



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP8/15

Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries

February 2015

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Responses are requested by 27 May 2015.

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1 Overview

1.1 This consultation paper (CP) is relevant to large banks, building societies and insurers and also to the auditors and actuaries of all PRA-authorised firms. It introduces two proposals on the interaction between the Prudential Regulation Authority (PRA) and auditors and actuaries of PRA-authorised firms.

- (a) In relation to the largest banks and building societies that are not subsidiaries of overseas undertakings (Relevant Firms),⁽¹⁾ the PRA proposes to require their external auditors (auditors) to provide written reports to the PRA as part of the statutory audit cycle. These reports will augment the existing bilateral and trilateral communications between the PRA, auditors and audit committees.
- (b) At the PRA's request, HM Treasury (HMT) has laid regulations to commence the PRA's disciplinary powers over actuaries and auditors under section 345A of the Financial Services and Markets Act 2000 (FSMA). This allows the PRA to apply disciplinary measures to an auditor or actuary that has failed to comply with a duty imposed by rules of the PRA (including in relation to the new written audit reports outlined in (a)) or failed to comply with a duty under FSMA to communicate information to the PRA. The CP lays out how the PRA intends to use its disciplinary powers, including co-operation with other regulators.

1.2 The overall aim of both these proposals is to encourage auditors and actuaries to consider the PRA's primary safety and soundness (and in relation to (b) policyholder protection) objectives when determining the nature and rigour of their respective reviews.

Background

1.3 An effective auditor-supervisor relationship supports judgement-based supervision and helps promote the safety and soundness of PRA-authorised firms. The PRA greatly values the benefits delivered by high-quality auditor-supervisor relationships as significant insights are gained from auditors that carry out thorough audits. These benefits include more efficient, risk-focused allocation of supervisory resources. This can help in mitigating emerging issues and risks that can threaten both the safety and soundness of individual firms and financial stability more broadly.

1.4 There has been enhanced focus on improving the audit of banks and building societies and improving the relationship between auditors and supervisors since the publication of a Financial Services Authority (FSA) and Financial Reporting Council (FRC) discussion paper in 2010.⁽²⁾ The PRA considers that now is an appropriate time to reconsider practice, to assess the status and benefit of the auditor-supervisor dialogue and to consider whether new arrangements need to be put in place.

Summary of content

1.5 There have been improvements in the last few years in how auditors and the PRA engage with each other, framed by documents such as the PRA Code of Practice⁽³⁾ (the PRA Code) and by closer and more frequent engagement between supervisors and auditors. The PRA has been monitoring the quality of auditor-supervisor dialogue and, as noted in its response on this topic to the Parliamentary Commission on Banking Standards (PCBS),⁽⁴⁾ it has reported to the PRA Board on the dialogue. A summary of the report and an outline of actions taken to improve matters are included in Chapter 2.

1.6 The PRA considers that to achieve maximum value from the auditor-supervisor dialogue, it is right to review it regularly. This will ensure that meetings and contacts do not over time become a matter of routine, but continue to be focused on those issues that pose the most significant risks to advancement of the PRA's objectives. The most significant change proposed in the PRA rules at this juncture would require auditors of certain UK banks and building societies (Relevant Firms, as defined in the rule) that pose most risk to financial stability to report in writing to the PRA on relevant aspects of their audit. This proposal is outlined in Chapter 3.

(1) See draft rule 8.2 in Appendix 1 on the detailed scope of the proposal. In summary the proposal applies to auditors of UK banks or building societies that are not subsidiaries of an overseas undertaking and have a balance sheet total (ie total assets) greater than £50 billion in their individual balance sheet or are members of groups that have a balance sheet total (ie total assets) greater than £50 billion in their consolidated balance sheet.

(2) *FSA/FRC Discussion Paper 10/3*, 'Enhancing the auditor's contribution to prudential regulation', June 2010; www.fsa.gov.uk/pubs/discussion/dp10_03.pdf.

(3) *PRA Supervisory Statement LS57/13*, 'The relationship between the external auditor and the supervisor: a code of practice', April 2013; www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/codeofpractice13-13.pdf.

(4) *Bank of England response to the Final Report of the Parliamentary Commission on Banking Standards*, October 2013; www.bankofengland.co.uk/publications/Documents/news/2013/pcbsresponse.pdf.

1.7 The main benefit of written audit reporting in terms of supporting the PRA's objectives is enhancement of the auditor-supervisor dialogue. The supervisors of the Relevant Firms will gain more consistent and in-depth information over time on which to base their dialogue with auditors. The process proposed for agreeing the questions to be addressed will give auditors an early indication of regulators' concerns in any particular year in relation to areas they cover as part of the statutory audit before the main audit commences. From the PRA's overall perspective, there will be more consistency in the areas of focus for all Relevant Firms each year, where appropriate, while the bilateral meetings will still be able to focus on firm-specific risks. This process will therefore help in allocating scarce resources and reduce the likelihood that accounting risks go undetected.

1.8 A supplementary benefit of written audit reporting and the process around it is that it will provide a mechanism through which shortcomings can be addressed that have been identified in the audit of firms as indicated by findings from the FRC Audit Quality Review Team (AQRT) reports, leading to more robust audits where risks are flagged to support timely and appropriate regulatory intervention.

1.9 Given the role and duties that auditors and actuaries⁽¹⁾ currently perform and are likely to undertake in the future on behalf of and for the PRA, the PRA has asked HMT to commence the FSMA provisions that empower the PRA to exercise disciplinary powers over auditors and actuaries where they have failed to comply with a duty imposed on them under PRA rules or a duty imposed under FSMA to communicate information to the PRA. This step is expected to help foster incentives for external auditors and actuaries to consider the PRA's primary objectives of safety and soundness and policyholder protection when undertaking their work. This is in line with one of the PCBS recommendations in relation to auditors.⁽²⁾ The application of these powers is discussed in Chapter 4, including an outline of how the PRA is liaising with the FRC and other regulators in terms of planned co-operation in this area.

Statutory obligations

1.10 In discharging its general functions of making rules, and in determining the general policy and principles by reference to which it performs particular functions, the PRA must act in a way that advances its general objective to promote the safety and soundness of the firms it regulates (so far as reasonably possible) and, where rules and policies are relevant to insurance activities, its insurance objective to contribute to securing an appropriate degree of protection for policyholders. Where the PRA is asking questions on which the auditor is required to respond, this is to provide the PRA with information by which to judge the safety and soundness of the firms it regulates. It will also strengthen the reliability of

information in the audited financial statements on which the PRA relies. The PRA's proposals in relation to the exercise of disciplinary powers over auditors and actuaries are intended to ensure that full and accurate information is made available to the PRA to support the PRA in advancing its objectives.

1.11 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles which apply to the PRA, including proportionality. In addition, when consulting on draft rules, the PRA is required to consider the impact on mutuals, and equality and diversity.

Impact on mutuals

1.12 The PRA has a statutory obligation to state whether the impact of proposed PRA rules on mutuals will be significantly different from the impact on other firms. The proposed rules will affect firms that are mutuals. The PRA does not expect the effect on mutuals to be significantly different from the impact on other firms.

Equality and diversity

1.13 The PRA may not act in an unlawfully discriminatory manner. It is also required, under the Equality Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. To meet this requirement, the PRA assesses the equality and diversity implications of any new policy proposals considered. The PRA's assessment is that the issues addressed in this CP do not give rise to equality and diversity implications.

Impact on competition

1.14 The PRA has a secondary objective to facilitate effective competition in the markets for services provided by PRA-authorized persons. This means that, in taking action which advances its general and insurance objectives it must, as far as reasonably possible, act in a way which advances its secondary objective. Given the nominal, incremental costs related to written audit reports, the PRA does not expect its proposals to give rise to any adverse effects on competition, and the PRA considers the content of this consultation as compatible with the competitive objective.

Cost-benefit analysis

1.15 The PRA is required to perform a cost-benefit analysis (CBA) of the impact of its policy proposals, specifically on introduction of any new rule. CBAs are included within Chapters 3 and 4 of the Consultation Paper.

(1) The regulatory landscape is changing as a result of the EC Solvency II Directive (Directive 2009/138/EC) and there may be further consideration of the work of auditors and actuaries in due course.

(2) Report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, June 2013, Volume II, page 463, paragraph 1.040; www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf.

2 Auditor-supervisor engagement in relation to large financial institutions

Background

2.1 The absence of an effective auditor-supervisor relationship in the pre-crisis period was identified as a weakness in the FSA's supervisory approach by the Bank of England, by the Treasury Select Committee and subsequently by the PCBS. As a result, the FSA changed the way it interacted with auditors following the crisis and those changes have been extended in recent years by the PRA. Much of this followed the publication of and responses to the FSA/FRC Discussion Paper 10/3.

2.2 The PRA looks to auditors to contribute to effective regulatory supervision by directly engaging with the PRA in a proactive and constructive way. In that engagement, the PRA indicates areas of concern to auditors where it is considered likely to aid the auditors to focus on the right areas of risk in the audited entity. Although certain minimum aspects are laid out formally in the PRA Code⁽¹⁾ covering the relationship between the auditor and the supervisor, the PRA's focus is on the quality of engagement, which can range from formal meetings to informal calls and *ad hoc* communications. As discussed in our response to the PCBS' recommendation⁽²⁾ on enhancing auditor-supervisor dialogue and to satisfy the commitments we made therein, we have commenced reporting annually on the quality of auditor-supervisor dialogue to the PRA Board, with our first report in July 2014, which is discussed below. A copy of the report has been shared with the Bank of England's Court Oversight Committee. The PRA will consider the best way in which to publish future reports.

2.3 The PRA believes that a valuable ancillary benefit of auditor-supervisor dialogue, and particularly the discussions around accounting and auditing issues of concern that take place, is to support improvements in the quality of audit of firms, particularly in situations where auditors can be made aware in advance of key areas of regulatory interest that may be relevant to that audit client. Such a dialogue in advance on key areas of regulatory interest will provide the auditor with a better understanding of matters that may influence the decisions of regulators based on the financial statements. This focus on issues of regulatory interest may also allow the auditors to challenge firm management at a greater level of granularity than would otherwise be the case, but also helps to underpin challenges to management assertions. While it is not the role of the PRA to judge audit quality directly — the

responsibility for this sits with the FRC AQRT — the PRA has both a direct interest in encouraging improvements in audit quality and the ability to encourage improvements that support the FRC's work, to the extent that work affects PRA-authorized firms.

Current engagement with audit firms

2.4 The most direct engagement between the PRA and auditors of the largest UK banks and building societies takes the form of regular meetings and *ad hoc* discussions between individual firm supervisors and the lead engagement partner of the auditor. In addition, in order to reinforce the PRA Code and support the individual firm auditor-supervisor engagement, the PRA's accounting specialists analyse the financial statements of the largest UK firms and reports from their auditors to their audit committees in order to understand better the risks to which the firms are exposed. This analysis is provided to supervisors, so they can use the information to confirm or identify emerging risks, for example in relation to specific valuations, as well as to aid generally their bilateral and trilateral discussions with firms and auditors.

