

AUDIT, SUPERVISION AND RISK IN FINANCIAL SERVICES

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AUDIT, SUPERVISION AND RISK IN FINANCIAL SERVICES

by

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FOREWORD

The financial crisis brought to the fore public and governmental concerns over the audit, regulation and supervision of financial services. One of the major initiatives undertaken in the UK following the crisis was the re-establishment of the links between supervisors of the financial services firms and their auditors. This is an ongoing initiative, with the Prudential Regulation Authority (PRA) recently publishing a consultation paper on the engagement between external auditors and supervisors.

It is within this context of regulatory change and public concern that this research project was undertaken to investigate the changes to the relationship between external auditors and supervisors of financial services firms, the impact of the financial crisis on risk governance in financial services firms, and the key accounting and auditing judgements of financial services firms. A series of interviews was conducted to gather the views of auditors and representatives of financial services firms on these issues. With a period of significant change continuing to occur within the sector, the findings from the research are linked to current developments and proposals for change, including the PRA consultation on the engagement between external auditors and supervisors and the changes to audit reports initiated by the FRC and followed by the IAASB.

The research finds widespread support for the re-invigoration of the relationship between auditors and supervisors, recognising that this is an evolving process. However, some concerns were expressed about supervisors trying to impose their views on accounting and auditing judgements, when this responsibility ultimately rests with the firm and their auditors. Interviewees confirm the rapid growth of the risk management function in financial services, including the establishment of risk committees and the changing nature of internal audit. The demarcation of issues between the risk and audit committees was sometimes an issue, although this was resolved by over-lapping membership. Whilst auditors have been criticised publicly for a lack of scepticism this was not borne out by interviewees from either the auditors or financial service firms.

The report concludes with a series of recommendations, including: support for the PRA's proposal for written reports from the auditors to the PRA; a recommendation that more information on the auditor-supervisor dialogue is included in the extended auditor's report; the formal monitoring of compliance with the Chartered

Institute of Internal Auditors (CIIA) internal audit code for financial services firms; and consideration of the establishment of specialist qualifications for auditors of UK banks and building societies.

The Research Committee of ICAS has been pleased to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the results of this research will be of benefit to supervisors and regulators operating within the financial services sector.

Allister Wilson
Convener of ICAS Research Committee
June 2015

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Finally, the Research Committee and researchers are grateful for the financial support of The Scottish Accountancy Trust for Education and Research (SATER), now known as the ICAS Foundation (charity registered in Scotland SCO34836). Without this support, exclusively from the SATER funds, the research would not have been possible.

EXECUTIVE SUMMARY

The financial crisis, beginning in 2007, called into question the role of auditors, supervisors and the nature of financial risk. Auditors were criticised for giving no warning of the financial crisis, for failing to communicate with supervisors, and for not exercising a sufficient degree of professional scepticism. Similarly, supervisors were criticised for a lack of communication with auditors and, more fundamentally, for inadequate supervision of financial services firms. The role of fair value accounting and, in particular, the apparent downgrading of the accounting concept of prudence, were also blamed for contributing to the crisis. Concerns were also raised about auditors' and supervisors' assessments of risk, especially of systemic risk, and about the risk governance of financial institutions.

This project investigated the role of auditors and supervisors in the system of UK and EU financial services supervision as it emerged post-financial crisis. In particular, it focused on three areas: liaison between auditors and supervisors; monitoring and reporting of risk; and accounting and auditing judgements in financial services audit. The objective of the project was to understand the evolution of these complex roles following the financial crisis and to provide policy recommendations.

The key themes investigated were:

- Changes to the relationship between external auditors and supervisors of financial services firms.
- The impact of the financial crisis on risk governance in financial services firms.
- Accounting and auditing issues emerging from the financial crisis, including professional scepticism, prudence, and accounting and auditing judgements.

Research approach

The project was undertaken in three stages. Stage one of the project involved a review of regulatory and other documentation, including official reports and inquiries into the causes of the financial crisis, in particular focussing on the role played by auditors and supervisors, accounting issues and conceptions of financial risk. In addition, the literature review was used to identify changes to accounting, audit, regulation and risk requirements following the financial crisis.

Stage two of the project involved an empirical investigation of the issues emerging from a pilot study, the review of regulatory and other documentation, and a previous ICAS (2005) study *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision*. In all 40 face-to-face interviews were conducted, involving 42 interviewees, between July 2012 and January 2014. Interviewees included: audit partners (20); and representatives of financial services firms (executive directors, non-executive directors, senior managers) with functional responsibility for finance, risk, internal audit or chief executive officers (22). Interviews were largely undertaken in the UK (29) with a further 11 interviews taking place in Belgium and the Netherlands. Interviews were semi-structured and typically lasted about an hour. Interviews were also conducted with regulators to enlarge and update the background for the project and are therefore not directly quoted in this report.

Stage three of the project involved updating the review of regulatory and other documentation to take account of a number of significant developments that had taken place after the completion of the interviews and these developments were linked to the findings of the empirical investigation.

Research findings

UK audit partners

For UK audit partners interviewed the major change post-financial crisis was the re-establishment of ongoing links with supervisors. This enabled a sharing of views and the best meetings were described as a 'two-way' process with auditors and supervisors contributing equally to the discussions. Audit partners were very much aware of the growth of the risk management function in financial services firms. This frequently involved the appointment of a chief risk officer and the establishment of a risk committee separate from the audit committee, but with overlapping membership to ensure that all risks were covered across the two committees. This development had also led some partners to attend risk committee meetings as well as those of the audit committee. For accounting and auditing judgements, audit partners interviewed believed they had always been sceptical and had challenged management, and the principal change was the requirement to document the process more formally.

UK financial services firms

The views of UK finance, risk and internal audit executives, and of non-executive directors, provided an interesting counterpoint to the views of UK audit partners. Interviewees from firms were aware of, and welcomed, the re-introduction of liaison between auditors and supervisors. Recognising that the process was new and would take time to settle down, their main concern was that the dialogue should be appropriately structured and that supervisors accepted accounting and auditing judgements ultimately rested with the firm and its auditors. Interviewees confirmed the rapid growth and strengthening in financial services firms of the risk management function based around the three lines of defence model, and similarly recognised the new structures and processes would take time to settle down. On accounting and auditing judgements, interviewees believed auditors had always been appropriately sceptical, but confirmed requirements to document challenge, and indeed for all participants to provide challenge, had increased.

European findings

The most significant difference between the UK and Belgium and the Netherlands was that auditor-supervisor liaison had been maintained. While the relationship changed and became more intensive during and after the financial crisis, it did not have to be re-invented as in the UK. An interesting feature in Belgium is the long standing requirement for audit partners also to be members of the Institute of Auditors for Accredited Financial Institutions. In many respects interviewees from Belgium and the Netherlands echoed remarks made by their UK counterparts including: the major development in financial services firms of the risk management function based on the three lines of defence model; and an increased need to document challenge and to record reasons for accounting and auditing judgements. Since Belgium and the Netherlands are both members of the Eurozone, an additional concern was emphasized that, under the banking union, a further set of regulations apply, including direct supervision of important banks by the European Central Bank, creating further uncertainty.

Developments and recommendations

A number of themes, developments and policy recommendations emerged from the research project. The developments and recommendations are set in a UK context but may also be of relevance at European and international levels.

Auditor-supervisor liaison

Liaison between auditors and supervisors has been re-invigorated since the financial crisis. This is especially true in the UK where contact between auditors and supervisors had largely disappeared prior to the crisis. The relationship is structured by *Codes of Practice* issued by the Financial Conduct Authority (FCA) and the Bank of England Prudential Regulation Authority (PRA) (FCA, 2013; PRA, 2013). The research project, involving interviews with individual audit partners, therefore provides an important insight into the changed relationship between external auditors and supervisors of financial services firms. Audit partners interviewed approved of the change and valued the opportunity to compare viewpoints. There was general agreement that meetings with supervisors were most productive where there was a genuine two-way exchange of views.

An important recent development is the PRA proposal (PRA, 2015) to require external auditors of the largest UK banks and building societies to provide written reports to the PRA as part of the statutory audit cycle. Interviews with audit partners indicated that initiatives to enhance the quality of auditor-supervisor dialogue would be welcomed. For the largest banks and building societies, themed reports on aspects of the audit relevant to the PRA would be a constructive way forward. The PRA states that the main benefit of its proposals is to enhance the auditor-supervisor dialogue by giving auditors an early indication of PRA concerns and by providing supervisors with more consistent and in-depth information, thereby enhancing the focus of subsequent bilateral and trilateral meetings. The PRA states that a supplementary benefit of its proposals is that the written auditor reports, and the processes surrounding them, should assist in promoting the Financial Reporting Council's (FRC) agenda of improving the quality of bank audit. The PRA further proposes to publish an annual report on the quality of auditor-supervisor dialogue.

