclosures included in their financial statements. This was reactive to the market conditions, without necessarily a consistently applied approach throughout the industry. We support the ICAEW view that the development of guidance should be a collaborative exercise between the industry and auditors. In this context, any new requirements incorporated into the current reporting framework should be balanced so that only information material to the users of the financial statements is disclosed rather than simply adding to the already significant level of disclosures given.

### **Directors' Report / Risk Disclosures**

The final part of the question considers a 'firm's financial position and performance more generally'. It is difficult to determine what exactly is meant by this, however, we believe that there is a debate to be had in relation to risk management disclosures and perhaps the development of a framework for a 'risk statement'.

There has been a substantial improvement in the disclosure of risks arising from financial instruments over the past three years. However, this has been achieved at the cost of lengthening financial statements and, to a degree, making them more complex.

As firms vary significantly in their business models and risk profiles, the usefulness of disclosures will differ both from firm to firm and from period to period. It is important to avoid an overload of detail that masks the overall picture and there is a tendency that once a particular disclosure has been mandated it is repeated in future years even if its relevance declines. For the same reasons we believe that disclosure requirements should remain principles based, allowing flexibility rather than based on a template model. The British Bankers Association Code for Financial Reporting Disclosure is a good example of the articulation of a set of principles for good disclosure and we support the FSA's positive response to the use of the voluntary Code as highlighted in the FSA's feedback statement to DP09/5.

### Risk statement

We support the recent ICAEW paper<sup>5</sup>, which suggested the use of risk statements that would clearly set out 'key issues for users to consider in order to understand the business'. This would help to improve the presentation of risk information and would bring it all into one place in the financial statements.

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<sup>4</sup> ISA 540 (revised and re-drafted) - Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures, – Paragraph A122

<sup>5</sup> ICAEW Paper 'Audits of Banks: Lessons From The Crisis' - Section 1.1

The extent to which auditors would be involved in these risk statements should be discussed. The exact form of this reporting and the nature and extent of additional liabilities imposed on the auditor as a consequence would need to be addressed.

### Additional comments

Question 3 raises some important issues. However, there are also comments included in Chapter 3 that are not captured by this question and we set out below our thoughts on some of these.

- Fair value – we have concerns regarding the discussion about certain aspects of fair value accounting, as follows:

1. Statements concerning valuations which are within an acceptable range.

We are concerned that the paper infers that there is ‘one answer’ to the question of where within that range a firm determines that the valuation falls. We do not believe this is the case and we also do not consider that it is the role of auditors to try to narrow what is considered to be the acceptable market range. In many cases, the market range exists because market participants are willing to pay different prices for the same instrument. If it is the case that the FSA believes there should be a particular range or methodology applied to valuation for the purpose of regulatory reporting, then it might be more appropriate for the FSA to provide guidance in that context.

2. Prudence in valuations.

We are also concerned that the approach in the paper (as highlighted in the prudential rules and reiterated in the FSA Discussion Paper 10/4 – The Prudential regime for trading activities) is to require firms to take a prudent approach to valuation. Whilst this is appropriate in the context of prudential regulation, accounting standards do not allow the application of such a bias in the preparation of financial statements and indeed provide for no specific allowance for ‘prudence’ e.g. no block discounts<sup>6</sup>.

3. Auditors’ views on valuations.

We have inferred from the paper that the FSA would encourage us to share our experience from one client who has taken one approach to valuation with another client (albeit not specifically naming them) where there is a disparity in the valuations of the same instruments with a view to amending one value to the more prudent approach. There are three significant difficulties with this:

- To avoid inadvertent client confidentiality breaches, it will typically not be appropriate for detailed information to be shared amongst client engagement

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<sup>6</sup> IAS 39 Financial Instruments: Recognition and Measurement para AG 71 - 73

teams and indeed many audit firms will not have a large enough client base which has similar financial instruments for them to know which valuation is 'better'.

- By prescribing alternative valuations to management when management's valuation is acceptable and fully supported by adequate evidence the firm is adopting the valuation of the auditor. This removes from the directors their statutory obligation to produce financial statements which in their opinion show a true and fair view. This would also create challenges to auditor independence.
  - Illiquid markets, by their nature, produce a range of valuations.
4. Consistent approaches to valuations.

Whilst auditors have access to the approaches of their clients, the FSA has oversight of the valuations used by all firms. Should the FSA determine that one approach is most appropriate for the purposes of prudential regulation we believe that it is in a better position to mandate this for supervisory purposes alone.