2.5 The PRA seeks to undertake broader engagement with the auditors through biannual bilaterals with the senior financial services partners of the largest auditors. In those bilaterals, as a basis for contributing to the PRA's identification of emerging risks in the sectors and in line with PCBS recommendations,⁽³⁾ the PRA and the auditors discuss key accounting and auditing issues that pose potential risks to PRA objectives and also outline current business trends and vulnerabilities that should be of interest to one another. Among other items, the PRA

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- (1) On 1 April 2013, the PRA published the Code of Practice covering the relationship between the auditor and the supervisor as a supervisory statement. This was provided to HMT and laid before Parliament to comply with section 339A FSMA. The PRA Code covers the minimum frequency of auditor-supervisor meetings, the suggested content of those meetings and, among other matters, sets out the principle that supervisors and auditors should have an open and constructive relationship sharing all information relevant to their respective statutory duties. Under section 339B FSMA the PRA is required to meet at least once a year with the auditors of any PRA-authorized person (other than an insurer or credit union) which is, in the opinion of the PRA, important to the stability of the UK financial system. This is covered through supervisors using the PRA Code. In early 2014, the Global Public Policy Committee of major audit firms identified the PRA Code as an example of good practice and used it as a basis for surveying the practice of auditor-supervisor dialogue for the Financial Stability Board.
- (2) Report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, Volume II, (www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf), paragraph 1,053 states that '... The Commission recommends that the Court of the Bank of England commission a periodic report on the quality of dialogue between auditors and supervisors...'
- (3) Report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, June 2013, Volume II, page 463, paragraph 1,053; www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf.

conveys key messages on matters of regulatory interest (eg concerns over valuations of commercial real estate or findings from our experts on the ranges of valuations for similar financial instruments).⁽¹⁾ The meetings are also used to give and receive feedback on the auditor-supervisor engagement compared to the PRA Code and hence the level of co-operation is kept under constant review.

Current engagement with audit committees

2.6 Given audit committee responsibilities — which include monitoring of the integrity of financial statements and assessment of the independence, objectivity and effectiveness of the auditor — the PRA regularly meets chairs of audit committees of the largest banks, building societies and insurers in roundtable meetings (currently three times a year) to share observations and expectations on topical accounting and auditing issues as covered in the biannual bilaterals with auditors. In addition to meetings with chairs of audit committees, the PRA also meets the individual chairs in trilaterals with auditors and as part of ongoing supervision.

Survey of supervisors and feedback from auditors

2.7 The first report on the quality of the auditor-supervisor relationship was provided to the PRA Board in July 2014. It was based on a survey, for the year to 31 March 2014, of the supervisors of the largest firms, as well as feedback obtained from the auditors.

2.8 To gather feedback from supervisors, the PRA used an electronic survey and follow up meetings. The survey questions sought to obtain feedback on the frequency and timing of scheduled or formal auditor-supervisor meetings, the quality of those meetings and whether the broader relationship was such that supervisors believe that auditors would proactively contact them, informally, outside scheduled meetings, to disclose emerging concerns.

2.9 To get auditors' perspectives, each auditor was asked to provide the PRA with its overall assessment of the quality of the auditor-supervisor relationship as an input to the report. To help ensure the auditor findings were comparable with the results of the supervisor survey, the PRA shared with the auditors the list of firms covered in the survey as well as the full suite of survey questions to the supervisors.

2.10 The report for the period to 31 March 2014 noted that the vast majority of engagement was considered only 'reasonable', and the PRA's aim is to improve this verdict in the longer term. In particular, in individual cases both supervisors and auditors considered there was room for improvement in the frankness with which information was shared, how often it was shared and what was covered in the bilateral meetings.

2.11 Some or all of the auditors noted that:

- (a) over the period in question there had been a high turnover of PRA supervisors and this had made establishing an effective dialogue more challenging;
- (b) bilateral meetings were more effective when attended by more senior and experienced supervisors;
- (c) the meetings could be more balanced, with supervisors sharing more information from the regulator's perspective (for example on capital adequacy, business models, governance and control); and
- (d) they had some concern about the extent to which the dialogue was focusing on the most important issues on which the auditors could make a contribution.

2.12 Generally, supervisors found the auditors to be proactive and open in their engagement, and were knowledgeable about the supervised firms. However, they also stated that:

- (a) auditors could have been more open in their interaction with the supervisors, especially in providing their independent views on the governance, controls, or significant judgemental areas in the financial statements of firms; and
- (b) in some cases, it would have been helpful if auditors were less defensive in their views or positions in relation to some of the more judgemental areas of financial statements.

2.13 Some supervisors found the trilateral meetings (auditors, audit committee chairs and supervisors) to be less useful than the bilateral meetings and indicated that the auditors tended to be less open than they were in the bilateral meetings.⁽²⁾

Actions as a result of the report

2.14 Following the survey and report on the quality of auditor-supervisor dialogue in summer 2014, the following actions were undertaken:

- (a) Discussions took place with each auditor to emphasise the overall messages from the report.
- (b) Presentations were provided to partners and managers of the large auditors which covered the results of the survey and feedback from supervisors and involved discussions

(1) The PRA frequently also presents to banks through the offices of the British Banking Association (BBA) and engages in understanding developing views in the sector through attending conferences and relevant meetings of industry groups, for example observing relevant committees at the Institute of Chartered Accountants in England and Wales (ICAEW).

(2) The PRA Code requires firms that are categorised as category 1, where the PRA is the home supervisor, to have at least one routine trilateral meeting per year between the lead supervisor, the lead audit partner and the chair of the audit committee of the firm.

about what the PRA expects from auditors under the PRA Code. This will be done for all future survey results.

- (c) More regular training is being provided for supervisors on auditor-supervisor engagement, with appropriate focus on how they might better understand the work of auditors and to encourage a more open and in-depth dialogue.

2.15 The PRA is committed to more involvement of senior and experienced staff in any team supervising the larger banks, building societies and insurers. The PRA will also continue to monitor the effectiveness of the relationships, involving frank assessments from all relevant parties, and will seek further

improvement over time. Future reviews, the results of which will also be published, will be used to assess the new written reporting regime that is being introduced, as outlined in Chapter 3 below.

2.16 Given the feedback noted above, and the proposed incremental changes to the auditor-supervisor dialogue, the PRA does not consider there is a need to make changes to the PRA Code. It will keep the PRA Code under review and consider whether the introduction of written reports by auditors, discussed in the next chapter, will require the PRA Code to be updated.

3 Written reports by external auditors of large UK banks and building societies to the PRA

Background

3.1 The PRA relies on external statutory audit to be of sufficient quality⁽¹⁾ to support its judgement-based supervision in promoting the safety and soundness of the firms it regulates and, for insurers, contributing to securing an appropriate degree of protection for those who are or will become policyholders. Importantly, through the auditor-supervisor dialogue described in the previous chapter, the PRA gains substantial insight into the corporate reporting and control environment of regulated firms through direct engagement with their auditors, as well as with audit committees, the management of firms, and those regulators with a direct remit over financial reporting and audit quality. The engagement with auditors in particular seeks to utilise the statutory audit work and the in-depth knowledge that auditors have of the audited firm, which offer insights into the firm's reporting and the underlying business that drives the reporting. As noted by the PRA's approach documents,⁽²⁾ 'Firms' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in a firm.'

Continuing issues with audits of the largest banks and building societies

3.2 As well as considering its dialogue with auditors, the PRA has been considering the impact on its work of the quality of statutory audits, in particular of the largest UK banks and building societies.

3.3 The PRA does not set or monitor the implementation of auditing standards but instead engages closely on auditing matters with the body that has these responsibilities, namely the FRC. The PRA has a Memorandum of Understanding (MoU)⁽³⁾ with the FRC under which the PRA gives input to the FRC's AQRT in relation to their identification of which audits to inspect and engages with the AQRT on matters of thematic interest. In relation to each audit inspected, the FRC AQRT provides private written reports to the auditors, the chair of the audit committee and to the PRA where it relates to a PRA-authorized firm. If the audit inspection indicates significant deficiencies in the audit of the firm, the PRA seeks to ensure that improvements are underway and deficiencies are being addressed.

3.4 Since the financial crisis, reports from the FRC AQRT have continued to indicate issues with the audits of the UK's major banks and building societies. These concerns can briefly be summarised as follows:

- (a) Auditors are often not sufficiently sceptical, and thus fail to challenge firm management consistently and effectively.
- (b) Adequate audit evidence is not always gathered, resulting in some cases in over-reliance on management information.
- (c) There is a tendency to look for evidence that supports the management assertions and resulting numbers rather than more neutral and even-handed evidence.
- (d) There is a general concern about inadequate quality control by auditors, and although this is a generic issue not restricted to PRA-authorized firms, it is a cause for concern to the extent that it affects any firm's audit.

3.5 This continuing concern over the quality of these audits has led the FRC to undertake more intense inspections and it has carried out a thematic review of the audits of thirteen of the major banks and building societies, including four UK subsidiaries of overseas banks.⁽⁴⁾

3.6 The FRC's thematic review of the audit of the major firms suggests that the audits are improving. The direction of travel

(1) In this CP, we consider an audit to be of sufficient quality to support the PRA's judgement-based supervision in promoting the safety and soundness of the firms it regulates and, for insurers, contributing to securing an appropriate degree of protection for those who are or will become policyholders, only if the auditor, when undertaking his or her duties in accordance with relevant auditing standards and the PRA Code, both (i) considers the risks to individual safety and soundness and financial stability and to the protection of policyholders (as informed by supervisors) in identifying, assessing and responding to the risks of material misstatement, and (ii) reports all findings germane to the risks to these objectives directly to us and the client's audit committee.

(2) *The Prudential Regulation Authority's approach to banking supervision*, Paragraph 180, June 2014; www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf.

(3) *Memorandum of Understanding between the Financial Reporting Council (FRC) and the Prudential Regulation Authority (PRA)*, www.bankofengland.co.uk/about/Documents/mous/moufrc.pdf.

(4) *Audit Quality Thematic Review*, 'The audit of loan loss provisions and related IT controls in banks and building societies', December 2014; www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-The-audit-of-loan-lo.pdf.

is therefore encouraging, but the pace of change is of concern as improvement has not been as rapid as might have been wished.⁽¹⁾ It is the case, of course, that improving audits is generally an incremental process as progress is often dependent not only on the auditor changing its approach, including the development of innovative audit techniques such as data analytics and benchmarking, but also on the audited firm developing — sometimes in reaction to the new audit techniques — new sets of data, systems or control mechanisms.

3.7 The results of the FRC's thematic review describe improvements in two areas only, and the auditors were warned in advance that the review would take place and would focus on those areas. But the new challenges that are going to arise in the near future — including the introduction of an expected credit loss impairment model and an expected increase in the use of non-observable fair values as a result of adjustments (Credit Valuation Adjustments, Debit Valuation Adjustments and Funding Valuation Adjustments) to fair value — mean that there is no room for complacency and further improvements will be needed. The PRA therefore believes it should take what actions it can to encourage continuing and lasting improvements to audit quality.

3.8 The PRA understands that investors in UK banks and building societies also want and expect consistent, high-quality audits. The PRA believes there is market demand, in the case of audits of major financial institutions, for auditors to undertake a more robust audit for these key financial institutions and provide more challenge and more analysis in their audits of significant areas of judgement around accounting estimates in financial statements. Market mechanisms cannot necessarily deliver the appropriate drivers to improve quality given the opacity of the audit process, an issue noted in the Competition & Markets Authority report on statutory audit.⁽²⁾ The FRC has introduced new extended audit reporting to seek to address this point⁽³⁾ and the PRA will continue to monitor the impact of the new regime in relation to large listed PRA-authorized firms that are subject to the Corporate Governance Code and the extent to which it improves audit quality through better insights into the audit being shared between auditors, audit committees and investors.