- **To strengthen the quality of the auditor-supervisor dialogue it is suggested that the PRA's proposal to require auditors of the largest banks and building societies to produce written reports to the PRA as part of the annual audit cycle be adopted.**

Following the revision of *ISA 700* and the introduction of extended auditor's reports (FRC, 2013a), a challenging question for the auditors of financial services firms is the extent to which the content and quality of the auditor-supervisor dialogue should be referred to in the new extended auditor's reports of financial services

firms. A recent FRC survey of experience of the first year of the implementation of extended auditor's reports found that auditors had not only provided greater information about the audit but had also demonstrated an encouraging level of innovation and diversity of approaches (FRC, 2015a, b).

- **To provide information to stakeholders about the auditor-supervisor dialogue it is suggested that auditors of financial services firms include discussion of the dialogue in the new extended auditor's report.**

Risk

The new version of the *UK Corporate Governance Code* and the associated guidance documents on risk management and internal control, and solvency, liquidity risk management and going concern for banks (FRC 2014a, b, c), together with the revised *ISA 700* requiring auditors to enhance the transparency of the audit report, means that considerably more information about risk is now disclosed to investors and other stakeholders.

Interviews with executive directors, non-executive directors and senior managers in financial services firms revealed that an important internal development is the three lines of defence model of risk governance which has become rapidly and routinely adopted across the financial services industry. Typically, it has resulted in the creation of a board risk committee separate from the board audit committee but with overlapping membership, the creation of a new role of chief risk officer, and a considerable expansion of the risk management function. In the restructuring of risk governance, interviewees were grappling with the challenge of which risks should come within the remit of the risk committee and which risks within the remit of the audit committee.

A related challenge facing interviewees was the changing nature of the role of internal audit. Traditionally, the reporting relationship of the internal auditor was to the board audit committee but the development of the three lines of defence model, and the increased intensity of supervision, has led to the internal auditor having closer relationships with the risk management function, the risk committee and also with supervisors, in addition to the internal auditor's traditional links with external auditor and the audit committee. To help internal auditors meet these challenges the Chartered Institute of Internal Auditors (CIIA) has issued a Code which provides guidance on the role of internal audit in financial services firms (CIIA, 2013).

The PRA and FCA welcomed the publication of the guidance and the CIIA has subsequently published two reports highly supportive of the Code's introduction and implementation (CIIA, 2014a, b). At the international level, the Basel Committee on Banking Supervision (BCBS) has issued supervisory guidance about the internal audit function in banks (BCBS, 2012).

The significant developments in risk governance, the expanding role of internal audit in financial services firms and the introduction of the CIIA Code has increased the importance of internal audit in financial services firms. In particular, the establishment of the Code invites the possibility of independent monitoring of compliance with the Code in terms of the quality of internal audit and the quality of internal auditor-supervisor dialogue. A question worthy of further consideration is how this might be achieved.

- **To enhance the status and quality of internal audit, and the effectiveness of the internal auditor-supervisor dialogue, it is suggested that the CIIA, in conjunction with regulators, establish a process for the independent monitoring of compliance with the CIIA Code.**

Accounting and auditing judgements

One of the important findings from interviews, both with audit partners and with executive directors, non-executive directors and senior managers in financial services firms, was that interviewees believed auditors had demonstrated sufficient challenge and scepticism of management. Various reasons were offered as to why this was not a common perception amongst regulators or the public. These reasons ranged from a failure to adequately document discussions, disagreement about what was appropriate to challenge within the audit remit, through to accounting standards permitting a range of outcomes depending on judgement. Indeed, some interviewees believed that regulators were dissatisfied with accounting and auditing standards and that supervisors were seeking to impose their own views in auditor-supervisor meetings. This latter view may in part be attributed to initial problems associated with reviving the auditor-supervisor dialogue that had largely ceased prior to the financial crisis.

The original Financial Services Authority (FSA) Code, and the subsequent FCA and PRA *Codes of Practice*, set out the relationship between the external auditor and the supervisor and have now been in place for some years. While the emphasis of the

Codes is on open, co-operative and constructive relationships between auditors and supervisors in order to support the effective fulfilment of their respective statutory functions, it should be remembered the statutory duties of each are different.

The recent PRA proposal notes there is now greater engagement between individual audit partners and supervisors under the Code of Practice, and regular high-level engagement between the senior financial services partners of the audit firms and the PRA (PRA, 2015).

- **To mitigate potential tensions between firms, auditors and supervisors over accounting, auditing and regulatory judgements, of particular importance are regular, high-level interactions and communication among the parties. It is suggested that a summary of the key accounting, auditing and regulatory topics discussed in high-level meetings between audit firms and the PRA be published to help inform financial services firms, investors and wider stakeholder groups.**

One of the advantages of undertaking research in different jurisdictions is the opportunity to discover differences in approach which may be worth considering or adopting in the UK. The FRC has had concerns about the quality of bank audit and the recent FRC audit quality thematic review has continued to reveal problems with bank audit quality which, arguably, reflects the inherent complexity of the audit of banks (FRC, 2014f). One of the recommendations of the review was to make sector specific training mandatory for partners and staff engaged in bank audit (FRC, 2014f, para. 1.2.3). The Belgian requirement for audit partners of banks and insurers also to be members of a separate professional institute is therefore of considerable interest. Whilst it may not be necessary or desirable to set up a separate professional institute for auditors of financial services firms in the UK, in the light of the findings of the FRC audit quality review an additional financial services audit qualification might serve to enhance the quality not only of bank audit but the audit of financial services firms more generally.

- **To support the FRC's stated requirement for mandatory training for staff undertaking bank audit it is suggested that the merits of an additional specialist qualification for financial services audit be investigated.**

Conclusion

In conclusion attention is drawn to a response by a chief risk officer to the question of what the interviewee saw as the main short to medium term challenges. The response was: ‘...it is very clearly regulation, regulation and regulation’. This captured the replies of many interviewees, whether audit partners, finance, risk or internal audit executives, or non-executive directors, who identified that responding to a variety of recent, current and proposed regulatory initiatives would be their main preoccupation in the short to medium term.

For auditors interviewed, this was not necessarily because of accounting and audit regulations directed specifically at banks and insurers as such, but rather the need to implement general accounting and auditing initiatives, combined with the ever increasing requirement to document challenges and support judgements, in the context of large and complex organisations, such as banks and insurers. For executive and non-executive directors interviewed, there was the need to respond to specific banking and insurance regulations, such as, in the UK the move to the regulatory regimes of the PRA and FCA, and for insurers the long awaited move to Solvency II. Such initiatives often required the urgent provision and analysis of data, which some interviewees argued could be at cross purposes with wider economic policy initiatives.

Notwithstanding the problems that led to the financial crisis, in the response there is a danger of regulatory overload, such that for auditors and financial services firms there is an undue focus on responding to new regulations rather than enhancing accounting, audit and business practices. The relationship between auditors, supervisors and risk explored in this project has changed significantly post-financial crisis, and the intensity of that relationship seems only set to grow. It is nevertheless important to remember the relationship is but one part of the much wider regulatory jigsaw.

1. BACKGROUND

The financial crisis, beginning in 2007, called into question the role of auditors, supervisors and the nature of financial risk. Auditors were criticised for giving no warning of the financial crisis, for failing to communicate with supervisors and for not exercising a sufficient degree of professional scepticism. Similarly, supervisors were criticised for a lack of communication with auditors and, more fundamentally, for inadequate supervision of financial services firms. The role of fair value accounting and, in particular, the apparent downgrading of the accounting concept of prudence, were also blamed for contributing to the crisis. Concerns were also raised about auditors' and supervisors' assessments of risk, especially of systemic risk, and about the risk governance of financial institutions.

This project investigated the role of auditors and supervisors in the system of UK and EU financial services supervision as it emerged post-financial crisis. In particular, it focused on three areas: liaison between auditors and supervisors; monitoring and reporting of risk; and accounting and auditing judgements in financial services audit. The objective of the project was to understand the evolution of these complex roles following the financial crisis and to provide policy recommendations.

Context

With the advent of the coalition government in May 2010, a key regulatory development was the restructuring of financial services regulation. This resulted in the abolition of the Financial Services Authority (FSA) and the creation of the Prudential Regulation Authority (PRA) under the Bank of England and an independent Financial Conduct Authority (FCA) from 1 April 2013, together with the establishment of a new Financial Policy Committee (FPC) within the Bank of England to monitor and take action to reduce systemic risk. The PRA is responsible for the prudential regulation of deposit-takers, insurers and major investment firms. The FCA is responsible for conduct of business regulation for all financial services firms and for the prudential regulation of those financial firms not supervised by the PRA. The FPC is responsible for identifying, monitoring and taking action to reduce or remove systemic risks to protect and enhance the resilience of the UK financial system. For further details, see the Bank of England quarterly bulletin which discusses the roles and relationships between these bodies (Bank of England, 2013).

