ICAEW FINANCIAL SERVICES FACULTY

ENHANCING THE DIALOGUE BETWEEN BANK AUDITORS AND AUDIT COMMITTEES

Good practice for bank auditors, audit committees and executive management

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The ICAEW Financial Services Faculty was established in 2007. Its objectives include becoming a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members in the sector, including those working for regulated firms, in professional services firms, intermediaries and regulators.

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CONTENTS

FOREWORD

The global financial crisis that started in 2007 (the 'global financial crisis') was observed first in the collapse of two hedge funds, resulting in the so-called credit crunch when global interbank credit markets suffered; funding problems in individual banks and financial institutions triggered financial contagion across the market, leading to public bailouts of individual institutions which were necessary to support the financial system as a whole. Even national economies and the Euro currency have come under threat.

It has not been possible to assign blame for the global financial crisis on any one factor, which has been frustrating for politicians and the wider public. Many aspects of the financial and banking system have come under scrutiny. One clear conclusion is that although tangible areas, such as regulation, may have been found wanting, the behaviour of individuals within the system also contributed to the crisis.

The behaviour of those responsible for governance in banks and financial institutions is one area worth examining. Audit committees are a core part of a bank's governance framework, and the relationship between auditors and audit committee can have a critical impact on the effectiveness of the committee. ICAEW in its June 2010 report *Audit of banks: lessons from the crisis* ('Audit of banks') highlighted the importance of this relationship and committed to develop this guidance for good practice for auditor–audit committee dialogue in banks.

The work undertaken in preparing this report underlined the critical nature of the auditor–audit committee relationship. The corporate governance requirements, rules and standards which govern auditor and audit committee activity only partly describe what is needed. There has been much recent debate on the degree to which sufficient challenge and professional scepticism is built into the audit process. While this is an important factor, our work indicated that there are also times where cooperation between the different parties is required. Taken to an extreme, relationships based solely on challenge could inhibit the effectiveness of the audit process if there is a breakdown of trust or an inability to agree on key decisions.

Perhaps the most important aspect of this report is in exploring the appropriate balance between cooperation and challenge. We recognise that auditors, audit committees and executive management share a common objective of contributing to financial statements that provide a 'true and fair view'. A consequence is that trust and cooperation are needed to foster an environment in which issues can be discussed robustly and decisions challenged in a constructive manner.

Gilly Lord
Working Party Chair

Iain Coke
Head of Financial Services Faculty

March 2012

1. INTRODUCTION

1.1 About this document

The ICAEW Financial Services Faculty published the report *Audit of banks: lessons from the crisis* in June 2010. That report examined the role of audit in the global financial crisis that started in 2007 (the 'global financial crisis'), and presented recommendations on how the audit process might evolve to promote confidence in the banking system.

One of the findings of that report was that the relationship between auditors and audit committees plays an important role in good governance. ICAEW committed to produce good practice guidance to enhance the dialogue between bank auditors and their audit committees.

This report sets out that guidance. It considers 'dialogue' in its broadest sense, covering the fundamentals of a good auditor/audit committee relationship, the structuring of meetings throughout the audit cycle, and the content and style of reporting to the audit committee.

This report does not seek to impose any new principles, rules or requirements for auditors or audit committees. It instead presents a number of observations on how to make the relationships work well. It is written from the perspective of auditing large, complex banks. The document may provide useful guidance to smaller banks or non-financial organisations although is not intended to address the different issues faced by those firms. At the end of each section it presents a summary of recommendations; auditors and audit committees can consider which of these are most relevant to individual relationships.

The report is not intended to support any particular model for corporate governance, whether the UK unitary board concept, where the board as a whole is collectively responsible for decisions, a more US-style separating executive and non-executive responsibilities within the board or a two-tier board structure more common in parts of continental Europe. Although the language refers to audit committees and executive management as distinct groups, this is only for ease of writing.

1.2 Why is this document important?

The roles of auditor and of the audit committee are critical to good governance. Today, nowhere is good and visible governance more important than in our banks; public confidence in our banks has been damaged and all parties need to work hard to rebuild that confidence through clear reporting, robust auditing and a transparent governance process.

This document contributes to the rebuilding of trust by recommending good practices to optimise the roles of auditor and audit committee and by recommending further transparency over the activities of all of those involved in the audit process.

1.3 Approach to our work

This document is the result of work undertaken by a working group convened by the ICAEW's Financial Services Faculty. Members of the working group were:

Gilly Lord (Chair)	Bank Audit Partner	PricewaterhouseCoopers
Guy Bainbridge	Bank Audit Partner	KPMG
Iain Coke	Head of Financial Services Faculty	ICAEW
John Coombe	Audit Committee Chair	HSBC
Robert Hodgkinson	Executive Director, Technical Strategy	ICAEW
Olivia Kirtley	Audit Committee Chair	US Bancorp
Rudi Lang	Bank Audit Partner	Mazars
Mike Lloyd	Bank Audit Partner	Deloitte
Andrew McIntyre	Bank Audit Partner	Ernst & Young
Steve Maslin	Bank Audit Partner	Grant Thornton
Brendan Nelson	Audit Committee Chair	Royal Bank of Scotland
David Roberts	Senior Manager	Deloitte
Martin Scicluna	Audit Committee Chair	Lloyds Banking Group
Martin Scrivens	Head of Audit	Lloyds Banking Group
Sarah Smith	Group Financial Controller	Goldman Sachs
Dan Taylor	Bank Audit Partner	BDO
Lindsay Tomlinson	Director	NAPF

In addition to holding discussions in the working group, we conducted a number of individual meetings with working group members and others with expertise in this area. Each of the audit firms involved in this exercise surveyed their own bank audit partners and discussed the subject with clients to gather and collate further observations, experiences and examples.

2. CHARACTERISTICS OF THE RELATIONSHIP

2.1 Experience from the global financial crisis

The global financial crisis has prompted much comment on the roles of bank auditors and audit committees, and of the relationships which exist between a bank's auditor, audit committee and executive management. Some commentators believe that relationships became too close during the crisis, perhaps as a result of parties working together to meet the inevitable challenges which arose. Regulators, particularly the UK Financial Services Authority, have been particularly vocal in stating the view that auditors did not exercise sufficient professional scepticism during their audits of banks' accounts in the months preceding the crisis.