3.9 The PRA has considered what additional actions it could take that would both instigate further improvements in auditor-supervisor dialogue and support the work of auditors and the quality of their audit. Auditing standards are principles-based, but because the standards can be applied with variable rigour and quality, the PRA believes it is appropriate to provide the incentive for auditors to be more robust in their audit of key areas of valuation and risk and to gather better quality and more appropriate audit evidence where necessary. The PRA believes that its proposals, outlined

below, will both meet its own needs in relation to its dialogue with auditors and reinforce good auditing practice.

Summary of proposals

3.10 The PRA will use its rule-making powers to require auditors of the largest UK banks and building societies to provide written reports to the PRA annually on aspects of firms' financial reporting and the audit thereof. The draft rule is laid out in Appendix 1 and a draft supervisory statement outlining the PRA's expectations of auditors and how the regime will work in practice is in Appendix 2. The draft rule contains a requirement (at Rule 8.5) for firms to co-operate with their auditors in preparing their report.

3.11 The PRA proposes to limit the scope of written auditor reporting to the PRA to the largest UK banks and building societies as these are the firms which pose most risk to the stability of the financial system in the United Kingdom. The proposed rule thus applies to auditors of UK banks and building societies that are not subsidiaries of an overseas undertaking and have a balance sheet total (ie total assets) greater than £50 billion in their individual balance sheet or are members of groups that have a balance sheet total (ie total assets) greater than £50 billion in their consolidated balance sheet (Relevant Firms). The PRA will keep this under review and will consider, once the regime is established, whether the benefits of extending the scope of written reporting by their auditors — for example, to UK banks that are subsidiaries of overseas-headquartered banking groups or to smaller UK-headquartered banks and building societies — would outweigh the costs. In relation to insurers, there are fewer concerns at present about the quality of insurers' statutory audit, but the work of auditors will also be reviewed as part of the PRA's implementation of the Solvency II Directive. Nevertheless, if a firm that is in scope is in a group that also carries out insurance activities, questions may also arise in relation to the audit of the results of those insurance activities.

3.12 The main benefit of written audit reporting in terms of supporting the PRA's objectives is enhancement of the auditor-supervisor dialogue (which was discussed in the previous chapter). In particular, the supervisors of the Relevant Firms will gain more consistent and in-depth information over time on which to base their dialogue with auditors. The

(1) This was identified by the FRC as a reason for concern before it launched the thematic review, 'FRC calls for rapid improvement in quality of bank audits', December 2013; [www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-calls-for-rapid-improvement-in-quality-of-\(1\).aspx](http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-calls-for-rapid-improvement-in-quality-of-(1).aspx).

(2) 'Statutory audit services for large companies market investigation — A report on the provision of statutory audit services to large companies in the United Kingdom', Section 5, October 2013; assets.digital.cabinet-office.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf.

(3) This change was introduced into the relevant auditing standard, ISA (United Kingdom and Ireland) 700, 'The independent auditor's report on financial statements', June 2013; www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/June/FRC-issues-revised-auditing-standard-Making-audito.aspx.

process proposed for agreeing the questions to be addressed will give auditors an early indication of regulator concerns in any particular year in relation to areas they cover as part of the statutory audit before the main audit commences. It will also aid audit committees as the reports are made available to them, and hence aid trilateral meetings between audit committee chairmen, supervisors and auditors. From the PRA's overall perspective, there will be more consistency in the areas of focus for all Relevant Firms each year, where appropriate, while the bilateral meetings will still be able to focus on firm-specific risks. This process will help in allocating scarce resources and reduce the likelihood that accounting risks go undetected.

3.13 A supplementary benefit of written audit reporting and the process around it is that it will provide a mechanism through which shortcomings can be addressed that have been identified in the audit of the firms as indicated by findings from the FRC AQRT reports, leading to more robust audits where risks are flagged to support timely and appropriate regulatory intervention.

3.14 The questions will be predicated on the scope of the statutory audit work expected to take place, but focused on those issues of most interest to prudential supervisors, many of which are also of interest to investors. As the questions will be identical across all audits in scope, all firm-specific issues will continue to be dealt with in the auditor-supervisor bilateral meetings. The written reports are thus not designed to be a substitute for those meetings; instead, the information from the written reports will aid supervisors in directing their questions towards the key areas of risk.

3.15 The aim is not to vary the scope of the statutory audit, ie to impose some form of regulatory audit, nor to introduce consistency of valuations of financial instruments through a supervisory mechanism. The written reports will also be distinct from skilled person reports (s166 reports) and will not augment or replace such reports (whether carried out by the statutory auditors or not). If the PRA wishes to investigate further an issue that is not relevant to the statutory audit in terms of its risk of material misstatement, a s166 report may represent an appropriate alternative mechanism to obtain bespoke information for the purposes of the PRA's functions.

Co-operating with the PRA

3.16 Rule 7.1 in the Auditor Part of the PRA Rulebook currently states that, in co-operating with the PRA in the discharge of its functions under any relevant legislation, auditors should attend such meetings and supply such information as the PRA reasonably requests about the firm to enable the PRA to discharge its functions under any relevant legislation. In reviewing the engagement between auditors and supervisors, and implementing the proposed written reporting by auditors,

it was considered more appropriate to move the section of Rule 7.1 which is more in the way of guidance⁽¹⁾ to the new supervisory statement.

Example questions

3.17 The PRA is in the process of developing questions that will be used as the basis for the written reporting regime for 2015 financial years (likely to be a dry run for full implementation — see paragraph 3.18). An indication of the kinds of question that might be raised in relation to aspects of measurement of (1) loan loss provisions and (2) customer redress provisions are given in the box below. These examples should be read in conjunction with the Supervisory Statement in Appendix 2. However, given the questions are likely to change each year, these only provide an indication of the style and focus of the questions that might be asked. As noted in the draft Supervisory Statement in Appendix 2, in scoping the written report, questions will be agreed annually with the auditors in the second quarter to ensure all parties are clear on what is being asked and why.

Timing of introduction of written audit reporting and dry run in advance of the rule

3.18 The PRA proposes to introduce the new written audit reporting regime in relation to the audits of financial reporting periods ending on or after 1 November 2016. As an aid to transition to the new regime, the PRA intends to discuss with all stakeholders how the 2015 year end audits might be used as an opportunity for a dry run of the process. The PRA encourages all auditors to engage fully with this preparatory phase, which the PRA regards as compatible with the auditor's existing duty to co-operate with, and respond to reasonable requests for information from the PRA under Rule 7.1 (as amended by this CP). The PRA expects to fine-tune the process as a result of the dry run and after obtaining feedback from those involved.

Cost-benefit analysis

3.19 The PRA has considered the following costs and benefits of implementing the measures to support the PRA's statutory objectives.

3.20 Additional reporting to the PRA comes with incremental auditor costs which, it is expected, would be passed on in full to the audit client. The baseline for the cost-benefit analysis (CBA) is the audit fees firms currently incur for the core statutory audit of the group.

(1) The text considered to be in the nature of guidance and which has been removed from the rule is: 'including by attending such meetings and supplying such information as the PRA reasonably requests about the firm to enable the PRA to discharge its functions under any relevant legislation'.

Example questions

Loan loss provisioning (incurred loss) example (to be aimed only at specified portfolios eg UK retail mortgages)

Consideration of past impairment provisions

How did you satisfy yourself that the accuracy of past estimates and projections has appropriately been factored into this year's provisioning process?

Estimation uncertainty

How did you satisfy yourself with the extent to which the firm reflects the risk that the current low interest rate environment may be obscuring incurred loss events?

How did you satisfy yourself that adequate allowances are made for the risk that the main indicators used by the firm to determine the occurrence of loss events on interest-only portfolios or portfolios with flexible payment terms (where borrowers have discretion to change payment patterns) are lagging indicators?

Given that by definition forbearance is granted only to borrowers in financial difficulty, what evidence did you consider to assess management's judgement about whether or not forbearance was a loss event?

Sensitivities to key judgements

How did you satisfy yourself that the disclosures provided about the major sources of uncertainty involved in estimating the impairment provisions were appropriate? In particular, how did you identify the drivers to which the numbers are most sensitive and then satisfy yourself that that sensitivity has been appropriately communicated to readers?

Is the choice, and successful execution, of a work-out strategy one of the main drivers of that sensitivity and, if it is, how did you satisfy yourself that the assumptions made in that regard were appropriate and that any execution risk or other uncertainty inherent in that assumption are properly reflected in the provision amount and disclosures? To your knowledge, is this an issue that is monitored and understood by the audit committee?

Is uncertainty in collateral valuations one of the main drivers of that sensitivity and, if it is, how did you satisfy yourself that that uncertainty in factors such as haircuts on disposal and time to sale have been properly reflected in the provision amount and disclosures?

How did you satisfy yourself that the implications that forbearance has for data about loan performance and impairment have been properly reflected in the provision amount?

How did you satisfy yourself about the assumptions around the degree to which forbearance activities will be successful in mitigating loss, particularly where historic loss information is limited or incomplete?

How did you satisfy yourself that risk disclosures are sufficiently comprehensive and balanced so as to capture the impact of interest rate risk on credit risk for customer loans (for example, due to existing levels of customer indebtedness) and reflect the extent to which the firm manages these risks in an integrated way?

Provisions and contingencies for customer redress and litigation example

Estimation uncertainty

In the case of provisions for PPI and similar items:

- did management estimate what the range of acceptable provision amounts might be and how did you satisfy yourself that this range appropriately reflected the estimation uncertainty involved?
- if management did not estimate such a range, what did you estimate to be the range of acceptable provision amounts and how did you make that estimate?
- where did the balance sheet amount sit in this range? Was it in a similar place last year? If it was not, what do you understand to be the reason for the change and how did you satisfy yourself that this did not negatively affect the quality of the estimate?

Sensitivities to key judgements

Are there any potential provisions that relate to present obligations and probable outcomes that have not been recognised because of reliability concerns? If there are, how did you satisfy yourself that a reliable estimate of the required measurement amount could not be made?

How did you satisfy yourself that the cut-off between provisions and contingencies had been properly applied?

In gathering audit evidence on the appropriateness of the provisions made, how did you ensure that there was as much emphasis given to searching for and appropriately weighing evidence that did not support the estimates made as that given to searching for and appropriately weighing evidence that did support the estimates?

Disclosure related to customer redress and litigation provisions

How did you satisfy yourself that the disclosures provided about the major sources of estimation uncertainty were appropriate? In particular, how did you identify the drivers to which the estimates are most sensitive and then satisfy yourself that that sensitivity has been appropriately communicated to readers?

Were there any disclosures that were curtailed as permitted under IAS 37.91–92? If so, how did you satisfy yourself that the requirements of those paragraphs were met?

3.21 The direct incremental costs comprise the preparation of the report. There may also be an element of increase in the scale of audit procedures performed where the requirements of written reporting are such that the auditors determine they wish to perform more work than they currently do for the purpose of the statutory audit. For example the auditors may gain a better understanding of what would influence the economic decisions of users of the financial statements and modify their judgements about materiality, or auditors may gain a better understanding of the business risks of the Relevant Firm and modify their judgements made in identifying, assessing and responding to the risks of material misstatement. It is anticipated that where a high-quality statutory audit has been undertaken, the auditors can utilise this effectively to minimise the scope of any work required to complete the report.

3.22 The incremental costs can vary depending on a number of factors, mainly the number and scope of issues raised, which could change annually. Other factors include size of the firm, issues encountered on the audit, changes in charge out rates, staff mix and auditor rotation. To assess incremental costs, we surveyed the current auditors of the Relevant Firms and asked each to analyse the nature and extent of the additional work that would be required and the additional fees that they would charge in satisfying the written report requirement.