The immediate aftermath of the financial crisis saw a number of wide-ranging Parliamentary investigations and the reports included recommendations encouraging the FSA to have greater engagement with auditors (Treasury Committee, 2009; Economic Affairs Committee, 2009; 2011). As part of its response to the recommendations of the Parliamentary Committees, the FSA issued a *Code of practice for the relationship between the external auditor and the supervisor* (FSA, 2011). The newly established PRA and FCA subsequently issued revised versions of the Code. In April 2013 the PRA issued a *Supervisory Statement*, which mirrored the principles of the FSA Code (PRA, 2013). In July 2013 the FCA issued as *Finalised Guidance* its own Code for the relationship between the external auditor and the supervisor with similar principles to that promulgated by the FSA (FCA, 2013). The respective Codes provided a set of common principles for auditors and supervisors as follows:

Principle 1: Supervisors and auditors shall seek an open, cooperative and constructive relationship.

Principle 2: Supervisors and auditors should engage in regular dialogue.

Principle 3: Supervisors and auditors shall share all information relevant to carrying out their respective statutory duties in a timely fashion.

Principle 4: Supervisors and auditors shall respect their duty to treat information shared between the two parties or received from firms confidentially.

(FSA, 2011; FCA, 2013; PRA, 2013)

Further to the work of the Parliamentary Committees, in 2012 a Parliamentary Commission on Banking Standards was established to report inter alia on the culture and professional standards of the UK banking sector. The Commission published its fifth and final report in June 2013 (Parliamentary Commission, 2013). The Parliamentary Commission (2013, para. 1039) proposed that financial institutions should provide for regulators a separate set of accounts based on specified, prudent principles set by the regulator, and that the second set of accounts should be externally audited. Where there was a public interest for these accounts to be published the regulator should have the power to direct that these (or abbreviated accounts) be included in the published financial statements, together with a reconciliation to the IFRS accounts. In its response, the government stated that the benefits of a parallel, more conservative accounting regime for banks needed to be balanced against the costs of providing the information,

including audit, and referred the issue to the PRA (HM Treasury, 2013, paras. 5.62-5.63). Second, the Parliamentary Commission (2013, para. 1042) recommended that an enhanced auditor commentary on key judgement areas, including valuation, risk and remuneration, be included in auditors' reports so as to increase investors' understanding of a bank's business model. This was substantially addressed by the FRC (2013a) in a general revision of the auditor's report to enhance its transparency and achieve better communication with investors by requiring auditors of companies applying the *UK Corporate Governance Code* to explain more about their work (see also below). Third, the Parliamentary Commission (2013, para. 1053) recommended that the minimum number of meetings between auditors and supervisors should be put on a statutory basis, and that the Court of the Bank of England should commission periodic reports on the quality of dialogue between auditors and supervisors. The government response (HM Treasury, 2013, para. 5.66) stated that the first issue was addressed in the Financial Services (Banking Reform) Act 2013 (section 134) by introducing a statutory duty that requires the FCA and the PRA to meet the auditors of authorised institutions at least once a year, and the PRA and the FCA should include the number of meetings that have taken place between the regulator and auditors during the period in their annual reports. In terms of the commissioning of reports on the quality of auditor-supervisor dialogue, the government observed that this might better be undertaken by the PRA Board. In a recent consultation paper the PRA stated that its first report on the quality of auditor-supervisor dialogue was presented to the PRA Board in July 2014, and that the PRA was considering the best way in which to publish future reports (PRA, 2015, para. 2.2). Overall, therefore, the Parliamentary Committees and the Parliamentary Commission initiated important contributions to the auditor-supervisor debate.

At the international level, the Basel Committee on Banking Supervision (BCBS) was active in further considering the role of auditors in banking supervision and issued revised guidance on the internal audit function in banks (BCBS, 2012) and on the external audit of banks (BCBS, 2014).

The FRC also engaged in a series of reforms designed to improve and strengthen audit and corporate governance. For corporate governance and stewardship codes and related guidance, there were new versions of the *UK Corporate Governance Code*, the most recent of which was issued in September 2014 (FRC, 2014a). The FRC also undertook substantive reviews of its guidance on risk management and internal control, and considered issues of solvency, liquidity risk management and going concern for banks. As a result of these reviews and in support of the

revised Code the FRC published two new statements of guidance – *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (FRC, 2014b) and *Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting* (FRC, 2014c). The FRC saw these as not only enhancing the quality of information for investors but also ‘raising the bar’ for risk management (FRC, 2014d). For institutional investors the FRC had previously published a new version of the *UK Stewardship Code* (FRC, 2012).

For audit, the FRC issued a major revision to *ISA 700: The independent auditor’s report on financial statements* to make the audit process more transparent to investors (FRC, 2013a, b). Thus, for audits coming within the scope of the *UK Corporate Governance Code* the audit report should: provide an overview of the scope of the audit showing how risk and materiality concerns were addressed; describe the risks that had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the effort of the audit engagement team; and provide an explanation of how the concept of materiality was applied in planning and performing the audit (FRC, 2013b). In this respect the FRC led a debate that was taken up by the IAASB, which has subsequently published its new and revised auditor reporting standards (IAASB, 2015a, b). The FRC recently published the results of a survey of the first year of the implementation of extended auditor’s reports which found that auditors had not only met the new requirements but in many cases had gone further and reported more widely than required, and the FRC considered the extent of innovation and diversity of approaches adopted by different audit firms to be very encouraging (FRC, 2015a, b).

Through its audit quality inspections, in successive annual reports the FRC has identified problems with the audit of banks and building societies. In particular, in its annual report for audit quality inspections 2012-13, the FRC stated that further improvements were required in the audit of financial services firms and that audit firms needed to strengthen financial services audit testing, particularly in respect of loan loss provisioning and related IT controls (FRC, 2013c, pp. 9-10). In its 2013-14 audit quality inspections annual report the FRC confirmed that ‘The overall grading of bank and building society audits is, and continues to be, generally below those of other types of entity’ and confirmed that in 2014 it would undertake a thematic review of such audits ‘to identify why progress in improving quality has been slow and what needs to be done to achieve necessary improvements’, (FRC, 2014e, p. 7). In December 2014 the FRC published the findings of its audit quality thematic review of bank audit, focussed on the audit of loan loss provisions and related IT

controls (FRC, 2014f). The FRC noted improvements and reported areas of good practice that had been observed. However, the FRC identified key messages for audit firms which included: being 'reactive to regulatory concerns'; ensuring 'that all regulatory and market risks are captured by risk assessment methodology and sector training'; applying 'an appropriate degree of challenge and professional scepticism in the audit of loan loss provisions, rather than seeking to corroborate management's views'; and making 'sector training mandatory for partners and staff engaged in bank audits' (FRC, 2014f, pp. 6-7).

Professional accountancy bodies also contributed to specific and general debates. For example, lessons from the crisis for the audit of banks and enhancing the dialogue between bank auditors and audit committees were explored by the ICAEW (2010; 2012; 2013). In July 2013 the Chartered Institute of Internal Auditors (CIIA) issued its own Code for internal audit for financial services firms that includes a paragraph on relationships with regulators and which echoes elements of the FCA and PRA Codes for external auditors:

The Chief Internal Auditor, and other senior managers within Internal Audit, should have an open, constructive and co-operative relationship with regulators which supports the sharing of information relevant to carrying out their respective responsibilities. (CIIA, 2013, para. 29).

Both the PRA and the FCA welcomed the publication of the guidance. The CIIA followed up implementation of the Code for internal audit in the financial services sector with two surveys of the heads of internal audit who were highly supportive of its introduction. (CIIA, 2014a, b).

There is also an agenda, both from regulators and the profession, to improve the understandability of financial statements by making corporate reports more relevant and reducing unnecessary disclosures (see for example, FRC, 2011; ICAS, 2010, 2012), whilst the ACCA published an innovative study on confidence accounting (ACCA, 2012). Internationally, as regards the controversy over prudence and fair value accounting, the IASB has with the publication of *IFRS 9: Financial Instruments* adopted a more forward looking 'expected-loss' impairment model to the valuation of financial instruments (IASB, 2014a, b). The formal reinstatement of prudence as a qualitative characteristic of accounting is being considered in debates over the revision of the *Conceptual Framework for Financial Reporting* (IASB, 2015, p. 19). At European level, the European Commission (EC) sought to draw lessons from

the financial crisis and in October 2010 issued a *Green Paper* on audit policy covering issues such as rotation of audit firms, tendering, joint audits, non-audit services and supervision of audit firms (EC, 2010). Starting in October 2011 the UK Competition Commission also undertook an investigation into the supply of statutory audit services to large companies. There followed extended debates in which many of the issues were paralleled at UK and European levels. In the UK the final report of the Competition Commission was published in October 2013 (Competition Commission, 2013) and at European level, provisional agreement was reached in December 2013 (EC, 2013). The European debate concluded in June 2014 with the introduction of a new Audit Directive and Audit Regulation (European Parliament and Council, 2014a, b). The latter introduced for public-interest entities the mandatory rotation of audit firms, the prohibition of certain non-audit services and a 70% cap on the provision of non-audit services (EC, 2014). The Department for Business, Innovation and Skills (2014; 2015) and the FRC (2014g) are currently undertaking consultations about the transposition of the Directive and Regulation into UK law by June 2016.