A challenge in assessing whether these criticisms are justified is that it is difficult to find objective evidence of what happens behind closed doors. However, this guidance considers the characteristics one might expect to see in an effective relationship between auditor and audit committee. The role of executive management must also be considered as its relationship with auditor and audit committee and the interaction between all three parties is crucial. However, while in many respects this is a three-way relationship, it is important that auditors and audit committees have their own separate relationship and distinct dialogue.

2.2 Activities of the auditor, audit committee and executive management

In order to understand the characteristics of effective relationships between auditor and audit committee it is helpful to consider the key activities undertaken by the key parties to the audit process: auditor, audit committee and executive management.

All activities are part of a process seeking to achieve a common objective: the issue of an audited set of financial statements which provide a true and fair view (or are fairly presented in accordance with accounting standards). In some cases, it is not possible to reach agreement on whether this objective has been met and a modified audit opinion may be needed. However, for investors to maintain trust in the key source of financial information it is important that, in most cases, a set of financial statements accompanied by an unqualified audit opinion is issued on a timely basis. Figure 1 sets out some of the principal activities which contribute to this common objective.

For some of the elements, the parties carry out very similar work – for instance both the auditor and the audit committee would expect to understand and challenge subjective accounting judgements. In other areas, the parties' activities differ, but are linked by a common subject matter – the responsibility of executive management to prepare the accounts and the auditor's responsibility to form an independent opinion on those accounts is a fundamental example of this. Table 1 includes further examples of key activities contributing to the finalisation of a set of audited financial statements.