(a) The potential range of incremental audit cost at this initial stage has been estimated by auditors as 5%–15% of the total group audit fee depending on the level of detail and range of questions each year. It is expected that these costs will be passed on to the Relevant Firms. Based on audit fees reported in 2013 annual reports, this estimate translates into incremental audit costs ranging between £7 million to £22 million for the industry overall. The range is necessarily large at this stage as there is still some uncertainty about how the process will work in practice. There is also some uncertainty as to how much of the increase will be ongoing, since the auditors indicated that the estimated increase also reflects one-off costs of altering internal documentation and reporting systems to facilitate written reporting. The PRA considers that once the scope is properly established each year, the cost should in most cases be closer to the lower end of the estimate.

(b) There is likely to be some cost for the Relevant Firms themselves as the auditors will wish to engage with them to discuss the PRA questions at both the planning and final report stages. These costs have not been fully estimated but ought to be marginal if the auditors' consultations with their clients are built in to the normal planning and finalisation stages of the audit.

3.23 The additional direct cost to the PRA is in the form of resource that would be required to establish the reporting requirements each year and then undertake the analysis of the written audit reports. The PRA already has a dedicated team that undertakes analysis of firms' annual reports that can incorporate review of written reports within its work. It is not likely that there would be a material increase required in PRA resources.

3.24 Indirect costs could arise to the extent that auditors become overly conservative in their risk assessment which could in turn lead to firms excessively reducing lending and other risk-taking activities. This should be balanced against the cost of an audit that does not flag inappropriate risk-taking behaviour by Relevant Firms.

3.25 The main benefit of written audit reporting in terms of supporting the PRA's objectives is that the supervisors of the Relevant Firms will gain more consistent and in-depth insight and information from the auditor over time and, from the PRA's overall perspective, there will be more consistency in the areas of focus for all Relevant Firms each year, where appropriate, while the bilateral meetings will be able to focus on firm-specific risks. It will therefore encourage better dialogue between auditors and supervisors, help in allocating scarce resources and reduce the likelihood that accounting risks go undetected.

3.26 A supplementary benefit of written audit reporting and the process around it is that it will provide a mechanism through which shortcomings can be addressed that have been identified in the audit of major UK banks and building societies as indicated by findings from the FRC AQRT reports, leading to more robust audits where risks are flagged to support timely and appropriate regulatory intervention.

4 The PRA's disciplinary powers over external auditors and actuaries

4.1 Previously the PRA could take no direct disciplinary action against an auditor or actuary that breached a duty set out in PRA rules, or an obligation under FSMA to communicate information to the PRA. To provide sufficient incentives for auditors and actuaries to carry out their duties to the PRA appropriately, and to implement the new written reporting regime for auditors in a robust manner, it is appropriate to introduce a proportionate, responsive range of PRA disciplinary powers over auditors and actuaries. Therefore, following HMT's commencement of these disciplinary powers, this chapter considers how the PRA will use the powers and how the PRA will work with other regulators of auditors and actuaries in relation to enforcement.

Background

4.2 FSMA contains provisions which permit the FCA and the PRA to exercise disciplinary powers over auditors and actuaries in respect of duties imposed under FCA/PRA rules or under FSMA. However, the PRA's powers were drafted so as not to come into effect until such time as an order to that effect was made by HMT.⁽¹⁾ HMT has now made regulations to put the PRA's disciplinary powers over auditors and actuaries into effect.⁽²⁾ The PRA now has the power to discipline auditors and actuaries of PRA-authorized firms by way of fine, public censure or disqualification if they fail to comply with duties imposed by the PRA or under FSMA.

4.3 The duties of auditors that currently exist are outlined in the 'Auditors' part of the PRA Rulebook made through Part XXII of FSMA. In particular Rule 7.1 (as amended in this CP)⁽³⁾ states that 'An auditor of a firm must co-operate with the PRA in the discharge of its functions under any relevant legislation.'

4.4 An insurer is required to appoint an actuary under the PRA rules made through Part XXII of FSMA, which are set out in Chapter 4 of SUP in the Handbook. These appointments include the actuarial function holder, and with-profits actuary roles, that are delineated in Chapter 4.3 of SUP (SUP 4.3.13R and 4.3.16R). For Solvency II firms, these rules will be replaced from 1 January 2016 with a new 'Actuaries' chapter in the PRA rulebook, on which the PRA is currently consulting in CP24/14.⁽⁴⁾

4.5 Actuaries provide specialist support to the management of insurers by computing actuarial values that form part of the financial statements. Actuaries also have a significant number

of duties and responsibilities imposed on them under PRA rules relating to risks run by insurers and regulatory capital requirements. The commencement of the PRA's disciplinary powers is consistent with the importance that the PRA places on the quality of the actuarial work that is performed by actuaries for insurance firms.

4.6 Other regulators and professional bodies also have disciplinary powers over auditors and actuaries. In particular, the FRC is the independent disciplinary body for individual accountants, accountancy firms and individual actuaries in the United Kingdom. It operates two separate disciplinary schemes, one for the accountancy profession (the Accountancy Scheme), and the other for the actuarial profession (the Actuarial Scheme). The schemes cover individual accountants and accountancy firms, and individual actuaries, who are members of the professional bodies who participate in the relevant scheme. The FRC deals with cases of potential misconduct which raise or appear to raise important issues affecting public interest in the United Kingdom. All other cases of potential misconduct are dealt with by the professional bodies. Under the Accountancy Scheme, individual auditors and firms can be investigated and sanctioned in relation to statutory audit work and all other aspects of auditors' professional work. The FRC also operates a sanctions procedure in respect of statutory audit work (the Auditor Regulatory Sanctions Procedure) and can agree sanctions in respect of registered auditors for poor-quality audit work identified by its AQRT which is considered to warrant regulatory action but does not appear to amount to misconduct.⁽⁵⁾

Consultation on related statutory Statements of Policy

4.7 The PRA is subject to a requirement under FSMA to publish a Statement of Policy as regards the imposition of

(1) These powers are already vested in the FCA under section 345 FSMA and have been made available by order to the PRA under section 345A FSMA. The FCA's powers give them a locus over auditors' client asset work.

(2) The Financial Services and Markets Act 2000 (Regulation of Auditors and Actuaries) (PRA Specified Powers) Order 2015 (S.I. 2015/61).

(3) See Appendix 1.

(4) *PRA Consultation Paper CP24/14*, 'Solvency II: further measures for implementation', November 2014; www.bankofengland.co.uk/pradocuments/publications/cp2014/cp2414.pdf.

(5) 'FRC publishes new Auditor Regulatory Sanctions Procedure and Guidance', November 2013; www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/November/FRC-publishes-new-Auditor-Regulatory-Sanctions-Pro.aspx.

financial penalties on auditors and actuaries and the amount of such penalties. A draft Statement of Policy is set out in Appendix 3. The PRA is also consulting on a proposed change to its Statement of Policy on statutory notices and the allocation of decision-making under FSMA, as explained in paragraphs 4.13–4.15 below. Statutory notice decisions are those which give rise to an obligation to issue a supervisory, warning or decision notice under FSMA and so would include the issuance of statutory notices in relation to the exercise of disciplinary powers over auditors and actuaries. Details of the proposed amendment to this existing Statement of Policy are included in Appendix 4.

Statutory Statement of Policy on the imposition and amount of financial penalties

4.8 For the purposes of the financial penalties regime, the term 'auditors and actuaries' refers to the 'person' who is formally appointed under or as a result of a statutory provision.⁽¹⁾ 'Person' in this context, may include either an individual auditor or actuary or an audit (or less commonly, an actuarial) firm, depending on the terms of the appointment. For this reason, the PRA does not consider that it has powers to impose penalties on (or to issue a public censure of or seek to disqualify) individual auditors and actuaries employed by, or holding partnership with, a firm where it is the firm (rather than the individual) which is appointed under or as a result of a statutory provision. Similarly, if an individual actuary (or more rarely, auditor) is appointed, the PRA would not be in a position to take disciplinary action against the firm which employs that individual or in which he or she is a partner. In relation to actuaries, individuals may be subject to disciplinary and enforcement powers derived from other parts of FSMA, through the current Approved Persons or proposed Senior Insurance Managers Regime,⁽²⁾ but these relate to different potential rule or behavioural breaches.

4.9 The PRA's forward-looking and proactive supervisory approach depends on the PRA being able to consider all circumstances and information which may be relevant to the safety and soundness of PRA-authorized firms and, in insurance matters, to the securing of an appropriate degree of protection for policyholders. Auditors and actuaries appointed by PRA-authorized firms play an important role in verifying information provided by firms and in drawing particular matters to the attention of the PRA.

4.10 The PRA recognises the importance of taking a reasonable and proportionate approach where it decides it is appropriate to impose a financial penalty. The principles outlined in the draft policy statement in Appendix 3 are intended to ensure this. A financial penalty can act as a direct and quantifiable punishment for the breach of a requirement placed on auditors and actuaries. Further, it may provide an incentive to other members of the relevant professions to effect behavioural changes. Where an auditor or actuary has breached the PRA's

regulatory requirements the PRA may also publish a Statement of Misconduct (a 'public censure'). The policy sets out a range of non-exhaustive factors that the PRA will consider in determining whether, in a specific case, a public censure rather than a financial penalty would be an appropriate regulatory outcome.

4.11 In determining the scale of a financial penalty, the following general points apply:

- (a) The more serious or pervasive the breach and the greater the threat or potential threat the breach posed or continues to pose to advancing the PRA's statutory objectives, the higher the financial penalty is likely to be.
- (b) Depending on the nature and particular circumstances of the case, the starting point may be an appropriate percentage of the firm's total revenue or its revenue in respect of one or more areas of its business (or, for individuals, the pre-tax profit of a sole trader or the relevant employment income for an actuary who holds a position within a firm).
- (c) The proposed policy will also leave discretion to increase (or decrease) the starting point figure for a punitive penalty, where appropriate.

4.12 A policy under which the PRA takes account of the circumstances of each case, and which gives it the flexibility to take other relevant factors into account, should lead to proportionate decisions being made on the amount of any penalty.

Amendment to Statutory Statement of Policy on statutory notices and the allocation of decision-making under FSMA

4.13 The PRA proposes to amend its existing Statement of Policy on statutory notices and the allocation of decision-making under FSMA ('decision-making policy')⁽³⁾ to include provisions dealing with the allocation of decision-making responsibilities regarding the exercise of its disciplinary powers in relation to auditors and actuaries under section 345A of FSMA. The PRA considers that decision-making involving the disciplining of auditors and actuaries does not fit neatly into the current decision-making policy framework and therefore proposes a separate approach to such cases, as laid out in Appendix 4.

(1) In accordance with section 342 of FSMA.

(2) *PRA Consultation Paper CP26/14*, 'Senior insurance managers regime: a new regulatory framework for individuals', November 2014; www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp2614.pdf.

(3) As set out in Appendix 1 of 'The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure', April 2013; www.bankofengland.co.uk/publications/Documents/other/pradocuments/other/pradocuments/enforcement.pdf.

4.14 The PRA considers that allocating the decision-making function to its Supervision, Risk and Policy Committee (SRPC) takes account of the special status auditors and actuaries have, given their important role in supporting prudential supervision. The PRA further considers that providing a mechanism for escalation to the PRA Board caters for those instances appropriate for engagement at a higher level of seniority.

