

The relationship between the external auditor and the supervisor:

A code of practice

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339A(6) of the Financial Services and Markets
2000 as amended by Section 42 of and
Schedule 13 to the Financial Services Act 2012

April 2013

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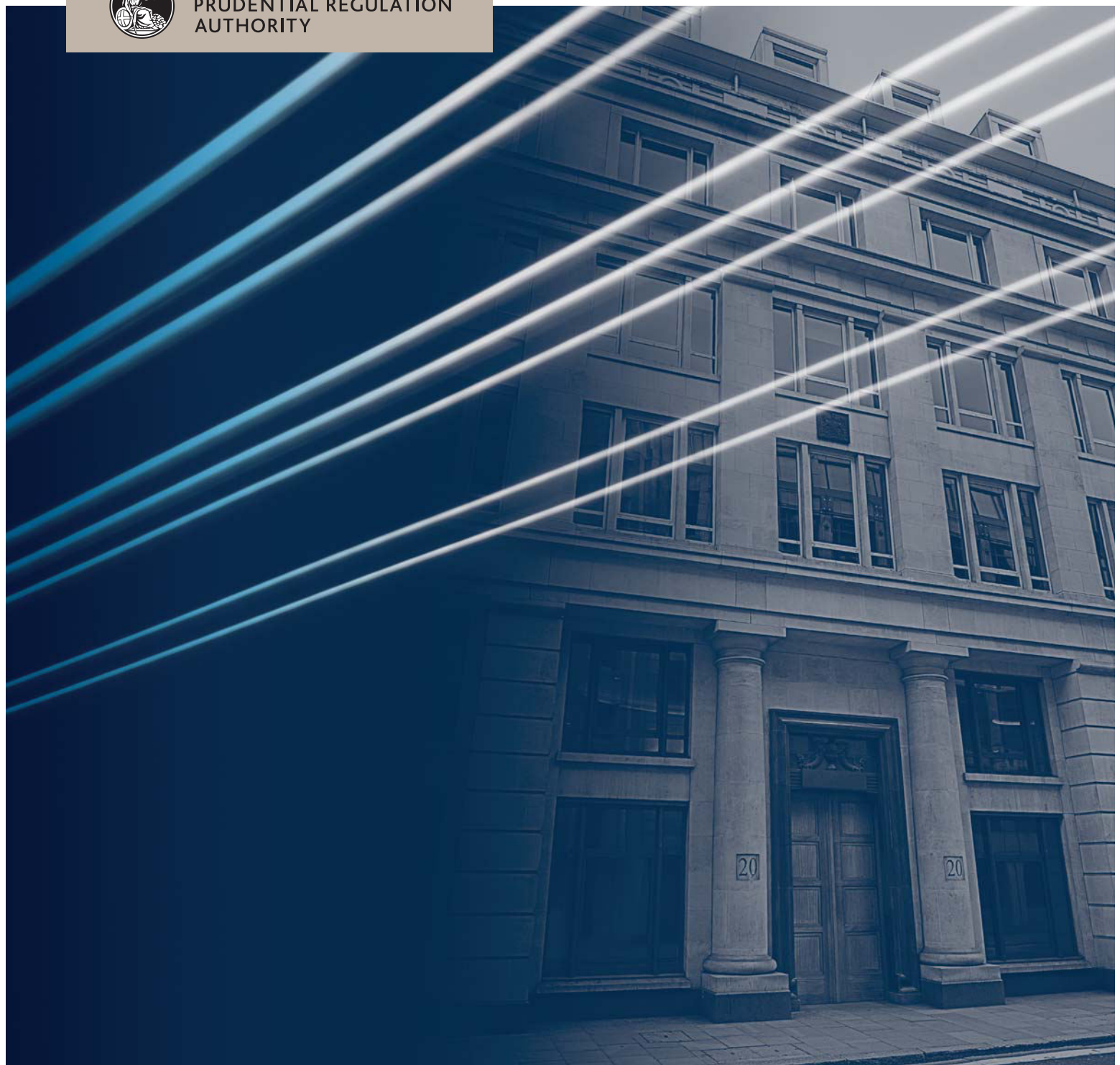
Supervisory Statement | LSS7/13

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April 2013



BANK OF ENGLAND
PRUDENTIAL REGULATION
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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA, has been adopted and revised by the PRA as a Supervisory Statement as part of this process. It is being reissued to fulfil the PRA's obligations under section 339A (2) of the Financial Services and Markets Act 2000 (FSMA).

Introduction

The external auditor has an important role to play in the regulatory framework, which requires confidence in audited financial information to ensure that supervisory efforts and policies are effective, appropriate and based on accurate data. This requires an open, co-operative and constructive relationship between the supervisor and the auditor so they can both provide effective input to the supervisory review. It is important, therefore, that the terms and scope of this relationship are clearly defined and understood by both parties and regulated firms.

This Code sets out principles that establish, in the context of a particular regulated firm:⁽¹⁾

- the nature of the relationship between the supervisor and auditor;
- the form and frequency that communication between the two parties should take; and
- the responsibilities and scope for sharing information between the two parties.

