Guidance

Audit and Assurance

Financial Reporting Council

July 2019

Practice Note 19 (Revised)

The audit of banks and building societies in the United Kingdom

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting responsible for promoting transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

PRACTICE NOTE 19

THE AUDIT OF BANKS AND BUILDING SOCIETIES IN THE UNITED KINGDOM (REVISED JULY 2019)

CONTENTS **PAGE**

PREFACE

This Practice Note contains guidance on the application of International Standards on Auditing (ISAs) (UK) issued by the Financial Reporting Council ('the FRC') to the audit of banks and building societies in the United Kingdom (UK). In addition a number of other entities, for example consumer finance companies, compete with banks in areas of banking business outside of deposit taking and auditors of such entities may find the guidance in this Practice Note helpful. A bank or building society can also be an 'authorised firm' in the context of regulation under the Financial Services and Markets Act 2000.

The Practice Note is intended to assist auditors in applying the requirements of, and should be read in conjunction with, ISAs (UK),. This Practice Note sets out the special considerations relating to the audit of banks and building societies which arise from individual ISAs (UK) listed in the contents. It is not the intention of the Practice Note to provide step-by-step guidance to the audit of banks and building societies so where no special considerations arise from a particular ISA (UK), no material is included.

This update addresses the latest versions of the ISAs (UK) that were in issue in June 2019. This includes ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*, which is effective for audits for financial statements for periods commencing on or after 15 December 2019 (early adoption is permitted). Guidance relating to the previous version of ISA (UK) 540 is included in the previous version of this Practice Note. However, as the guidance for ISA (UK) 540 (Revised December 2018) includes, in particular, material relevant to the audit of estimates for expected credit losses (ECL), auditors may find this guidance helpful for the audits of periods ending before 15 December 2019 even if they have not early adopted that standard.

Auditors of banks and building societies need to be aware of the specific regulatory requirements, including capital adequacy requirements, that apply to banks and building societies, some of which impact on the auditor. This Practice Note gives guidance on these. Other particular areas of bank and building society accounts that can necessitate special audit considerations are those that require preparers to exercise significant judgment, particularly the valuation of complex financial instruments and the calculation of impairment provisions for loan portfolios. Many banks have extensive trading portfolios of derivatives and other financial instruments and so this Practice Note should be read in conjunction with Practice Note 23 (Revised), 'Special Considerations in Auditing Financial Instruments'. The valuation of financial instruments is an area where the auditor may need to consider the use of specialist staff.

One further important area where the nature of banking business requires special consideration is in the assessment of going concern and disclosure of related liquidity risks.

The term 'Investment Bank' is commonly used to refer to entities that are engaged in primary or secondary trading in the debt, equity and commodity markets or in the provision of corporate finance advice. Many of these entities are banks, i.e. they hold an authorisation to accept deposits but some are not and so the term investment bank can be confusing. This Practice Note together with Practice Note 23 (Revised) considers issues relating to the principal secondary market trading activities of such entities but does not include any special considerations relating to primary market activities or the specialist nature of commodity trading.

This Practice Note is based on the legislation and regulations in effect at 1 July 2019.

At the time of publication, there are EU regulations, including binding technical standards, that apply directly to UK firms. References to these are made in this Practice Note. When the UK ceases to be a member of the EU these references will be updated accordingly.

INTRODUCTION

1. Banks can operate in the UK as:

   - a 'UK bank' – a company incorporated in the UK which is authorised[1] by the Prudential Regulation Authority (PRA) to accept deposits, and is not a building society;

   - a 'non EEA bank' – a UK branch of an entity incorporated outside the EEA, authorised by the PRA to accept deposits ;

   - an 'EEA bank' a UK branch of a credit institution incorporated in the EEA which has exercised EEA Passport rights[2] to carry on regulated activities in the UK.

   A 'building society' is a mutual society incorporated under the Building Societies Act 1986 (‘BS Act 86’) and must also be authorised by the PRA.

   In addition to being authorised by the PRA, which regulates prudential requirements, banks and building societies operating in the UK must comply with the Conduct of Business Rules of the Financial Conduct Authority (FCA). The PRA is the lead regulator in authorising banks and building societies, but entities cannot be authorised unless the FCA gives its consent to the PRA.

   Auditors of entities that carry out similar business to banks and building societies but do not take deposits may find the guidance in this Practice Note useful.

2. This Practice Note addresses the responsibilities and obligations of the auditor concerning:

   - the audit of the financial statements in accordance with the Companies Act 2006[3] (‘CA2006’) and Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008[4] (‘Companies and Groups Accounts Regulations 2008’) – applicable to UK banks;

   - the audit of the financial statements in accordance with BS Act 1986 and Building Societies (Accounts and Related Provisions) Regulations 1998[5] (‘BS Accounts Regulations 1998’) and related obligations – applicable to building societies;

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1 Authorised under FSMA 2000 to undertake regulated activities.

2 Exercising passport rights entitles an entity incorporated in one EEA member state (‘home country’) who is authorised to conduct one or more regulated activities subject to the passport rights in the home country to establish a branch and carry out those regulated activities in another EEA member state (‘host country’) without the need to be authorised by the host country supervisor, (in the UK the PRA) in respect of activities that are subject to the passport rights.

3 Banks which are incorporated in the United Kingdom are subject to the provisions of the Companies Act 2006.

4 SI 2008/410.

5 SI 1998/504 (as amended).

- the right and duty to report[6] direct to the FCA, PRA or BoE in certain circumstances – applicable to UK banks, non-EEA banks, building societies and to EEA banks with top-up permissions[7];
- reporting on interim profits for the purposes of their inclusion in capital resources. This is applicable to UK banks and building societies but required only if requested by the entity; and
- reporting on a statement of particulars of transactions and arrangements concerning directors under s78(9) BS Act 86 applicable to building societies.

3. Non EEA banks and EEA banks are not subject to the audit provisions of the CA2006 and so the terms of engagement are a matter of contract between the auditor and their client who may, for example, be local or head office management or the EEA/non EEA bank's home country auditor. Such engagements take many different forms: the auditor may be asked to report on the financial statements of the UK branch or only on particular aspects thereof, and the form of their opinion will also vary from case to case. The auditor undertaking such an assignment does not have to apply International Standards on Auditing (ISAs) (UK) unless required to by the terms of engagement but, if they are not applied, the auditor may find some of the guidance in this Practice Note of assistance.

4. In addition to accepting deposits, banks and building societies may also undertake other activities regulated under the Financial Services and Markets Act 2000 (FSMA 2000) for which Part 4A permission[8] from the FCA or PRA is required. This may include one or more forms of investment business or insurance intermediation. Regulated activities are subject to FCA conduct of business rules and can give rise to auditor reporting responsibilities concerning client assets. This can occur even where the entity is not authorised to hold client assets – a negative assurance report. These reporting responsibilities are addressed in the Standard for Providing Assurance on Client Assets to the Financial Conduct Authority (the Client Asset Assurance Standard). In addition, banks and building societies may also undertake regulated mortgage activity. While this also requires to be covered by the Part 4A permission and is also subject to FCA conduct of business rules, no auditor reporting obligations arise in relation to client assets.

5. The scope of the statutory audit of a UK bank's financial statements is no different from that of the generality of companies incorporated in the UK. Concerning a building society, in addition to the financial statements and the directors' report, the auditor also

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6 Provided for in s342 and s343 FSMA 2000 and Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587, as amended by SI 2013/472).

7 A Part 4A permission granted by the FCA or PRA to an EEA bank to enable it to undertake UK regulated activities in the UK, for example when authorisation to undertake the activity in the home country is not required by the home country supervisor.

8 A permission granted by FCA or PRA under Part 4A FSMA 2000 permitting an authorised firm to carry on regulated activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended. A dual regulated firm, wishing to vary its permission, should apply to the PRA for a change - the PRA will work with the FCA to assess the application.

reports on an annual business statement which accompanies the financial statements. Further, the auditor of a building society is required to report on the summary financial statement that all building societies are obliged to prepare and send to all those members entitled to receive notice of the Annual General Meeting.

LEGISLATIVE AND REGULATORY FRAMEWORK

6. The auditor of a bank or building society needs to be familiar with relevant legal and regulatory requirements. The extent to which an auditor considers compliance with regulatory requirements in the course of auditing a bank or building society's financial statements is discussed in the section of this Practice Note that addresses ISA (UK) 250 Section B.

7. The legal and regulatory framework within which banks and building societies operate in the UK is summarised in the following paragraphs. The relevant lead regulators are the Financial Conduct Authority (FCA) and, at the Bank of England (BoE), the Prudential Regulation Authority (PRA). The BoE is the Resolution Authority for a failing bank or building society that requires resolution[9].

8. This Practice Note was written with reference to the framework of law and regulation in effect at 1 July 2019. Practice Note 19 is not intended to provide a complete description of that framework, and nor can it anticipate or reflect changes which have taken place after it was written.

At the time of publication, there are EU regulations, including binding technical standards, that apply directly to UK firms. References to these are made in this Practice Note. When the UK ceases to be a member of the EU these references will be updated accordingly.

Public interest entities

9. Banks and building societies are public interest entities (PIEs) as defined in legislation, including section 2 of The Statutory Auditors and Third Country Auditors Regulations 2016. This means they and their auditors have to comply with the applicable legal and regulatory requirements for PIEs. The ISAs (UK) and the FRC's Ethical Standard include requirements for auditors specific to PIEs, many of which reflect underlying legal requirements.

Auditor appointment and independence

10. The PRA Rulebook and FCA Handbook contain specific rules regarding the appointment of auditors and their duties, including, among other matters, in relation to: auditors' qualifications and independence, cooperation of audited firms with their auditors; cooperation of auditors with the regulators; and specific matters to be communicated to the regulators. In this connection the auditor is aware that:

    - the FCA and PRA do not need to approve the appointment of an auditor but may seek to satisfy themselves that an auditor appointed by a firm is independent and has the necessary skills, resources and experience (SUP 3.4.7R and PRA Rule 3.3 in the Auditors section of the PRA Rulebook);

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9 The BoE is provided with powers under the Banking Act 2009 to carry out resolutions.

- the auditor is required to cooperate with the FCA and PRA (SUP3.8.2R, and PRA Rule 7.1 in the Auditors section of the PRA Rulebook); and

- the auditor must notify the FCA and PRA as appropriate if the auditor ceases to be the auditor of an authorised firm.

11. Many of the specific requirements relating to audits of PIEs are intended to ensure and support the independence and objectivity of the auditor. Independence issues can be complex for the auditor of a bank, and to a lesser extent a building society because of banking and other relationships that the auditor and/or its partners and staff may have with the bank. The auditor makes careful reference to Section 2 of Part B of the FRC's Ethical Standard – Financial, business, employment and personal relationships.

12. Of particular relevance to banks and building societies, having regard to the audit firms that will have the expertise and capability to undertake their audit, are the restrictions on the engagement periods for which auditors can be appointed[10] (the audit firm rotation requirements) and the restrictions on non-audit services that are deemed to compromise independence. Some non-audit services provided while not the auditor may prevent the acceptance of appointment as auditor in subsequent periods – for example where there is a specific restriction or where the service has established an ongoing self-review threat. Forward planning is necessary for banks and building societies to ensure that audit firms they may wish to invite tenders from to be their auditor are able to do so. Audit firms are required to ensure that they do not accept or continue an audit engagement that would cause the legal requirements relating to the appointment of auditors to be breached.

Prudential requirements

13. Banks and building societies are subject to certain prudential requirements established in the PRA Rulebook and the EU Capital Requirements Regulation (CRR). Measures include, among others:

    - capital adequacy – ensuring sufficient capital resources in relation to risk requirements to absorb losses;

    - liquidity – ensuring sufficient liquid assets or maturing assets to meet liabilities as they fall due; and

    - large exposures – avoiding undue credit risk concentrations.

    The PRA expects banks and building societies to engage directly with policy materials, including rules in the PRA Rulebook, supervisory statements (see paragraph 25) and EU materials and determine, bearing in mind the overarching principle of safety and soundness, whether they are meeting the expectations set out in them.

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[10] Companies Act 2006: sections 485C, 489C and 494ZA.

Financial statements

14. The form and content of the financial statements of UK banks prepared under UK GAAP is governed by the CA2006 and United Kingdom Accounting Standards. (United Kingdom Accounting Standards comprise Financial Reporting Standards ('FRSs')). The prescribed format for a UK bank's financial statements that comply with UK GAAP is set out in the Companies and Groups Accounts Regulations 2008 made under Part 15 CA2006. However, listed UK groups (including listed UK banking groups) must prepare consolidated financial statements in accordance with those International Financial Reporting Standards adopted by the European Union (EU IFRSs)[11] and those parts of CA2006 applicable to companies reporting under EU IFRSs. UK companies or non-listed groups, including UK banks and banking groups, are permitted to adopt voluntarily EU IFRSs for their financial statements.

15. The form and content of a building society's financial statements prepared under UK GAAP are prescribed in the BS Accounts Regulations 1998 made under s72C BS Act 1986. These are similar to the Companies and Groups Accounts Regulations 2008 applicable to UK banks. As for UK banks, building societies apply FRSs when reporting under UK GAAP. Building societies with listed securities, including permanent interest-bearing shares, are also required to apply EU IFRSs in their consolidated financial statements. Like UK companies, building societies may also voluntarily adopt EU IFRSs for their entity financial statements.