4.15 If the PRA's decision-making policy changes as a result of HMT's Review of enforcement decision-making at the financial services regulators,⁽¹⁾ the PRA will look to apply any such change to the framework for auditors and actuaries as appropriate.

Engagement with other regulatory bodies

4.16 Where appropriate, the PRA will utilise the legal gateways available to it to exchange information on disciplinary actions with the FRC and the relevant institutes (including the Institute and Faculty of Actuaries, ICAEW and Institute of Chartered Accountants of Scotland).

4.17 The PRA and FRC already have a MoU which outlines generally the way the regulators co-operate. The PRA is currently working with the FRC on developing a protocol as a basis for open and co-operative co-ordination of enforcement action where the FRC and PRA have a mutual interest (whether involving auditors or actuaries) and could both take action in respect of the same broad set of facts and circumstances. In particular it is recognised that the FRC's Accountancy Scheme covers the conduct of auditors in all aspects of their professional work, not just statutory audit, including their conduct in relation to PRA reporting. The protocol between

the FRC and the PRA will deal with how the two regulators decide who should take the lead in taking disciplinary action in areas of potential overlap. In light of the fact that the two enforcement regimes have different scope and powers in relation to individuals and firms, due consideration will be given to the positions of individuals and firms when both regulators could take action.

Cost-benefit analysis

4.18 In cases where it is appropriate to take disciplinary action against auditors and actuaries, resources will be required to undertake an investigation and this will depend, among other factors, on the nature of the case, including its factual, evidential and legal complexity and the number of subjects to be investigated. Similarly, the cost borne by the auditor or actuary will be dependent on the outcome of the investigation. Effective liaison with other regulators, demonstrated by the proposed protocol with the FRC, should avoid duplication of costs.

4.19 The disciplinary tool helps to give more emphasis to the importance of the PRA engagement with auditors and actuaries and the extent to which both have a role in supporting the PRA's objectives. It ensures that the PRA can take direct action against auditors and actuaries in circumstances where their failures have threatened the financial stability of an institution and/or impeded the work of the PRA in supporting financial stability overall, as distinct from the concerns of other regulators, for example in the case of auditors in relation to statutory audits generally.

(1) 'Review of enforcement decision-making at the financial services regulators', December 2014; www.gov.uk/government/uploads/system/uploads/attachment_data/file/389063/enforcement_review_response_final.pdf.

Appendices

-
- 1 PRA Rulebook: Auditor Reports to the PRA Instrument

 - 2 Draft Supervisory Statement — Written reports by external auditors to the PRA

 - 3 Draft Statement of Policy — Penalties

 - 4 Draft Statement of Policy — Decision-making

**PRA RULEBOOK: NON-AUTHORISED PERSONS: WRITTEN REPORTS BY AUDITORS TO THE
PRA INSTRUMENT [YEAR]**

Powers exercised

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (the PRA’s general rules);
 - (2) section 137T (general supplementary powers); and
 - (3) section 340(3A) (Appointment: requirements as to co-operation).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

**PRA Rulebook: Non-authorized persons: Written Reports by Auditors to the PRA Instrument
[YEAR]**

- D. The PRA makes the rules in the Annex to this instrument.

Commencement

- E. This instrument comes into force on [DATE].

Citation

- F. This instrument may be cited as the PRA Rulebook: Non-authorized persons: Written Reports by Auditors to the PRA Instrument [YEAR].

By order of the Board of the Prudential Regulation Authority
[DATE]

Annex

Amendments to the Auditors Part

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part

AUDITORS

Chapter content

1. APPLICATION AND DEFINITIONS
- ...
7. DUTIES OF AUDITORS
8. WRITTEN REPORTS BY AUDITORS TO THE PRA

Links

1 APPLICATION AND DEFINITIONS

...

1.3 In this Part the following definitions shall apply:

annual report and accounts

means

- (1) (in relation to a company incorporated in the UK) an annual report and annual accounts as those terms are defined in section 471 of the Companies Act 2006 together with an auditor's report prepared in relation to those accounts under sections 495 to 497A of the same Act;
- (2) (in relation to any other body) any similar or analogous documents which it is required to prepare whether by its constitution or by the law under which it is established.

accounting reference date

- (1) (in relation to a company incorporated in the UK under the Companies Acts) the accounting reference date of that company determined in accordance with section 391 of the Companies Act 2006;
- (2) (in relation to any other body) the last day of its financial year.

balance sheet total

means the aggregate of the amounts shown as assets in the balance sheet.

...

7 DUTIES OF AUDITORS

7.1 ~~An auditor of a firm must cooperate with the PRA in the discharge of its functions under any relevant legislation including by attending such meetings and supplying such information as the PRA reasonably requests about the firm to enable the PRA to discharge its functions under any relevant legislation.~~

...

8 WRITTEN REPORTS BY AUDITORS TO THE PRA

8.1 This Chapter applies in relation to annual reports and accounts with an accounting reference date on or after 1 November 2016.

8.2 Unless otherwise stated, this Chapter applies to an auditor of a firm that:

- (1) is a UK bank or building society;
- (2) is not itself the subsidiary of an undertaking that is not an UK undertaking; and
- (3) meets at least one of the following criteria:
 - (a) it has an individual balance sheet total greater than £50,000,000,000; or

(b) it is a member of a group that has a consolidated *balance sheet total* greater than £50,000,000,000,

as at the *accounting reference date*.

8.3 An auditor must provide annually a written report to the *PRA* in relation to that firm's audited *annual report and accounts*.

8.4 The report in 8.3 must:

(1) be provided within 120 days of the end of the relevant *accounting reference date*;

(2) provide qualitative information about key judgement areas, including:

(a) matters of valuation;

(b) quality of earnings;

(c) key accounting judgements; and

(d) the quality of the systems and controls relevant to the preparation of a *firm's annual report and accounts*; and

(3) be prepared with due skill, care and diligence.

8.5 An auditor must consult with the *PRA* in advance of preparing the report.

8.6 A *firm* must cooperate with its auditors in preparing the report.



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Appendix 2

Draft Supervisory Statement SSx/15

Written reports by external auditors to the PRA

February 2015

1 Introduction and purpose

1.1 The statement sets out the PRA's expectation of auditors in relation to the requirement to provide written reports to the PRA concerning the audit of major banks and building societies as laid out in Chapter 8 of the Auditors Part of the PRA Rulebook and should be read in conjunction with that chapter.

1.2 Auditors should refer to this statement both at the stage where the questions are discussed and agreed and when the report is being prepared and submitted. The regime will give auditors earlier and more consistent insights into regulatory concerns that may be relevant to their statutory audit in advance of their main audit work, and will encourage supervisors to focus on questions which are most relevant to what auditors do during the statutory audit that are also of interest to prudential supervisors.

2 Logistical and timing issues

2.1 The questions the PRA expects auditors to answer in their reports each year are the same across all the audited firms in scope for that year. The questions can vary from year to year, although some may be repeated. To the extent possible the PRA will keep the overall expected burden represented by the questions stable from year to year, although in a year of major change, for example the implementation of a major new accounting standard, the number or extensiveness of the questions is likely to rise on a temporary basis.

2.2 The timing of agreement of the questions and the submission of the final report is in line with the statutory audit cycle around planning and final completion respectively.

2.3 To facilitate effective planning for the reporting, the PRA and auditors will discuss and agree the scope of the report by the end of the second quarter of each financial year. The timetable for agreeing the questions will be sent to the auditors each year in the first quarter and auditors must use their best endeavours to reach an agreement with the PRA by the end of the second quarter under their general duty to co-operate with the PRA. Once agreement is reached, no further questions may be added before the report is due to be submitted; if the PRA wishes to raise any other questions with the auditors this will be done orally during the bilateral meeting and only an oral response will be expected.

2.4 The report should be submitted to the firm's supervisor at the PRA within four months of the end of the relevant financial year. This deadline is designed to provide sufficient leeway for the auditors to complete their audit procedures and sign off on the statutory financial statements which are generally required to be issued to a shorter deadline (but in any case for listed entities matches the deadline for issuing the annual report under the FCA's Disclosure and Transparency Rules).

2.5 The auditors will nevertheless be expected to submit the report as soon as possible following the completion of their audit. Auditors should consult with the PRA, through the relevant supervisor, before submission of the final version of the report, in order to ensure the PRA's expectations about the content will be met and that the report fully covers the agreed scope. This can be at any stage during the finalisation of the audit, but with sufficient time for the PRA to respond before the statutory audit is completed. Draft reports are thus shared with the PRA so that timely feedback and clarification can be provided on any areas of uncertainty in what is being sought through particular questions. Meetings are arranged to discuss issues arising from the draft report if necessary.

2.6 The physical format of the report is not mandated. All questions should be answered, if relevant, and to an appropriate standard (see further below).

3 Scope of questions and content of report

3.1 The matters addressed form part of the agenda of the existing bilateral meetings between auditors and supervisors. The introduction of a written report requirement whose scope is agreed in advance instils more discipline and focus on sharing key audit findings with the PRA and should be seen as a part of the overall bilateral relationship between the PRA and auditors. The bilateral meeting will continue to focus on more firm-specific risks and issues, although building on information obtained from the written reports.

3.2 Auditors will use the audit work undertaken for the annual report and accounts to comply with the reporting requirements. Other than potential overarching questions about adequacy of application of key accounting policies and the auditors' assessment of areas at risk of material misstatement, all questions will be directed only at portfolios or, where appropriate, line items or account balances that in the auditor's judgement require the performance of further audit procedures to be responsive to an assessed risk of material misstatement in relation to that item (as defined by auditing standards) in the circumstances of that firm.

3.3 Some of the questions may nevertheless drive auditors to undertake more work than originally envisaged in their audit planning. The initial dialogue with the PRA about the questions may lead auditors to reconsider their identification and assessment of risks of material misstatement and their planned responses to those risks. It is the choice of the auditors, however, if they decide to do more work than is necessary to respond to any such reconsideration of the risks of material misstatement in order to become comfortable about providing the report to the PRA. The PRA does not consider this to be an unwelcome outcome if it can be managed efficiently as part of the normal audit process and

could potentially help auditors to challenge management's assertions more effectively.

3.4 The PRA will seek to avoid asking questions that could just as easily be answered by the firm. Usually, the questions the PRA asks will require a discursive response that describes audit processes, methodologies and judgements. Auditors should nevertheless consider whether it is necessary to include management information to allow for a clear and full response (eg to clarify the scope of testing or quantify judgements).

3.5 The PRA will endeavour to respect the fact that some issues are likely to be immaterial in relation to some firms. While the PRA understands that the auditor's opinion is on the truth and fairness of the financial statements as a whole in the context of what is material, paragraph 10 of ISA (United Kingdom and Ireland) 320 Materiality in Planning and Performing an Audit, discusses the need to set materiality levels in relation to 'particular classes of transactions, account balances or disclosures' as well. Therefore there may be areas on which the PRA's questions are directed to materiality at this level, depending on the significance of the particular issues, including disclosures, to users of the accounts.

3.6 When raising questions about note disclosures, the PRA will bear in mind that in the context of bank reporting, some note disclosures are extremely important to users of the accounts in terms of giving necessary analysis of summarised figures in the main financial statements or providing additional insights into key financial statement assertions. Moreover, auditing standards make clear that note disclosures are important and should be part of the auditors' consideration, including in relation to materiality.