Recent UK development in the auditor-supervisor relationship

In February 2015 the PRA published a consultation paper about enhancing engagement between external auditors and supervisors (PRA, 2015). For the largest banks and building societies the PRA proposed to require external auditors to provide written reports to the PRA as part of the statutory audit cycle – such reports would augment the existing bilateral and trilateral meetings (para. 1.1). The main benefit of written audit reporting was seen as enhancing the auditor-supervisor dialogue as supervisors would gain more consistent and in-depth information, and the process for agreeing the questions to be addressed would give auditors an early indication of regulators' concerns in relation to areas covered as part of the statutory audit before the main audit commenced. The result would be to provide more consistency in areas of focus across the relevant financial firms each year, while bilateral meetings would still be able to focus on firm-specific risks. Overall the process would help in the allocation of scarce resources and reduce the likelihood that accounting risks would go undetected (para. 1.7). A supplementary benefit was seen to be as providing a mechanism through which audit shortcomings found in FRC audit quality reviews could be addressed, leading to more robust audits where risks would be flagged to support timely and appropriate regulatory intervention (para. 1.8). A separate proposal in

the consultation paper set out how the PRA intended to use its disciplinary powers over auditors and actuaries under section 345A, Financial Services and Markets Act (FSMA) 2000.

The implications of the findings of this study in relation to this recent consultation paper on the interaction between the PRA and external auditors are considered in the concluding chapter.

Overview

The financial crisis led to important changes to audit in general and significant changes to the relationship between the external auditor and the financial supervisors in particular, changes which are still taking place. Taking the period as a whole, which saw major reforms of UK, European and international financial services regulation, audit and governance, the key themes investigated were:

- Changes to the relationship between external auditors and supervisors of financial services firms.
- The impact of the financial crisis on risk governance in financial services firms.
- Accounting and auditing issues emerging from the financial crisis, including professional scepticism, prudence, and accounting and auditing judgements.

The focus of the project was to explore these emerging themes and investigate how the new relationships between the external auditor and the supervisor were being forged, within the context of other significant debates at UK, European and international levels that were taking place at the same time.

The report is structured as follows:

- Chapter 2 sets out the research approach for this study.
- Chapters 3 and 4, respectively, discuss the perspectives of UK audit partners, and senior executives and office holders of financial services firms on the relationships between auditors and supervisors, key accounting and auditing judgements affecting financial services firms, assessments of risk and risk governance.
- Chapter 5 explores the regulation of financial services firms in other EU

jurisdictions, notably in Belgium and the Netherlands, and discusses the perspectives of Dutch and Belgian audit partners and senior executives and office holders of financial services firms.

- Chapter 6 sets out recommendations and policy implications emerging from the study.

2. RESEARCH APPROACH

The research approach of this study was developed from a programme of research, including the resultant ICAS publications *The contrasting roles of auditors in UK and Swiss banking* (Dewing and Russell, 2010) and *The role of auditors, reporting accountants and skilled persons in UK financial services supervision* (Dewing and Russell, 2005).

In 2010 the programme of work continued with a pilot study *The role of auditors in prudential supervision post-financial crisis: UK, EU and international developments* which involved interviews with national regulators in London, European regulators in Brussels and international regulators. The purpose of these interviews was to obtain general contextual background and to help refine the research agenda for this project. None of the interviewees' comments from this pilot study are therefore included in this report.

The current project was undertaken in three stages. Stage one of the project involved a review of regulatory and other documentation, including official reports and inquiries into the causes of the financial crisis, in particular focussing on the role played by auditors and supervisors, accounting issues and conceptions of financial risk. In addition, the review was used to identify changes to accounting, audit, regulation and risk requirements following the financial crisis. It was not within the scope of the research project to undertake a review of the extensive academic literature.

Stage two of the project involved an empirical investigation of the issues emerging from the pilot study, the review of regulatory and other documentation. In all 40 face-to-face interviews were conducted, involving 42 interviewees, between July 2012 and January 2014. Interviewees included: audit partners; and representatives of financial services firms (executive directors, non-executive directors, senior managers) with functional responsibility for finance, risk, internal audit or chief executive officers. The main series of interviews was conducted in the UK. However, in order to obtain alternative perspectives, a second series of interviews was undertaken in Belgium and the Netherlands. Both countries are EU jurisdictions that have small open economies with significant banking and insurance industries, and where audit has the potential to contribute to financial regulation. Details of the interviewees are set out in Table 2.1.

Table 2.1 Analysis of interviewees

	Interviews	Interviewees
Audit partners	19	20
Representatives of firms	21	22
Total	40	42
UK	29	31
Belgium, Netherlands, EU	11	11
Total	40	42

Interviews were semi-structured and typically lasted about an hour. Topics discussed included post-financial crisis developments, auditor-supervisor engagement, roles of auditors, supervisors, audit and risk committees in risk assessment, and key accounting and auditing judgements.

Interviews were also conducted with 10 regulators, involving 12 interviewees, to enlarge and update the background for the project and are therefore not directly quoted in this report. In the following chapters the term ‘regulator’ is generally used, or substituted, as regulatory bodies both in the UK and EU underwent reforms following the financial crisis.

Stage three of the project involved updating the review of regulatory and other documentation to take account of a number of significant developments that had taken place after the completion of the interviews and the developments were linked to the findings of the empirical investigation.

The project was concerned with three main research questions:

- *Auditor-supervisor liaison*: How can the effectiveness of communication between auditors and supervisors be enhanced?
- *Risk*: What issues are associated with the monitoring, reporting and auditing of risks in financial institutions?
- *Accounting and auditing judgements*: What are the implications of accounting and auditing judgements in the financial statements of financial services firms?

The next chapters report the findings of the study from a UK perspective (Chapters 3 and 4) and a European perspective (Chapter 5).

3. RESEARCH FINDINGS – UK AUDITORS

Perceptions on the key issues were obtained from senior audit partners specialising in the audit of banks and other deposit takers, and insurers. A number of the partners also had experience of the regulatory regimes in place before FSMA 2000.

Auditor-supervisor liaison

Several of the banking audit partners interviewed had experience of the regime under the Banking Act 1987. These partners recalled the cycle of reporting accountants' reports commissioned annually on each bank by the Bank of England and discussing the nature, scoping and findings with the bank's supervisors. This involved a trilateral meeting involving the client, supervisor and auditor and a bilateral meeting with only the supervisor and auditor.

Reporting accountants' reports were not taken forward under FSMA 2000 and, although the Act did not prohibit supervisors from meeting audit partners to discuss the affairs of a bank, contact between auditors and supervisors 'fell away'. Partners emphasised that it was not from their side that the meetings lapsed but most supervisors did not call for such meetings and the regular contact between audit partners and supervisors disappeared.

Following the financial crisis supervisors re-engaged with auditors. One partner summarised the contrast:

One big change has been to put communication between auditor and supervisor at an individual bank level much higher up the regulatory priority list. It was very patchy pre-the crisis; it happened on some, it didn't happen at all on others, and that was down to the personal inclination of the supervisor rather than there being any policy.

The nature of the engagement between supervisors and auditors was formalised into a *Code of Practice* (FSA, 2011; FCA, 2013; PRA, 2013). For 'very high impact' firms the guidance recommended at least two meetings per year – the first meeting to be held at the audit planning stage, the second meeting to be held 'pre-close', that is, before sign off by the audit engagement partner. One partner commented

that the issue was not the Code as such but what underpinned it, 'I think the Code itself is not a particularly good document. I think it's the principle behind it, of more conversation, that's important'.

Audit partners interviewed confirmed that meetings with supervisors took place and there had been a 'sea change' in the level of contact. Partners commented, however, that not all meetings were equally successful and it depended on the supervisor – the best meetings were characterised as those that were 'two-way' where there was a genuine exchange of information. Less successful meetings were where the audit partners felt supervisors could have been more forthcoming. As one partner commented, 'I think it's still got further to go in terms of actually being a meaningful dialogue between the two. I get the impression at the moment it's more of a checklist approach from the regulator'.

