

Policy Statement | PS1/16

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

January 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923



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This policy statement contains the feedback received on the proposals in Consultation Paper 8/15 'Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries'. It includes links to the final rules on Auditor Reports to the PRA, a supervisory statement relating to the requirement to provide written auditor reports to the PRA, a new statement of policy on the imposition and amount of financial penalties on auditors and actuaries of PRA-authorized persons, and an amendment to the PRA's statement of policy on statutory notices and the allocation of decision making which relates to the exercise of disciplinary powers over auditors and actuaries.

1 Introduction

Background

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) sets out feedback and links to final rules,¹ an associated supervisory statement,² a new statement of policy on the imposition and amount of financial penalties on auditors and actuaries of PRA-authorized persons, and an amendment to the PRA's statement of policy on statutory notices and the allocation of decision making which relates to the exercise of disciplinary powers over auditors and actuaries.³ This follows on from proposals in Consultation Paper (CP) 8/15 'Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries'.⁴

1.2 The CP introduced two proposals on the interaction between the PRA and external auditors and actuaries. One was to require the external auditors of the largest UK-headquartered deposit-taking institutions that are not subsidiaries of non-UK firms to provide annual written reports to the PRA as part of the statutory audit cycle. These reports would address a set of questions agreed each year with the PRA in areas such as valuation matters, quality of earnings, key accounting judgements, and quality of systems and controls. The second proposal set out a draft statement of policy governing the imposition of financial penalties on auditors and actuaries and the amount of such penalties, and at the same time proposed a change to the PRA's statement of policy on statutory notices and the allocation of decision making under the Financial Services and Markets Act (FSMA)⁵ setting out how the PRA will deal with decision making in the exercise of these disciplinary powers. FSMA contains provisions that permit the PRA to exercise disciplinary powers over auditors and actuaries in respect of duties imposed either under rules made by the PRA or under FSMA to communicate information to the PRA; these powers were commenced by order of HM Treasury with effect from 20 February 2015.⁶

1.3 An effective auditor-supervisor relationship supports judgement-based supervision and helps promote the safety and soundness of PRA-authorized firms. The overall aim of both of the initiatives is to encourage auditors and actuaries to consider the PRA's safety and soundness objective (and policyholder protection in the case of the second proposal) when determining the nature and rigour of their respective reviews. The provision of systematic information will facilitate the PRA in advancing its general objective of safety and soundness, through minimising the risk that a firm will fail, the impact that the firm's failure would have, and the wider impact that the firm's activities have. Moreover, as was explained in the CP, a major benefit of written auditor reporting will be enhancement of the auditor-supervisor dialogue in a number of ways. The introduction of proportionate and responsive disciplinary powers is also intended to support an effective working relationship between auditors or actuaries and supervisors, by providing further incentives for auditors and actuaries to carry out their duties to the PRA appropriately. Prior to the commencement of PRA disciplinary powers over auditors and actuaries, the PRA could take no direct disciplinary action against an

1 Available at www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps116.aspx.

2 Supervisory Statement 1/16 'Written reports by external auditors to the PRA', January 2016; www.bankofengland.co.uk/pr/Pages/publications/ss/2016/ss116.aspx.

3 The new and amended statements of policy are incorporated in the updated Statement of Policy 'The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure', January 2016; www.bankofengland.co.uk/pr/Pages/publications/sop/2016/approachenforcementupdate.aspx.

4 February 2015; www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp815.aspx.

5 See footnote 3.

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

auditor or actuary that breached a duty set out in PRA rules or an obligation under FSMA to communicate information to the PRA.

Scope and application

1.4 The requirement for written auditor reporting to the PRA applies to the external auditors of the largest (ie with a balance sheet total greater than £50 billion – either individual or at consolidated group level) UK-headquartered deposit-taking institutions that are not subsidiaries of non-UK firms. The regime will commence during the audit cycle for financial reporting periods ending on or after 1 November 2016.