- Loan loss provisions. The paper notes concern over loan loss provisioning levels whilst also noting that despite these concerns they 'may be' in compliance with accounting standards. The nature of the incurred loss model included in IFRS will mean that credit losses booked reflect economic conditions at a point in time and a deterioration to these conditions will mean that additional losses will be recorded when a loss event is considered to have occurred. If there is a concern on this attribute it is the accounting standards that need to be addressed (and indeed changes are currently being considered by the IASB in this area) rather than their application in practice.
- Materiality. The paper provides specific examples of concerns with the scepticism applied by auditors. However these are not put into any context, in particular whether these issues were material to the financial statements as a whole.

Materiality is a vital consideration in the audit process and in rendering an opinion, the auditor will consider the materiality of any particular issue to the truth and fairness of the financial statements as a whole – the auditor is not required to report on the truth and fairness of individual balances and transactions. Where the FSA would like a firm to take a different approach to materiality either as a whole or in connection with individual transactions or balances for the purpose of prudential regulation (for example regarding the appropriateness of the individual and collective assessments of loan impairments) then the FSA should mandate this solely for purposes of prudential reporting.

#### **Chapter 4**

##### **Q4 Do you agree with our proposal to enter into dialogue with firms' audit committees and auditors as set out above? If not, why not?**

We believe that audit committees generally adopt a diligent approach to the requirement under the FRC guidance to assess the qualification, expertise and resources, and independence of

the auditor and therefore they may welcome the views of the FSA. It is important that in communicating these views to audit committees (or management) the supervisors charged with such discussions provide evidence based comments and observations.

Whilst we have no objection to the FSA sharing information with audit committees and auditors as proposed, there is already a framework for the audit committee to receive independent feedback from the regulators on the auditor. Since January 2008 the AIU has issued reports on individual audits it has reviewed to the relevant audit firms with a view to them being made available by the auditors to the directors (and audit committees) of the audit clients concerned. To the extent that the remit of the FRC is expanded (as noted in our response to question 5 below), we wonder if a more complete 'regulators' view' could be given through this report which will presumably also report on the matters included in the widened scope.

**Q5 Do you consider that it would be appropriate to widen the scope of the FRC's independent monitoring arrangements? If so, what additional work do you believe should be covered by these arrangements?**

We believe that there is already sufficient independent monitoring performed by various bodies (including the FRC and CCAB member bodies) covering the main areas of work performed by the accounting firms. However, if the FRC considers certain forms of public reporting, such as on interim financial information, reports on regulatory returns and other reporting on which the FSA relies, to be of public interest, then some widening of scope could be appropriate.

We consider that any widening of scope should be carefully assessed, taking into account the specific circumstances of the work being undertaken and the benefits to stakeholders. Reporting on interim financial information, for example, shares many characteristics with work carried out on statutory audits in its function, its stakeholders and its periodic nature which makes it suited to retrospective review. In contrast, investment circulars are, by their nature, transaction-specific documents which are subject to significant contemporaneous oversight (and approval) by the FSA, together with the active involvement of the FSA-regulated sponsor.

The nature and function of financial information in an investment circular is notably different from that of periodic financial reporting; for example, typically much of the financial information reported on within an investment circular is based on existing financial information which has previously been audited and so is already subject to oversight. We do not believe that the investment circular contains reports on financial information which would typically be used in prudential regulation. In overall terms, we believe that additional oversight would not provide any significant benefit in the context of investment circulars as the interests of stakeholders appear to be covered adequately under the existing regime.

**Q6 Do you believe that the FRC's powers should be improved in scope and clarity, and its resources increased, to conduct investigations in a short timeframe in relation to areas of concern?**

We believe there is a framework in place that is working to allow investigations to be conducted and it is not clear to us what is meant or what would be achieved by '*improving the scope and clarity of the FRC's powers*' nor by the term '*areas of concern*'.

We consider the question of resources to be an internal matter of strategy and funding for the FRC and given our uncertainty regarding what is being proposed we are unable to comment further. The FRC has a well established process for consulting on any changes and any such proposals should be subject to that due process.

**Q7 Do you think the FSA should seek an enhanced range of enforcement tools in relation to audit firms as described above? If so, do you think that there should be powers to take enforcement action against individuals within an audit firm as well as the audit firm as a whole? If not, why not?**

We do not believe the FSA should seek an enhanced range of enforcement tools as suggested. There are already sufficient existing enforcement tools over the accounting profession (both firms and individuals) as noted in the paper. The FSA and other regulatory bodies have gateways to exchange information effectively. They are used in practice.