When asked whether meetings had brought out significant differences between the views of auditors and supervisors, audit partners interviewed commented that this was generally not the case. After setting aside those risks that were relevant to audit but not prudential regulation, and vice versa, audit partners viewed the process more as getting a different perspective on the same risk rather than each identifying different risks. Two partners described the process of comparing where the auditor and supervisor thought the bank was in terms of risk as providing a 'temperature check'. Another partner commented 'there hasn't been anything that's been a surprise to either party' and the aim was of checking 'we've been on the same page'.

Of more controversy was the possibility of an intervention by the supervisor in the pre-close meeting as auditors and management were in the process of finalising the accounts. This was because the supervisor could raise concerns with the auditor about the proposed treatment of certain items in the accounts. As one partner put it, 'This is where I think banks would have some concern, is the regulator getting close to saying, well, you should have this provision in your accounts'. Partners interviewed were of the view that to raise such issues at the pre-close meeting was inappropriate, partly because of the timing, partly because decisions on the accounts properly belonged to the directors and auditor, and partly because such issues can be raised by supervisors via other channels. As one partner reported, 'The audit committee chairman just basically said no way, that's not happening, you're not going to interfere, that's a director's job – one. And two – we haven't got time to do it'.

Risk

Partners interviewed confirmed that whereas previously risk had been considered by the audit committee, most banks and insurers had created risk committees. Another development mentioned by partners was that most banks had established the post of chief risk officer. In creating separate audit and risk committees there was the question as to how the issues should be shared between the committees to avoid the dangers of duplication on the one hand or items falling between the two committees on the other. Partners interviewed reported that the work of the audit committee became focused on risks related to financial reporting, with the risk committee dealing with wider business risks. However, many business risks have implications for financial reporting and this was generally dealt with by having overlapping committee membership.

Audit partners interviewed generally confirmed that as their primary interest was risks related to financial reporting they attended audit committees as a matter of course. In general, partners did not attend risk committees unless for a specific reason, but would read the minutes of the risk committee. Two partners, however, stated they normally attended risk committees, one confirming that he insisted on attending risk committee meetings and commented, 'I've never had a client that has a problem with that because they recognise that what's being discussed there is – large chunks of it are – very pertinent to the audit'. Further developments of risk committees, the appointment of chief risk officers and the 'three lines of defence model' are further discussed in Chapter 4.

Accounting and auditing judgements

Under the IAS Regulation, the EU requires that the accounts of listed companies are prepared on the basis of IFRSs. The process of endorsing IFRSs for use in the EU proceeded, with only *IAS 39* giving rise to controversy and eventually being endorsed with two 'carve outs'. The financial crisis however raised a series of accounting and auditing concerns which included: a lack of auditor scepticism; concerns over the appropriateness of the IFRS regime, such as the use of fair value and the downgrading of prudence; and whether a separate accounting treatment was needed for banks. These and related issues were discussed with audit partners.

As regards scepticism, partners interviewed generally believed they had been sufficiently sceptical previously, and as such their degree of scepticism and challenge of management had not necessarily increased. One partner expressed

disappointment that the regulator had raised concerns about the lack of scepticism:

I don't think we ever accepted something that was incorrect or has been shown to be wrong or questionable. ...it jarred with me a bit because I could certainly think to some of my audits where we had been extremely sceptical and asked institutions to make very material adjustments to their numbers.

This partner, however, recognised that what had changed was the level and rigour of stress testing that was being conducted by management as a result of the regulator's more intensive approach to regulation:

The whole regime is not so much about, do we think we're going to be there? It's more around, what could break us? Let's have a look at how probable those things might be, what might cause that?

Most partners argued that what had significantly changed was the need for partners to document the process of management challenge more extensively. As one partner commented:

... for all clients of a certain size, we have a specific documentation requirement to document where we have applied professional scepticism. So I think we've become more aware of it formally as a concept, of being professionally sceptical, and of being able to demonstrate and evidence that. But I don't think that I am more sceptical or more challenging, or that I was less rigorous two or three years ago than we are now. I think it's just an acknowledgement that we have to be able to document and evidence that more clearly than previously. ... The finance director's response was, 'Look I thought we had actually worked quite well together through these things, but your report reads as if we've been fighting all the way'.

The topic of prudence continued to arouse controversy and has been extensively debated. Partners interviewed tended to rehearse the standard arguments about prudence – for example, that it introduces bias, gives rise to differences in interpretation, allows management undue flexibility – whilst retaining a fondness for the traditional concept of prudence. This tension was summed up by the comment of a partner who, when asked whether bringing it back in as a concept would be

helpful, responded, 'I don't actually – even though it feels a nice cosy place to be'. Reflecting the views of other partners, this partner believed it was more appropriate to have a full discussion around the range of outcomes and judgements, where particular judgement lies within the range, how that compares with other judgements that are being made, and the reasoning disclosed.

Partners interviewed were generally against a separate accounting regime for banks, mainly on the grounds that this would lead to calls from other industries for the introduction of industry-specific accounting regimes which would add to the complexity of financial reporting. Partners pointed out that the regulator has powers either to obtain additional information for its own use, to apply prudential filters to the regulatory returns, or to require additional information to be made publicly available through bank-specific disclosures. The regulator's requirement for the publication of Basel Pillar 3 disclosures on banks' websites was cited as an example of the latter. Two partners referred to the ACCA's proposals for 'confidence accounting' which shows the expected range and distribution of likely values for significant balance sheet items. They commented that it was an 'interesting concept' but had major reservations because it would be 'too complex to explain' and suffers from 'all the normal statistical problems'. In an interesting comment one of these partners drew attention to the lack of understanding by the public of the difference between 'uncertainty around the value today' and 'uncertainty around the value tomorrow', giving the example of valuing a portfolio of US Treasury bonds where there would be no uncertainty about its value 'today' but significant uncertainty about its value 'tomorrow' which depended on changes in economic and monetary circumstances.

In terms of other topics currently under discussion or shortly to be implemented, partners interviewed welcomed moves to greater narrative reporting in the front end of annual financial statements and greater disclosures in the audit report of issues of importance for the audit, though partners also recognised the danger of 'boilerplate' statements complying with the letter rather than the spirit of such new disclosure requirements. These and other suggestions involve the disclosure of further information. However, there is also a parallel debate taking place about 'cutting the clutter' from company accounts which has also received considerable support. As a partner pointed out:

I think we're going through that stage at the moment where lots of people want lots of different things... And I think we'll get pulled in different directions.

Summary

For UK audit partners interviewed the major change post-financial crisis was the re-establishment of ongoing links with supervisors. This enabled a sharing of views and the best meetings were described as a 'two-way' process with auditors and supervisors contributing equally to the discussions. Audit partners were very much aware of the growth of the risk management function in financial services firms. This frequently involved the appointment of a chief risk officer and the establishment of a risk committee separate from the audit committee, but with overlapping membership to ensure that all risks were covered across the two committees. This development had also led some partners to attend risk committee meetings as well as those of the audit committee. For accounting and auditing judgements, audit partners interviewed believed they had always been sceptical and had challenged management, and the principal change was the requirement to document the process more formally.

4. RESEARCH FINDINGS – UK FINANCIAL SERVICES FIRMS

Views on the key issues were also obtained from a diverse set of interviewees within financial services firms, including finance, risk and internal audit executives, and non-executive directors. Whereas audit partners provided a breadth of experience of a variety of clients, these interviewees generally provided more in-depth views relating to their firm.

Auditor-supervisor liaison

Firm representatives were asked to comment as to how they perceived the process of auditor-supervisor liaison. One finance executive commented that the dialogue should not be seen in isolation since there was a series of ongoing dialogues between the firm, the auditors and the regulator, ‘...we talk to the auditors a lot, we talk to the regulator a lot, and the regulator will talk to the auditors separately, not with us there’. This interviewee further emphasised that the auditor-supervisor dialogue needed to be seen in the broader context of regular dialogues the regulator undertook individually with other senior officials of the firm citing, for example, the head of the risk committee; the head of the audit committee; the chief executive; the chief financial officer; the chief risk officer; and the chairman of the board. In addition, the regulator obtained information from other sources besides the firm, such as analysts’ reports. As this interviewee commented:

So they draw information from a lot of sources and they try and triangulate it all and see where they’re getting inconsistencies of you. ...they are getting comfort that they’re getting the same answers from different people.

Another finance executive emphasised that there needed to be a clear understanding by the firm, the auditor and the regulator of the nature of the dialogue between the auditor and the regulator. In particular, that if either the auditor or the regulator had concerns, these should have previously been discussed with the firm:

...we have done quite a lot of work in the last two years ... to ensure that the auditors, the supervisors are communicating in, shall we call it, an appropriate manner, that there is due process

around when supervisors and auditors speak and frankly our view is that they can speak any time they like, but as they have those conversations there is transparency about the topics of conversation ... it is an inclusive process in which each party demonstrates, if you like, mutual respect.