1.5 The statements of policy on disciplinary powers have immediate relevance and apply to persons who are or have been: (i) auditors of PRA-authorized persons, appointed under or as a result of a statutory provision; and (ii) an actuary acting for an authorized person and appointed under, or as a result of, a statutory provision ('auditors and actuaries').

Consultation feedback and final policy

1.6 The PRA received 22 written responses on the proposals set out in CP8/15, and has also discussed the proposals with the Financial Reporting Council (FRC). This section summarises the most significant issues raised by respondents, and the PRA's responses to them, noting those areas where the PRA is making changes to the proposals contained in the CP. The accompanying documents listed in the appendices set out in full the final policy.

2 Written auditor reporting

Scope

2.1 Several respondents queried the basis for the firms in scope of the regime, although there was no consensus in the alternative suggestions. The PRA remains of the view that, on financial stability and proportionality grounds, initial application to the largest UK banks and building societies is the right choice. In line with its approach to supervision, the PRA tailors its actions to the specific characteristics of the types of firms being regulated and the threats that firms can pose to the PRA's primary objective of safety and soundness. However, in response to various questions raised, the PRA is taking the opportunity to clarify the following points:

2.2 Any extension of the regime's scope beyond the initial definition, whether to a different range of banks or building societies or to PRA-regulated insurance firms, would be the subject of a new consultation.

2.3 The balance sheet test – total assets greater than £50 billion – is measured as at the previous accounting reference date.

2.4 An auditor in scope must provide a written report to the PRA in relation to the UK bank's or building society's audited annual report and accounts. Annual accounts are defined in section 471 of the Companies Act 2006¹ and mean any individual and group accounts prepared by the UK bank or building society in relation to a financial year, although the PRA will generally expect only one written report per consolidated group, if more entities of a group are in scope, and will agree the coverage of this with the auditors.

1 www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf.

Process, timetable and implementation

2.5 A number of respondents requested that the dry run of the regime (which is currently in progress) should be allowed to be completed and analysed before the final policy is decided.

2.6 The PRA's objective in running a voluntary preliminary trial of the reporting was to gain experience of the process, including the setting of appropriate questions, that would allow fine-tuning prior to formal implementation. The dry run has been conducted with that objective in mind, rather than with a view to securing evidence for or against implementation of the proposal. For these reasons, the PRA considers that the dry run is unlikely to produce information that changes its view of the fundamental value of the regime or the broad methodology for its application, particularly as, in the interests of keeping costs of the trial down, a full suite of questions is not being applied across the board. Therefore, the PRA has concluded that the possible advantages of delaying finalisation of the policy are outweighed by the considerable disadvantage of a consequent full year's delay to introducing the final policy.

2.7 Many respondents were concerned about the expectation set out in the CP that auditors should share a draft of their report with the PRA before submission of the final version, on the grounds that this would risk disrupting or refocusing the audit at a late stage. The PRA has therefore altered the text of the supervisory statement to clarify that prior consultation is expected to be an ongoing process, taking place at any time during the preparation of the report and the conduct of the audit. There is no requirement to submit a draft version of the report, and references to this have been deleted; but firms are encouraged to resolve any uncertainties early with the PRA.

2.8 The CP stated that the PRA expects that auditors may want to share the report with the audited firm, particularly the Audit Committee (AC). Several respondents expressed the view that the report should definitely go to the firm or its AC before submission to the PRA. The PRA considers that early sharing of the report is likely to be beneficial but that the exact procedure for this is a matter for the firm and auditor to decide.

Format of questions and of reporting

2.9 A frequent comment in the replies received was that a set of standard questions for all firms would not elicit useful information, and that it would be better to tailor questions to individual firms. The PRA accepts that some questions, or areas of questioning, will not be relevant to some firms. Nil returns to some questions will be acceptable when their lack of applicability can be explained to the PRA, including on grounds of audit materiality. In addition, the PRA envisages that during discussion with each auditor, the exact approach to answering questions can be tailored where necessary to reflect practical considerations, provided this does not risk undermining the usefulness of the exercise. In general, however, it is the PRA's intention to focus the questions on areas it deems to pose significant risk to its objectives, after careful consideration of the major issues that have arisen during its contacts with supervised entities and audit firms. Questions are therefore likely to have broad relevance. The additional advantage of a standard set of questions is that this will allow some cross-firm comparison.