3.7 The PRA will aim to keep the scope of questions both as clear and as tightly drawn as possible. Duplication to a degree with audit committee material and management letters is inevitable and, bearing in mind the different duties of care involved, will not be something that the PRA will actively seek to avoid. Having said that, the PRA's purpose is to learn new things about the audit, not to make auditors repeat to the PRA things they are already putting in writing to their clients.

3.8 A question may be marked in the written report as not applicable in relation to any audit that is in scope for either of the following reasons (simply designate A or B as the reason):

- A The firm does not hold or is not exposed to the items in question, for example if a question is about a loan portfolio exposure in a particular country where the firm has done little or no relevant business.
- B The auditor's consideration of materiality, and its identification and assessment of the risks of material misstatement, in relation to the portfolio or balance did

not, in the auditor's judgement, require the performance of further audit procedures in relation to that item, in accordance with auditing standards, for that firm in that year and therefore the auditor expects to do little or no audit work on the item or items as part of their overall audit process beyond making that assessment.

3.9 Areas of focus on which questions are asked of auditors arise from their knowledge of valuation matters, quality of earnings, key accounting judgements and their observations on the quality of the systems and controls relevant to the preparation of the financial statements. Questions in relation to these revolve around specific issues, transactions and balances, as well as the overall picture presented in the financial statements. In each case auditors will be expected to provide their observations on the factors they have considered and challenges they made before forming their conclusion on the appropriateness of management judgements.

- (a) Valuation matters relate to audit work on major asset and liability categories in the firm's balance sheet. Auditors are expected to report their findings from consideration of inappropriate valuations, testing controls over valuation procedures and methodologies, and substantive testing, including sensitivity and scenario analysis. Disclosures around key valuation matters are also included.
- (b) Quality of earnings reporting by the auditors focuses on their consideration of aspects or components of a firm's revenue and expenses, in order to provide insights into the trends in historical earnings and relationships between revenue and cost lines so as to aid identification of areas of risk. The auditors are asked to discuss how they used any analytical procedures to assess the reasonableness of relationships between major revenue and cost categories.
- (c) Key accounting judgement areas typically address matters such as loan loss provisioning, customer redress provisions and level 2 and 3 fair values, but other questions may arise in any particular year, for example in relation to uncertain tax exposures, deferred tax assets, goodwill and other intangible assets. These areas typically involve a significant degree of management judgement in determining what should be recognised in the financial statements and how it should be measured. Disclosures around key judgement areas are also included. Where firms are part of groups that have insurance activities, questions may also arise in relation to that area.
- (d) Questions on the quality of the systems and controls relevant to the preparation of financial statements include the design effectiveness of the key controls over these important financial reporting areas. This also covers any control operating weaknesses identified during audit testing together with recommendations for remediation

and explanation of mitigating or compensatory tests the auditors have undertaken in order to be able to place reliance on the relevant systems.

4 Disclosure of the report

4.1 The PRA expects that the auditors may want to share the report with the audited firm, particularly the audit committee and discuss its content during both the planning phase and at the final report stage.

5 Co-operation with the PRA and interaction with other duties

5.1 Rule 71⁽¹⁾ of the Auditor Part of the PRA Rulebook requires auditors to co-operate with the PRA in the discharge of its functions under any relevant legislation.

5.2 The annual written report by auditors does not negate the existing auditors' duty to notify certain matters to the PRA under Chapter 7 of the Auditors Part of the PRA Rulebook or the auditors' right and duty to report to the PRA under FSMA.⁽²⁾⁽³⁾

5.3 In cases where the auditors undertake a section 166 (s166) FSMA (Reports by skilled persons) engagement for a firm they audit, this will not relieve them from their written reporting obligation. The auditors may make use of the work undertaken for s166 as appropriate but will still owe duty of care to the PRA with respect to the written report.

5.4 In addition, in situations where the PRA is concerned about areas that are not central to the audit on grounds of the auditor's assessment of risk of material misstatement, and it is considered to be a proportionate response, the PRA may use the tool of a S166 report, perhaps commissioned from a skilled person other than the auditor, to carry out such work.

6 Duties of auditors and firms

6.1 The auditor is expected to conduct the written audit reporting assignment to the same professional standard as that attached to the statutory audit.

6.2 A firm must co-operate with its auditors in preparing the report. Where the firm imposes any restrictions on the auditors' ability to complete the report fully, the auditors should bring this to the attention of the PRA as early as possible.

7 Interaction with EC Audit Directive and Regulation

7.1 Both the UK government and the FRC are currently consulting on the impact of Regulation (EU) No537/2014 and the revised EU Audit Directive (2014/56/EU), due to come into force in June 2016. The classification and treatment of different non-audit services is being dealt with in those consultations and the PRA will consider the outcome as regards this issue when finalising this Supervisory Statement.

(1) As amended by CP8/15.

(2) Section 342 (3) FSMA.

(3) Statutory Instrument 2001 No. 2587, FSMA 2000 (Communications by Auditors) Regulations 2001.



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Appendix 3

Draft Statement of Policy

Penalties

February 2015

Statement of the PRA's policy on the imposition and amount of financial penalties under the Act on persons who are, or have been, auditors or actuaries of a PRA-authorized person, appointed under or as a result of a statutory provision

Introduction and interpretation

1. This Statement of Policy is issued by the Prudential Regulation Authority (the 'PRA') in accordance with the requirements of section 345D of the Act.⁽¹⁾ It sets out the PRA's policy on the imposition and amount of penalties under section 345A(4)(c) of the Act on persons who are, or have been, auditors or actuaries of a PRA-authorized person, appointed under or as a result of a statutory provision (auditors or actuaries).⁽²⁾

2. The auditor or actuary who is so appointed, and to whom this statement of policy applies, may be an individual or a firm, depending on the specific terms of the relevant appointment. For this reason, where it is a firm (rather than the individual) who is appointed under or as a result of a statutory provision, the PRA does not consider that it has powers to impose penalties on (or to issue a public censure of or seek to disqualify) individual auditors and actuaries employed by, or holding partnership with, that firm. Similarly, if an individual actuary (or less commonly, auditor) is appointed, the PRA would not seek to impose a financial penalty (or to issue a public censure of or seek to disqualify) a firm which employs that individual or in which he is a partner.

3. In applying this Statement of Policy, the PRA may have regard to the following general principles and considerations:

(a) In discharging its general functions, the PRA must, so far as is reasonably possible, act in a way which advances its statutory objectives.⁽³⁾ The PRA is also required to have regard to certain regulatory principles.⁽⁴⁾

(b) The desirability of:

(1) upholding and encouraging high standards of behaviour that are consistent with persons⁽⁵⁾ who are subject to the PRA's regulatory requirements and standards, meeting and continuing to meet those requirements and standards;⁽⁶⁾ and

(2) demonstrating the benefits of such behaviour.

(c) The need to ensure that where disciplinary measures, including penalties, are imposed by the PRA:

(1) they properly reflect the seriousness of the breach of the PRA's regulatory requirements;

(2) they are proportionate to the breach;

(3) they, and the threat of similar disciplinary measures for any future misconduct, are effective in deterring the person who committed the breach, and others who are subject to the PRA's regulatory requirements, from committing similar or other breaches; and

(4) they are in the public interest.

(d) Where relevant, published statements of the PRA's approach to arrangements governing its interactions with auditors and actuaries who are subject to its regulatory requirements and standards.⁽⁷⁾

Determining whether the PRA will take action for a penalty

4. The PRA will consider all relevant facts and circumstances of each case when determining whether to take action against an auditor or actuary for a penalty under section 345A(4)(c) of the Act (and/or other appropriate enforcement action).

Factors that may be relevant for this purpose include:

(a) The general principles and considerations set out in paragraph 3 above.

(b) The impact or potential impact of the misconduct on the stability of the financial system.⁽⁸⁾⁽⁹⁾

(c) The seriousness of the breach of the PRA's regulatory requirements, including:

(1) its impact or potential impact on and any threat or potential threat it posed or continues to pose to the advancement of the PRA's statutory objectives and any effect action for a penalty could have on the advancement of those objectives;

(1) 'The Act' means the Financial Services and Markets Act 2000 (as amended).

(2) As set out in section 342 of the Act.

(3) As set out in sections 2B and 2C of the Act.

(4) As set out in sections 2H and 3B of the Act.

(5) Unless inconsistent with the subject or context, in this statement of policy words importing the singular number include the plural and *vice versa*, and words importing the masculine gender only include the feminine.

(6) In relation to the possible imposition of financial penalties on auditors and actuaries, the PRA may have regard to the impact or likely impact of a penalty or a particular level of penalty on the person concerned, including their continuing ability to provide services of an appropriate standard to PRA-authorized persons going forward.

(7) In this regard, see in particular *PRA Supervisory Statement LSS7/13*, 'The relationship between the external auditor and the supervisor: a code of practice', April 2013; www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/codeofpracticelss7-13.pdf.

(8) As set out in section 11 of the Act, 'the financial system' refers to the financial system operating in the United Kingdom and includes: (a) financial markets and exchanges, (b) regulated activities, and (c) other activities connected with financial markets and exchanges.

(9) Misconduct by auditors or actuaries which could have an impact on financial stability might include, for example, failure promptly to draw the PRA's attention to matters which may be material to the exercise of functions by the PRA, including failure to notify the PRA in good time that a firm is failing to meet threshold conditions, may no longer be a going concern or is in breach of PRA rules.

- (2) its duration or frequency;
- (3) whether it was deliberate or reckless;
- (4) whether the auditor or actuary has derived any economic benefits from or in consequence of a breach (including, in instances where, in the opinion of the PRA, the auditor or actuary appears to have allowed commercial considerations to take precedence over that auditor's or actuary's duty to the PRA, economic benefits in the form of fee income);
- (5) whether it reveals serious or systemic weaknesses or potential weaknesses in the auditor's or actuary's management of the provision to PRA-authorized persons of audit or actuarial services which relate to requirements imposed on those persons or on the auditor or actuary by the PRA and/or the governance and controls relating to the oversight of all or part of those services; and
- (6) whether there is more than one issue which, considered individually, may not justify the imposition of a penalty but, when considered together, may do so.
- (d) The extent of the auditor's or actuary's responsibility for the breach.
- (e) The conduct of the auditor or actuary after the breach was committed, including:
- (1) how promptly, comprehensively and effectively the auditor or actuary brought the breach to the attention of the PRA and/or any other relevant regulatory or professional body⁽¹⁾ or law enforcement agency;
 - (2) the degree of co-operation the auditor or actuary showed during the investigation of the breach by the PRA and/or any other relevant regulatory or professional body or law enforcement agency;
 - (3) the nature, extent and effectiveness or likely effectiveness of any remedial action the auditor or actuary has taken or will take in respect of the breach and how promptly it was or will be taken;
 - (4) the likelihood that the same or a similar type of breach (whether on the part of the person in question or other auditors and actuaries who are subject to the PRA's regulatory requirements) will recur if action for a penalty (and/or other appropriate enforcement action) is not taken by the PRA and/or any other relevant regulatory or professional body or law enforcement agency;
- (5) whether the auditor or actuary has promptly and effectively complied with any requests or requirements of the PRA and/or any other relevant regulatory or professional body or law enforcement agency relating or relevant to their behaviour, including as to any remedial action; and
- (6) the nature and extent of any false, incomplete or inaccurate information given by the person and whether the information has or appears to have been given in an attempt knowingly or recklessly to mislead the PRA and/or any other relevant regulatory or professional body or law enforcement agency.
- (f) The previous disciplinary record and/or regulatory relationships of the auditor or actuary including:
- (1) any previous enforcement or other regulatory action⁽²⁾ by the PRA, the Financial Conduct Authority ('FCA'), any predecessor regulators, the Financial Reporting Council ('FRC') and/or professional body resulting in an adverse finding against the auditor or actuary;
 - (2) any private warning given to the auditor or actuary by the PRA, FCA and/or any predecessor regulators;⁽³⁾
 - (3) any previous agreement or undertaking by the auditor or actuary to act or behave or refrain from acting or behaving in a particular way and their compliance with it; and
 - (4) the general disciplinary record of the auditor or actuary, or specific aspects of it relevant to the behaviour in question, and the auditor's or actuary's approach to being open and co-operative with the PRA, FCA or any predecessor regulators.
- (g) Relevant guidance or other information or materials provided by the PRA, FCA and/or any predecessor regulators, and/or relevant auditing standards, ethical standards and related practice notes and bulletins issued by the FRC, which were in force at the time of the behaviour in question.⁽⁴⁾

(1) 'Professional body' would include, but is not limited to, accounting and actuarial bodies covered by the disciplinary scheme of the Financial Reporting Council.