16. In addition to financial statements and a directors' report, building societies are also required, by BS Act 1986, to prepare:

    - an annual business statement – part of the annual report (s74 BS Act 1986); and
    - a summary financial statement (s76 BS Act 1986).

17. In 2010, the British Bankers Association published a voluntary Code for Financial Reporting Disclosures (the BBA Code). This sets out key principles for disclosure and also establishes a process for banks to consider areas of topical interest that may have an impact on financial reporting disclosures and how to enhance the ability to make comparisons across the banking sector. Each bank subscribing to the BBA Code states as such in its annual report. Auditors need to be alert to any disclosures that will follow from the BBA Code each year. In 2017 the BBA was integrated into UK Finance which adopted the BBA Code with effect from 1 July 2017.

Financial Services and Markets Act 2000

18. FSMA 2000 sets out the high level regulatory framework for the financial sector more generally and does not relate just to banks and building societies. Appendix 2 sets out the main parts of FSMA 2000 relevant to authorised firms which are banks or building societies.

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[11] Article 4 of EC Regulation 1606/2002 as acknowledged in s403 CA2006 – the IAS Regulation.

19. The wide scope of FSMA 2000 reflects the FCA's and PRA's extensive responsibilities. These are set out in FSMA 2000 as regulatory objectives covering:

FCA:

- the protection of consumers;
- protecting and enhancing the integrity of the UK financial system; and
- promoting effective competition.

PRA:[12]

- promoting the safety and soundness of authorised persons.

In essence, for banks and building societies, the FCA is the conduct regulator and the PRA the prudential regulator.

20. The PRA is required to pursue its general objective primarily by seeking to avoid adverse effects on financial stability resulting from the way firms run their business, and by preventing disorderly failure. When discharging its general functions in a way that advances its objectives, the PRA must so far as is "reasonably possible" act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.

21. Part 9B of FSMA 2000 establishes legal provisions in relation to ring fencing of bank activities. With effect from 1 January 2019 the largest UK banks must have separated core retail banking from investment Banking. In this context, the FCA and PRA in pursuing their objectives seek to avoid adverse effects on the continuity of the provision in the UK of core banking services.

22. FSMA 2000 covers not only the regulation and supervision of financial sector entities but also other issues such as official listing rules, business transfers, market abuse, compensation and ombudsman schemes, investment exchanges and clearing houses.

23. FSMA 2000 is also supported by a large number of statutory instruments. Significant components of the definition and scope of the regulatory framework are contained in the main statutory instruments. A list of important provisions of FSMA 2000 and a list of statutory instruments relevant to the auditor is included in Appendix 3.

24. Under Part 9A FSMA 2000 the FCA and PRA have the power to make 'rules' for firms and auditors. The FCA also has specific power to give guidance, including with respect to its rules, functions and other matters. Rules made by the regulators are set out in the FCA Handbook and the PRA Rulebook. The legal effect of a rule varies depending on the power under which it is made and on the language used in the rule. Rules are mandatory unless a waiver has been agreed with the FCA or PRA as applicable. If an authorised firm contravenes a rule it may be subject to enforcement action and

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12 Under FSMA 2000, the PRA also has a specific regulatory objective in relation to insurance which is outside the scope of this PN.

consequent disciplinary measures under Part XIV FSMA 2000. Furthermore, in certain circumstances an authorised firm may be subject to an action for damages under s138D FSMA 2000. In contrast, FCA guidance is generally issued to throw light on a particular aspect of regulatory requirements, and is not binding. However, if an authorised firm acts in accordance with it in the circumstances contemplated by that guidance, the FCA will proceed on the basis that the authorised firm has complied with the rule to which the guidance relates.

25. In addition to its Rulebook, the PRA also issues various 'Statements'. These include:

- Supervisory statements (SS) – these set flexible frameworks for firms, incorporating new and existing expectations. They focus on the PRA's expectations and are aimed at facilitating firm and supervisory judgment in determining whether they meet those expectations. They do not set absolute requirements – those are contained in rules.

- Statements of policy (SoP) – these are the formal document in which the PRA details its policy on a particular matter. Statements of policy usually set out the PRA's approach to exercising powers conferred by FSMA 2000. They do not contain the PRA's expectations, which are set out in supervisory statements.

- Policy statements (PS) – these set out PRA feedback on consultation responses, together with its policy line. The PRA only issues feedback when there have been extensive comments by the public and industry. Policy statements are published on the same page as the accompanying consultation paper.

26. There also a number of relevant EU regulations including, in particular, the Capital Requirements Directive IV (CRD IV) which is made up of the Capital Requirements Directive (CRD) (2013/36/EU), which must be implemented through national law, and the Capital Requirements Regulation (CRR) (575/2013), which applies directly to firms across the EU. In addition, the European Banking Authority (EBA) also issues guidelines. The PRA has stated that relevant EU regulations, including binding technical standards that apply directly to UK firms, will not be reproduced in the PRA Rulebook but will be part of the PRA's requirements of firms.

27. It is unrealistic to expect members of an audit engagement team to have detailed knowledge of the entire FCA Handbook, PRA Rulebook and relevant EU regulations. ISA (UK) 250 Section B requires the level of knowledge of the members of the audit engagement team of the provisions of the applicable legislation; regulator's rules and guidance; and other specific requirements placed on the audited entity, to be appropriate to an individual's role in the audit and sufficient (in the context of that role) to enable them to identify situations which may give reasonable cause to believe that the matter should be reported to a regulator. ISA (UK) 220 requires the engagement partner, among other things, to:

- Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.

- Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.

The Building Societies Act 1986

28. In addition to FSMA 2000 which applies to FCA and PRA authorised firms generally, BS Act 1986 applies to building societies. It sets out the legal framework applicable to building societies. A list of important provisions of BS Act 1986 and related statutory instruments relevant to the auditor is included in Appendix 3. The BS Act 1986 includes, for example:

- s5 principal purpose (see paragraph 29);
- s6 lending limit (see paragraphs 30 to 32);
- s7 funding limit (see paragraphs 30 to 32); and
- s9A restrictions on treasury activities (see paragraph 33).

29. A building society's purpose or principal purpose must be to make loans secured on residential property and funded substantially by its members. The lending and funding limits (see paragraph 30 below) are quantitative criteria which help to determine a building society's compliance with this purpose. The PRA Supervisory Statement 'Supervising building societies' treasury and lending activities' (SS20/15) is applicable to all building societies and sets out the PRA's expectations in respect of building societies' compliance with the requirements of the BS Act 1986, FSMA 2000, the PRA Rulebook and SS24/15 'The PRA's approach to supervising liquidity and funding risks'.

30. There are particular quantitative limits specified in BS Act 1986 that are used in the assessment of compliance with this principal purpose criterion – collectively known as 'nature limits'. The BS Act 1986 limits are as follows:

- at least 75% of business assets must be loans fully secured on residential property – the lending limit (s6 BS Act 1986);
- at least 50% of total funds (i.e. total shareholder funds, wholesale deposits and bills of exchange and debt instruments) must be raised in the form of shares (deposits conferring membership rights) held by individual members – the funding limit (s7 BS Act 1986).

31. These nature limits are additional to the prudential measures referred to in paragraph 13 above. The funding limit and the lending limit as at the end of the financial year must both be reported to members, together with the statutory limits, in the annual business statement, and are also required to be reported to the PRA. The annual business statement is reported on by the auditor and is attached to the annual accounts of the building society (see paragraphs 314 and 315).

32. Both these limits must be calculated on a group basis where that is appropriate. With reference to the lending limit, business assets means total assets, plus provisions for bad and doubtful debts, less fixed assets, less liquid assets and less any long-term insurance funds. Business assets, therefore, typically comprise loans, investments in

connected undertakings and sundry debtors and prepayments. Building societies preparing their financial statements in accordance with EU IFRS use the appropriate equivalent balance sheet captions. Residential property is defined in the BS Act 1986 as being land at least 40% of which is normally used as, or in connection with, one or more dwellings, or which has been, is being, or is to be developed or adapted for such use.

33. A building society may undertake almost any activity, provided that such activity is included within its Memorandum[13] and provided that the building society or group as a whole continues to comply with the principal purpose and with the nature limits. However s9A BS Act 1986 includes a number of specific prohibitions on a building society's treasury activities, which are that (subject to certain exceptions) a building society is not permitted to:

- act as a market maker in securities, commodities or currencies;
- trade in commodities or currencies; or
- enter into any transaction involving derivative instruments, except in relation to hedging.

Reporting direct to regulators – statutory right and duty

34. Under FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587, as amended by SI 2013/472) the auditor of an authorised firm or the auditor of an entity closely linked to an authorised firm who is also the auditor of that authorised firm has a statutory duty to communicate matters of material significance to the FCA, PRA or BoE as appropriate. Under s340 FSMA 2000, 'the auditor' is defined as one required to be appointed under the 'rules' of the appropriate regulator or appointed as a result of another enactment. In addition, s342 FSMA 2000 provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the regulator any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the regulator. Guidance on the identification of matters to be reported to the regulators is set out in the section dealing with ISA (UK) 250 Section B.

35. An EEA bank is not required to appoint an auditor under the PRA's rules in respect of its UK branch operations unless it has a top-up permission. Furthermore, a UK branch of a bank incorporated outside the UK is not required to appoint an auditor under CA2006. Consequently, if an EEA bank (without top-up permissions) appoints an auditor to undertake audit procedures at its UK branch this does not fall within the definition of 'auditor' for the purposes of s342/3 FSMA 2000 and SI 2001/2587. As a result the auditor undertaking such work has neither a statutory right nor statutory duty to report direct to the regulator and may not have relief from its duty of confidentiality to its client if the auditor decides to do so. In the event that an auditor of an EEA bank identifies a matter that would be likely to be of material significance to the FCA, PRA or BoE the auditor considers whether they have a responsibility to report such matters to

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13 A Memorandum within the meaning of Sch 2 BS Act 1986.

the 'head office' auditors of the EEA bank or to the home country regulator. See Appendix 6 concerning disclosure in the public interest.

36. A non-EEA bank authorised by the PRA is required to appoint an auditor under the PRA's rules and therefore an auditor appointed in accordance with this rule has both the right and duty to report. Whilst, in principle, there is a requirement to appoint an auditor, there is no requirement for the auditor to undertake audit procedures and there is no corresponding requirement to report on the results of those procedures. Therefore, some non-EEA banks with UK operations that are not material to the non-EEA bank as a whole may have no need to commission an auditor to undertake audit procedures.

Communication between the auditor and the FCA and PRA

37. The FCA and PRA have published codes of practice[14] for the relationship between the external auditor and the supervisor. The codes of practice, which set out principles that establish, in the context of a particular regulated firm, the nature of the relationship between the supervisor and the auditor, the form and frequency that communication between the two parties should take, and the responsibilities and scope for sharing information between the two parties. The FCA and PRA expect supervisors and auditors of banks and building societies to apply the principles set out in the code having regard to the related guidance within it.

38. Within the legal constraints that apply, the FCA and PRA may pass on to the auditor any information which they consider relevant to his function. Auditors are bound by the confidentiality provisions set out in Part XXIII of FSMA 2000 (Public record, disclosure of information and co-operation) in respect of confidential information received from the FCA or PRA. An auditor may not pass on such confidential information even to the entity being audited without lawful authority (for example if an exception applies under the FSMA 2000 (Disclosure of confidential information) Regulations 2001[15]) or with the consent of the person from whom the information was received and, if different, to whom the information relates. Further guidance in respect of information communicated to the auditor by the FCA or PRA is set out in paragraphs 100 – 103 below.

39. The auditor is required to cooperate with the FCA or PRA as appropriate (SUP3.8.2R, PRA Rule 7.1 in the Auditors section of the PRA Rulebook). This may involve attending meetings, including routine bilateral meetings, and providing the FCA or PRA with information about the authorised firm that the FCA or PRA may reasonably request in discharging their functions.

40. The auditor must notify the FCA or PRA as appropriate without delay if the auditor is removed from office, resigns before the term of office expires or is not re-appointed by the authorised firm. Notification to the FCA or PRA includes communicating any matters connected with this event that the auditor considers ought to be drawn to the FCA's or PRA's attention or a statement that there are no such matters (s344 FSMA 2000, SUP3.8.11R and 12R, and PRA Rule 2.1 in the Auditors section of the PRA Rulebook).

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14 FCA – 'FG13/3'; PRA – 'LSS7/13'.

15 SI 2001/2188.

ISA (UK) 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS

41. ISA (UK) 210 sets out the auditor's responsibilities when agreeing the terms of audit engagements. These include establishing that the 'preconditions for an audit' are present and that there is a common understanding between the auditor and management and, where appropriate, those charged with governance.

42. Matters which the auditor may decide to refer to in the engagement letter are as follows:

- the responsibility of the directors/senior management to comply with applicable FSMA 2000 legislation and FCA and PRA rules and guidance including the need to keep the FCA and PRA informed about the affairs of the entity;

- the statutory right and duty of the auditor to report direct to the FCA and PRA in certain circumstances (see the section of this Practice Note relating to ISA (UK) 250 Section B);

- the requirement to cooperate with the auditor (SUP3.6.1R in the FCA Handbook and Rule 5.1 of the Auditors section in the PRA Rulebook). This includes taking steps to ensure that, where applicable, each of its appointed representatives and material outsourcers gives the auditor the same right of access to records, information and explanations as the authorised firm itself is required to provide the auditor (s341 FSMA 2000, SUP 3.6.2G to 3.6.8G and Rule 5.2 of the Auditors section in the PRA Rulebook). It is a criminal offence for an authorised firm or its officers, controllers or managers to provide false or misleading information to the auditor (s346 FSMA 2000)[16];

- the need for the entity to make the auditor aware when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt.