One issue raised was if the regulator raised matters in bilateral meetings with the auditor that had not been discussed with the firm, and which the firm became aware of through its relationship with the auditor. The underlying concern was that the regulator might in effect be seeking to set accounting policy and instruct auditors accordingly. This interviewee explained that while the regulator was entitled to express its view and engage in discussion, decisions about the interpretation and application of accounting standards ultimately rested with the firm and its auditors. The interviewee believed that one of the problems of building relationships between the firm, the auditors and the regulator was that, prior to the financial crisis this process had lapsed. On this point the interviewee concluded:

But I think where we've found ourselves now probably for the last twelve months is in a position of mutual understanding between supervisors, the auditors and the firm, that I think the communication is open and transparent. I think the process is reasonably clear.

Another finance executive confirmed that considerable interaction took place between the firm, the auditor and the regulator, including bilateral meetings between the auditor and supervisors. However, this interviewee also expressed concern about the regulator's approach to accounting issues, 'What I think, where we're finding things quite challenging, and I think all the banks will be in the same position, is where the regulator has a view about accounting standards'. This interviewee cited the example of provisioning where:

...there isn't a right answer. There is a spectrum and you will provision along the spectrum. ... The accounting standards say you provision according to your strategy. The regulator doesn't like that. The regulator wants everybody to come out with the same answer.

Risk

The severity and unexpectedness of the financial crisis caused even those firms who had emerged from the crisis relatively unscathed to re-evaluate their approach to risk. For most firms, risk had previously been dealt with by board audit committees but with the increasing prominence of risk issues, and the widening debate about risk governance, firms had established separate board risk committees, appointed chief risk officers and strengthened the risk management function. Interviewees described their firm as adopting and implementing the ‘three lines of defence’ model:

- The first line involved employees and managers taking responsibility for risks within their operations in accordance with the firm’s control framework.
- The second line involved the risk management function providing oversight and challenge of activities undertaken by employees and managers in the first line of defence.
- The third line was internal audit which provided independent assurance to the board on the firm’s risk management framework and on the operation of the first and second lines of defence.

The timing and nature of the reviews were strongly influenced by the regulator. As one risk executive explained, ‘The process was provoked by the regulators. ... And very central to the regulator’s thinking, as it was at the time, is the insistence that there should be three lines of defence’. Interviewees confirmed, except for the very smallest firm, that their firms had adopted the three lines of defence model but emphasised that the structures were new and evolving. For one non-executive director the fundamental issue was instilling a ‘risk culture’:

...if you want to step back and talk about this in terms of just pure common sense and simple language, it’s all about individuals who go about whatever they’re doing, they think about all of these things in a very responsible, sensible way in terms of risk.

An important question that arose was how the risks were divided up between the audit and risk committees. Interviewees broadly agreed with the view that the risk committee was forward looking and the audit committee was backward looking, seeing it as a useful shorthand distinction. On the other hand, interviewees recognised the distinction was problematic commenting ‘I’m not saying we’ve got this right’ and that there were instances where ‘it could go either way’. A

non-executive director and member of both committees summed up the initial experience of separating the committees, ‘...the first year we were really tripping over, because when does audit start and risk begin?’ This interviewee however confirmed that separating the committees proved to be invaluable:

Audit really is about backward-looking risks... All of your classic auditing work is now done in the audit committee. The risk committee focuses on the future risks, so it’s much more about ‘What are the big things that are going to kill this bank?’

The interviewee who most strongly felt the backward-looking audit committee/ forward-looking risk committee distinction was unhelpful was an internal audit executive. This interviewee commented, ‘A convenient distinction but utterly meaningless’. The interviewee continued:

It would be absolutely wrong of me not to look at what risks are coming out, what can go wrong for this organisation in the future, and is the organisation future proofing it ... It’s an easy way of coming up with some words but I think it’s the wrong answer.

An important question therefore concerns the role of internal audit which traditionally reports via the audit committee. However, the three lines of defence model for risk management implies that internal audit, as the third line of defence, should also report to the risk committee. But it must also be remembered that the role of risk management, as the second line of defence, is to have oversight of and provide challenge to management as the first line of defence. Therefore, an emerging challenge is to avoid risk management and internal audit ‘bumping into each other’.

Following a restructuring of risk management, one risk executive commented that the focus of the audit committee was settling around financial reporting and internal control, or as the interviewee put it around the ‘accounting traffic’, with the risk committee picking up ‘everything else’. This interviewee noticed a tendency for conduct issues to go to the audit committee with prudential issues going to the risk committee, but also said ‘...that’s nowhere near a one to one match, it’s just the shape that’s starting to emerge’. To ensure nothing was missed all interviewees were agreed that it was necessary to have over-lapping board membership with at least the chair of each committee being a member of the other committee.

Accounting and auditing judgements

Following the financial crisis, there was criticism as to whether auditors had demonstrated sufficient scepticism. Financial executives were therefore asked about the extent to which they believed auditors had become more sceptical and challenging since the financial crisis.

One financial executive believed that this criticism of auditors was 'harsh'. Taking the example of Northern Rock, this interviewee commented 'The fact that it was a really risky business model ... doesn't mean the accounts were wrong'. In terms of current audit work, this interviewee believed that auditors were more conscious of being able to demonstrate reasons for their view:

I think they are more rigorous in terms of quality of documentation, particularly in ensuring consistency around issues where there is a spectrum of judgement, there is not a correct answer.

Another financial executive considered the approach of the current auditor and commented:

Communication is open, always transparent, challenging, asks the right questions, detail oriented, requires the teams to be detail oriented. Just simply doesn't shrink away from the difficult conversations at all...

This finance executive also referred to the case of Northern Rock and the issue of challenging the business model and asked:

Have I ever run into an auditor willing to challenge the viability of a business model? ... Is it part of the responsibility of the audit firm to challenge the viability of a business model?

Overall, this interviewee reflected that what needed to be clarified was 'the obligation of the audit firm versus the obligation of management versus the obligation of supervisors'.

Another finance executive stated that the issue was not simply whether auditors' scepticism had increased but the fact that in all areas there was a greater emphasis on challenge:

Whether you're the second line risk department, whether you're internal audit, whether you're external audit or whether you're the regulator, there's a much greater emphasis on being sceptical now, to be seen to be sceptical.

Overall however, non-executive directors who were members of audit committees expressed satisfaction with the role played by auditors. One non-executive director argued that the problem was not with auditors but with accounting standards commenting:

I think some of what was lost in terms of fair value accounting and everything was just basic principles – substance over form, prudence, rather than specific conformity with a standard. I regret that we're still not back where we could have been.

Summary

The views of UK finance, risk and internal audit executives, and of non-executive directors, provided an interesting counterpoint to the views of UK audit partners. Interviewees from firms were aware of, and welcomed, the re-introduction of liaison between auditors and supervisors. Recognising that the process was new and would take time to settle down, their main concern was that the dialogue should be appropriately structured and that supervisors accepted accounting and auditing judgements ultimately rested with the firm and its auditors. Interviewees confirmed the rapid growth and strengthening in financial services firms of the risk management function based around the three lines of defence model, and similarly recognised that the new structures and processes would take time to settle down. On accounting and auditing judgements, interviewees believed auditors had always been appropriately sceptical, but confirmed requirements to document challenge, and indeed for all participants to provide challenge, had increased.

5. EUROPEAN FINDINGS

This chapter looks at the same basic issues from the perspective of audit partners and executives based in two other jurisdictions, namely Belgium and the Netherlands. In the Netherlands prudential supervision is undertaken by the Dutch National Bank. In Belgium supervision prior to the financial crisis was undertaken by the Banking, Insurance and Finance Commission. Following the crisis it is now undertaken by the National Bank of Belgium. A particular feature in Belgium is the requirement for audit partners to be members of the Institute of Auditors for Accredited Financial Institutions. This involves demonstrating appropriate experience and passing an additional set of exams. The most important difference between Belgium and the Netherlands, as compared to the UK, is that auditor-supervisor liaison in the UK had all but disappeared prior to the financial crisis, whereas in Belgium and the Netherlands the relationship had been maintained. It is worth noting, however, that one of the features of the financial crisis was that virtually all countries were affected regardless of the regulatory regime that was in place. In the UK the auditor-supervisor relationship had to be 'reinvented' post-financial crisis but even in Belgium and the Netherlands, where it still existed, the nature of the relationship changed substantially.

Auditor-supervisor liaison

In the Netherlands, pre-financial crisis, contact between the auditor and the supervisor was limited to an annual tripartite meeting, the agenda of which was routine. A partner commented:

Typically, if you look at the communication we had it was around: okay, you have done the audit, what were your findings, what was the management letter, walk through the approach – and then shook hands and walked away. And through the year we didn't have any contact at all.