Figure 1: Principal activities

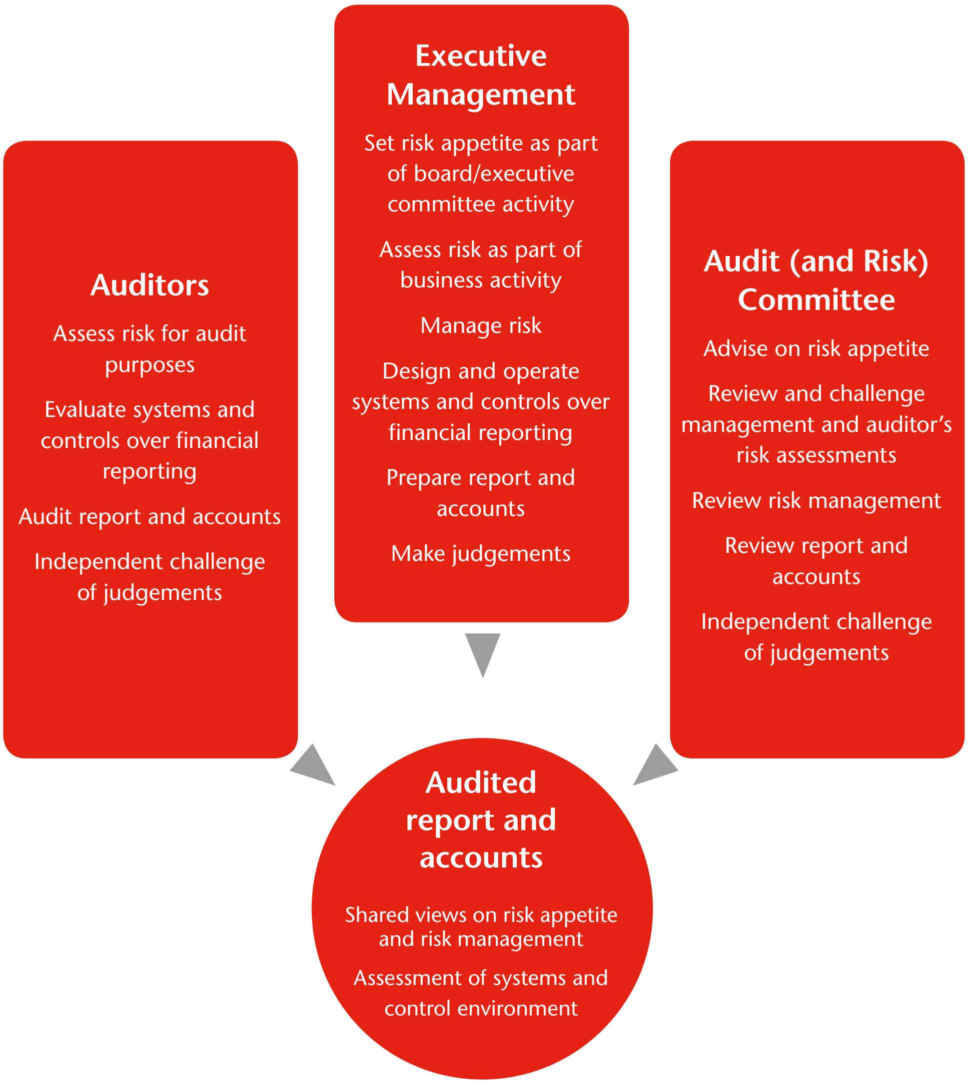


Table 1: Key reporting activities

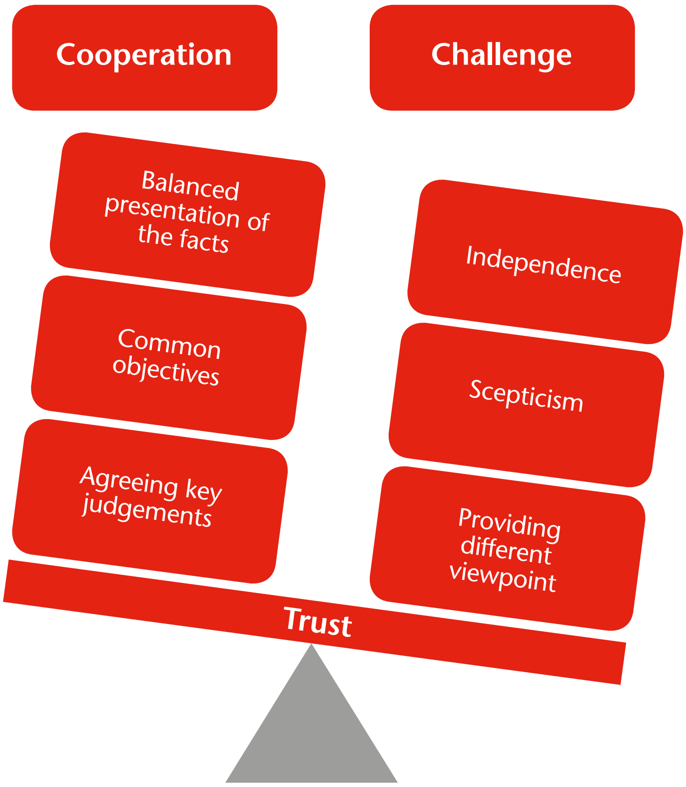
	Parties undertake similar activities	Parties undertake different activities on a common subject matter
Risk appetite	Both executive and non-executive management contribute to setting a firm's risk appetite.	
Risk identification	Executive management assesses risk as part of day-to-day activity. Auditor assesses risk as part of audit planning.	Audit committee reviews and challenges both executive management and auditor's risk assessment.
Risk management	Auditor evaluates systems and controls over financial reporting. Audit (or risk) committee reviews all risk management activity.	Executive management designs and operates systems and controls over financial reporting, and manages risk as part of day-to-day activity.
Report and accounts	Auditor audits report and accounts. Audit committee reviews report and accounts.	Executive management prepares report and accounts.
Key judgements	Auditor and audit committee challenge key judgements.	Executive management form key judgements.

The degree of similarity between these activities will influence the relationships between the different parties. For similar activities, working together may improve the quality of outcomes. Where activities are different, healthy debate and challenge between the parties may lead to better outcomes.

A similar analysis could be undertaken including internal audit as one of the parties. The internal audit function typically does not participate in the accounts preparation and review process, but their consideration of risk, systems and controls will often complement the activities described in Table 1.

2.3 Trust, cooperation and challenge

Figure 2: Balancing cooperation and challenge



The relationship between the auditor, audit committee and executive management can be characterised as a balance of cooperation and challenge. At different stages of an audit the balance will vary. If there is a difficult accounting issue to analyse, the auditor and executive management may work together on the accounting analysis but if there is a key judgement associated with that issue where executive management is taking an aggressive position, we would expect to see robust challenge from both the auditor and audit committee.

As the balance changes between cooperation and challenge it is essential that the relationships are always underpinned by trust: trust that, whatever debates and challenges take place, all parties share an objective of achieving good governance. This trust should not reduce the need for auditors and audit committees to apply appropriate professional scepticism, it should instead facilitate free, open and, if necessary, vigorous debate on contentious issues. If this trust is compromised, it may not be possible for the parties to fulfil their duties effectively and one or more of the auditor, audit committee or executive management may need to be replaced.

At relevant points of the debate, internal audit will be an important contributor to the balance between cooperation and challenge. As for the external auditor, there are times when the internal audit function will work closely with executive management, in developing a shared view on risk, for example. There will be other occasions where the internal audit function will to take a robust and independent position and may be more aligned with the external auditor.

Cooperation

There are many examples in the relationships between the auditor, audit committee and executive management where parties need to work together effectively to achieve particular results.

The audit cycle focuses around the production of an audited report and accounts and all parties share the objective of producing a transparent set of accounts that provide a true and fair view, to a reasonable deadline. Cooperation is needed to plan the logistical challenges of an audit for the delivery of a high-quality report and accounts to the required timetable. In many cases, the key judgements involved in producing those accounts can be discussed and debated in a collegiate environment, with different parties contributing viewpoints which naturally provoke an evolution of the debate.

The auditor and audit committee should cooperate in many different areas, including:

- Development of a common view of risk that will then underpin the audit planning process.
- Working together to challenge the key judgements made by executive management in preparing the report and accounts.
- Sharing views on risk management and controls which can be used to drive improvements.

Challenge

The audit committee of a listed bank consists of independent non-executives; auditors must also be independent as set out in the international code of ethics[1] and related professional guidance. Auditors and audit committees demonstrate this independence through robust and rigorous challenge of executive management. At times this may mean that challenge outweighs cooperation when either the auditor or audit committee (or both) disagree with the executive management; this should be an expected part of a good governance process.

The audit committee and auditor are independent parts of the governance process and so, by definition, are independent of each other. There will therefore be occasions where the auditor challenges the audit committee and vice versa. Such challenge is part of the healthy debate on key judgements that can result in stronger and deeper agreements on positions between all parties.

While auditors must always exercise professional scepticism and auditors and audit committees would normally examine significant items and major areas of judgement, including potentially asking for further information, this will not always result in challenge or debate. Challenge and debate should be prompted by concerns over positions taken or differences in views between parties. If judgements are not contentious, there should be no pressure to create a debate to fulfil a perceived expectation from, for example, the regulator.

Promoting challenge

There is a danger that audit committee chairs, the executive management and/or auditors may seek to agree positions before audit committee meetings. The audit committee meeting can then become a series of scripted presentations of positions that have already been agreed, incorporating little or no debate and challenge. This behaviour may be caused by concerns about timing, particularly towards the end of an accounts finalisation process, and the degree to which the process could be destabilised by a late change in position. It may also reflect a culture of avoiding public disagreements.

It is never appropriate to attempt to remove debate and challenge from the audit committee meeting artificially. However, the year-end process does create logistical problems. Later sections of this guidance address how auditor and audit committee debate could be structured throughout the audit cycle; by planning meetings throughout the year, and earlier in the year-end process.

Having discussions between different parties prior to audit committee meetings is not incompatible with healthy debate and dialogue at the meeting itself. These discussions can improve the efficiency of meetings as they allow full information to be prepared for the meeting, together with briefing papers giving an account of the points debated.