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[16] An offence is committed also under s501 CA2006 by a person who knowingly or recklessly makes to an auditor of a company a statement (oral or written) that: (a) conveys or purports to convey any information or explanations which the auditor requires, or is entitled to require, under s 499 CA 2006, and (b) is misleading, false or deceptive in a material particular. An equivalent offence is included under s79(9) of the Building Societies Act 1986.

ISA (UK) 240: THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

43. ISA (UK) 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

44. As with other entities, fraud in banks and building societies, either fraudulent financial reporting (for example the manipulation of profits or the concealment of losses) or misappropriation of assets, can occur through a combination of management fraud, employee fraud or fraud perpetrated by third parties. However, various factors make banks and building societies particularly vulnerable to fraud such as:

    - They have custody of valuable and fungible assets including money, making them a particular target for fraudsters;
    - They handle very large volumes of transactions and collect and disburse large amounts of money on a daily basis, for example in taking deposits, making loans and providing a payments service to customers. This creates more opportunity for fraud unless properly controlled;
    - Certain aspects of their businesses are complex both in terms of the risks taken on and the operational risks the activities entail, which makes their operations more difficult to control; and
    - Banks and building societies tend to be very heavily dependent on information technology (IT) to manage their businesses. This represents a significant opportunity for computer based fraud.

    As a result, fraud is an increased risk in a banking business.

45. In order to mitigate these fraud risks, it is essential for the entity to have very strong internal controls including:

    - The right ethical and cultural framework being set by senior management;
    - Appropriate status and authority being given to control functions such as risk and internal audit;
    - Clear lines for reporting control deficiencies and suspicions of misdoings;
    - Thorough procedures for investigating the background of clients and transactions;
    - Strong segregation of duties;
    - Clear control policies and requirements that are checked in detail and monitored by management;
    - Strong IT controls to prevent fraudulent access and manipulation of data and fraudulent access to assets (e.g. via internet banking); and

- Appropriate measures in place to fight fraudulent activity, both physical and technological.

46. In addition, whilst remuneration policies can create excessive performance pressures in many industries, in certain banks and building societies or divisions of large banks (in particular treasury and investment banking operations) performance related bonuses can be significant, both in absolute terms and in relation to base remuneration. Significant bonus related remuneration often extends beyond senior management to quite junior members of staff and can lead to more pervasive pressures that increase the risks of fraudulent financial reporting as these staff seek to enhance their bonuses or protect their jobs by inflating their reported results. The FCA dual regulated firms Remuneration Code (SYSC 19D) applies to banks and building societies meeting particular conditions (set out in SYSC 19D.1.1) and requires (SYSC 19D.2.1) that an authorised firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management. The PRA Rulebook also includes a section on Remuneration.

47. Principle 3 of the FCA Principles for Businesses (PRIN 2.1) requires a firm to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. The PRA Rulebook includes similar requirements in the Fundamental Rules section. SYSC 6.1.1 requires a firm to maintain adequate policies and procedures to ensure compliance with its obligations under the regulatory system and for countering the risk that it might be used to further financial crime[17]. Whilst the inherent risk of fraud may continue to exist, the establishment of accounting and internal control systems sufficient to meet these requirements frequently reduces the likelihood of fraud giving rise to material misstatements in the financial statements. Guidance on the auditor's consideration of accounting systems and internal control is provided in ISA (UK) 315 and the section of this Practice Note that covers that standard. Examples of deficiencies in control that could give rise to fraud risk factors are also set out in that section.

48. In considering how to respond to the threat of misstatement by fraud the auditor considers the following:

    - A thorough understanding of the nature of the entity's business, and in particular how profits and losses can arise in relation to particular products and transactions, is very important in detecting fraud, because it enables unusual patterns and trends that may indicate fraud to be more easily identified. An auditor considers how to enhance his/her knowledge of the entity's business, for example by:

        - Interviewing a wide range of management, including business as well as financial management;

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[17] Further, record keeping requirements are set out in SYSC 9.

  - Discussing findings with control functions such as risk, legal, compliance and internal audit together with considering reviews undertaken by third parties such as skilled person's reports prepared under s166 FSMA 2000[18];
  - Using experts to help improve understanding; and
  - Comparing the entity to peers in the market where feasible to identify unusual trends.

- Auditors of all entities familiarise themselves with the control environment as a whole and controls designed to prevent fraud that might affect the financial statements. They also assess the robustness of their design. Deficiencies in control are taken into account when planning audit procedures and reported to those in charge of governance. This is a particularly important aspect of the audit of a bank or building society because of the nature of the fraud risks they face and the complexity of the systems and controls required to combat them. The auditor ensures that the engagement team has the appropriate skills available to undertake this task, including the necessary information technology expertise.

- Many basic audit tests also help address audit fraud risk and the auditor considers the implications of the results of such tests for the risk of fraud. In particular, fraud usually has to be concealed through the use of fictitious or misleading balances. These can be revealed through:

  - Comparing balances to external sources, for example through bank and depository reconciliations;
  - Ensuring that suspense and transit accounts (the latter being accounts through which the progress of payments are monitored) are properly reviewed and promptly cleared;
  - Checking that the contents of all balance sheet accounts are properly understood and validated; and
  - Verifying valuations to external sources.

- Much fraud is brought to the attention of companies through complaints and other more confidential means of reporting. An auditor considers checking the results of whistleblowing and complaints procedures within the entity, including how the entity ensures that these procedures are robust.

- An entity's regulators may also be aware of suspicious activity and the auditor considers maintaining a dialogue with them.

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18 Section 166 FSMA 2000 provides the FCA and PRA with the power to require a firm to appoint a skilled person to provide a report on any matter that the FCA or PRA may reasonably require in connection with the exercise of the functions conferred on them by or under FSMA 2000. The requirements concerning skilled persons are set out in SUP5 of the FCA Handbook and the Use of Skilled persons section of the PRA Rule book.

- The expectations of investors and other third parties and management compensation policies can indicate areas of particular pressure for management, which could lead to management fraud. Understanding these areas can help an auditor focus work in particularly vulnerable areas.

Revenue recognition

49. The auditor considers how revenue recognition can be manipulated. For example:

    - Interest and fee income are typically recognized on a systematic basis over the period of a loan or deposit automatically by the IT system. It is likely that the risk of material misstatement due to fraudulent revenue recognition will be reduced where relevant IT controls are strong;

    - Trading income is strongly influenced by period-end valuations, so considering how fraudulent misreporting in this area can be prevented is important;

    - Many entities generate significant fees, the timing of whose recognition can require considerable judgment. The auditor considers how these judgments are made and whether they are influenced by a desire for a fee to be recorded in a particular period.

Journal entries

50. Banks and building societies will typically have high numbers of journal entries relating to the financial reporting process. When identifying and selecting journal entries for testing, the auditor ensures the complete population is identified and is alert for non-standard and unusual journal entries for further investigation.

Communication

51. Reduction of financial crime is one of the FCA's statutory objectives. The FCA's rules require authorised firms to report 'significant' fraud, errors and other irregularities to the FCA (SUP15.3.17R).The auditor also considers whether the matter is of material significance to the PRA and should be reported accordingly. The auditor is aware of the auditor's duty to report direct to FCA and PRA in certain circumstances (see the section of this Practice Note relating to ISA (UK) 250 Section B).

ISA (UK) 250: SECTION A – CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

52. ISA (UK) 250 Section A deals with the responsibilities of an auditor when considering laws and regulations in an audit of financial statements. Banks and building societies are subject to wide-ranging laws and regulation including, in certain circumstances, elements of foreign laws and regulations (for example money-laundering and transactions with trade sanctioned entities and countries).

53. ISA (UK) 250 Section A distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

    (a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements; and

    (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties; non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

54. ISA (UK) 250 Section A specifies differing audit requirements for each of the above categories of laws and regulations. For the category referred to in paragraph 53(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations. For the category referred to in paragraph 53(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements. Therefore, the auditor considers, at the planning stage of the audit, the identification and categorisation of the relevant laws and regulation. The risk assessment phase of the audit considers the risk of material misstatement from each category separately. In respect of the determination of material liabilities relating to past conduct of business matters (e.g. financial product mis-selling or regulatory fines), this determination may require judgment (see also paragraphs 247 – 250).

UK regulatory permissions

55. FSMA 2000 and related statutory instruments are important elements of the legal and regulatory framework applicable to banks and building societies, these are supplemented by certain EU regulation, which has a direct effect in the UK - see the section of this PN that summarises the legislative and regulatory framework.

56. In addition to accepting deposits, an entity may also have permission under the FSMA 2000 to undertake one or more types of investment business, insurance intermediation, regulated mortgage, payment services activity or other regulated activities. If this is the case, the auditor also considers the laws and regulations relevant to the entity’s ability to conduct these additional regulated activities.

57. The auditor is alert to any indication that the entity is conducting business outside the scope of its Part 4A permission or the entity is failing to meet FSMA 2000 Threshold Conditions[19] or contravening any FCA Principles for Businesses or PRA Fundamental Rules[20]. Such action may be a serious regulatory breach, which may result in fines, public censure, suspension or revocation of authorisation and may also impact the going concern assumption. The auditor compares the current activities of the entity with the Scope of Part 4A Permission granted by the PRA (and set out in the Financial Services Register on the FCA website) and considers ISA (UK) 250 Section A and where appropriate ISA (UK) 250 Section B. Consideration may also be given to the following:

- permissions granted in foreign jurisdictions to conduct business in those jurisdictions which may be subject to change, particularly where UK permissions are accepted in those jurisdictions under EEA Passport rights[21] which may be impacted by the UK's exit of the European Union; and

- the implications of the ring-fencing requirements for banks with deposits in excess of £25 billion, which may restrict the activities that can be carried out within the ring-fenced bank.

58. Specific areas that the auditor's procedures may address include the following:

- obtaining a general understanding of the legal and regulatory framework applicable to the entity and industry, and of the procedures followed to ensure compliance with the framework;

- inspecting the entity's Scope of Part 4A Permission (in the Financial Services Register, which sets out the regulated activities that the firm is permitted to engage in, including any limitations and requirements imposed on those permitted activities);

- inspecting correspondence with the PRA, FCA and other UK and overseas regulators (including that relating to any supervisory visits, requests for information by regulators or progress concerning periodic risk mitigation (PRA) and firm evaluation (FCA) programmes);

- inquiring of the entity's compliance with prudential capital requirements, including reporting to the PRA;

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19 The minimum standards that a firm needs to meet to become and remain authorised by the FCA and PRA– see Appendix 4.

20 FCA Handbook and PRA Rulebook define Principles for Businesses and Fundamental Rules respectively with which authorised firms must comply – see Appendix 4.

21 Exercising passport rights entitles an entity incorporated in one EEA member state ('home country') who is authorised to conduct one or more regulated activities subject to the passport rights in the home country to establish a branch and carry out those regulated activities in another EEA member state ('host country') without the need to be authorised by the host country supervisor in respect of activities that are subject to the passport rights.

- holding discussions with the entity's Compliance Officer and other personnel with regulator-designated Senior Manger Responsibilities;
- inquiring of management and, where appropriate, those charged with governance as to whether the entity has instances of non-compliance with laws and regulations;
- inspecting compliance reports prepared for the Board, audit, risk and other committees;
- considering the work on compliance matters performed by internal audit;
- inspecting the results of any complaints monitoring procedures of the entity and any trends that may indicate conduct of business issues; and
- periodically meeting with the FCA and PRA supervisory teams in accordance with the FCA and PRA published codes of practice[22] for the relationship between the external auditor and the supervisor.

Money laundering

59. Banks and building societies are subject to the requirements of the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2017 as well as FCA rules in relation to money laundering risks. These laws and regulations require institutions to establish and maintain procedures to identify their customers, establish appropriate reporting and investigation procedures for suspicious transactions, and maintain appropriate records.

60. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which banks and building societies conduct their business. By the nature of their business, banks and building societies are ready targets of those engaged in money laundering activities. The effect of this legislation is to make it an offence to provide assistance to those involved in money laundering and makes it an offence not to report suspicions of money laundering to the appropriate authorities, usually the National Crime Agency ('NCA'). FCA requirements are set out in SYSC6. In this context, the FCA has due regard to compliance with the relevant provisions of guidance issued by the Joint Money Laundering Steering Group ('JMLSG') (SYSC6.3.5).

61. In addition to considering whether the entity has complied with the money laundering laws and regulations, the auditor has reporting obligations under the Proceeds of Crime Act 2002, and the Money Laundering Regulations 2017, to report knowledge or suspicion of money laundering offences, including those arising from fraud and theft, to NCA. The auditor is aware of the prohibition on 'tipping off' when discussing money laundering matters with the entity. Given the nature of banking business and the likely frequency of needing to report to NCA, the auditor is aware of the short-form[23] of

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22 FCA – 'FG13/3'; PRA – 'LSS7/13'.

23 These are termed limited intelligence value reports or suspicious activity reports.

reporting to NCA that can be used in appropriate circumstances to report minor and usually numerous items.

62. The auditor, in the context of money laundering, is aware of the auditor's duty to report direct to FCA in certain circumstances (see the section of this Practice Note relating to ISA (UK) 250 Section B).