The FSA has extensive statutory powers over the firms that it regulates. In general, as in the financial services sector, the statutory framework for regulating professions operates on the basis that the regulator for the profession is the appropriate body to assess and instigate disciplinary action. We see no justification for an exception to this principle being made and would question whether it would be cost effective for the FSA to expand its resources to cover the ability to discipline auditors when there is already a regulatory body that has that remit.

Depending on the nature and extent of the FSA's concerns regarding the performance of an audit, the FSA should raise these concerns directly with the senior management of the audit firm in the first instance and then if still unsatisfied invoke the pre-existing procedures for dealing with a complaint as to the conduct of the accountant.

**Chapter 5**

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

We fully support an increase in both bilateral and trilateral meetings between the firms, auditors and the FSA. To make these meetings most effective, they would need to be at appropriate times in the firm's annual cycle and must be mutual in terms of information sharing (recognising that there are some limitations as noted in Question 9 below).

Each year we believe a plan should be put in place for the high impact firms concerning the engagement between the firms, auditors and FSA. Depending on the specific firm's circumstances the plan should include the frequency and timing of meetings and potential topics to be considered. This should be shared and agreed amongst all parties.

We note that, in addition to the potential additional costs incurred by auditors, there might also be additional costs for the FSA.

**Q9 Are you aware of any significant barriers to mutual information sharing between auditors and the FSA, and, if so, what should be done to remove them?**

We welcome additional sharing of information given that the FSA has valuable insight across the market. Such information sharing occurred regularly in the past but has reduced in recent years. We believe it is a positive step to reinstate more frequent meetings.

Auditors have a statutory obligation to report matters of material significance to the FSA. No duty to which the auditor is subject is contravened by communicating in good faith to the FSA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA. Also, Auditing Standards expand on our statutory responsibility to report to the regulator on any significant matters<sup>7</sup> and therefore we do not perceive any significant barrier to information sharing with the FSA. In addition, the APB has recently consulted on revised guidance on the auditors' rights and obligations to report to regulators in the financial sector, within its recent Exposure Draft, Practice Note 19<sup>8</sup>. This revised guidance now includes examples of the types of issue that should be reported under the existing legislative framework and we believe this illustrates that the current framework is sufficient.

Whilst in principle we are happy with the concept of sharing information with the FSA, we are troubled by the statement that 'where there is a concern, the default should be to share the information unless there are restrictions that would prohibit this'. This will be difficult to apply in practice as we will not determine the extent of our concern until we have performed a certain level of investigation. This also risks creating a barrier to a constructive but challenging audit relationship if firms are concerned that any potential issue (whether justified or not) will be immediately shared with the FSA.

We would also note that there is currently an imbalance, given that there is no duty for the FSA to pass on information to auditors that may be material to the audit. Our understanding is that the FSA can disclose any information to an auditor to enable them to fulfil their statutory duty or to assist the auditor to discharge the functions conferred by or under FSMA<sup>9</sup>. The only potential restriction we are aware of is relating to information provided by an overseas regulator to the FSA where there is a restriction on subsequent disclosure. We recognise that this may be a barrier to some information sharing. The recent ICAEW paper<sup>10</sup> discusses this issue more fully and concludes 'we would advocate a change to the legislation to impose a reciprocal duty upon bank supervisors to share information directly with auditors'. We share this view and it would help to ensure good quality dialogue between supervisors and auditors.

## **Chapter 6**

### **Q10 In what ways should the use of s.166 SPRs be developed so that they are of greatest benefit in terms of the FSA's statutory objectives?**

It is important that the FSA has, in its toolkit, the ability to commission work from a skilled person before a problem occurs or to investigate after a problem has occurred. In this regard we support the increased and more effective use of s.166 reports. Whilst the ICAEW<sup>11</sup> noted in their report on the banking crisis earlier this year, the infrequent use of such reports does not necessarily link to a weakness in the supervisory process itself, there is an acknowledgement that the FSA's current resources would not enable it to perform the scale of on-site work seen in other territories e.g. in Spain and the USA. By using skilled persons to perform thematic reviews, the resource available to the FSA could increase significantly.

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<sup>7</sup> ISA 250 (re-drafted) Consideration of laws and regulations in an audit of financial statements – Paragraph 28

<sup>8</sup> ASB's Exposure Draft – Practice Note 19 - ISA (UK and Ireland) 250: Section B – The Auditors' Right and Duty to Report to Regulators in the Financial Sector

<sup>9</sup> Reference the Financial Services and Markets Act (Disclosure of Confidential Information) Regulations 2001

<sup>10</sup> ICAEW Paper 'Audits of Banks: Lessons From The Crisis' - Section 3.2

<sup>11</sup> ICAEW Paper 'Audits of Banks: Lessons From The Crisis' - Section 4.1

We consider that the use of s.166 SPRs could be best developed 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. This would allow the FSA to obtain more timely insight into the areas it is interested in within the industry on a targeted basis. The additional dialogue with firms that was discussed earlier in the paper would help the FSA to identify the areas where they would like to focus these reviews. Other uses are also discussed in the questions below.