The aim and focus of the Code is to enhance the supervisory review and to contribute to high-quality external auditing by promoting an effective relationship between the auditor and supervisor in the context of a particular regulated firm. Other wider relationships also exist between the PRA and audit firms (both individually and collectively) through which inputs to the continuous supervisory assessment take place (such as insights into developments relevant to macro-prudential supervision). These wider relationships are not addressed in the Code.

However, the subject matter and concerns that are envisaged in the Code to be raised between supervisors and auditors about particular firms will inform and guide discussions at all levels of dialogue between the PRA and audit firms.

The nature of the relationship and information sharing between the PRA and audit firms should be considered in the context of the respective roles and responsibilities of auditors, a firm's management and those charged with the governance of a firm:

- A firm's management is responsible for maintaining an effective system of internal control for producing financial statements, applying accounting policies, forming judgements and developing appropriate assumptions in doing so.
- Auditors are responsible for gathering sufficient and appropriate evidence to form an independent opinion about management's assertions on those financial statements, taken as a whole within the context of a true and fair audit opinion.
- As part of its governance structure, a firm's audit committee is charged with holding management to account for internal control and financial reporting, overseeing the external audit process and appointing external auditors.

While the relationship with supervisors as guided by the Code is designed to enhance the effectiveness of both the audit and the supervisory process, it does not detract from the independent role the auditor plays in forming judgements

(1) A 'regulated firm' denotes any firm regulated by the PRA, ie a PRA authorised person under FSMA.

and opinions on a regulated firm's financial statements for the benefit of investors and other stakeholders.

To the extent that they are relevant, the principles set out below should be applied in a manner that is proportionate to the level of risk of the regulated firm.

Principle 1: Supervisors and auditors shall seek an open, co-operative and constructive relationship

There should be an open and constructive two-way dialogue between the auditor and supervisor to support the effective fulfilment of their respective statutory functions. Communication should be both through formal channels, such as scheduled bilateral⁽¹⁾ and trilateral⁽²⁾ meetings with relevant individuals, and through informal channels, such as telephone calls and meetings as appropriate. For an individual regulated firm, the primary relationship will be between the relevant supervisory team leader and the lead audit partner, but there will be occasions when there is dialogue between other individuals within the two parties.

At all times, both parties should aim to create an open and co-operative relationship that supports the other in carrying out their statutory functions. Auditors and supervisors are encouraged to have a relationship where views can be expressed on an informal basis.

Principle 2: Supervisors and auditors should engage in regular dialogue

Communication between the supervisor and the auditor should be as frequent as necessary and in whatever form to ensure that the two parties' statutory responsibilities are effectively fulfilled. The form, content and frequency of this dialogue will vary depending on the characteristics and circumstances of the firm.

For formal meetings, there should be at least one routine bilateral⁽³⁾ per year for deposit-takers, insurers and designated investment firms⁽⁴⁾ that are categorised as Category 1 and Category 2 firms (as determined in accordance with the Supervisory Assessment Framework).⁽⁵⁾ In addition there should be one routine trilateral per year for Category 1 firms where the PRA is the home supervisor. Trilateral meetings should involve at least the supervisory team leader, the lead audit partner and the chair of the audit committee (or an alternate independent non-executive director if appropriate to the circumstances). The meetings should cover all issues that they consider may be of interest to the other parties in carrying out their functions.

Additional bilateral meetings between the supervisors and auditors of Category 1 firms⁽⁶⁾ will be necessary around the

time of planning and concluding the annual audit. The Annex to this Code provides guidance on the timing and content of these meetings. The topics suggested in the Annex are examples of the potential content of meetings for any firm, as circumstances may dictate.

When a regulated firm's own auditors are appointed to conduct a skilled persons' review under section 166 or 166A of FSMA⁽⁷⁾ and where the responsible partner for the skilled persons' review is different from the lead audit partner, the supervisor should consider discussing the scope of the review with the lead audit partner before formal commissioning to benefit from any relevant insights he/she might have.

Similarly, when a firm other than the regulated firm's own auditors are appointed to undertake the skilled persons' review, the supervisory team leader will determine whether to engage with the lead audit partner at the time of scoping of the engagement. The auditor will ordinarily have access to the final scope and findings of the engagement, which should be discussed with the supervisory team leader on a timely basis, to the extent relevant to the audit.

It is desirable to ensure that regular dialogue is maintained throughout the review work between the team responsible for the skilled persons' review and the supervisory team, to ensure that the output from the engagement meets the requirements of the supervisor.

At the end of the process, the supervisory team leader should give feedback on the quality of output from the skilled person review to the person responsible for the review.