63. Additionally, banks and building societies may be subject to money laundering, terrorist financing and trade sanctioned entities and countries of other overseas jurisdictions, for example in relation to transactions in US dollars. The auditor considers the remit of such extra-territorial foreign laws and regulations in planning and risk assessing the audit.

Other regulations

64. Other regulation that may require specific consideration by the auditor includes:

(a) Banks and building societies are required to comply with capital, liquidity and leverage requirements. Breach of these requirements may impact the going concern assumption of the entity, this is further considered in the section of this PN that addresses ISA (UK) 570. Additionally, disclosures of the capital and liquidity position may be included in the financial statements under accounting standards. The auditor may determine that elements of the entity's capital and liquidity management process require audit procedures in respect of material disclosures.

(b) Non-compliance with conduct of business requirements may give rise to material liabilities for banks and building societies (e.g. customer redress for payment protection insurance). Although an auditor may not conduct extensive procedures to determine whether all product terms or sales practices are compliant with conduct of business requirements, the auditor understands the potential risks of material misstatement created by known industry-wide conduct of business issues (see also paragraphs 247 to 250).

(c) The EBA issued Guidelines on credit institutions credit risk management practices and accounting for expected credit losses in May 2017, this is applicable to all EU credit institutions applying IFRS 9. These Guidelines do not interpret accounting standards but seek to ensure banks and building societies (included in the scope of the definition of credit institutions) adopt IFRS 9 in a high quality manner. Where an entity states in its financial statements that it has adhered to the Guidelines, the auditor obtains an understanding of whether the Guidelines have a direct effect on the determination of material amounts and disclosures in the financial statements.

ISA (UK) 250: SECTION B – THE AUDITOR'S RIGHT AND DUTY TO REPORT TO REGULATORS OF PUBLIC INTEREST ENTITIES AND REGULATORS OF OTHER ENTITIES IN THE FINANCIAL SECTOR

65. ISA (UK) 250 Section B deals with the circumstances in which the auditor of an entity subject to statutory regulation (a "regulated entity") is required to report direct to a regulator information which comes to the auditor's attention in the course of the work undertaken in the auditor's capacity as auditor of the regulated entity.

66. The assurance of an entity's compliance with the FCA's client assets rules may be conducted in parallel with the financial statement audit. The FRC's standard on *Providing Assurance on Client Assets to the FCA* provides additional considerations to auditors regarding the reporting directly to a regulator information which comes to the auditor's attention in the context of its client assets audit.

67. Additionally, auditors of certain large banks are required to provide long-form reports to the PRA on an annual basis under chapter 8 of the Auditors section of the PRA Rulebook. Where this is the case the auditor will be contacted directly by the PRA with the specific information required. The auditor takes this into consideration when planning and performing the audit.

Auditors' duty to report to the relevant regulator

68. Under FSMA 2000 (Communication by Auditors) Regulations 2001 ('the 2001 Regulations'), as amended by SI 2013/472, auditors have duties in certain circumstances to make reports to the relevant regulators (PRA, FCA or Bank of England as appropriate). The auditor considers which regulator(s) a matter may be relevant to and reports to each of them separately if appropriate ((usually one or both of the PRA and FCA). Information and opinions to be communicated are those meeting the criteria set out below which relate to matters of which the auditor[24] of the authorised person (also referred to below as a 'regulated entity')[25] has become aware:

    (i) in his capacity as auditor of the authorised person; and

    (ii) if he is also the auditor of a person who has close links with the authorised person, in his capacity as auditor of that person.

    The 2001 Regulations do not require auditors to perform any additional audit work as a result of the statutory duty to make a report to the relevant regulator, nor are auditors required specifically to seek out breaches of the requirements applicable to a particular authorised person. However, in circumstances where the auditor identifies that a reportable matter may exist, the auditor carries out such extra work, as the auditor considers necessary, to determine whether the facts and circumstances cause the

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[24] An 'auditor' is defined for this purpose in the Regulations as a person who is, or has been, an auditor of an authorised person appointed under, or as a result of, a statutory provision including Section 340 of FSMA 2000.

[25] In the context of FSMA 2000, these terms equate to the term 'authorised firm'.

auditor 'reasonably to believe' that the matter does in fact exist. It should be noted that the auditor’s work does not need to prove that the reportable matter exists.

69. The criteria for determining the matters to be reported are as follows:

(i) the auditor reasonably believes that there is, or has been, or may be, or may have been a contravention of any 'relevant requirement' that applies to the person[26] concerned and that contravention may be of material significance to the relevant regulator in determining whether to exercise, in relation to that person, any of its functions under FSMA 2000 (other than in part VI, i.e. rules relating to official listing); or

(ii) the auditor reasonably believes that the information on, or his opinion on, those matters may be of material significance to the relevant regulator in determining whether the person concerned satisfies and will continue to satisfy the FSMA 2000 Threshold Conditions or contravening any FCA Principles for Businesses or PRA Fundamental Rules[27].;[28] or

(iii) the auditor reasonably believes that the person concerned is not, may not be, or may cease to be, a going concern; or

(iv) the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with the CA2006 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation[29].

70. In relation to paragraph 69(i) above, 'relevant requirement' is a requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FCA 's rules (other than the Listing Rules) including the Principles for Businesses and PRA rules. The duty to report also covers any requirement imposed by or under any other Act[30], the contravention of which constitutes an offence which the relevant regulator has the power to prosecute under FSMA 2000.

71. In relation to paragraph 69(ii) above, the duty to report relates to either information or opinions held by the auditor which may be of significance to the relevant regulator in determining whether the regulated entity satisfies and will continue to satisfy the

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[26] In this context the person is an ‘Authorised Person’.

[27] FCA Handbook and PRA Rulebook define Principles for Businesses and Fundamental Rules respectively with which authorised firms must comply – see Appendix 4.

[28] The Threshold Conditions are set out in Schedule 6 to FSMA 2000 and represent the minimum conditions that a firm is required to satisfy and continue to satisfy to be given and to retain Part 4A permission.

[29] The relevant rules and legislation are set out in article 2(2)(d) of the 2001 Regulations, and include rules made by the FCA and PRA, and relevant provisions of, and regulations made under, BS Act 1986.

[30] Examples include The Proceeds of Crime Act 2002 and prescribed regulations relating to money laundering.

Threshold Conditions. The duty to report opinions, as well as information, allows for circumstances where adequate information on a matter may not readily be forthcoming from the regulated entity, and where judgments need to be made.

Material significance

72. Determining whether a contravention of a relevant requirement or a Threshold Condition is reportable under the 2001 Regulations involves consideration both of whether the auditor 'reasonably believes' and that the matter in question 'is, or is likely to be, of material significance' to the relevant regulator.

73. As indicated above, paragraph 12 of ISA (UK) 250 Section B requires that, where an apparent breach of statutory or regulatory requirements comes to the auditor’s attention, the auditor obtains such evidence as is available to assess its implications for the auditor’s reporting responsibilities and determine whether, in the auditor’s opinion, there is reasonable cause to believe that the breach is of material significance to the relevant regulator.

74. 'Material significance' is described by paragraph 9(d) of ISA (UK) 250 Section B as follows:

‘the term “material significance" requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.’

75. 'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of an entity, it may be of a nature or type that is likely to change the perception of the regulator. For example, failure to reconcile client money accounts may not be significant in financial terms but could have a significant effect on the FCA's consideration of whether the regulated entity was satisfactorily controlled and was behaving properly towards its customers.

76. The determination of whether a matter is, or is likely to be, of material significance to the relevant regulator inevitably requires the auditor to exercise judgment. In forming such judgments, the auditor needs to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered.

77. The auditor of a regulated entity bases the judgment of 'material significance' to the relevant regulator solely on his understanding of the facts of which the auditor is aware without making any assumptions about the information available to the relevant regulator in connection with any particular regulated entity. Appendix 7 gives examples of areas where a duty to report might arise.

78. Clearly the concept of material significance means that not every breach or suspected breach, however minor, of relevant requirements needs to be reported. However, in considering whether to report minor matters, the auditor will need to consider (amongst other things):

- Whether the breach or suspected breach would relate to the entity's assets or amount to misconduct or mismanagement.

- That the cumulative effect of matters which come to the auditor's attention may collectively be of material significance, even if particular matters in isolation might not be regarded as being so.

- In circumstances where the auditor concludes that a matter gives rise to a statutory duty to report, the auditor has a duty to report that matter to the relevant regulator even if the entity has already reported it.

79. On completion of their investigations, the auditor ensures that the facts and circumstances, and the basis for his conclusion as to whether these are, or are likely to be, of 'material significance' to the relevant regulator, are adequately documented such that the reasons for his decision to report or not, as the case may be, may be clearly demonstrated.

80. Section 342 of FSMA 2000 provides that an auditor may communicate matters to the relevant regulator even where this would place the auditor in breach of any duty to which he would ordinarily be subject (such as a duty of confidence to his client). The auditor may communicate information to the relevant regulator which he has become aware of in his capacity as auditor of the regulated entity. He may also communicate his opinion in relation to any such matter. In each case the following conditions must be met: (1) the auditor must be acting in good faith; (2) the auditor must reasonably believe the information or opinion is relevant to any of the functions of the relevant regulator.

Conduct of the audit

81. Understanding, commensurate with the individual's role and responsibilities in the audit process, is required of:

- the provisions of the 2001 Regulations concerning the auditors' duty to report to the regulator;

- the standards and guidance in ISA (UK) 250 Section B, and in this section of this Practice Note; and

- relevant sections of the FCA Handbook and PRA Rulebook including those provisions relating to the Threshold Conditions, the FCA Principles for Businesses and the PRA Fundamental Rules[31] and the prudential requirements for capital, liquidity and leverage.

82. The auditor includes procedures within his planning process to ensure that members of the audit team have such understanding (in the context of their role) as to enable them to recognise potentially reportable matters, and that such matters are reported to the

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[31] FCA Handbook and PRA Rulebook define Principles for Businesses and Fundamental Rules respectively with which authorised firms must comply – see Appendix 4.

audit engagement partner without delay so that a decision may be made as to whether a duty to report arises.

83. An audit firm appointed as auditor of a regulated entity needs to have in place appropriate procedures to ensure that the audit engagement partner is made aware of any other relationship which exists between any department of the firm and the regulated entity when that relationship could affect the firm's work as auditors. (This matter is covered in more detail in Appendix 2 of ISA (UK) 250 Section B.) The auditor also requests the regulated entity to advise him when it appoints a third party (including another department or office of the same firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt. This matter may usefully be referred to in the engagement letter.

Closely linked entities

84. Where the auditor of a regulated entity is also auditor of a closely linked entity[32], a duty to report arises directly in relation to information relevant to the regulated entity of which he becomes aware in the course of his work as auditor of the closely linked entity.

85. The auditor establishes during audit planning whether the regulated entity has one or more closely linked entities of which the audit firm is also the auditor. If there are such entities the auditor considers the significance of the closely linked entities and the nature of the issues that might arise which may be of material significance to the regulator of the regulated entity. Such circumstances may involve:

- activities or uncertainties within the closely linked entity which might significantly impair the financial position of the regulated entity;
- money laundering and, if the closely linked entity is itself regulated;
- matters that the auditor of the closely linked entity is intending to report to its regulator.

86. Following the risk assessment referred to in paragraph 85, the auditor of the regulated entity identifies the closely linked entities for which the procedures in this paragraph are necessary. The engagement team of the regulated entity communicates to the engagement team of the selected closely linked entities the audit firm's responsibilities to report to the relevant regulator under the 2001 Regulations and notifies the engagement team of the circumstances that have been identified which, if they exist, might be of material significance to the relevant regulator. Prior to completion the auditor

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32 An entity has close links with an authorised person for this purpose if the entity is a:

(a) parent undertaking of an authorised person;

(b) subsidiary undertaking of an authorised person;

(c) parent undertaking of a subsidiary undertaking of an authorised person; or

(d) subsidiary undertaking of a parent undertaking of an authorised person.

of the regulated entity obtains details from the auditor of the closely linked entity of such circumstances or confirmation, usually in writing, that such circumstances do not exist. Where the closely linked entities are part of the inter-auditor group reporting process these steps can be built into that process.

87. Section 343 of FSMA 2000 confers a similar protection on auditors when they report information or opinions to the relevant regulator to that of section 342 (considered above). This enables the auditor to disclose to the relevant regulator information of which he has become aware in his capacity as the auditor of the closely linked entity, or his opinion on such matters. Again two conditions apply: (1) the auditor must be acting in good faith; (2) the auditor must reasonably believe the information or opinion is relevant to any of the functions of the relevant regulator.

88. No duty to report is imposed on the auditor of an entity closely linked to a regulated entity who is not also auditor of the regulated entity.

89. In circumstances where he is not also the auditor of the closely linked entity, the auditor of the regulated entity decides whether there are any matters to be reported to the relevant regulator relating to the affairs of the regulated entity in the light of the information that he receives about a closely linked entity for the purpose of auditing the financial statements of the regulated entity. If the auditor becomes aware of possible matters that may fall to be reported, he may wish to obtain further information from the management or auditor of the closely linked entity to ascertain whether the matter should be reported. To facilitate such possible discussions, at the planning stage of the audit the auditor of the regulated entity will have considered whether arrangements need to be put in place to allow him to communicate with the management and auditor of the closely linked entity. If the auditor of the regulated entity is unable to communicate with the management and auditor of the closely linked entity to obtain further information concerning the matters he has identified, he reports the matters, and that he has been unable to obtain further information, direct to the relevant regulator.