(2) Including any requests made by the PRA, FCA and/or any predecessor regulators to take remedial action, and how promptly and effectively such action has been taken.

(3) Private warnings are a non-statutory tool. Subject to the facts and circumstances of the case in question, the PRA may decide to give an auditor or actuary a private warning rather than taking formal action against him. A private warning by the PRA is not a formal determination of whether the PRA's regulatory requirements have been breached. Where the PRA is minded to give a private warning, it will normally set out its concerns in writing and afford the person a reasonable opportunity to respond to those concerns prior to any private warning being given.

(4) The PRA may have regard to any relevant guidance or other materials provided by it, the FCA, any predecessor regulators, and/or the FRC, whether in the form of general guidance issued publicly or advice given to particular auditors or actuaries. For example, where this helps to illustrate ways in which an auditor or actuary can comply (or could at the relevant time have complied) with relevant regulatory requirements or the standards of behaviour expected of them.

- (h) The PRA's determination of whether action by it for a penalty (and/or other appropriate enforcement action) against the auditor or actuary is or is likely to be an appropriate and effective regulatory response to the behaviour in question.
- (i) Any relevant action by other domestic and/or international regulatory authorities or law enforcement agencies (including whether, if such agencies are taking or propose to take relevant action in respect of the behaviour in question, it is necessary or desirable for the PRA also to take its own separate action, including action for a penalty):
- (1) Certain misconduct by auditors and actuaries may result in breaches of the rules and requirements of the PRA, the FCA or other domestic or overseas regulatory or law enforcement agencies. Such cases may result in investigation and enforcement action by the PRA and/or such other agencies.
 - (2) When deciding how to proceed in such cases, the PRA will examine the facts and circumstances of the case in question and the threat the misconduct posed or continues to pose to the advancement of its statutory objectives. Where required by the Act or appropriate, the PRA will also consult or co-operate with the FCA⁽¹⁾ and/or any other relevant regulatory or professional body or law enforcement agency.
 - (3) The PRA will determine, in the light of these matters and the principles and considerations set out in paragraph 3 above, whether it is appropriate for the PRA to investigate and take enforcement or other legal action in respect of the misconduct. In appropriate cases, the PRA in conjunction with the FCA and/or any other relevant regulatory or professional body or law enforcement agency will determine whether any joint or co-ordinated investigation and enforcement or other legal action is required.

Public censures

5. Pursuant to section 345A(4)(b) of the Act, where an auditor or actuary has breached the PRA's regulatory requirements, the PRA may publish a Statement of Misconduct (a 'public censure').

6. In deciding whether it is appropriate to issue a public censure rather than impose a penalty (and/or take other appropriate enforcement action), the PRA may have regard to:

- (a) The general principles and considerations set out in paragraph 3 above.

- (b) The factors set out in paragraph 4 above (determining whether the PRA will take action for a penalty).

- (c) The factors set out in paragraphs 8 to 33 below (determining the appropriate level of penalty).

7. Other considerations that may be relevant include the approach of the PRA in any similar previous cases.⁽²⁾

Determining the appropriate level of penalty

8. Where, in the light of the matters set out in paragraphs 3 and 4 above relevant to the case in question, the PRA has decided to impose a penalty, it will be calculated in accordance with a five-step approach, which can be summarised as follows:

- (a) Step 1: where relevant, the disgorgement of any economic benefits derived from the breach.
- (b) Step 2: in addition to any disgorgement at step 1, the determination of a starting-point figure for a punitive penalty having regard to the seriousness of the breach, whether the auditor or actuary that committed the breach is a firm, a sole trader or an individual working in a firm and the financial position of that auditor or actuary.
- (c) Step 3: where appropriate, an adjustment to the figure determined at step 2 to take account of any aggravating, mitigating or other relevant circumstances.
- (d) Step 4: where appropriate, an upwards adjustment to the figure determined following steps 2 and 3, to ensure that the penalty has an appropriate and effective deterrent effect.
- (e) Step 5: if applicable, one or both of the following factors may be applied to the figure determined following steps 2, 3 and 4:
 - (1) a settlement discount;⁽³⁾
 - (2) an adjustment based on any serious financial hardship which the PRA considers payment of the penalty would cause the auditor or actuary (see paragraphs 28 to 34 below).

(1) See in this regard the draft memorandum of understanding between the FCA and the PRA published on 27 January 2012 (the 'MoU') or such revised or additional versions of the MoU that may be produced from time to time.

(2) Subject to the particular facts and circumstances of the case in question, the PRA will seek to achieve a consistent approach to its decisions on whether to impose a penalty or issue a public censure.

(3) Any such discount does not apply to the disgorgement of any economic benefits derived by the auditor or actuary from the breach (step 1).

9. These steps will apply in all cases, although the detail of the application of one or more of them may differ for cases against auditing and actuarial firms as opposed to individual auditors and actuaries.⁽¹⁾

10. The PRA recognises that the overall penalty arrived at pursuant to its five-step approach must be appropriate and proportionate to the relevant breach. The PRA may decrease the level of the penalty which would otherwise be determined following steps 2 and 3 if it considers that it is disproportionately high having regard to the seriousness, scale and effect of the breach. In determining any deterrence uplift at step 4, the PRA will also ensure that the overall penalty is not disproportionate.

11. Part 3 (Penalties and Fees) of Schedule 1ZB to the Act provides *inter alia* that the PRA may not, in determining its policy with respect to the amounts of penalties to be imposed by it under the Act, take account of expenses which it incurs, or expects to incur, in discharging its functions.

The five steps for calculating penalties to be imposed on auditors and actuaries

Step 1 — disgorgement

12. Where relevant and where it is practicable to ascertain and quantify them, the PRA will seek to deprive an auditor or actuary of any economic benefits derived from or attributable to the breach of its regulatory requirements. The PRA may also charge interest on such benefits.⁽²⁾

13. For these purposes, in instances where, in the opinion of the PRA, the auditor or actuary appears to have allowed commercial considerations to take precedence over that auditor's or actuary's duty to the PRA, 'economic benefits' may include part or whole of:

- (a) the fee, including disbursements, payable to the auditor or actuary in respect of the engagement in which the misconduct occurred; and
- (b) the total fees, including disbursements, payable to the auditor or actuary in respect of any further engagements between the auditor or actuary and the PRA-authorized person who was party to the engagement in which the misconduct occurred (or members of its group), which run concurrently with, or commence within twelve months of the end of, the engagement in relation to which the misconduct occurred.

14. In assessing whether 'economic benefits' should include relevant fee income, the PRA will have regard to the extent to which an individual auditor or actuary working in a firm was in a position to benefit from such fee income.

Step 2 — the seriousness of the breach

15. In addition to any figure in respect of disgorgement established at step 1, the PRA will determine at step 2 a starting-point figure for a punitive penalty having regard to:

- (a) the seriousness of the breach by the relevant auditor or actuary, including any threat or potential threat it posed or continues to pose to the advancement of the PRA's statutory objectives; and
- (b) a suitable indicator of the size and financial position of the audit or actuarial firm;⁽³⁾ or
- (c) the income of the individual auditor or actuary.⁽⁴⁾

16. In respect of firms:

- (a) A suitable indicator of the size and financial position of the audit or actuarial firm may include, but is not limited to, the firm's total revenue or its revenue in respect of one or more areas of its business.⁽⁵⁾
- (b) In those cases where the PRA considers that revenue is an appropriate indicator of the size and financial position of the audit or actuarial firm, ordinarily it will calculate the audit or actuarial firm's revenue during its last business year, that is, the financial year preceding the date when the breach ended⁽⁶⁾ ('relevant revenue').
- (c) The PRA will apply an appropriate percentage rate to the audit or actuarial firm's relevant revenue to produce a figure at step 2 that properly reflects the nature, extent, scale and gravity of the breach.⁽⁷⁾

17. In respect of auditors and actuaries who are individuals:

- (a) The PRA will ordinarily determine a figure at step 2 based on the individual's annual income. 'Annual income' means either (i) the pre-tax profit that the auditor or actuary

(1) See paragraphs 15 to 18.

(2) The PRA will determine on a case by case basis whether interest should be charged and, if so, the interest rate that should apply and the period for which interest should be payable. In determining an interest rate, the PRA may have regard to the rates applied by the civil courts or other regulatory authorities.

(3) The firm size in this case would relate only to the UK firm and would not be by reference to the size of the network to which it belongs.

(4) Where the PRA determines that an individual's income is not an appropriate basis for determining a penalty at step 2 that properly reflects the seriousness of the breach, it may use an alternative, for example, the net worth of the individual.

(5) Where the PRA determines that revenue is not an appropriate indicator of the size and financial position of the firm for the purpose of determining a penalty for the breach, it may use an appropriate alternative indicator.

(6) In this connection, the PRA may have regard to any relevant considerations. These may include, for example, (a) any unusual features of the business year in question; or (b) where the breach is continuing, the PRA may have regard to the firm's relevant revenue in its last and/or current business year.

(7) The PRA has the discretion to determine an appropriate seriousness percentage. In general, the more serious and widespread the breach and the greater the threat or potential threat it posed or continues to pose to the advancement of the PRA's statutory objectives, the higher the percentage is likely to be, subject to the overall penalty being appropriate and proportionate to the relevant breach.

- made from their work as a sole trader or (ii) the gross amount of all benefits, including any deferred benefits, received by the individual from the employment in connection with which the breach of the PRA's requirements occurred.
- (b) For the purposes of (a)(ii) above, 'benefits' include, but are not limited to, salary, bonus, pension contributions, share options and share schemes and 'employment' includes, but is not limited to, employment as an adviser, director, partner, consultant or contractor.
- (c) Ordinarily, the PRA will calculate the individual's annual income during the tax year preceding the date when the breach ended⁽¹⁾ ('relevant income').
- (d) The PRA will apply an appropriate percentage rate to the individual's relevant income to produce a figure at step 2 that properly reflects the nature, extent, scale and gravity of the breach.⁽²⁾
18. In determining a percentage rate reflecting the seriousness of the breach in cases involving auditors or actuaries, the factors to which the PRA may have regard include, as appropriate:
- (a) The effect or potential effect of the breach on the advancement of the PRA's statutory objectives.
- (b) The duration or frequency of the breach in relation to the nature of the requirement contravened.
- (c) Whether the breach was deliberate or reckless.
- (d) The extent of the auditor's or actuary's responsibility for the breach.
- (e) Whether the person against whom action is to be taken is an individual auditor or actuary.
- (f) Whether the breach forms part of a course or pattern of non-compliant behaviour.⁽³⁾
- (g) Whether the breach reveals serious or systemic weaknesses or potential weaknesses in the auditor's or actuary's management of the provision of audit and/or actuarial services to PRA-authorized persons and the governance and controls relating to the oversight of all or part of those services.
- (h) The seniority or experience of an individual auditor or actuary.
- (i) Whether the auditor or actuary failed to act with integrity,

abused a position of trust or committed a breach of any applicable professional code of conduct.