It will always be useful for the audit committee to understand the debate that has happened between the auditor and executive management prior to the meeting. It will not always be necessary to repeat that debate at the audit committee meeting where the audit committee shares the common position. However, on occasions where a position remains contentious, or where a common position has not been reached, the audit committee will wish to challenge and debate the issue further.

[1] 'Code of ethics for professional accountants' issued by the International Ethics Standards Board for Accountants.

The audit committee chair has a crucial role in ensuring that high-quality debate takes place in the meetings of the audit committee. The chair should ensure that individual audit committee members contribute and challenge. Where executive management and the auditor have reached a common position on contentious issues prior to the audit committee meeting, the chair should ask each to describe the debate that resulted in that agreement, exploring whether the final position was difficult to reach and if so, why. This allows the audit committee to understand better the issues, the extent to which the executive management may be assuming aggressive or conservative positions and the degree of challenge and scepticism being shown by the auditor. The quality of the debate that takes place at audit committee level should be one of a number of areas subject to annual assessment as part of the evaluation of the external auditor and the audit committee's own effectiveness.

2.4 Transparency

Critics have suggested that auditors may not have exercised sufficient professional scepticism in their audits of banks leading up to, and during, the global financial crisis that started in 2007. The ICAEW Financial Services Faculty examined this criticism in preparing the report *Audit of banks: lessons from the crisis*. It did not find objective evidence to support this criticism and those involved in the audit process largely rejected it. However, it found that 'much of this work is behind closed doors, therefore the impact of an audit on financial statements and on the discipline provided by internal controls is not visible'.

Table 2 suggests different approaches to improving the degree of transparency over the challenge that does take place. The objective in implementing any of these suggestions should be to increase the value of published financial reporting, not just to increase the volume of a firm's annual financial statements; 'boilerplate' statements should be avoided in favour of specific disclosures unique to each firm and each set of financial statements.

Table 2: Approaches to improving transparency

Challenge between	Interested stakeholders	Potential transparency mechanism
Auditor and executive management	Audit committee	Auditor's report to the audit committee: details of debate could be provided, including changes of position and description of any areas where decisions do not reflect the auditor's preferred position.
	Investors	Report and accounts: critical accounting judgements disclosure could describe the process undertaken to challenge any contentious positions.
	Regulators	Contentious issues could be clearly described at meetings between auditor and regulator, together with the process undertaken to challenge those judgements.
Executive management and audit committee	Investors	Audit committee's report in the annual report and accounts could include details of the key accounting judgements challenged by the audit committee.
	Regulators	Clear evidence of debate and challenge could be captured in the minutes of audit committee meetings. Minutes could be sufficiently detailed to allow the reader to determine where judgements and outcomes have changed as a result of the challenge process.
Auditor and audit committee	Investors	Audit committee's report in the annual report and accounts could include details of any significant debates which took place between auditor and audit committee. These could encompass not only accounting judgements, but also debates over risk management practices and financial control.
	Regulators	Clear evidence of debate and challenge could be captured in the minutes of audit committee meetings. Minutes could be sufficiently detailed to allow the reader to determine where judgements and outcomes have changed as a result of the challenge process.

2.5 Recommendations

Recommendation	Relevant to
While both cooperation and challenge are needed between auditors, audit committees and executive management for an effective audit, the balance should vary according to the circumstances. However, the need for cooperation should never prevent robust challenges from being made when needed.	Auditor, audit committee, executive management
Identify those activities in the audit cycle where there are natural overlaps and maximise cooperation in their performance.	Auditor, audit committee, executive management
Do not seek to avoid debate and challenge in audit committee meetings by pre-agreeing positions; discussions that led to agreed positions should also be presented.	Auditor, audit committee, executive management
Encourage all audit committee members to contribute to an open and energetic debate on key judgements.	Audit committee chair
Assess the quality of debate in annual evaluations of auditors and of the audit committee.	Audit committee
Make the challenge and debate that has taken place as transparent as possible to relevant stakeholders.	Auditor, audit committee, executive management

3. STRUCTURE OF THE DIALOGUE

3.1 The annual reporting cycle

The annual reporting cycle of a bank drives the formal meetings between the auditor of a bank and the audit committee.

Auditors should attend the audit committee meetings at which the financial information they report on is approved. In most cases, it will also be good practice for the auditor to attend all other audit committee meetings, even if there are no items explicitly relevant to the audit on the agenda. The auditor's attendance facilitates the exchange of views on business performance, risk and many other matters relevant to the objectives of both auditor and audit committee.

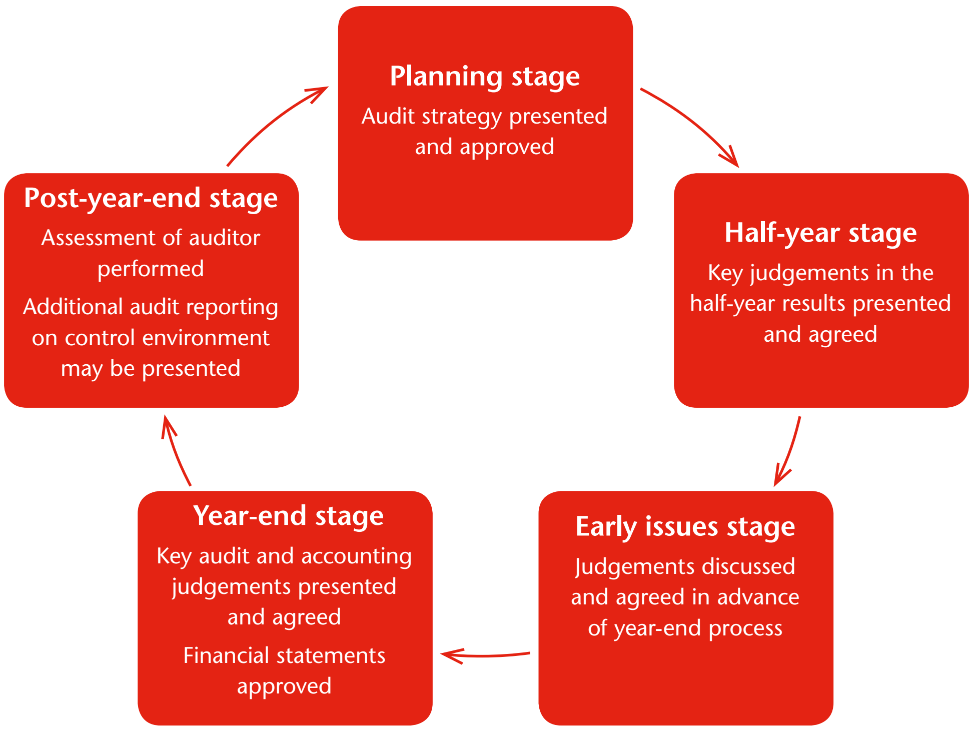
A typical cycle of scheduled audit committee meetings and items for discussion with auditors is set out in Figure 3. This illustrates the key components of a typical reporting cycle. Smaller, less complex banks may combine certain meetings. Other banks with quarterly reporting responsibilities, or with a more complex risk profile, may have more scheduled meetings.