Information received in a capacity other than as auditor

90. There may be circumstances where it is not clear whether information about an entity coming to the attention of the auditor is received in the capacity of auditor or in some other capacity, for example as a general adviser to the entity. Appendix 2 to ISA (UK) 250 Section B provides guidance as to how information obtained in non-audit work may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit.

Discussing matters of material significance with the directors

91. The directors[33] are the persons principally responsible for the management of the regulated entity. The auditor will therefore normally bring a matter of material significance to the attention of the directors subject to compliance with legislation relating to 'tipping off' and seek agreement on the facts and circumstances. However,

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33 This term would include the senior management of branches of EEA or non EEA banks.

ISA (UK) 250 Section B, paragraph 13, emphasises that where the auditor concludes that a duty to report arises, the auditor shall bring the matter to the attention of the relevant regulator as soon as practicable. The directors may wish to report the matters identified to the relevant regulator themselves and detail the actions taken or to be taken. Whilst such a report from the directors may provide valuable information, it does not relieve the auditor of the statutory duty to report directly to the relevant regulator.

Timing of a report

92. The duty to report arises once the auditor has concluded that he reasonably believes that the matter is or is likely to be of material significance to the relevant regulator.

93. The report should be made as soon as is practicable once a conclusion has been reached. Unless the matter casts doubt on the integrity of the directors this should not preclude discussion of the matter with the directors and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are, however, undertaken on a timely basis to enable the auditor to conclude on the matter as soon as practicable.

94. The FCA has set up a dedicated 'Auditor's duty to report' mailbox[34] for the storage and logging of these reports. Auditors send any such reports to this mailbox and copy in the supervisor of the firm the report relates to. For the PRA and other regulators, the entity supervisor would usually be the relevant contact for reporting.

Auditors' right to report to the relevant regulator

95. In addition to the duty to report particular information, the auditor has a right to report other information that is relevant to the functions of the relevant regulator. S342 FSMA 2000 provides that no duty to which an auditor of an authorised person is subject shall be contravened by communicating in good faith to the relevant regulator information which he has become aware of in his capacity as auditor of the regulated entity, or his opinion on any such matter. As mentioned above, two conditions apply: (1) the auditor must be acting in good faith; (2) the auditor must reasonably believe the information or opinion is relevant to any of the functions of the relevant regulator.

96. The scope of the duty to report is wide, particularly as an authorised firm must disclose to the relevant regulator appropriately anything relating to the authorised firm of which the relevant regulator would reasonably expect notice. However in circumstances where the auditor concludes that a matter does not give rise to a statutory duty to report but nevertheless should be brought to the attention of the relevant regulator, in the first instance he advises the directors of his opinion. Where the auditor is unable to obtain, within a reasonable period, adequate evidence that the directors have properly informed the relevant regulator of the matter, then the auditor makes a report themselves to the relevant regulator as soon as practicable.

[34] Auditorsdutytoreport@fca.gov.uk

Taking legal advice

97. In considering when to report (or when a report to the relevant regulator benefits from the protection of FSMA, sections 342(3) and 343(3)[35]), an auditor may wish to take legal advice. An auditor may wish to ensure, for example, that only relevant information is disclosed and that the form and content of his report is such as to secure the protection of FSMA 2000. Appendix 6 provides additional guidance on disclosure in the public interest. This is relevant to both the auditor's consideration of the right to report and also where neither the right nor the duty to report exists – as is the case for EEA banks without top up permissions. However, the auditor recognises that legal advice will take time and that speed of reporting is likely to be important in order to protect the interests of customers and/or to enable the relevant regulator to meet its statutory objectives.

Formal bilateral meetings

98. Formal bilateral meetings between the relevant regulator and auditors (see paragraph 39) vary in frequency according to factors such as the PRA and FCA's assessment of systemic risk of the bank or building society concerned.

99. The formal bilateral meeting is intended to provide a forum for frank one-to-one discussions on issues of concern to either the relevant regulator or auditor. The relevant regulator does not, however, expect auditors to make supervisory judgments nor, in the normal course of events, does it expect to base its own supervisory judgments and decisions solely on comments provided by auditors.

100. Although there is no requirement to produce an agenda for a formal bilateral meeting, where the relevant regulator has specific matters which it intends to discuss, it will, where possible, communicate these to the auditor in advance. Similarly, the relevant regulator will not, as a matter of course, circulate minutes of the bilateral meeting to the auditor, although they may provide a summary list of the main items covered. Auditors therefore consider taking their own notes of the formal bilateral meeting (as explained below, the confidentiality restrictions of FSMA 2000 generally prevent such notes being made available to the bank or building society although they can be shared with the relevant regulator if the auditor considers a particular discussion requires clarification).

101. The relevant regulator expects auditors to participate fully in the bilateral meeting, and to discuss views and impressions gained within the audit context as well as factual information. Under sections 342 and 343 of FSMA 2000, auditors are protected from breach of their duty of client confidentiality in communicating matters[36] to the relevant regulator provided that they do so 'in good faith' and reasonably believe that the information or opinion is relevant to any functions of the relevant regulator. In appropriate cases, the auditor may consider obtaining legal advice on the application of this provision. In general terms, it is not essential that conclusive evidence is available

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35 Allowing the auditor to report notwithstanding any duty, such as confidentiality, to which the auditor is subject.

36 Specifically, information on a matter which the auditor has or had become aware of in his capacity as auditor of the authorised person, or his opinion on such a matter.

to support an opinion expressed in a bilateral meeting but, in communicating matters 'in good faith', the auditor:

(a) reports facts in a balanced manner and without selectivity or bias; and

(b) expresses any opinions in a neutral and responsible manner, making clear that they are opinions and not facts and explaining the basis for them,

and the auditor's actions must be without malice. In addition, general law provides protection in certain circumstances for disclosing certain matters even where a duty of confidence exists to a proper authority in the public interest.[37]

102. Auditors are bound by the confidentiality regime of FSMA 2000[38] in respect of confidential information[39] communicated to them by the relevant regulator. Under that regime, where confidential information is disclosed to a person by the relevant regulator the information may not be disclosed by that person to any other person unless the requirements of FSMA 2000 are complied with (including to the bank or building society).

103. In practice, the auditor obtains the express consent of the relevant regulator to any onward disclosure of confidential information. This is because normally the consent of the person who provided the information to the relevant regulator, and, if different, the person to whom the information relates is needed before the information may be disclosed. Some information communicated by the relevant regulator to the auditor will relate only to the bank or building society but many matters discussed may be relevant also to other parties, such as customers or employees. Also, where the relevant regulator has received information which it communicates to auditors and reporting accountants from another regulator or in a capacity other than as banking supervisor, there may be other restrictions on disclosure.

104. The auditor can, however, disclose to the bank or building society information which the auditor has communicated *to the* relevant regulator during the bilateral meeting (except where to do so would have the effect of disclosing information communicated by the relevant regulator). If the auditor is uncertain about whether particular information can be communicated to the bank or building society, the auditor considers, for the avoidance of doubt, seeking the consent of the relevant regulator.

105. Matters communicated *by the* relevant regulator during the bilateral meeting may be conveyed by those representatives of an accounting firm who were present at the meeting to other partners, directors and employees of the firm who need to know the

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37 Case law provides for when this defence is available, which is not considered in this Practice Note.

38 In Part 23 of FSMA 2000, and in the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (SI 2001/2188).

39 'Confidential information' within the meaning of section 348 of FSMA 2000. Note that this is broadly defined (and much broader in scope than information to which a private law duty of confidence would attach), for example, including information relating to the business or affairs of any person or was received by the relevant regulator for the purposes of, or in the discharge of, any of its the regulator's functions.

information in connection with the firm's performance of its duties as auditor without the regulator's express permission.

Other periodic meetings with relevant regulator

106. In addition to the formal meetings with the relevant regulator outlined above, the auditor may be involved in other discussions with the relevant regulator on either a trilateral or bilateral basis. Examples include:

- meetings with the FCA or PRA during the risk assessment phase of the supervisory process;
- presentations by the FCA or PRA on the results of its risk assessment or evaluation and the resulting supervisory programme; and
- ad hoc meetings to discuss matters communicated to the relevant regulator by the auditor under the right or duty to report (as discussed above).

107. The normal protections and confidentiality restrictions apply to these meetings in the same way as to formal bilateral meetings.

ISA (UK) 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS

108. ISA (UK) 300 deals with the responsibilities of auditors in planning an audit of financial statements.

109. Matters the auditor of a bank or building society may consider as part of the planning process for the audit of the financial statements include:

- the nature and scope of the entity's business;
- the entity's governance, including the FCA and PRA regulatory regimes for senior managers;
- the extent of head office control over networks of branches;
- the entity's relationships with the PRA, FCA and any other regulators;
- changes in applicable laws, regulations and accounting requirements;
- the potential for the use of information technology in performing audit procedures;
- the need to involve specialists in the audit;
- the extent to which controls and procedures are outsourced to a third-party provider; and
- issues relating to the auditor's statutory duty to report.

110. Guidance on the first five of these matters is set out in the section in this Practice Note on ISA (UK) 315 'Identifying and assessing the risks of material misstatement through understanding the entity and its environment'. Considerations in relation to other matters in planning the audit include:

- the nature and complexity of banking business increases the likelihood that the auditor may consider it necessary to involve specialists in the audit process. For example, the auditor may wish to utilise the work of a specialist or expert in the measurement of expected credit losses (ECL) or derivative and other financial instruments not traded in an active market; or to utilise IT specialists to assist in designing and performing procedures in relation to the bank or building society IT systems. The auditor considers the need to involve such specialists at an early stage in planning their work. Where such specialists are to be used, they may be involved in the development of the audit plan and may take part in discussions with the management and staff, in order to assist in the development of knowledge and understanding relating to the business;
- the auditor considers the implications of the outsourcing of functions by the entity, and the sources of evidence available to the auditor for transactions undertaken by service organisations in planning the audit work.; and

- issues relating to the auditor's statutory duty to report include the adequacy of the audit team's understanding of the law and the identification of closely linked entities.

ISA (UK) 315: IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

111. ISA (UK) 315 deals with the responsibilities of an auditor in respect of identifying and assessing the risks of material misstatement.

112. Banks and building societies can be complex and the auditor obtains an understanding of the entity's business, business environment (including the regulatory regime in which it operates) and its control environment.

113. These entities would typically operate formal risk and control structures (such as enterprise risk-wide management frameworks, regulatory-defined senior management roles and responsibilities, and three-lines of defence risk and control structures), governed by Audit and Risk Committees. Outputs from these processes may aid the auditor in identifying and assessing the risks of material misstatement.

Understanding the entity and its environment, including the entity's internal control

114. In assessing the nature and scope of the business and its control environment, the auditor may consider:

- The entity's strategy, risk appetite and capital and liquidity resources and how it manages tensions that are likely to exist between them (for example an entity's strategic ambition may require an appetite for risk that those in charge of governance regard as imprudent or strain capital and liquidity too far);

- The entity's recovery and resolution plans in place which consider the triggers and actions that may be required if the entity gets into difficulties – these may, for example, provide an insight into the most significant commercial risks;

- The products it uses and its strategies for making money from them. An auditor might seek to understand how the entity monitors returns on these products and then check that these are reasonable in the light of returns in the rest of the market;

- How the entity is governed and whether it complies with relevant regulatory requirements and best practice;

- The quality of the entity's risk analysis and whether there are risks that are not properly analysed and controlled;

- The views of the regulator about the entity and broader industry concerns;

- The tone set by senior management and those in charge of governance, the quality of what is reported to them and their consequent ability to run the business; and

- The quality of controls and in which locations or functions there may be deficiencies.

In making this assessment the auditor considers gathering information from as wide a range of sources as possible in order to compare one source against another for consistency. In particular it can be important to interview business and front office staff as well as back office, risk and finance staff in order to get a full appreciation of the entity's activities.

115. For the largest institutions, the PRA and FCA intend to meet the auditor, usually at an early stage in the financial reporting process, and identify areas where there may be concerns over key areas of accounting judgment and perceived areas of risk. These meetings take place at least once a year and could cover areas such as fair value estimates and provisions for impairment.

116. When performing procedures to obtain an understanding of the entity, the auditor considers:

- the relative importance to the entity of each of its business activities[40]. This includes an understanding of the type and extent of specialised activities, for example:
  - derivatives and other complex trading activities (where both documentation, accounting and valuation aspects can be difficult);
  - trade finance, invoice discounting and factoring (where the documentation used can be complex and highly specialised);
  - leasing (where there are particular accounting issues, especially relating to income recognition); and
  - other specialised finance products (for example leveraged finance, commercial real estate and syndicated lending).
- the introduction of new categories of customers, or products or marketing and distribution channels;
- the relevant aspects of the entity's risk management procedures;
- the legal and operational structure of the entity, including the use of structured entities for either financing, regulatory capital or tax purposes;
- the availability of capital, liquidity and funding to the entity;
- the complexity of the entity's information systems, including its use of third-party service organisations and use of open-banking data interfaces;

40 The auditor of a building society is aware of the BS Act 1986 statutory and the relevant regulatory limitations on funding, lending and treasury activities and considers whether the continuing activities of the society are, for example, within the restrictions of section 9A of the BS Act 1986 and are compliant with the limitations within the society's treasury approach. See paragraphs 13 and 28-33 of this Practice Note.