Following the crisis, more formal tripartite meetings between the bank, the supervisor and auditor were introduced. The first mandatory meeting was held to discuss audit planning and the second to discuss the findings and conclusions of the audit. One feature of the audit planning meeting was a sharing of risk assessments between internal audit, external audit and the supervisor. As one partner described it, internal audit shared their 'risks and weaknesses on

internal controls', the external auditor their 'risks of misstatement in the financial statements' and the supervisor 'concerns about liquidity and solvency'. This partner suggested the process could be pictured as 'three circles' with 'overlapping areas but inside its own interest'. So that the auditor and client were fully informed about each other's position before the meeting with the supervisor, pre-meetings were held both with management and with internal audit, 'That is the proper way of doing things in such circumstances, you are not there to affront people or to make it necessarily difficult'. Another partner similarly suggested that the supervisor was trying to be more proactive post-financial crisis. This partner also explained that agreement as to the auditor's findings had already been reached before the meeting with the supervisor, '...in having the meeting with the [supervisor] basically the client has already accepted and agreed the findings and our discussion topics'.

Bilateral meetings between the auditor and supervisor also developed during the financial crisis. A partner suggested that the 'personal relationship' that developed arising from the frequency of such meetings helped improve auditor-supervisor liaison, '...if anything new pops up you have very easy access. So it has helped to bring that to a better level'. Another partner however suggested it was only in a 'rare situation' when there was a 'real issue' that a bilateral meeting was held. This partner went on to stress the value of regular meetings, including bilateral meetings, which he wished would become more routine:

But because you have multiple conversations you get a better sense of what is really going on. And that is something you can typically do if you are just sitting two people in a room. And that type of conversation is not necessarily happening now. It is lacking in that sense.

Another partner explained that the regulator used the external auditor to confirm information provided to them by management concerning, for example, internal controls and risk management. Such confirmations were often gleaned through informal discussion:

...we have had a few private conversations and they are seeking to have confirmation of what has been told them, and that is I think a good role because there you can talk about content and not about what is in your audit file, what is not, etc. So that's very good.

In Belgium of particular interest is the requirement to undertake a special

accreditation process, involving additional exams to demonstrate *inter alia* thorough knowledge of all financial services regulations, in order to be authorised to audit banks. One partner explained the situation as follows:

So the profession in Belgium is not very big we are talking about 1,000 people, no more. Within those thousand people there are only about 70 who are allowed to audit banks, insurance companies, funds. So this is a very small club and people know each other really well.

The partner explained that banking audit partners also have to undertake 'special reporting' to the regulator on whether the bank fully complies with Belgian banking law and regulations and on internal controls:

The second one, which is interesting also, is that he (sic) has to give an opinion on the quality of internal controls but in a very broad sense, not only financial controls surrounding financials but operations also, governance also. No opinion on the effectiveness.

In addition to special reporting the auditor would typically, 'in normal years, normal times' meet the supervisor twice a year, once on a bilateral basis, and once on a trilateral basis with the supervisor and head of internal audit. As the regulator did its own inspections, the trilateral meeting sought to avoid duplication and ensure adequate coverage.

For the bilateral meeting, on being asked whether there was a two way flow of information, the partner commented, 'It was two-way to some extent'. The key issue for this partner was whether the supervisors were holding back any information:

We are uncertain if they know something we don't know ... they might know about a troublesome matter which hasn't been made public or we don't know about.

In addition to the increased intensity of contact between external auditors and supervisors, there was a similar increase in contact between internal auditors and supervisors. Whilst accepting this as inevitable and in line with BCBS recommendations, an internal audit executive commented there was a tendency for supervisors to regard internal audit as an 'inside informer'.

Risk

In the Netherlands, the three lines of defence model, was described by one partner as a 'very good' model which he had seen develop. Pointing out that the first line of defence became 'more important', the partner commented:

But the best thing which happened there is that the front office people themselves became to feel more responsible on what they were doing, and internal controls second, and internal audit became more important.

Belgian financial services firms have similarly seen the creation of a separate risk committee, the establishment of the post of chief risk officer and the adoption of the three lines of defence model. For one partner the important issue was the evolution away from 'compliance' towards a genuine risk function:

It has become a more vocal player. ... It leads to a real debate on the real risks with management and the chief risk officer being kind of a facilitator of that debate. ... But it's more of an evolution in the mindsets of the management and especially of the board.

On the other hand another organisation had expanded the audit committee to cover audit, risk and compliance. An internal audit executive explained there was a conscious decision to retain a single committee because '...members favoured the fact that the different control functions within the group all meet and give their own point of view to the same people at the same time'. The external auditor also attended all meetings and therefore in addition to audit obtained an overview of risk and compliance issues.

Accounting and auditing judgements

In the Netherlands, from an accounting perspective, one partner explained that with IFRS 'prudence somewhere lost its importance a bit' but that this went against the natural risk aversion of an auditor. The partner pointed to a difference in emphasis between the Dutch professional accountancy regulatory body and the supervisor about the accounting concept of prudence.

The professional body who is reviewing our files just took the IFRS book, put it on the table and said, "Where does it say that you can be prudent?" Of course it does not say anything there. So hence my prudence (sic) was not supported by the rules and that's

when it came into all kind of difficult questions. I had a better conversation with the banking supervisor.

Another partner was more supportive of the concept of fair value, 'In principle, I'm a great fan of fair value' but also recognised some of its limitations:

But when it is really difficult is over the last years when there was no data points, and then you're kind of maybe it's the best approach but I don't know. I don't even know where I am in the cloud – am I conservative or am I very aggressive. I don't know.

This partner thought there should be greater disclosure of judgmental areas in the financial statements:

I'm extremely positive about the fact that, especially those judgmental areas and where they are from a scale of prudent to aggressive, that should be in the annual accounts. My view is that it should be not necessarily be in the audit opinion ... but it should be in the report of the audit committee. It should be management, audit committee, supervisory body who present.

Partners were agreed on the unavoidable necessity of documenting challenge to management and recording reasons for audit judgements, one partner commenting, 'Yes, documentation is king nowadays...'.

In Belgium as regards prudence, one partner noted that the regulator might comment that there should be a high level of provisioning. Auditors and companies would then point out that financial statements had to be prepared, '...not on a prudent basis but on an IFRS basis'. This partner believed that because of different accounting traditions, the shift to IFRS reporting remained a problem in a European context. This partner believed that prudence nevertheless could still have a part to play, 'I'm still of the opinion that even with IFRS there could be some general provision so long as it is disclosed'.

In discussing the hotly debated issue of a lack of auditor scepticism one partner commented that bank profitability precluded challenge by auditors and supervisors, 'We went through quite a number of years where banks were so profitable that the question of challenging management was not on the agenda'. The partner acknowledged that with the advantage of hindsight it could be argued that auditors had provided insufficient challenge to management, but it was the case

that auditors had complied with then current auditing standards and guidelines. Another partner believed there had not been a lack of scepticism, stating that 'I can talk for my firm and I think it's true for the others, I don't see a lack of scepticism in the things where there is judgement'.

Partners were concerned about the increasing need to document challenge and reasons for their decision:

...it's really a concern from the profession, that we are all spending a lot of time on documentation. And I'm not against documentation, but the essence of the auditor is that healthy scepticism.

An important issue is whether there should be a separate accounting regime for banks. A possible way around this problem would be to publish the regulatory accounts. A partner explained that the regulatory accounts are very similar to the published accounts, except the former have, '...quite a lot of additional disclosures on regulatory matters ... capital adequacy, liquidity, concentration risks'. When asked whether the regulatory accounts should be made publicly available the partner responded, 'What would the public make with this? ... This is really regulatory and so investors need to have a good understanding of those regulations, which is not always right'.

Summary

The most significant difference between the UK and Belgium and the Netherlands was that auditor-supervisor liaison had been maintained. While the relationship changed and became more intensive during and after the financial crisis, it did not have to be re-invented as it had in the UK. An interesting feature in Belgium is the long standing requirement for audit partners also to be members of the Institute of Auditors for Accredited Financial Institutions. In many respects interviewees from Belgium and the Netherlands echoed remarks made by their UK counterparts including: the major development in financial services firms of the risk management function based on the three lines of defence model; and an increased need to document challenge and to record reasons for accounting and auditing judgements. Since Belgium and the Netherlands are both members of the Eurozone, an additional concern was emphasised that, under the banking union, a further set of regulations apply, including direct supervision of important banks by the European Central Bank, creating further uncertainty.

6. DEVELOPMENTS AND RECOMMENDATIONS

This chapter brings together a number of themes, developments and policy recommendations emerging during the course of this research project. The recommendations and developments are set in a UK context but may also be of relevance at European and international levels.