3.2 Planning the process

It is important that the meeting schedule and proposed agendas are well planned at an early stage. The year-end reporting timetable can impose severe time constraints, particularly in those large and complex banks with public and regulatory reporting requirements. One consequence can be that the final year-end audit committee meeting is held at such a late stage in the process that changes to judgements or requests for further audit work can be logistically difficult to implement. As a result, there is a risk that the final year-end audit committee meeting is seen as a formal approval exercise, with no opportunity to change the numbers. This situation undermines the role of the audit committee and the objectives of good governance.

The audit committee meeting schedule should be planned to allow changes to be made, if necessary, following the debate in the meeting. As Section 3.3 will discuss, it may also be helpful to schedule an 'early issues' audit committee meeting to encourage debate of key judgements without the immediate pressure of finalising the numbers.

Figure 3: The reporting cycle



3.3 Early issues stage

The cycle in Figure 3 includes an 'early issues stage'. A meeting would typically be convened either at month 10 or 11 of the annual reporting cycle, or at a very early stage in the year-end closing process. The objective of the meeting would be to identify, discuss and, where possible, conclude upon significant judgements that could have a material impact on the year-end results.

Debating the judgements at an earlier stage in the process allows for a deeper consideration of the options and their implications; if those discussions result in a changed approach, there is time to implement the change in an orderly manner.

3.4 Year-end meeting

As noted above, the year-end audit committee meeting can be subject to significant time constraints. Nonetheless, it is important that the audit committee properly assesses the financial statements and feels able to ask for changes, if necessary. However, with good planning, early discussion of contentious or difficult issues, and good quality briefing papers, time constraints should be less problematic.

There is always the possibility that an issue will come to light late in the audit process, or that events happen after the year-end that may have implications for the financial statements. Such issues may require discussion for the first time at the year-end audit committee meeting. As with any other issue, a tight timetable should not prevent the audit committee from challenging and debating the treatment, and if necessary mandating a change to the annual report and accounts.

3.5 Informal meetings between auditor and audit committee

In addition to the schedule of formal meetings, informal meetings between the auditor and audit committee can be useful. They allow debate and exchange of views on subjects which may not always appear on formal agendas; ideas can be 'tested' in an environment which does not demand written reporting or precise conclusions. In these meetings, the necessary formality and protocol which surrounds audit committee meetings can be temporarily set aside, replaced by off-the-record conversations which seek to identify potential and emerging risks to the business. The exchange must be underpinned by trust between the parties as views shared may not always be underpinned by normal levels of audit evidence.

Typical questions which are explored by both parties at these meetings include 'What else are you worried about?' and 'Where are executive management strong and weak?' among many others.

Informal meetings usually take three forms:

- A **briefing meeting** held between the auditor and the audit committee chair in advance of a formal audit committee meeting. This meeting allows for initial discussion of important issues, prioritisation of the agenda and leads to better quality debate and agenda management. For judgements which are particularly technical, this meeting allows time for the audit committee chairman to review the technical background so that the audit committee meeting can focus on judgemental areas.
- **Private sessions** held as part of the audit committee meeting itself. It has become accepted practice for there to be an opportunity for the auditor and audit committee to hold a private session within the audit committee meeting, without the presence of the executive management. Such sessions not only allow the discussion of highly sensitive issues, but can also be used to cover more subjective areas, such as the quality of management; these areas may not have been covered by the formal reporting of the auditor to the audit committee. It can be useful to schedule a private session in all audit committee meetings where the auditor is in attendance. If these sessions become a regular part of the governance process, the sensitivity sometimes felt by the executive management to these sessions will be lessened.
- **Ad-hoc meetings** held between audit partner and audit committee chair on an informal basis throughout the year. These meetings are typically held without an agenda, and allow both parties to exchange views on the firm, its strategy, performance and management. These meetings can be helpful not only in terms of their content, but also as an opportunity to deepen the relationship between audit partner and audit committee chair, increasing the mutual understanding of the priorities and viewpoints of each party.

3.6 Other audit committee members

Most of the informal meetings described above, and which take place in practice, are between the auditor (usually the audit partner) and the audit committee chair. It may be useful to extend informal meetings to include other members of the audit committee. The differing membership of audit committees, with different levels of expertise, experience and working styles, mean that we would not recommend any 'one-size-fits-all' solution to this question. Auditors and audit committees should discuss the engagement between the auditor and other audit committee members and determine whether the schedule of formal audit committee meetings is sufficient to meet both parties' needs.

3.7 Recommendations

Recommendation	Relevant to
The auditor should attend all meetings of the audit committee, even if the agenda does not include items explicitly relevant to the external audit process.	Auditor, audit committee, executive management
Plan ahead for an efficient year-end process.	Auditor, audit committee
Schedule an 'early issues' audit committee meeting to identify, discuss and conclude on key judgemental areas.	Auditor, audit committee, executive management
Do not allow pressures of the timetable to prohibit the audit committee from challenging and debating issues or requiring changes at the year-end meeting, though try to resolve questions earlier in the process.	Auditor, audit committee, executive management
Include private sessions between auditor and audit committee in all audit committee meetings.	Auditor, audit committee
Hold briefing meetings between the auditor and audit committee chair prior to each audit committee.	Audit committee chair, auditor
Arrange ad-hoc meetings between the auditor and audit committee chair to exchange views across a broader agenda.	Audit committee chair, auditor
Consider whether other audit committee members have sufficient engagement with the auditor or whether additional informal meetings should be arranged.	Auditor, audit committee members

4. CONTENT OF THE DIALOGUE

4.1 Reporting requirements

As noted in the ICAEW Financial Services Faculty report *Audit of banks: lessons from the crisis*, 'The primary source of information for audit committees is the executive management. Good quality reporting from auditors to audit committees can add context to that and highlight gaps in management reporting.'