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

FSMA permits auditors to communicate to the PRA any information or opinion on a matter that the auditor reasonably

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- (1) A bilateral meeting is a meeting involving representatives of the PRA and the audit firm.
 - (2) A trilateral meeting is a meeting involving representatives of the PRA, the audit firm and the regulated firm.
 - (3) It may be useful to hold the bilateral in the run up to the annual Periodic Summary Meeting (PSM) to assist supervisors in setting supervisory strategy for the forthcoming year. The key risks identified during the meeting should be shared with the lead audit partner before finalisation.
 - (4) An investment firm would meet the conditions for designation by the PRA where, broadly speaking, it:
 - (a) has, or has applied for, permission to deal in investments as principal; and
 - (b) has, or would have if it were authorised, a minimum capital of EUR 730,000, or is a broadly analogous EEA passporting firm or non-EEA firm (a 730K Investment Firm).
 Provided these conditions are met, the PRA may designate the eligible firm if it considers it "desirable" to do so having regard to its statutory objectives.
 - (5) The different firm categories are defined in the PRA approach documents.
 - (6) Where the PRA is the home supervisor.
 - (7) Section 166 of FSMA gives the regulator the power to commission a skilled person to provide a report. Section 166A of FSMA gives the regulator the power to commission a skilled person to collect and update information.

believes is relevant to any function of the PRA.⁽¹⁾ The overriding consideration should be to disclose information that, according to the judgement of the lead audit partner, would assist the PRA in carrying out its functions. Such information should be disclosed in a timely fashion by the auditor directly to the supervisor. On many occasions, these matters will have already been discussed with management as appropriate. It is not sufficient for the auditor to rely on the firm to notify the supervisor.

The supervisor should disclose information to the auditor that it judges to be relevant to the fulfilment of the auditor's statutory duties. While there are restrictions on the information the supervisor can share with auditors and the circumstances in which it can be shared, the presumption should be that the supervisor will want to share any information it has that is likely to contribute to higher quality audits.

There are also requirements placed on auditors by the PRA Handbook and guidance provided in the Financial Reporting Council's Practice Notes. The Code does not address the duty of the auditor to report to the PRA under the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001.

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

Both the PRA and auditors are required by statute to treat much of the information received while carrying out their functions as confidential. There are, however, statutory gateways that permit auditors and the PRA to share information. There is specific provision within FSMA for the PRA to share confidential information with auditors for enabling or assisting either the PRA or the auditor to perform their functions. FSMA also provides for auditors to communicate in good faith with supervisors without contravening other duties they are subject to⁽²⁾ (as discussed under Principle 3 above).

The PRA and auditors, when in receipt of information from the PRA, are both bound by the confidentiality provisions under Part 23 of FSMA. Auditors are also bound by professional ethical standards on confidentiality.

There may be situations where supervisors impose additional restrictions on the further disclosure of information passed to auditors.

(1) FSMA, sections 342(3) and 343(3).

(2) Section 342 of FSMA provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the PRA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the PRA.

Annex

Guidance on the timing and content of auditor/supervisor bilateral meetings for regulated Category 1 firms

To improve the quality of the audit and the effectiveness of supervision, the timing and content of meetings between the supervisor and auditor of a regulated Category 1⁽¹⁾ firm should be aligned to the typical phasing of the regulated firm's audit and should focus on the key issues and judgements within the scope of that audit.

The lead audit partner and the supervisory team leader should liaise closely around the annual audit of such regulated firms and hold additional meetings as necessary. We suggest, as a minimum, that two meetings be held before the audit closes. Here we set out guidance on the possible scope of these meetings.

Meeting 1 — Planning stage of audit

- Risk assessment and scope — both the auditor's and supervisor's assessments in light of the external environment and the firm's performance, business model, risk appetite, etc (specifically including risks relating to the valuation and impairment of financial instruments).
- Discuss current key risks the firm poses to PRA objectives, skilled persons' report findings and other supervisory reviews.
- Audit strategy/approach and views on materiality.
- Observations on internal control (governance effectiveness, control environment, application controls, IT controls, monitoring controls, etc).
- Views and judgements on key risk areas based on audit/supervisory work performed to date, including specific significant transactions, material valuations and impairment decisions, methodologies, assumptions, etc.

- Assessment of risks relating to the going concern assumption.
- Accounting policy application and changes.
- Sources of potential management bias.
- Culture and tone set from the top.
- Observations on any areas of potential reputational risk for the firm.
- Observations arising from any work on regulatory reporting, including capital.
- Actions from previous years.

Meeting 2 — Pre-close

- Update on all areas covered in meeting 1.
- Discussion of adequacy and reliability of disclosures in light of statutory reporting requirements and risks, transactions, judgments, assumptions discussed in this and previous meetings.
- Critical accounting estimates and indications of management bias.
- Analysis of management's going concern assessment.
- Content of (anticipated) reporting to those charged with governance.
- Unadjusted misstatements and the auditor's evaluation in light of materiality.
- Material control weaknesses identified.
- Additional matters arising from the audit.
- Anticipated modifications to the audit report.
- Plans for potential skilled persons' reviews in the following year.

One or more subsequent meetings may be held, as appropriate, after the close of the audit to debrief on matters considered during the annual audit cycle and to consider any assessment of risks and anticipated issues.

(1) Where PRA is the home supervisor.

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