2.10 At the same time the PRA acknowledges, as it did in the CP, that the written auditor reporting will by no means provide a full picture of issues for any one particular firm, and that therefore it is not a substitute for existing sources of information and assessment.

2.11 Several respondents made the point that the reports should be limited to information that can be provided by the auditor in the ordinary course of audit work. As was made clear in the CP, the PRA's questions will be predicated on the scope of the statutory audit work

expected to take place, and a statement to this effect has now been added to paragraph 2.1 of the supervisory statement. The process outlined in chapter 2 of the supervisory statement will help ensure this is achieved: questions each year will be discussed in draft with the audit firms and this ought to bring to light at an early stage any areas of questioning which might be considered as falling outside the scope of a normal high quality audit. As was acknowledged in the CP it is, of course, possible that auditors decide to perform some additional investigations as a result of the PRA's questions, but the PRA does not expect this to contradict the principle that the work will reflect the scope of the statutory audit.

2.12 More than one respondent suggested that there would probably be a wide variety in the reports received, given that the PRA has not laid down a specific format. The reports will be largely qualitative; the PRA aims to make the questions sufficiently granular that comparability is possible without specifying a uniform format, although this is not ruled out for the future. The PRA is taking this opportunity to emphasise that it expects all the reports to observe certain qualities, namely to be clear, understandable largely on a stand-alone basis, and concise.

Cost effectiveness of the framework

2.13 Respondents were generally supportive of the PRA's aim of improving the quality of auditor-supervisor dialogue, but many considered that there were other avenues for this and that, for example, improving the focus and procedures of bilateral meetings would be a less costly means of meeting the PRA's objectives compared to the proposals in the CP. The PRA has taken note of the various suggestions for improving the quality of bilaterals and other communication channels and is considering incorporating some of them into procedures, but will do this in parallel to introducing written reporting: the PRA remains of the view that a requirement for written reporting will introduce extra discipline into auditor processes and communication, and will provide supervisors with useful information on key issues. However, the PRA is announcing at this point that the policy will be formally reviewed no later than after five years of receiving written reports. The PRA expects further development and improvement both in the area of bank audits generally, and in the area of auditor-supervisor dialogue. Accordingly, a formal re-assessment of the continuing value of the regime is likely to be appropriate, and would assess lessons arising for this specific policy or other related work as well as examine realised and anticipated future costs and benefits in relation to the PRA's objectives. It may, of course, be that this review reaffirms the benefits of the policy but concludes in favour of some changes to the format or scope: any significant change to the policy would be the subject of a further consultation.

Effect on audit conduct or objectives more generally

2.14 Another area of concern from respondents was whether the introduction of written reporting to the PRA would in some way unduly shape the whole audit, with some possible undesirable consequences – suggestions included shifting the focus of the audit to the PRA concerns at the expense of other important issues, or weakening of the function of the AC. The PRA's view is that such consequences are unlikely given its aim of setting questions that are answerable in the course of a good-quality audit. There is no intention to change the responsibilities of the AC; by contrast, the PRA hopes that the process and reports will be helpful to ACs in carrying out their role.

Interaction with the EC Audit Directive and Regulation

2.15 Paragraph 7.1 of the draft supervisory statement published in February 2015 noted the classification and treatment of non-audit services was under consultation by other bodies. Some respondents raised this issue in their replies. The PRA is taking this opportunity to clarify that a requirement contained in PRA rules would fall within the exemption from the fee cap

which is allowed for services required by national legislation, as provided by the EC Audit Regulation.¹

3 Disciplinary powers over external auditors and actuaries

3.1 In respect of the PRA's ability to exercise disciplinary powers over statutory auditors and actuaries, it should be noted that these disciplinary powers are contained in FSMA and were not the subject of the CP. CP8/15 consulted on draft statements of policy which set out how the PRA proposed to exercise these FSMA powers. Following the consultation, the PRA does not consider that any changes are needed to the statements of policy on which the PRA consulted.