Auditor dialogue with audit committees includes both formal reporting requirements and more informal communication. Through informal communications, such as those discussed at Section 3.5 of this document report, the auditor has the opportunity to provide additional qualitative context to formal audit reporting.

The formal reporting by the auditor to the audit committee must respond to relevant regulation. Auditing standards and other regulations mandate that reporting must cover certain areas. This guidance does not repeat the rules setting out required reporting. Instead, it highlights those matters which could be covered in the discussions between the auditor and the audit committee in order to enhance the quality of that dialogue.

4.2 Dealing with the compliance agenda

There is a danger that compliance with auditing standards and other regulations can dominate audit committee meeting agendas. Dealing with extensive compliance requirements is a particular challenge in the US, but the issue is also faced in Europe. Examples of compliance-related matters include:

- The need to review the auditor's provision of non-audit services. The audit committee has an important role in monitoring auditor independence. However that there can be a tendency for audit committees to spend too much time reviewing the detail of small and less contentious assignments, instead of focusing on larger or more risky assignments that may pose greater threats to independence.
- The need to perform an annual review of accounting policies. This can result in a disproportionate amount of time being spent considering areas of no change rather than new, contentious or judgemental subjects.

There are a number of important items, both in Europe and in the US, that are required by regulation to be placed on the audit committee agenda. Regulatory requirements clearly need to be addressed. However, the potential impact of those items should be carefully assessed in determining how much time is spent on them during audit committee meetings. There should always be sufficient time allowed to discuss contentious issues and material judgements, as noted in Section 3.4. Agendas should be managed to allow this, for example by circulating papers in advance. Low risk, non-contentious and non-judgemental items could be dealt with at the meeting by confirming agreement with the treatments proposed in pre-circulated papers.

4.3 Style of reporting

The style of reporting to the audit committee makes a significant difference to the value of the content presented.

It is important that the reporting is clear and tailored to provide the audit committee with the information it needs. Audit committees should aim to understand the true story of the audit, and in particular to understand the substance of the debate on judgements and contentious issues that has taken place. Auditor reports to the audit committee that present final conclusions without describing the route to reaching those conclusions will not provide the narrative story that the audit committee needs.

The language used is important and should be appropriate to the form of report. Written reports from auditors are likely to use formal, professional language and may be drafted with regard to both compliance with standards and risk management concerns. The wording may also have been subject to discussion and agreement with the executive management before being finalised. This creates the risk that subjective or contentious matters are not clearly highlighted and explained. It can be difficult to provide a sense of colour when using very formal language, which may tend towards more black and white presentation.

Oral discussions in meetings can allow much more of the flavour of debates to be presented. One audit committee chairman commented that he wanted auditors to communicate as if they were telling a story to a friend. This informal comment illustrates the type of communication that could be helpful in enabling the audit committee to understand properly areas where agreement between the executive management and auditor has been difficult to achieve.

4.4 Recording the dialogue

Auditors and audit committees were accused by certain regulators of not demonstrating enough challenge and professional scepticism in the lead up to the financial crisis. If auditors describe the nature of the debate that has taken place in their reporting to the audit committee, it also gives the auditor an opportunity to demonstrate to audit committees the exercise of professional scepticism. Minutes of audit committee meetings should record areas of debate and challenge by the audit committee, and also descriptions provided orally of earlier debates and challenge between auditors and executive management. Clear minutes can demonstrate to regulators that auditors and audit committees are effectively challenging executive management and applying an appropriate degree of professional scepticism.

4.5 Reporting on the audit plan

Auditing standards set out a number of areas which must be covered in the audit planning document reported by the auditor to the audit committee; we have not repeated these here. The elements of the audit plan of most importance to audit committee members are the identification of audit risk, and the planned response of the auditor to that risk, including consideration of whether reliance could be placed on management's risk control activities. Suggested content that may provoke valuable debate is set out in the Table 3.

Table 3: Audit risks and responses

Identification of audit risk	
Considerations for the auditor	**Considerations for the audit committee**
Present a clear and comprehensive picture of audit risk.	Compare the picture of risk to: • audit committee's own view of firm-wide risk; and • management's view of firm-wide risk. Challenge discrepancies and understand reasons for any differences.
Assess the potential for the going concern assumption to be threatened through considering the level of risk inherent in the firm's business model. The global financial crisis illustrated the importance of this analysis.	Consider whether there are particular risk areas where more insight from the auditors may be required.
Planned audit response	
Considerations for the auditor	**Considerations for the audit committee**
Present a clear picture of where there is planned reliance on management's risk control activities.	Consider whether proposed audit approach is consistent with audit committee view on management risk control activities. Where little or no reliance is planned on management risk control activities, understand the reasons for this approach.
Highlight areas where management's risk mitigation activity is considered weak, together with the consequent audit response.	Consider potential implications of any control weaknesses or concerns identified, and executive management response.

4.6 Reporting on judgements

The description of the key audit and accounting judgements made during the course of the audit is of course a critical element of the auditor's reporting to the audit committee. Our discussions indicated that good reporting explained the objective aspects of the judgements made, but also described the judgemental features – for example capturing how difficult it was to reach a conclusion, how aggressive or conservative that conclusion was etc.

Table 4 suggests areas relevant to the reporting of audit and accounting judgements which may be used to enhance the dialogue between auditor and audit committee in these areas.