- a change in the market environment (for example, new entrants to the market and technology changes);
- a change in the financial reporting environment (for example, the introduction of a new accounting standards);
- the complexity of products;
- the consistency of methods and operations in different departments or locations; and
- the respective roles and responsibilities attributed to the finance, risk control, compliance and internal audit functions.

117. Many banks and UK banking groups are managed globally on product/business lines rather than focused around legal structure. Such 'matrix management' structures typically involve local reporting (often on a legal entity basis) on operational and compliance matters; and business/product based reporting (often globally) of activities undertaken. In addition, global trading activities may mean that transactions are entered into in one location but are recorded in another; it may even be the case that they are controlled and settled in a third location. Furthermore, parts of a bank's operations may be undertaken through special purpose entities which may have structures and features that can mean they are excluded from financial statement consolidation. Given these factors, the auditor gains an understanding of how and where transactions are undertaken, recorded and controlled, in order to plan the audit. Further guidance on particular matters arising in the audit of banking groups is given in the section on ISA (UK) 600 in this Practice Note.

118. Many banks and building societies operate a network of branches. In such instances, the auditor determines the degree of head office control over the business and accounting functions at branch level and the scope and effectiveness of the entity's inspection and/or internal audit visits. The extent and impact of visits from regulators is also relevant. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to assessing audit risk.

119. In obtaining an understanding of the regulatory factors the auditor considers:

- any formal communications between the regulators and the entity, including any risk assessments, firm evaluations and risk mitigation programmes issued by the FCA or PRA and the results of any other supervisory visits conducted by regulators;
- the contents of any recent reports prepared by 'skilled persons' under s166 FSMA 2000 together with any correspondence, minutes or notes of meetings relevant to any recent skilled persons' report; and

- discussions with the entity's compliance officer together with others responsible for monitoring regulatory compliance.

Accounting policies

120. Accounting policies of particular relevance may include allowances for impairment, hedge accounting, classification of assets and liabilities (and thereby their measurement), embedded derivatives, valuation of complex financial instruments, revenue/expense recognition (including effective interest rates), consolidation of special purpose entities, offsetting and derecognition and debt versus equity classification. The auditor undertakes procedures to consider whether the policies adopted are in compliance with applicable accounting standards and gains an understanding of the procedures, systems and controls applied to maintain compliance with them.

121. There are a number of areas of complex accounting in banks and building societies, such as expected credit loss and valuation adjustments, which may lead to elevated risk of material misstatement. Where new complex requirements are being introduced in the financial period, an auditor considers any specific additional risks arising from the implementation of these requirements.

Objectives, strategies and related business risks

122. It is important for the auditor to understand the multi-dimensional nature and extent of the financial and business risks which are integral to the environment, and how the entity's systems record and address these risks. Although they may apply to varying degrees, the risks include (but are not limited to):

    - strategic risk: the risk that an entity's business strategy and operating model is not sustainable in the face of economic, market and competitive changes. As more of the traditional services of banks and building societies may be performed by other types of business (for example, payments institutions and peer-to-peer lenders), this may impact the profitability or viability of the entity;

    - credit risk: at its simplest, this is the risk that a borrower or other counterparty will be unable to meet its obligations. However, where credit risk is traded (in the form of secondary market loan trading or credit derivatives, for example), credit risk is often regarded as having two distinct forms:

        - spread risk: the risk arising from day-to-day changes in the price of a credit instrument because of changes in market perceptions about the credit standing of the debtor and the liquidity of the instrument;

        - default risk: the risk that a debtor will default on its obligations; or settlement risk: the risk that a counterparty will be unable to settle its obligations under a transaction (in a securities settlement or payment system, for example) on the due date;

    - concentration risk: the risk arising when an entity's exposure is heavily weighted to a particular class or sector of borrower or geographic region and thus runs the risk of disproportionate exposure to problems with that particular class, sector or region;

- liquidity risk: the risk that arises from the possibility that an entity has insufficient liquid funds to meet the demands of depositors or other counterparties;
- interest rate risk: the risk that arises where there is a mismatch between the interest rate reset dates or bases for assets and liabilities;
- currency risk: the risk that arises from the mismatching of assets, liabilities and commitments denominated in different currencies;
- market risk[41]: the risk that changes in the value of assets, liabilities and commitments will occur as a result of movements in relative prices (for example, as a result of changes in the market price of tradable assets or inputs into valuation models for more complex instruments). Market risk is a generic term which, in addition to interest rate and currency risk and, in some environments, spread risk, also includes equity risk and commodity price risk;
- operational risk: the risk of loss, arising from inadequate or failed internal processes, people and systems or from external events including legal risk. Given the volume of transactions conducted by a bank or building society and their use of highly-automated information systems, operational risk includes risks from systems outages, data loss and cyber-risk;
- regulatory risk: the risk of public censure, fines (together with related compensation payments) and restriction or withdrawal of authorisation to conduct some or all of the entity's activities both from UK and overseas regulators; and
- conduct risk: the risk of loss arising from failure to sell or service financial products in a manner that treats customers fairly (as determined by the relevant legal and regulatory requirements). This risk arises from a combination of regulatory and operational risks and has been a source of increased losses for banks and building societies in recent years (for example, losses on payment protection insurance).

Failure to manage the risks outlined above can also cause serious damage to the entity's reputation, potentially leading to loss of confidence in the entity, withdrawal of deposits or problems in maintaining liquidity (this is sometimes referred to as reputational risk or franchise risk).

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41 Some forms of market risk are 'non-linear', i.e. there is not a constant relationship between the profit and loss and the movement in the underlying price. For example, the relationship between an option's price and the price of its underlying instrument is 'non-linear'; the 'delta' measures the change in the price of an option for a unit change in the price of the underlying instrument whilst the 'gamma' indicates the extent of the 'non-linearity' (the change in delta for a unit change in the price of the underlying instrument).

Financial performance

123. The auditor obtains an understanding of the measures used by management to review the entity's performance. Further guidance in respect of key performance indicators is given in the section on ISA (UK) 520.

Internal control

124. The quality of the overall control environment is dependent upon management's attitude towards the operation of controls. A positive attitude may be evidenced by an organisational framework which enables proper segregation of duties and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the operation of a control is treated as a matter of concern, the control environment will be stronger and will contribute to effective control systems; whereas a weak control environment will undermine detailed controls, however well designed.

125. In accordance with the requirements of the Senior Managers and Certification Regime (SMCR) set out in the FCA Handbook and in the PRA Rulebook, senior management has a responsibility for establishing and maintaining such systems and controls as are appropriate to the operations of an authorised firm. The FCA and PRA can hold senior managers personally accountable for an area or business for which they are responsible. This responsibility extends to personal behaviour not only by senior management but also to other Approved Persons. The SMCR framework is wide-ranging and includes requirements around acting with integrity, due skill and care and diligence. The fit and proper test applied to Approved Persons includes competence and capability.

126. The FCA and PRA require an authorised firm to maintain systems and controls appropriate for its business. These include (but are not limited to):

- clear and appropriate reporting lines which are communicated within the entity;
- appropriate controls to ensure compliance with laws and regulations (this may mean a separate Compliance function);
- appropriate risk assessment process (including a risk assessment function and/or risk committee where appropriate);
- appropriate management information;
- controls to ensure suitability of staff;
- controls to manage tensions arising out of remuneration policies;
- documented and tested business continuity plans;
- documented business plans or strategies;
- an internal audit function (where appropriate);
- an audit committee (where appropriate); and

- appropriate record keeping arrangements.

127. For large banks and building societies, the volume of transactions can be so great that it may be extremely difficult for the auditor to express an opinion without obtaining considerable assurance from adequate systems of control. Systems of internal control are important in ensuring orderly and prudent operations of the entity and in assisting the directors to prepare financial statements which give a true and fair view. The following features of the business of banks and building societies may be relevant to the auditor's assessment of such internal controls:

    - the substantial scale of transactions, both in terms of volume and relative value, makes it important that control systems are in place to ensure that transactions are recorded promptly, accurately and completely and are checked and approved, and that records are reconciled at appropriate intervals in order to identify and investigate differences promptly;

    - the complexity of the entity's information systems, including its use of third-party service organisations and use of open-banking data interfaces. The responsibility for accurately and completely processing data remains with the bank or building society but risk may arise from interactions with other parties, controls may also reside at third-parties that are relevant to the audit;

    - processing and accounting for complex transactions or high volumes of less complex transactions will almost inevitably involve the use of sophisticated technology. For example, transactions subject to 'straight through processing' involve little or no manual intervention after they have been initiated;

    - a bank or building society deals in money or near money instruments. In the case of most commercial organisations, most movements of funds are the result of a related movement of goods and some audit assurance may therefore be obtained by reference to this relationship. This is not available, however, in the case of banks, building societies and similar financial organisations. Management must therefore establish robust systems of control. As the centralised funds transfer departments which exist in larger banks and building societies will often process very high volumes and a high value of transactions each day, the need for strong and effective controls over this area is particularly important. Transactions with customers over the internet are another area requiring strong security controls;

    - the fact that banks and building societies deal in money and near money instruments makes proper segregation of duties between and amongst those entering into transactions, those recording the transactions, those settling them and where relevant, those responsible for their physical security particularly important;

    - the geographical or organisational dispersal of some entities' operations means that, in order to maintain control over their activities, they need to ensure not only that there are sufficient controls at each location, but also that there are effective communication and control procedures between the various locations and the centre. It is important that there should be clear, comprehensive reporting and responsibility lines, particularly where the business is managed using a 'matrix' structure;

- the activities of banks and building societies can typically result in the creation or use of derivatives and other complex transactions. The fact that the resultant cash flows may not take place for a considerable time creates the risk that wrongly recorded or unrecorded positions may exist and that these may not be detected for some time, thereby exposing the entity to risk of misstatement. The valuation of these instruments also poses risks of misstatement, particularly as not all instruments are capable of being valued using observable market prices. Consequently, banks and building societies will normally have developed important operational controls to mitigate such risks of misstatement;

- the provisions of the UK tax legislation require banks and building societies to operate various tax deduction and collection arrangements, such as those relating to paying and collecting agents and lower rate tax deducted from interest paid to individuals. In addition, the VAT position can be particularly complex. These may give rise to significant liabilities if not properly dealt with. Accordingly, an effective control system is essential to ensure that the record-keeping requirements of UK tax legislation are satisfied, and that tax is accounted for promptly and accurately. Similar measures may be needed to address similar provisions arising in any other jurisdictions where the entity operates; and

- the UK regulatory framework is both complex and evolving for banks and building societies. This may give rise to significant liabilities for compensation to clients if not properly dealt with. Accordingly, an effective control system is essential to ensure that the requirements of the UK regulators are satisfied. Measures may also be needed to address regulators in other jurisdictions.

128. There is a wide variation between different banks and building societies in terms of size, activity and organisation, so that there can be no standard approach to internal controls and risk. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. Examples of deficiencies that may be relevant to the auditor's assessment of the risk of material misstatement are as follows:

- complex products or processes inadequately understood by management; this includes undue concentration of expertise concerning matters requiring the exercise of significant judgment or capable of manipulation such as valuations of financial instruments or allowances for impairment;

- deficiencies in back office procedures underpinning the completeness and accuracy of accounting records such as:

  - backlogs in key reconciliations, particularly those over correspondent bank accounts, settlement accounts and the custody of assets such as securities (either those held on own account or as collateral);

  - inadequate maintenance of suspense or clearing accounts;

  - deficiencies in controls over completeness and accuracy of data for credit provisioning; and

- backlogs in confirmation processes relating to financial instrument transactions.

- deficiencies in information systems and data controls, particularly in respect of user access controls;
- deficiencies in new product and complex trade approval procedures;
- lack of segregation of duties such as between critical dealing, operational, control, settlement and accounting functions; and
- deficiencies in payments systems such as inadequate controls over access to payment systems and data.

129. Some of the control activities which are usually performed by banks and building societies involve reconciliations of balances and positions with other organisations, testing of which may provide a source of assurance for the auditor as to the accuracy and completeness of the recording of transactions. These include reconciliation of:

- balances payable to or from other banks (sometimes referred to as vostro and nostro balances);
- securities in the course of settlement and the corresponding balances owing to or from the bank with settlement systems such as Euroclear and Crest;
- centrally cleared derivative transactions and margin balances with clearing houses such as the London Clearing House; and
- balances and positions with other group entities.

130. Controls relating to outsourcing activities are considered in the ISA (UK) 402 section of this Practice Note.

131. As a result of the type and complexity of transactions undertaken, and records held, by banks and building societies and the need for swift and accurate information processing and retrieval, many functions are highly automated, including: funds transfer systems, the accounting function, the processing and recording of customer transactions, trading activities, financial instrument valuations, regulatory reporting and the supply of management information.

132. The auditor assesses the extent, nature and impact of automation within the entity and plans and performs work accordingly. In particular the auditor considers:

- the required level of IT knowledge and skills may be extensive and may require the auditor to obtain advice and assistance from staff with specialist skills;
- the extent of the application of audit software and related audit techniques;
- general controls relating to the environment within which IT based systems are developed, maintained and operated; and

- external interfaces susceptible to breaches of security.

Depending on the size and range of their activities, banks and building societies employ a large number of different systems. The auditor identifies and understands the communication between information technology systems in order to assess whether appropriate controls are established and maintained to cover all critical systems and the links between them and to identify the most effective audit approach.