3.2 Issues raised by respondents fell broadly into two categories: concerns with the principle of PRA disciplinary powers over auditors and actuaries, and, more commonly, concerns with how the powers would in practice be exercised.

PRA powers over auditors and actuaries in principle

3.3 Some respondents raised the possibility that auditors might become more defensive in their relations with the PRA or even be discouraged from taking on financial firm audits.

3.4 The PRA notes that auditors and actuaries are under an existing duty to comply with PRA rules and to communicate particular matters in accordance with FSMA. Therefore, the PRA's expectation that auditors and actuaries should diligently comply with their duties to the PRA should not act as a disincentive to an open and constructive dialogue between these professionals and the PRA, nor to auditors and actuaries accepting appointment to PRA- authorised firms.

3.5 The PRA's forward-looking supervisory approach depends on it being able to consider all circumstances and information which may be relevant to the safety and soundness of PRA- authorised firms and, in relation to insurance, to the securing of an appropriate degree of protection for policyholders. Auditors and actuaries appointed by PRA- authorised firms play an important role in verifying information provided by firms and in drawing particular matters to the attention of the PRA. For this reason, the PRA considers that providing sufficient incentives for auditors and actuaries to carry out their duties to the PRA appropriately is important for the advancement of its objectives. Therefore, it is appropriate to introduce a proportionate and responsive range of PRA disciplinary powers over auditors and actuaries.

3.6 The PRA recognises the importance of taking a reasonable and proportionate approach where it decides it is appropriate to impose a sanction on an auditor or actuary. Sanctions can act as a direct punishment for the breach of a requirement placed on auditors and actuaries and may also provide an incentive to other members of the relevant professions to effect behavioural change. As set out in the statement of policy on penalties, in deciding whether to impose a financial penalty on an auditor or actuary, and the amount of that penalty, the PRA will take account of all the relevant circumstances, including the seriousness of any breach of duty and the nature of the auditor or actuary's business. Therefore, the PRA considers that the statement of policy on penalties is consistent with the PRA's proportionate approach to enforcement.

3.7 The PRA also notes that the exercise of disciplinary powers over auditors and actuaries by the PRA is subject to a range of procedural safeguards under FSMA, including the duty on the

¹ Article 4 (2) of Regulation (EU) No. 537/2014.

PRA to issue statutory notices and the provision of rights to the subject of any disciplinary action by the PRA to make representations or to refer a disputed matter to the Upper Tribunal or the courts.¹

Exercise of PRA powers over auditors and actuaries

3.8 On the practical exercise of the PRA's disciplinary powers, a common concern expressed by respondents was that the PRA penalties could duplicate or overlap with sanctions from other regulatory bodies, in particular the FRC. Several suggested that the FRC should take the lead on enforcement, or that disciplinary action by the PRA would be inconsistent with the new structure as then proposed by the Department for Business Innovation and Skills whereby the FRC would be the designated competent authority for regulating the audit profession,² which has since been announced as confirmed.³

3.9 The scope of the PRA's disciplinary powers over auditors and actuaries is clearly defined in FSMA and is limited to circumstances in which an auditor or actuary who is appointed by or under statute breaches a duty to the PRA either by failing to comply with PRA rules or by failing to comply with a duty under FSMA to communicate information to the PRA.

3.10 This is in contrast to the broader disciplinary powers available to the FRC which deal with cases of potential misconduct which raise, or appear to raise, important issues affecting public interest in the United Kingdom, and those of professional bodies which are concerned with other misconduct. Therefore, the PRA does not anticipate a significant degree of overlap with disciplinary powers exercised by these other bodies where an auditor's or actuary's breach of duty to the PRA is not accompanied by further examples of misconduct in relation to the same appointment.