Table 4: Reporting audit and accounting judgements

Considerations for the auditor	Considerations for the audit committee
Report all material judgements that have been debated with management, even if agreement on position was reached easily.	Take account of the technical and evidence-based arguments in assess judgements, but also consider the quality and extent of the debate between management and the auditor.
Expose the evolution of the debate, setting out the differing viewpoints. If positions changed, explain the triggers for that change.	Seek to identify those areas where it has been difficult for the auditor and management to reach agreement. Particular focus should be given to the rigour of the conclusions reached in any such areas.
Specify whether, in the auditor's view, the final conclusion to be aggressive or conservative, and how the position taken compares to the peer group and to prior year positions, where relevant.	Consider whether the level of conservatism inherent in judgements made is appropriate to the firm's overall risk appetite. Clearly understand and acknowledge where a position is taken which renders the firm an outlier when compared to the peer group.
Report judgemental areas at an early stage of the audit cycle wherever possible (see Section 3.3). Have an objective of facilitating a full debate and reaching an early resolution of issues.	Challenge executive management and the auditor to highlight issues in advance of the year end.
Report any areas where the audit plan has changed during the course of the audit. Explain clearly the reason for the change, for example if there has been a change in risk profile or a change in the auditor's view on the reliability of controls.	Ascertain the reason for any changes to the audit plan, and evaluate whether the change is consistent with the audit committee's view of the firm's risk profile and control activities.

Table 4 suggests that the audit committee considers whether the accounting judgements made are appropriate for the firm's overall risk appetite. This may represent a change as, while banks may have articulated their risk appetites, most have not applied this when considering financial reporting judgements.

For instance, a firm may have a view, based on its overall risk appetite, on the degree of risk it wishes to take on a loan portfolio. However, the accounting judgements relevant to the valuation of those assets may not take this context into account. If the business is willing to accept a reasonably high degree of risk on a business line, one might expect a relatively large range of potential valuations and more risk disclosures. The audit committee, given its role in advising on risk appetite, might debate whether, for example, it is appropriate to both accept a high degree of risk and use a valuation at the aggressive end of the acceptable range.

4.7 Reporting on controls over financial reporting

Auditors often report their observations on the control environment after the year-end debate on key audit and accounting judgements, particularly outside the US. This timetable, if not carefully managed, can lead controls reporting to be perceived as less important, or less relevant; the reporting relates to 'last year', where management focus may have moved onto a new year's planning cycle.

The reporting of control observations should nonetheless be given proper time and focus. Although it may not be possible to consider all control observations during the busy year-end period, audit committee meeting timetables should be planned so that a post-year-end meeting is scheduled. Often work on controls takes place earlier in the audit cycle, and there may be opportunity to report some or most of the auditor's observations on controls at an earlier stage.

Auditors and audit committees should consider whether there are any particular areas which should be covered in the auditor reporting of their observations on the control environment. The audit committee, as part of the planning process, should determine whether there are particular themes it would like to see explored in the controls reporting. The auditor, in preparing its controls report, should incorporate thematic as well as individual observations. Specific areas which could be considered as part of the thematic reporting include:

- views on the firm's governance and risk management culture;
- the implications of any changes in the firm's business model on the firm's control environment;
- a comparison of the firm's control environment with that observed in the peer group; and
- observations on the quality and depth of resource and the adequacy of succession planning.

There are a number of these areas which are more subjective in nature. Depending on the nature of the relationship between the auditor, audit committee and executive management, and the sensitivity of the items to be discussed, some themes may be better explored as part of the informal or private meetings between the auditor and audit committee members discussed in Section 3.5 above.

4.8 Identifying future issues

In Section 3 we discuss the logistical challenges which may be present by the timing of the annual reporting cycle, in particular where issues arise towards the end of the year. This risk cannot be completely eliminated. It can, however, be mitigated through the auditor, audit committee and executive management working together to identify future issues at an early stage. A good example some auditors use is to provide a radar screen of upcoming issues as part of the reporting to the audit committee. The radar screen sets out those areas which could be relevant to future years' financial statements and is used to provoke early discussion and planning. Typical items included could be the consequence of material transactions, changes in regulation or internal restructuring.

4.9 Recommendations

Recommendation	Relevant to
Carefully plan audit committee agendas to ensure that all areas mandated by regulation are covered but that sufficient time is devoted to the most judgemental, contentious and significant matters.	Audit committee chair, executive management
Deal with procedural, low risk and non-judgemental matters by preparing agenda papers that are pre-read and briefly confirmed at the meeting.	Auditor, audit committee, executive management
Tell a full, clear story to the audit committee about the debate, challenges and judgements involved in the audit and reporting process.	Auditor
Record areas subject to debate and challenge in audit committee minutes, providing sufficient information to explain how final conclusions were reached.	Audit committee
Consider reporting observations on the control environment at a pre-year-end audit committee meeting.	Auditor, audit committee

Recommendation	Relevant to
Consider the specific recommendations made in each of the three core reporting areas, set out in Sections 4.4, 4.5 and 4.6 and agree how these might be incorporated in the planned audit committee reporting.	Auditor, audit committee
Consider presenting a 'radar screen' of upcoming issues to the Audit Committee, seeking to identify items which could impact the financial statements in future years.	Auditor, audit committee

5. OTHER RELEVANT MATTERS

5.1 The internal audit function

While this report does not specifically examine role of the internal audit function, there are many corollaries between the observations made here and the relationships maintained by the internal audit function. External auditors, audit committees and executive management each need their own relationship with the internal audit function, and the audit committee (and external auditor) should monitor the effectiveness of those relationships.

Like the external auditor, the internal audit function undertakes activities that are in some cases complementary to those of the audit committee and the external auditor – for example, the internal audit function must perform a risk assessment of the firm as the core part of its planning process. In these areas, internal audit should work closely with the corresponding party. The internal audit function will often need to provide a rigorous challenge to the executive management in presenting its findings and recommendations on systems and controls. It is important that the relationship allows this challenge to be made and received in a constructive manner. Because of the nature of its work, the internal audit function can also be a useful source of intelligence for the auditor and audit committee.

Internal auditors may find it helpful to read this document, and the recommendations herein, and consider whether there are elements which could be applied in their own activities.