133. Information technology systems continue to become increasingly important to banks and building societies with the expansion of mobile and online service offerings, open-banking interfaces, faster payments and increased expectations of service availability and resilience. Information technology incidents often attract increased risk of financial loss. For example, cyber-attacks may result in direct financial losses or indirect losses through reputational loss or regulatory sanction. As part of the risk assessment process, the auditor considers the possible financial statement implications of evolving information technology risks arising. These risks may include:

- developments in the cyber-risk and external technology-threat landscape on the risk of material financial loss (e.g. customer and employee enabled frauds);

- new data or technological-driven revenue streams (e.g. algorithmic trading or data-information services);

- reliance on legacy information technology architecture and controls to support enhanced mobile, online and open-banking offerings and implications for the efficacy on the control environment (e.g. many banks have encountered issues maintaining the effectiveness of access and change controls given a more complex information technology architecture);

- evolution of the control environment in light of cloud service providers, machine-based learning, artificial intelligence and distributed-ledger technologies where traditional control processes may no longer be effective (e.g. trade finance confirmations provided through distributed-ledger platforms); and

- the potential financial implications of technology failings and the associated reputational damage (e.g. consideration of non-financial risks in the going concern assessment).

134. Banks also commonly use end user applications (applications that sit on the computer of the end user rather than on a centrally managed server), which can involve the use of complex spreadsheets, to generate important accounting and/or internal control information. Such end user applications are not subject to centrally managed general controls and so the auditor assesses the significance of the use of such applications and plans procedures to test the controls around them as appropriate.

Identifying and assessing risks of material misstatement

135. Significant risks are likely to arise in those areas that are subject to significant judgment by management or are complex and properly understood by comparatively few people within the entity.

136. Examples of significant risks requiring special audit consideration may include:

- allowances for impairment (particularly in relation to expected credit loss estimates);
- provisions related to conduct or regulatory breaches;
- application of complex hedge accounting;
- determination of the appropriate effective interest rate; and
- valuation of certain derivatives and other financial instruments.

137. The auditor considers and documents its rationale for allocating significant risks to specific components of the entity's financial instruments portfolio (for example, allowance for loans losses on identifiable portfolios) or significant assumptions within broader models (for example, redemption periods in the assumption of effective interest rates).

138. The application of complex accounting standards for financial instruments such as IAS 32, IFRS 7 and IFRS 9 (for entities using EU IFRS) and FRS 102 (for entities using UK GAAP) may also give rise to significant risk with respect to hedge accounting, incurred and expected credit losses, classification of assets/liabilities, revenue/expense recognition (effective interest rates) and over the adequacy of financial statement disclosure.

ISA (UK) 320: MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

139. ISA (UK) 320 deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

140. The principles of assessing materiality in the audit of a bank or building society are the same as those applying to the audit of any other entity. In particular the auditor's consideration of materiality is a matter of professional judgment, and is affected by the auditor's perception of the common information needs of users as a group.

141. Most banking organisations are profit orientated and a profit based measure, such as a percentage of profit before tax is likely to be used in determining materiality for the financial statements as a whole. However, a key difference of a bank or building society from other entities is that balance sheet balances tend to be much larger compared to the profit and loss account/income statement, so that the application of materiality based on profit may be too low when auditing elements of the balance sheet.

142. To deal with this, the auditor typically uses materiality based on the profit and loss account/income statement if a misstatement in a balance sheet item could affect the profit and loss account/income statement or equity and reserves. If, however, a misstatement in a balance sheet item is likely only to lead to a reclassification between line items within assets and liabilities, a higher materiality level can be applied for detecting such misstatements only. Although paragraph 10 of ISA (UK) 320 indicates that there can only be one overall measure of materiality for the accounts as a whole, paragraph A20 of ISA (UK) 450 states that there may be circumstances involving the evaluation of qualitative considerations where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios. When applying a separate balance sheet materiality level for the purpose of identifying and evaluating the effect of such misclassifications the auditor considers:

- the extent any misstatement of these items would influence the economic decisions of users taken on the basis of the financial statements;
- the extent any misstatement of these items would affect users' expectations regarding the measurement or disclosure of these items;
- the effect of the classification misstatement on debt or other contractual covenants;
- the effect on individual line items or sub-totals; and
- the effect on key ratios.

143. An example of such an adjustment would be grossing up net counterparty positions into assets and liabilities. The adjustment that is required can only affect the balance sheet;

even if wrongly calculated, there will be no case for any write-off or write-back to profit and loss.

144. ISA (UK) 320, paragraph 10, also allows the setting of a lower materiality level for a specific class of transactions, account balance or disclosure, if this class of transactions, account balance or disclosure is of a particular interest to the users of the financial statements. The auditor is alert to the wider constituency of users of the financial statements, when considering this requirement and pays attention to the risk profile of the institution concerned. Factors to be taken into consideration include, for example:

- the concerns of regulators; and
- the attention that may be given to pay and staff and director rewards.

145. The nature of banks and building societies' exposures means that their value or level of impairment can, at times, be subject to considerable uncertainty. The range of acceptable values or provisions can, as a consequence, be wide and sometimes wider than the materiality set by the auditor. Under such circumstances the auditor needs to assess whether management have determined the most appropriate point in the range for the purposes of the financial statements (which may not be the mid-point in the range) and whether the extent of the uncertainty is adequately disclosed.

146. This guidance is not intended to cut across the guidance on the auditor's duty and right to report matters to the FCA and PRA, where 'material significance' has a different meaning (see ISA (UK) 250: Section B and paragraphs 72–80 above).

ISA (UK) 330: THE AUDITOR'S RESPONSES TO ASSESSED RISKS

147. ISA (UK) 330 deals with the auditor's responsibility to design and implement responses to the assessed risks of material misstatements identified and assessed in accordance with ISA (UK) 315.

Tests of controls

148. ISA (UK) 200, paragraph 17, requires that to obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. In practice the nature and high volume of transactions relating to the operations of banks and building societies often means that performing tests of relevant controls is the most effective means of reducing audit risk to an acceptably low level as an approach based on substantive procedures alone is unlikely to be efficient.

149. Whilst some aspects of the income statements and balance sheets of banks and building societies lend themselves to the application of analytical procedures, income and expense resulting from trading activities is unlikely to be susceptible to these methods because of its inherent unpredictability.

Confirmations

150. ISA (UK) 330 states that external confirmations may provide relevant audit evidence relating to certain assertions in the financial statements. Given the nature of banks and building societies business, external confirmations may be effective evidence for transactions with other financial institutions or sophisticated counterparties (for example, derivative transactions and transactions with central clearing counterparties). An auditor assesses whether confirmations in relation to balances with individuals (for example, individual savings balances) will provide appropriate audit evidence depending on the efficacy of such procedures and the auditor's knowledge of the confirming party. See also the Section of this PN that addresses ISA (UK) 505.

Dual-purpose tests

151. The auditor may design a test of controls to be performed concurrently with a test of details. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design and evaluate the results of a test to examine the entity's written documentation for a complex financial instrument to determine whether it has been approved and to provide substantive audit evidence of the transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

152. In addition some of the controls which are usually performed by banks and building societies involve reconciling transactions, balances, securities and derivative positions with other banks, settlement systems, clearing houses and group entities. The auditor may design and evaluate the results of tests of such controls, both to obtain assurance as to the effectiveness of those controls and to provide substantive audit evidence.

Specific disclosure considerations

153. Specific financial reporting standards can require extensive quantitative and narrative disclosures in the financial statements of banks and building societies; for example, in relation to the nature and extent of risks arising from financial instruments. In designing and performing procedures to evaluate these disclosures the auditor may obtain audit evidence regarding the assertions about presentation and disclosure described in paragraph A129 of ISA (UK) 315. ISA (UK) 540 also includes requirements in relation to disclosures about accounting estimates.

154. Disclosures that may require particular consideration in the audit, for example due to their significance to banks and building societies or the complexity of methodologies used in producing them, include:

- IFRS 7 financial risk management disclosures, particularly those relating to credit risk, market risk and liquidity risk where specific methodologies are used to explain the significance of such risks (for example, value at risk ('VAR') and liquidity sensitivity and stress analysis);

- IAS 1 disclosures of judgments and estimates, for example sensitivity analysis of expected credit loss;

- IAS 1 disclosure of capital disclosures, where often the amounts disclosures are calculated with reference to the CRR regulations; and

- Financial institutions disclosures provided in accordance with section 34 of FRS 102.

Understanding the methodologies adopted by the management in developing disclosures

155. The auditor obtains an understanding of the methodologies adopted by management to develop the information to be disclosed and how this method is reflective of the business of the bank or building society. These methodologies would usually be consistent with the entity's risk management approach (for example, how it reports information to its Risk Committee), regulator prescribed capital and liquidity approaches, or be an industry standard approach (for example, value at risk).

156. Gaining this understanding may be done in conjunction with obtaining an understanding of the entity's accounting and internal control systems. For example, the auditor considers the independence of the entity's risk management function from the front-line business in the context of their understanding of the control environment. Typically, banks and building societies will adopt the three-lines of defence risk and control model (where risks are managed by the business or first-line, reviewed by an independent second-line risk or control function, and subject to periodic internal audit review (third-line)), and the auditor may consider the consistency of risk management methodologies used by each line of defence.

Considering the skills needed by the audit team

157. The audit team is assembled on the basis of the skills needed. The auditor's approach to disclosures may be based on reviewing and testing the process used by the

management to develop the information to be disclosed, rather than on re-performing the calculations (or making or obtaining an independent assessment). However, obtaining an understanding of that process and assumptions used may require technical knowledge of risk measurement methodologies and regulatory capital and liquidity approaches. Specific quantitative measurement skills may be required where detailed modelling is performed in preparing the disclosures. Accordingly, when planning the audit, the auditor considers the skills needed in order to obtain and evaluate audit evidence in this part of the engagement.

158. The nature and extent of any technical knowledge of risk measurement methodologies and regulatory capital and liquidity approaches are required depends on the circumstances. The auditor takes into account such factors as the complexity of, and control surrounding, the model used and whether the model has received regulatory recognition. Where appropriate, the auditor may involve an expert in elements of this work (ISA (UK) 620 covers using the work of an auditor's expert).

Considering the application of the methodologies adopted by management in the disclosure

159. Audit procedures when considering whether the methodologies adopted have been applied reasonably may include:

- reviewing, and where necessary testing, the internal controls relating to the operation of the entity's risk management, capital or liquidity system, in order to obtain evidence that the data used in the underlying calculations is reliable. This may be done in conjunction with the auditor obtaining an understanding of control procedures including those over the data fed into these systems and independent review of the algorithms. If the entity has applied for regulatory recognition of the method used, the auditor reviews correspondence with the regulator regarding such matters;

- reviewing, and where necessary testing, the internal controls relating to changes in the relevant system (for example, controls over changes to algorithms and assumptions);

- if a model is used in preparing the disclosure, performing analytical review of the model's predictions during the year against actual outcomes (a process commonly referred to as 'back-testing'). The auditor reviews any comparisons made by the entity as part of its own back-testing procedures (for an entity to receive regulatory recognition of the model used it is required to undertake back-testing procedures); and

- agreeing the amount disclosed to the output of the relevant systems.

160. If an approach based upon internal controls and back-testing proves to be unsatisfactory, the auditor may wish to consider testing the accuracy of the calculations and supporting data used to develop the required information. However, if benchmarking proves unsatisfactory, it may mean the methodology is not effective and that it would be more appropriate for the entity to make disclosures on a different basis, which is considered more appropriate.

Considering the consistency of the risk measurement method adopted

161. The main purpose of many relevant disclosures is to provide users of an entity's financial statements with a better understanding of the relationship between the entity's profitability and its exposure to risk. For example, an increase in profitability may be achieved by taking on increased risk (either by increasing exposure to risk or reducing levels of capital or liquidity used to mitigate the risk). The auditor considers the consistency of the methods, the main assumptions and parameters with those used in previous years. In certain circumstances IFRS 7 or FRS 102 also requires disclosure of changes in the methods and assumptions in the financial statements.

162. If the methods used for developing the relevant disclosures are also used in the entity's risk management system, modifications will be made to the method as the need arises. If the entity performs its own back-testing procedures, this may lead to modification of, for example, the algorithm used, the assumptions and parameters specified or the parts of the entity covered. Where modifications have been made, the auditor considers their effect on the risk measures and whether appropriate disclosures about the changes have been made.

163. In some cases where changes in method are adopted, re-statement of comparatives may not be possible if the relevant data for the previous year cannot be constructed and in this case the auditor considers whether the disclosures provide sufficient information about the nature and extent of any change in the entity's risk profile. For example, as well as providing the current year figure on the 'new' basis, it may be relevant to show both the current year and the previous year figure on the 'old' basis. In such cases, the auditor considers whether the disclosures contain sufficient narrative explanation of the change.

Considering the adequacy of disclosures

164. Information provided in respect of certain IFRS 7 and FRS 102 risk management disclosures may be impacted by the methodologies adopted by management in the disclosure. For example:

- there are different methodologies for presenting the quantitative risk position and sensitivity analysis. It is to be expected that, in any particular case, the management of the entity will make an informed choice of the method that it considers to be most suitable. It may be appropriate for the disclosure to explain the basis on which it has been prepared; and

- most methodologies involve the management making a number of important assumptions in order to develop the disclosures. These may be hypothetical (in the cases of future of stress scenarios) or based on management's judgment (for example, when using a VAR model, assumptions are made concerning the appropriate holding period, confidence level and data set).