3.11 Where such overlap may occur, paragraph 4(i) of the statement of policy on penalties makes it clear that the PRA will consider the ongoing or proposed actions of other regulators when deciding whether to take action for the imposition of a financial penalty on an auditor or actuary. In this regard, the PRA has in place a Memorandum of Understanding (MoU) with the FRC which lays out the basis for co-operation and co-ordination of enforcement action between the regulators, where the circumstances require.⁴ The PRA has agreed with the FRC and HM Treasury that once the Bank of England and Financial Services Bill has become an Act of Parliament and taking account of any changes to the FRC's powers and remit as part of the transposition of the EU Audit Directive, the current MoU will be supplemented as appropriate to reflect the PRA's disciplinary powers over auditors and actuaries.

3.12 In addition, the PRA will be engaging as necessary with relevant professional bodies to discuss how the PRA and these bodies could best co-operate in relation to disciplinary matters, including how any arrangements might be affected as a result of the above-mentioned announcement that the FRC would become the designated competent authority. Legal gateways for the exchange of information on disciplinary matters already exist in respect of the FRC and these bodies.

1 Section 345B of FSMA.

2 www.gov.uk/government/uploads/system/uploads/attachment_data/file/400231/bis-14-1285-auditor-regulation-discussion-document-on-implications-of-eu-and-wider-reforms.pdf.

3 www.gov.uk/government/uploads/system/uploads/attachment_data/file/471898/BIS-15-605-technical-consultation-on-the-audit-directive-and-regulation.pdf.

4 www.bankofengland.co.uk/about/Documents/mous/otherdomestic/moufrc.pdf.

3.13 Many of the other issues raised by respondents were requests for clarification or elaboration of the statement of policy on the imposition or amount of financial penalties. The PRA provides clarifications in relation to these points in the following paragraphs.

3.14 A number of respondents made reference to the use of the word 'punitive' in Step 2 of the PRA's policy for determining the amount of any penalty. In particular, it was noted that the word 'punitive' could be seen as having implications for the level of penalty to be imposed by the PRA. The use of the term 'punitive' does not imply any particular approach to determining an appropriate amount of a penalty but is instead employed to distinguish this element of a financial penalty from disgorgement at Step 1. Disgorgement is the surrender of identifiable economic benefits associated with the breach or misconduct: examples of this are given in paragraph 13 of the statement of policy.

3.15 Two respondents requested more clarity on the application of a penalty when a group which comprises multiple legal entities, including entities incorporated overseas, undertakes a statutory audit. As set out in paragraph 2 of the statement of policy on penalties, the PRA's disciplinary powers for breach of a relevant duty by an auditor only extend to the person who is appointed by, or under, statute as an auditor of a PRA-authorized person. Therefore, any financial penalty imposed in respect of such a breach would be applied only to the legal entity or individual who is the subject of that statutory appointment, and with reference to that appointed entity's or individual's financial position.

3.16 Clarifications were also requested on the process involved in an investigation by the PRA into an alleged breach of duty by an auditor or actuary and on the expertise at the disposal of the PRA to pursue such an investigation. The PRA's investigative powers in relation to circumstances where a person may have contravened its rules (and related procedural requirements to be followed by the PRA) are set out in Part XI of FSMA. These include the ability of the PRA to appoint investigators to undertake an investigation on its behalf. Where the PRA determines that it would be appropriate for it to investigate an alleged breach of duty by an auditor or actuary, it would decide the most appropriate means to undertake any investigation, taking into account a variety of factors, including the nature of the alleged breach and available resources within the PRA.

4 Cost benefit and impact analysis

4.1 Costs and benefits associated with the new policies were considered prior to publication of the CP, as were impacts on mutuals and on competition as well as implications for equality and diversity. Since the policies have not changed materially following consultation, the PRA's assessments of these impacts are unchanged.

Appendices

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- 1** PRA RULEBOOK: NON-AUTHORISED PERSONS: WRITTEN REPORTS BY AUDITORS TO THE PRA INSTRUMENT 2016, available at www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps116.aspx.

 - 2** Supervisory Statement 1/16 'Written reports by external auditors to the PRA', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2016/ss116.aspx.

 - 3** Updated Statement of Policy 'The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure', available at www.bankofengland.co.uk/pr/Pages/publications/sop/2016/approachenforcemenupdate.aspx.
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