5.2 Auditor communication with other groups

Auditors are formally required to report certain matters to 'those charged with governance'. This document deals with communication with audit committees and, to an extent, executive management but auditors may also have to communicate with the board, chairman, senior independent director and other board committees. Many of the recommendations made in the previous sections are also relevant to the relationships between the auditor and these stakeholders.

5.3 Dialogue between auditor and risk committee

Many banks now have separate audit and risk committees. A bank's risk committee usually has an overarching objective to ensure that risk is identified, managed and monitored effectively throughout the firm; activities undertaken to achieve this objective have much in common with those discussed in Section 2 of this document. It would be valuable, therefore, for the auditor to engage with the risk committee throughout the course of the audit. Sharing risk assessments could assist both auditor and risk committee in performing their roles. Similarly, the auditor may become aware of matters during the course of the audit that would be of relevance to the risk committee.

The appropriate engagement between the auditor and the risk committee should reflect the individual split of responsibilities between audit and risk committees at each bank. If there is common membership between the audit and the risk committee, this in itself may allow for sufficient engagement with the auditor. Often, the auditor attends risk committee meetings in addition to audit committee meetings in order to share insight and to ensure a full understanding of the risk management framework. Some audit and risk committee members felt strongly that the auditor should be invited to attend all risk committee meetings, particularly in the largest and most complex organisations.

5.4 Other duties of audit committees

Some observations made on ineffective audit committees have pointed to problems in the appointment process and in additional duties undertaken by audit committees as root causes. These observations are made, in particular, from a US perspective.

Section 2.3 discusses the need for audit committee members to be, and to be perceived to be, entirely independent of the executive management. If members are appointed directly by the chief executive then it may be difficult to maintain this absolute independence.

Some audit committees have been given additional responsibilities over and above their core governance responsibilities, such as managing the level of the audit fee and, in some cases, being treated as a cost centre subject to budgetary constraints. Audit committees should monitor the performance of the auditor and assess whether the audit fees provide good value for money. However, negotiation of audit fees is usually better conducted by the executive management in order that the audit committee can retain an independent focus on the quality, depth and scope of the audit.

5.5 Other duties of auditors

The responsibilities of auditors and audit committees in respect of non-audit services provided by the auditor are outside the scope of this document which focuses on matters related to the audit of financial statements. Some of these additional services may appear close in nature to an audit, for example the provision of assurance on compliance with client assets rules, where the UK Auditing Practices Board has issued updated guidance for auditors, and skilled persons' engagements, where ICAEW provides professional guidance. However, auditors, audit committees and executive management should consider their engagement on these assignments to ensure these engagements are performed effectively.

Another area of focus in light of the global financial crisis has been strengthening the dialogue between bank auditors and bank supervisors, which was another key recommendation of the ICAEW report *Audit of banks: lessons from the crisis*. In the UK, the Financial Services Authority, working with the Bank of England, auditors and ICAEW, issued a 'Code of Practice for the relationship between the external auditor and the supervisor', to encourage more effective dialogue between auditors and supervisors. This may include formal engagement, through scheduled bilateral and trilateral meetings (which may include executive management and audit committees) and informal channels, such as telephone calls and meetings. Although this guidance does not seek to repeat that included in the code of practice, matters discussed between the auditor and supervisor are likely to be of interest to the audit committee in considering whether to explore any issues more deeply.

5.6 Recommendations

Recommendation	Relevant to
Internal audit functions may wish to review this document and consider whether the recommendations made can be applied to their own activities.	Internal audit function
Consider communication between auditor, the risk committee, the board as a whole and key board members, not just between auditor and audit committee.	Auditor, risk committee, board
Ensure independence of audit committee is not compromised when appointing members of and assigning additional responsibilities to the audit committee.	Auditor, audit committee, executive management

ABOUT THE *INSPIRING CONFIDENCE IN FINANCIAL SERVICES* INITIATIVE

The *Inspiring Confidence in Financial Services* initiative debates issues affecting confidence in the financial services sector. It develops new insights and ideas by questioning financial services providers, consumers and regulators about how they interact with each other and how information flows between them.

Market conditions were very different when we launched the campaign in early 2007 and confidence in financial services was high. However, we identified four themes that represent challenges in the sector, all related to supporting confidence: responsible providers; responsible consumers; better regulation; and better information. To have stable, efficient markets that support consumer interests and sustain wider economic development, it is necessary to draw together these elements.

Enhancing the dialogue between bank auditors and audit committees is the third major report issued under the *Inspiring Confidence in Financial Services* initiative, and principally falls under the 'Better information' theme. It follows up the report *Audit of banks: lessons from the crisis*, issued in June 2010, implementing one of our own recommendations.

Other activities in the programme have included hosting major conferences, producing briefing and issues papers, and informing ICAEW policy and representational activity, including evidence provided to parliamentary committees.

The financial crisis has highlighted the importance of debating these issues on a continued basis to allow the financial system to react and adapt to change, including changes in behaviours and in the regulatory environment.

FINANCIAL SERVICES FACULTY CORPORATE MEMBERSHIP

The Financial Services Faculty's corporate membership programme provides funding to support the Inspiring Confidence in Financial Services initiative. This report is an example of our ability to lead and influence public debate on long-term issues relating to financial services.

We are proud to acknowledge our corporate members and thank them for their support and contribution. Our corporate members include:

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How can my organisation get involved?

Corporate membership of the Financial Services Faculty is available for financial institutions, professional firms, regulatory authorities, industry bodies and associated service providers wishing to demonstrate a commitment to promoting long-term confidence in the financial services sector.

Corporate membership allows you to engage fully in the thought leadership and policy work of the faculty at a corporate level. As a corporate member of the Financial Services Faculty, your support will be publicly acknowledged in publications and conferences relating to the *Inspiring Confidence in Financial Services* initiative, as well as on the faculty website.

Further information

Please contact our client relationship manager Thomas Gannage-Stewart for further information about corporate membership of the Financial Services Faculty (020 7920 8659 or thomas.gannage-stewart@icaew.com). Alternatively, visit the faculty website icaew.com/fsf

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