Penalties for the late, inaccurate or incomplete reporting of matters to the PRA

19. The PRA attaches considerable importance to the timely,⁽⁴⁾ accurate and complete⁽⁵⁾ communication and/or notification of matters on which auditors and actuaries are required to report to the PRA under legislation⁽⁶⁾ and/or PRA rules. This is because information reported by auditors and actuaries is essential to the effectiveness of the PRA's forward-looking, judgement-based approach to the exercise of its functions.

20. In addition to the factors set out in paragraphs 14–17 for cases against auditors and actuaries, the following considerations may be relevant where the PRA is considering the imposition of a penalty on an auditor or actuary for late, inaccurate or incomplete communications or notifications (whether in isolation or together with other enforcement action such as disqualification):

- (a) The length of time after which the communication or notification was made and the implications or potential implications of that default.
- (b) The nature and extent of any omissions, inaccuracies or incomplete information in the report.
- (c) Any repeated failures to submit accurate and complete reports or to do so on time.
- (d) Any failure or persistent failure fully, promptly and adequately to engage with the PRA in connection with submission of communications and/or notifications or matters ancillary thereto.

Step 3 — adjustment for any aggravating, mitigating or other relevant factors

21. In cases involving auditors or actuaries, the PRA may increase or decrease the starting-point figure for a punitive penalty determined at step 2 (excluding any amount to be

(1) Where the breach is continuing, the PRA may, for example, have regard to the individual's annual income in the last and/or current tax year.

(2) The PRA has the discretion to determine an appropriate seriousness percentage. In general, the more serious or pervasive the breach (both in relation to the activities of the auditor or actuary concerned or in the wider market for audit and actuarial services) and the greater the threat or potential threat it posed or continues to pose to the advancement of the PRA's statutory objectives, the higher the percentage is likely to be, subject to the overall penalty being appropriate and proportionate to the relevant breach.

(3) For example, in relation to consistently late, inaccurate or inadequate communication or notification of matters to the PRA.

(4) The PRA may treat a report as not received where the method by which it is submitted to the PRA does not comply with any prescribed method of submission.

(5) The PRA may treat a report which is materially incomplete or inaccurate as not received until it has been submitted in a form which is materially complete and accurate.

(6) Including, by way of non-exhaustive example, in Part XXII of FSMA, the FSMA 2000 (Communications by Auditors) Regulations 2001 and the FSMA 2000 (Communications by Actuaries) Regulations 2003.

disgorged pursuant to step 1) to take account of any factors which may aggravate or mitigate the breach or other factors which may be relevant to the breach or the appropriate level of penalty in respect of it. Any such adjustment will normally be made by way of a percentage adjustment to the figure determined at step 2.

22. Factors that may aggravate or mitigate the breach include:

- (a) The conduct of the auditor or actuary in bringing (or failing to bring) promptly, effectively and comprehensively to the PRA's attention (or, where relevant, the attention of any other relevant regulatory or law enforcement agencies) the full facts, circumstances and implications or potential implications of the breach.
- (b) The nature, timeliness and adequacy of the auditor's or actuary's response to any regulatory interventions by the PRA and any remedial actions proposed or required by the PRA.
- (c) The degree of co-operation the auditor or actuary showed during the investigation of the breach by the PRA (or, where relevant, any other relevant regulatory or professional body or law enforcement agency) and the impact of this on the PRA's ability to conclude its enforcement process promptly and efficiently.
- (d) Where the auditor or actuary is a firm, whether the firm's senior management was aware of the breach (or could reasonably be expected to have been aware of the breach) and, if so, the nature and extent of their knowledge of or involvement in it and the timeliness, adequacy and effectiveness of any steps taken by them to address it and/or the consequences of it.
- (e) The previous disciplinary record and general supervisory history of the auditor or actuary, both in respect of the PRA's regulatory requirements and, where relevant, those of any other relevant regulatory or professional body or law enforcement agency, including the reporting or non-reporting of concerns in relation to the issue giving rise to the breach in question.
- (f) The nature and impact or likely impact of any compliance or training policy or programme or other remedial steps taken by the auditor or actuary since the breach was identified meaningfully to address it and reduce the risk of future breaches or, where they occur, the effective management of the consequences of them (including whether these were taken on the auditor or actuary's own initiative or that of the PRA or any other relevant regulatory or professional or law enforcement agency).

23. Other relevant factors may include any action taken against the auditor or actuary by other domestic and/or international regulatory authorities or law enforcement agencies relevant to the breach of the PRA's regulatory requirements. This may include any penalties or fines or other disciplinary measures imposed by those agencies.

Step 4 — adjustment for deterrence

24. If the PRA considers the penalty determined following steps 2 and 3 is insufficient effectively to deter the auditor or actuary who committed the breach and/or others who are subject to the PRA's regulatory requirements from committing similar or other breaches, it may increase the penalty at step 4 by making an appropriate deterrence adjustment to it.

25. The circumstances in which the PRA may make a deterrence adjustment to the penalty include:

- (a) Where the PRA considers the value of the penalty is too small in relation to the breach to achieve effective deterrence.
- (b) Where previous action by the PRA, FCA, any predecessor regulators, FRC or professional body in respect of the same or a similar breach has failed to improve or sufficiently improve the relevant standards of the subject of the PRA's action and/or relevant industry standards.
- (c) Where the PRA considers it likely that, in the absence of a deterrence adjustment, the same or a similar breach will be committed in the future by the relevant auditor or actuary or by other members of the auditing or actuarial communities more widely.

Step 5 — application of any applicable reductions for early settlement or serious financial hardship Settlement discount

26. The PRA and the auditor or actuary on whom a penalty is to be imposed may seek to agree the amount of the penalty and any other appropriate settlement terms. In recognition of the benefits of such agreements, the PRA's settlement policy provides that the amount of the penalty which would otherwise have been payable may, subject to the stage at which a binding settlement agreement is reached, be reduced.⁽¹⁾

27. The PRA will apply its Statement of the PRA's settlement decision-making procedure and policy for the determination of the amount of penalties and the period of suspensions or restrictions in settled cases to settlement with an auditor or actuary subject to a proposed penalty under section 345A(4)(c) of the Act, save that paragraph 1 of that

(1) Any applicable settlement discount applied at stage 5 will not apply to the disgorgement of any economic benefits determined at step 1.

Statement shall be deemed to be amended to (i) refer to the settlement of actions by the PRA to impose penalties under section 345A(4)(c) and (ii) be read in conjunction with:

- (a) This Statement of the PRA's policy on the imposition and amount of financial penalties under the Act on persons who are, or have been, auditors or actuaries of a PRA-authorized person, appointed under or as a result of a statutory provision; and
- (b) The PRA's Statement of policy on statutory notices and the allocation of decision-making under the Act, with particular reference to the arrangements for decision-making in relation to the use of PRA disciplinary powers under section 345A(4).

Serious financial hardship

28. Where an auditor or actuary claims that payment of a penalty determined by the PRA will cause them serious financial hardship, in exceptional circumstances the PRA may reduce the penalty. The onus is on the firm or individual to satisfy the PRA that this would be the case and they must first ask whether the PRA will consider representations on this point.

29. Where the PRA agrees in principle to consider an auditor's or actuary's written and/or oral representations as to serious financial hardship, the firm or individual auditor or actuary must:

- (a) promptly provide to the PRA relevant, comprehensive and verifiable evidence that payment of the penalty will cause them serious financial hardship; and
- (b) co-operate fully with the PRA and promptly, transparently and comprehensively comply with any requests by it for further information or evidence concerning and relevant to a proper assessment of their financial position or other relevant circumstances.

30. In respect of firms, in assessing whether the penalty would cause the firm serious financial hardship the factors which the PRA may have regard to include:

- (a) the firm's financial strength and viability; and
- (b) any impact payment of the penalty would or would be likely to have on the firm's ability to meet and continue to meet the PRA's regulatory requirements and standards in providing services to PRA-authorized persons.

31. The PRA may, in addition to imposing a penalty, disqualify a firm under section 345A(a) of the Act. Such action by the PRA would not affect its assessment of the appropriate penalty in relation to a breach of its requirements. Where the PRA's

disqualification of a firm from being the auditor or actuary of a PRA-authorized person or a particular class of PRA-authorized person results in that firm having less earning potential, this may be a relevant factor in assessing whether the penalty will cause the firm serious financial hardship.

32. In respect of individuals, in assessing whether the proposed penalty would cause the individual serious financial hardship the factors which the PRA may have regard to include:

- (a) The individual's ability to pay the penalty over a reasonable period (normally no more than three years).
- (b) The PRA's starting point is that an individual may suffer serious financial hardship only if during that period his net annual income will fall below £14,000 and his capital⁽¹⁾ will fall below £16,000 as a result of payment of the penalty.⁽²⁾

33. The PRA may also disqualify an individual auditor or actuary under section 345A(a) of the Act. Such action by the PRA would not affect its assessment of the appropriate penalty in relation to a breach of its requirements. Where the PRA's disqualification of an individual from being the auditor or actuary of a PRA-authorized person or a particular class of PRA-authorized person results or is likely to result in an individual having less earning potential, this may be a relevant factor in assessing whether the penalty will cause the individual serious financial hardship.

34. The PRA will consider agreeing to defer the due date for payment of the penalty or accepting payment by instalments where, for example, an auditor or actuary requires a reasonable time to realise a particular asset to enable the totality of the penalty to be paid within a reasonable period.

(1) The PRA will consider as capital anything that could provide the individual with a source of income, including savings, property (including personal possessions), investments and land. The PRA will normally consider as capital the equity that an individual has in the home in which he lives as his only or principal residence, but will consider any representations by the individual about this, including as to the position of any other occupants of the property or the practicability of remortgaging or selling the property within a reasonable period.

(2) The PRA will keep these income and capital thresholds under review and will consider all relevant facts and circumstances in determining whether they should be modified in a particular case. Where a penalty is reduced, it will be reduced to an amount which the individual can pay without going below the income and capital threshold levels that apply in that case. If an individual has no income, any reduction in the penalty will be to an amount that the individual can pay without going below the capital threshold.



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Appendix 4

Draft amendment to Statement of Policy

Decision-making

The paragraph below is proposed to be inserted after paragraph 16 of the existing Statement of the PRA's Policy on statutory notices and the allocation of decision-making under FSMA, as set out in Appendix 1 of: 'The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure', April 2013, which can be found at www.bankofengland.co.uk/publications/Documents/other/prapproach enforcement.pdf.

Insert after paragraph 16:

Disciplinary Powers in relation to Auditors and Actuaries

16A. SRPC will ordinarily act as the decision-making committee for all statutory notice decisions where the PRA is proposing or deciding to exercise its disciplinary powers in relation to auditors and actuaries under section 345A of the Act, as well as for decisions associated with a statutory notice (as set out in paragraph 11 of this policy). SRPC has the right to escalate any such decisions to the Board where it considers it appropriate to do so.