Auditor-supervisor liaison

Liaison between auditors and supervisors has been re-invigorated since the financial crisis. This is especially true in the UK where contact between auditors and supervisors had largely disappeared prior to the crisis. The relationship is structured by *Codes of Practice* issued by the regulators (FCA, 2013; PRA, 2013). The research project, involving interviews with individual audit partners, therefore provides an important insight into the changed relationship between external auditors and supervisors of financial services firms. Audit partners interviewed approved of the change and valued the opportunity to compare viewpoints. There was general agreement that meetings with supervisors were most productive where there was a genuine two-way exchange of views.

An important recent development is the PRA proposal (PRA, 2015) to require external auditors of the largest UK banks and building societies to provide written reports to the PRA as part of the statutory audit cycle. Interviews with audit partners indicated that initiatives to enhance the quality of auditor-supervisor dialogue would be welcomed. For the largest banks and building societies, themed reports on aspects of the audit relevant to the PRA would be a constructive way forward. The PRA states that the main benefit of its proposals is to enhance the auditor-supervisor dialogue by giving auditors an early indication of PRA concerns and by providing supervisors with more consistent and in-depth information, thereby enhancing the focus of subsequent bilateral and trilateral meetings. The PRA states that a supplementary benefit of its proposals is that the written auditor reports, and the processes surrounding them, should assist in promoting the FRC's agenda of improving the quality of bank audit. The PRA further proposes to publish an annual report on the quality of auditor-supervisor dialogue.

- **To strengthen the quality of the auditor-supervisor dialogue it is suggested that the PRA's proposal to require auditors of the largest banks and building societies to produce written reports to the PRA as part of the annual audit cycle be adopted.**

Following the revision of *ISA 700* and the introduction of extended auditor's reports (FRC, 2013a), a challenging question for the auditors of financial services firms is the extent to which the content and quality of the auditor-supervisor dialogue should be referred to in the new extended auditor's reports of financial services firms. A recent FRC survey of experience of the first year of the implementation of extended auditor's reports found that auditors had not only provided greater information about the audit but had also demonstrated an encouraging level of innovation and diversity of approaches (FRC, 2015a, b).

- **To provide information to stakeholders about the auditor-supervisor dialogue it is suggested that auditors of financial services firms include discussion of the dialogue in the new extended auditor's report.**

Risk

The new version of the *UK Corporate Governance Code* and the associated guidance documents on risk management and internal control, and solvency, liquidity risk management and going concern for banks (FRC 2014a, b, c), together with the revised *ISA 700* requiring auditors to enhance the transparency of the audit report, means that considerably more information about risk is now disclosed to investors and other stakeholders.

Interviews with executive directors, non-executive directors and senior managers in financial services firms revealed that an important internal development is the three lines of defence model of risk governance which has become rapidly and routinely adopted across the financial services industry. Typically, it has resulted in the creation of a board risk committee separate from the board audit committee but with overlapping membership, the creation of a new role of chief risk officer, and a considerable expansion of the risk management function. In the restructuring of risk governance, interviewees were grappling with the challenge of which risks should come within the remit of the risk committee and which risks within the remit of the audit committee.

A related challenge facing interviewees was the changing nature of the role of internal audit. Traditionally, the reporting relationship of the internal auditor was to the board audit committee but the development of the three lines of defence model, and the increased intensity of supervision, has led to the internal auditor having closer relationships with the risk management function, the risk committee and also with supervisors, in addition to the internal auditor's traditional links with external

auditor and the audit committee. To help internal auditors meet these challenges the CIIA has issued a Code which provides guidance on the role of internal audit in financial services firms (CIIA, 2013). The PRA and FCA welcomed the publication of the guidance and the CIIA has subsequently published two reports highly supportive of the Code's introduction and implementation (CIIA, 2014a, b). At the international level, the BCBS has issued supervisory guidance about the internal audit function in banks (BCBS, 2012).

The significant developments in risk governance, the expanding role of internal audit in financial services firms and the introduction of the CIIA Code has increased the importance of internal audit in financial services firms. In particular, the establishment of the Code invites the possibility of independent monitoring of compliance with the Code in terms of the quality of internal audit and the quality of internal auditor-supervisor dialogue. A question worthy of further consideration is how this might be achieved.

- **To enhance the status and quality of internal audit, and the effectiveness of the internal auditor-supervisor dialogue, it is suggested that the CIIA, in conjunction with regulators, establish a process for the independent monitoring of compliance with the CIIA Code.**

Accounting and auditing judgements

One of the important findings from the interviews, both with audit partners and with executive directors, non-executive directors and senior managers in financial services firms, was that interviewees believed auditors had demonstrated sufficient challenge and scepticism of management. Various reasons were offered as to why this was not a common perception amongst regulators or the public. These reasons ranged from a failure to adequately document discussions, disagreement about what was appropriate to challenge within the audit remit, through to accounting standards permitting a range of outcomes depending on judgement. Indeed, some interviewees believed that regulators were dissatisfied with accounting and auditing standards and that supervisors were seeking to impose their own views in auditor-supervisor meetings. This latter view may in part however be attributed to initial problems associated with reviving the auditor-supervisor dialogue that had largely ceased prior to the financial crisis.

The original FSA Code, and the subsequent FCA and PRA *Codes of Practice*, set out the relationship between the external auditor and the supervisor and have now

been in place for some years. While the emphasis of the Codes is on open, co-operative and constructive relationships between auditors and supervisors in order to support the effective fulfilment of their respective statutory functions, it should be remembered the statutory duties of each are different.

The recent PRA proposal notes there is now greater engagement between individual audit partners and supervisors under the *Code of Practice*, and regular high-level engagement between the senior financial services partners of the largest audit firms and the PRA (PRA, 2015).

- **To mitigate potential tensions between firms, auditors and supervisors over accounting, auditing and regulatory judgements, of particular importance are regular, high-level interactions and communication among the parties. It is suggested that a summary of the key accounting, auditing and regulatory topics discussed in high-level meetings between audit firms and the PRA be published to help inform financial services firms, investors and wider stakeholder groups.**

One of the advantages of undertaking research in different jurisdictions is the opportunity to discover differences in approach which may be worth considering or adopting in the UK. The FRC has had concerns about the quality of bank audit and the recent FRC audit quality thematic review has continued to reveal problems with bank audit quality (FRC, 2014f). One of the recommendations of the review was to make sector specific training mandatory for partners and staff engaged in bank audit which, arguably, reflects the inherent complexity of the audit of banks (FRC, 2014f, para. 1.2.3). The Belgian requirement for audit partners of banks and insurers also to be members of a separate professional institute is therefore of considerable interest. Whilst it may not be necessary or desirable to set up a separate professional institute for auditors of financial services firms in the UK, in the light of the findings of the FRC audit quality review an additional financial services audit qualification might serve to enhance the quality not only of bank audit but the audit of financial services firms more generally.

- **To support the FRC's stated requirement for mandatory training for staff undertaking bank audit it is suggested that the merits of an additional specialist qualification for financial services audit be investigated.**

Conclusion

In conclusion attention is drawn to a response by a chief risk officer to the question of what the interviewee saw as the main short to medium term challenges. The response was: ‘...it is very clearly regulation, regulation and regulation’. This captured the replies of many interviewees, whether audit partners, finance, risk or internal audit executives, or non-executive directors, who identified that responding to a variety of recent, current and proposed regulatory initiatives would be their main preoccupation in the short to medium term.

For auditors interviewed, this was not necessarily because of accounting and audit regulations directed specifically at banks and insurers as such, but rather the need to implement general accounting and auditing initiatives, combined with the ever increasing requirement to document challenges and support judgements, in the context of large and complex organisations, such as banks and insurers. For executive and non-executive directors interviewed, there was the need to respond to specific banking and insurance regulations, such as, in the UK the move to the regulatory regimes of the PRA and FCA, and for insurers the long awaited move to Solvency II. Such initiatives often required the urgent provision and analysis of data, which some interviewees argued could be at cross purposes with wider economic policy initiatives.

Notwithstanding the problems that led to the financial crisis, in the response there is a danger of regulatory overload, such that for auditors and financial services firms there is an undue focus on responding to new regulations rather than enhancing accounting, audit and business practices. The relationship between auditors, supervisors and risk explored in this project has changed significantly post-financial crisis, and the intensity of that relationship seems only set to grow. It is nevertheless important to remember the relationship is but one part of the much wider regulatory jigsaw.

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The financial crisis brought to the fore public and governmental concerns over the audit, regulation and supervision of financial services. One of the major initiatives undertaken in the UK following the crisis was the re-establishment of the links between supervisors of the financial services firms and their auditors.

It is within this context of regulatory change and public concern that this research project was undertaken to investigate the changes to the relationship between external auditors and supervisors of financial services firms, the impact of the financial crisis on risk governance in financial services firms, and the key accounting and auditing judgements of financial services firms. A series of interviews was conducted to gather the views of auditors and representatives of financial services firms on these issues.

With a period of significant change continuing to occur within the sector, the findings from the research are linked to current developments and proposals for change. The report concludes with a series of recommendations for the sector.

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