One potential concern regarding a widespread increased use of s.166 reports is that they are costly to our clients and the industry as a whole. Ensuring that the s.166 tool is used in a targeted and risk based way with clear terms of reference without automatically commissioning a report every year would help to minimise additional costs while increasing the quality of the overall reporting to the FSA.

**Q11 Would some form of external assurance on regulatory returns be helpful in ensuring that data in returns is complete and accurate? If so, why, and would greater use of s.166 RARs be preferable to introducing an audit requirement for all returns?**

We share the view of the ICAEW that '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'<sup>12</sup>.

We believe the form of periodic assurance would be best suited to a s.166 report, rather than a full audit. In addition, we consider a targeted risk based approach for the review of specific regulatory returns, as opposed to a blanket introduction across all returns would be the most efficient and effective. In our experience of reviewing such returns we regularly note errors. The use of s.166 reports is also a more cost effective way of obtaining periodic assurance.

As noted in the paper this is different from the regime currently in place for insurance companies where regulatory returns are audited each year. We understand this is because the content of these returns is public and considered to be of such importance from an investor's perspective that an annual audit is desirable. Given that regulatory returns of insurers are well established public documents and are widely used, we concur that their routine audit strengthens market confidence. By contrast, the banking returns are not published and hence our view is that the periodic s.166 review is more appropriate in these circumstances. Should this position change this would need to be reconsidered.

**Q12 Do you believe there could be benefit in auditors providing additional direct reports to the FSA? If so, what should these reports cover? What do you consider would be the additional costs of such reporting?**

We see the benefit of additional reporting to the FSA particularly in the areas of business model, systems, controls, risk management and governance where this is in relation to prudential reporting. This is likely to involve a significant cost as these may not have been considered as part of the process of auditing the financial statements. We believe that the requirement for this reporting should be risk based and scoped as a result of bilateral (or trilateral) meetings.

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<sup>12</sup> ICAEW Paper 'Audits of Banks: Lessons From The Crisis' - Section 4.2

We believe that our papers to the audit committee (which are available to the FSA) already cover areas of significant accounting judgements which materially affect the firm's results and financial position, as well as the identified weaknesses in the internal control environment resulting from our audit of the financial statements. Whilst we believe that there are other areas where additional reporting could be provided by the auditors, this would need to be considered within the broader context of other information already available to the FSA, the additional benefit the reporting would provide and the reporting framework.

The cost of providing these additional reports could be significant and hence the cost/benefit analysis of such reporting would need to be considered carefully.

## **Chapter 7**

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

An audit would increase confidence in the numbers being provided. However, we support the sentiment in the paper and the ICAEW research that a case has yet to be proved for the audit of Pillar 3 disclosures and hence incurring additional costs. We believe that this should be kept under review as firms, stakeholders and market participants become more accustomed to the Pillar 3 reporting and the extent of reliance on the information becomes clearer.

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

The proposed regulatory information for insurance companies is adding to public information already in the insurance annual returns, which is widely used and has been for a number of years. Stakeholders, including the FSA, have already demonstrated a clear appetite for this information to be subject to audit. We are supportive of this provided the information is "auditable" and the costs are proportionate to the benefits. Because the information given by banks under Pillar 3 is in its infancy, and is not adding to an already established framework, the use of this by market participants is as yet unclear and so to introduce an audit requirement would seem to be a premature and costly decision. We believe the different approaches are currently justified but the audit of Pillar 3 information for BIPRU firms should be kept under review.

### **Q15 To what extent do you believe external audit of information linked to the regulatory capital numbers in the annual report, which is not covered by accounting standards, should be audited, and why? What do you consider would be the additional costs of such reporting?**

We recognise the importance of the capital and risk numbers to stakeholders and therefore support the need for increased focus on them. We think that these issues should be considered as part of the consideration of the content to be included in the risk statements noted in Question 3 above. This might be considered in the context of the overall wider debate on the reporting model that we suggest in our covering letter.

The audit of regulatory capital ratios could involve a significant cost because the RWA systems and controls are generally separate from financial reporting systems and are therefore not considered as part of the audit of the financial statements.