165. The auditor considers the overall adequacy of the disclosures made by the entity in response to the requirements of IFRS 7/FRS 102 and whether the risk information is presented fairly so that its limitations can be understood. In particular, the auditor considers whether it is sufficiently clear that:

- the risk information is a relative estimate of risk rather than a precise and accurate number;
- the risk information represents a certain scenario or hypothetical outcome and is not intended to be predictive (in the case of probability-based methods, profits and losses are almost certain to exceed the reported amount with a frequency depending on the confidence interval chosen); and
- where the risk information is quantified with reference to past performance, future conditions could vary significantly from those experienced in the past.

166. In many entities and related groups, risk is primarily managed at the level of individual business units rather than on a legal entity or group-wide basis. The auditor considers the appropriateness of the basis on which the risk information to be disclosed in the financial statements is to be compiled. It may be inappropriate simply to aggregate the operating unit information to arrive at the information to be disclosed for the entity or group as a whole.

ISA (UK) 402: AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION

167. ISA (UK) 402 deals with the auditor's responsibilities relating to an entity using a service organisation.

168. In common with other industries the outsourcing of functions to third parties is common for banks and building societies. Some of the more common areas, such as customer call centres, may have no direct impact on the audit, while others such as IT functions may have a direct relevance. Further, the provision of other services or information to banks and building societies is also common in areas such as market infrastructure for communication (for example SWIFT), or market pricing information. While these may have an impact on the audit, dependant on their nature they are unlikely to be considered outsourced functions within the scope of ISA (UK) 402 (external information sources are considered in ISAs (UK) 500 and 540). The auditor therefore gains an understanding of the extent of outsourced functions and their relevance to the financial statements. The entity is obliged to ensure that the auditor has appropriate access to records, information and explanations from material outsourced operations.

169. Whilst an entity may outsource functions to third parties the responsibility for these functions remains that of the entity. The entity should have appropriate controls in place over these arrangements including:

- risk assessment prior to contracting with the service provider, which includes a proper due diligence and periodic review of the appropriateness of the arrangement;
- appropriate contractual agreements or service level agreements;
- contingency plans should the provider fail in delivery of services;
- appropriate management information and reporting from the outsourced provider;
- appropriate controls over customer information for example in relation to data confidentiality; and
- right of access of the entity's internal audit to test the internal controls of the service provider.

170. If the auditor is unable to obtain sufficient appropriate audit evidence concerning outsourced operations the auditor considers whether it is necessary to report the matter direct to the PRA and FCA as appropriate – see the section of this Practice Note relating to ISA (UK) 250 Section B.

ISA (UK) 505: EXTERNAL CONFIRMATIONS

171. ISA (UK) 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence. ISA (UK) 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures.

172. In general, external confirmation procedures may be useful as part of the audit of account balances and classes of transactions such as loans and deposits (including other receivables and payables such as settlement balances and nostro/vostro balances), securities held by third party custodians and derivative transactions. Such procedures are likely to be particularly useful when confirmation can be obtained from settlement systems and clearing counterparties of securities in the course of settlement and centrally cleared derivative and other transactions. As banks and building societies normally have well established control procedures to reconcile such transactions, balances, securities and derivative positions, the auditor may consider it to be more effective to perform dual purpose tests on these controls as described in paragraph 151.

173. However, external confirmations may not always provide useful audit evidence in relation to:

    - retail loans and deposits; and
    - certain counterparties of wholesale market balances and transactions such as nostro/vostro balances, interbank loans and deposits and derivative transactions.

174. Retail loans and deposits typically comprise high volumes of comparatively low value amounts. Such third parties do not usually maintain independent records of their balances, largely depending on information already provided to them by the entity. Accordingly the auditor may consider the inherent reliability of such responses is comparatively low.

175. Wholesale counterparties incorporated in some jurisdictions outside the UK have countrywide policies of not responding to confirmation requests by auditors at all. Some counterparties will respond to requests to confirm specified balances and transactions but not open requests for unspecified information.

176. If external confirmations are not used, the auditor seeks sufficient appropriate evidence from tests of control and other substantive procedures. For example, in relation to wholesale market balances and transactions most banks and building societies also have well developed transaction confirmation controls within their trading activities as described in paragraph 129. The auditor may consider it more effective to test these controls, in addition to other substantive procedures, rather than carry out their own confirmation procedures.

ISA (UK) 520: ANALYTICAL PROCEDURES

177. ISA (UK) 520 deals with the auditor's use of analytical procedures as a basis for the identification and assessment of risks of material misstatement; to obtain relevant and reliable audit evidence; and to assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. In addition to the objectives and requirements established in ISA (UK) 520, requirements for analytical procedures are also established in ISA (UK) 315.

Risk assessment procedures

178. Where non-financial information or reports produced from systems or processes outside the financial statements accounting system are used in analytical procedures, the auditor considers the reliability of that information or those reports.

179. Aspects of the entity's business where there are high volumes of similar transactions or balances, such as interest receivable/payable or interest margins, may lend themselves to risk assessment procedures to highlight anomalies.

180. Whilst some aspects of the income statement and balance sheet of a bank or building society lend themselves easily to analytical procedures, income and expense resulting from trading activities is unlikely to be susceptible to these methods because of its inherent unpredictability. Analytical procedures on income and expense items such as interest will be most effective if returns are calculated on the basis of average daily (or at least monthly) balance information.

Overall conclusion on the financial statements

181. When performing the review of the financial statements as a whole for consistency with the auditor's knowledge of the entity's business and the results of other audit procedures, the auditor considers transactions occurring either side of the year end, including:

- material short-term deposits which are re-lent on broadly similar terms; loan repayments which are received shortly before the year end then re-advanced shortly afterwards; material sale and repurchase transactions or other financing or linked transactions. Experience and judgment are required to identify and assess the implications, if any, of these transactions; they may, for example, be indicative of 'window dressing'[42] of the balance sheet over the year end date;

- other transactions around the year end, apparently at rates which are significantly off market including those that appear to give rise to significant profits or losses;

- the value and nature of transactions between related parties/associated undertakings around the year end; and

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42 'Window dressing' refers to actions taken or not taken prior to issuing financial statements in order to improve the appearance of the financial statements.

- the reclassification of balances and transactions to achieve advantageous income recognition and balance sheet treatment/presentation.

182. The auditor assesses evidence of window dressing and other transactions designed to achieve advantageous income recognition or balance sheet presentation and considers the implications for the financial statements (e.g. whether related disclosure is needed in order for the financial statements to give a true and fair view and, if so, given) and the consequences for the auditor's assessment of risks. If the auditor has concerns about such transactions and their treatment in the financial statements, the auditor communicates those concerns to those charged with governance and considers whether the auditor has a duty to, or should otherwise, make a report direct to the FCA or PRA, on which guidance is set out in the section of this Practice Note relating to ISA (UK) 250 Section B.

ISA (UK) 540: AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

183. ISA (UK) 540 deals with the auditor’s responsibilities relating to accounting estimates and related disclosures in an audit of financial statements.

184. Accounting estimates are frequently made by banks and building societies. Common areas where accounting estimates are made include:

- the determination of allowance for credit losses under an expected credit loss or incurred loss model (see paragraphs 188 - 223 below);
- the fair value measurement of financial instruments where quoted market prices are not available for those instruments (see paragraphs 224 - 231 below);
- the application of hedge accounting (see paragraphs 232 - 244 below);
- the determination of the appropriate effective interest rate (‘EIR’) (see paragraphs 245 - 246 below); and
- provisions related to conduct or regulatory breaches (see paragraphs 247 - 250 below).

These areas may represent significant risks of material misstatement.

185. In banks and building societies the levels of estimation uncertainty, complexity and subjectivity of accounting estimates are often high. Complex modelling will be used for some estimates by many banks and building societies. It is important for the auditor to obtain a sufficient level of understanding to identify and assess the risks of material misstatement and to develop further audit procedures addressing those risks. It is likely that there will be some estimates where performing substantive procedures alone would be unable to provide sufficient appropriate audit evidence and so the auditor also tests the operating effectiveness of relevant controls. Engagement teams often need specialised skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. The auditor may need to use an auditor's expert.

186. Auditors must comply with all the applicable requirements in ISA (UK) 540. The guidance in this section is intended to help auditors in applying those requirements in relation to particular types of accounting estimate; it does not address every requirement individually and should not be considered in isolation.

Professional scepticism

187. ISA (UK) 200 requires the auditor to plan and perform the audit with professional scepticism. ISA (UK) 540 emphasises the importance of professional scepticism in relation to auditing accounting estimates and related disclosures, particularly when those estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. This is particularly relevant to banks and building societies as they will typically have estimates with greater levels of estimation uncertainty and/or that are affected by a greater degree of complexity and subjectivity, with the associated risk(s) assessed towards the upper end of the spectrum of inherent risk. Audit procedures performed in accordance with

ISA (UK) 540 typically include questioning or challenging management, when appropriate, and evaluating whether judgments and decisions made by management in making the accounting estimates give rise to indicators of possible management bias. Audit procedures are designed and performed in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. Applying professional scepticism is also necessary to address the risk of management bias, which is inherent to management estimates (refer to paragraphs 257 – 262 below).

Allowance for credit losses

188. Allowance for credit losses estimates are likely, in most cases, to be significant to the financial statements in banks and building societies. There are typically high levels of estimation uncertainty, complexity and subjectivity leading to the assessment of inherent risk at the higher end of the spectrum of inherent risk.

189. Recognition of an allowance for credit losses can be based on one of two concepts depending on the accounting framework applied: expected credit loss (e.g. IFRS 9 or US GAAP) or incurred credit loss (e.g. FRS 102, section 11). The guidance presented below focuses on expected credit losses as determined in accordance with IFRS 9 as that can be particularly challenging in banks and building societies; however, the auditing principles illustrated could also apply to allowance for credit losses prepared under US GAAP, IAS 39 or FRS 102.

190. IFRS 9 requires a loss allowance for expected credit losses ('ECL') to be recognised for financial assets carried at amortised cost, lease receivables, loan commitments, financial guarantee contracts and financial assets at fair value through other comprehensive income. ECLs are determined as the present value of the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). The ECL estimate is required to be unbiased and probability-weighted and reflect a range of possible outcomes.

191. The auditor obtains an understanding of the ECL estimation process and methodologies applied by the entity and uses this understanding to identify and assess risks of material misstatement and identify controls relevant to the audit that address those risks. Refer to the section of this PN on ISA (UK) 315 where audit risk assessment is discussed. This understanding includes evaluating how the ECL models developed by the entity, which are often complex, have been designed and implemented. The auditor plans further audit procedures, including substantive testing procedures that respond to identified risks of material misstatement.

192. Controls relevant to the audit of ECL may include the following:

- Review by a function independent from the preparer and validation of ECL models by management;

- Review and challenge of key assumptions in the period-end ECL estimation by a management committee, including forecasts of future macroeconomic conditions and probabilities of different possible outcomes;
- Governance process around ECL estimation, including multi-layer reviews of key judgments and ECL estimation outcomes by management and those charged with governance;
- General IT and reconciliation controls related to data used in the ECL estimation process and data transfers between different systems, particularly reconciliations of data obtained from different risk and finance systems;
- Controls over data inputs used in the ECL estimation process, including inputs or other information obtained from external information sources;
- Logical and physical access controls, change management controls and controls over computer operations over the application and IT infrastructure used to implement the ECL calculation process;
- Controls to ensure assets are properly assessed for significant increase in credit risk ('SICR');
- Controls to ensure SICR is appropriately calibrated and appropriate reasonable thresholds used;
- Review by a function independent from the preparer of the ECL assessment performed at an individual exposure level, including assessment of expected cash flows under different recovery scenarios and probabilities of these scenarios.

Some or all of the above mentioned controls may operate at service organisations used by the bank or building society. *ISA (UK) 402* establishes requirements and guidance when the auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively.

Evaluation of management's policy

193. The auditor evaluates the policy adopted by the entity to estimate the allowance for ECL for compliance with the requirements of IFRS 9. In doing this, the auditor may consider other guidance that may be relevant on the interpretation of IFRS 9, such as that produced by the IFRS Transition Resource Group for Impairment of Financial Instruments, and the Taskforce on Disclosures about Expected Credit Losses (the 'DECL Taskforce)[43].

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43 The DECL Taskforce was established and sponsored by the UK Financial Conduct Authority, the Financial Reporting Council and the Prudential Regulation Authority. The recommendations in DECL report were developed primarily for use by the preparer firms represented on the Taskforce. However, the report identifies that the recommendations may be of relevance to other banks and similar financial institutions as a guide to best practice, particularly for those that manage their investor-base actively.

194. For financial assets which are in scope for IFRS 9 impairment requirements other than purchased or originated credit-impaired assets ('POCI'), an allowance for either 12 month or lifetime ECL needs to be recognised depending on whether a significant increase in credit risk ('SICR') has occurred since origination or acquisition. The determination of credit risk at inception and any subsequent SICR may involve highly subjective assumptions and judgments, contributing to high inherent risk. Other factors contributing to high inherent risk in relation to SICR may, for example, include the complexity of product design; the complexity of underlying accounting requirements, including the need for management to consider all reasonable and supportable information that is available without undue cost, including forward looking information; and the use of complex modelling. If, for example, management uses inappropriate assumptions or methods it may result in SICR not being recognised, or recognised too slowly or too quickly, and/or threshold calibrations not representing a fair picture of the change in credit risk.

195. The auditor evaluates the determination of credit risk, including whether the entity's qualitative (such as an exposure being put on a watchlist) and quantitative (such as relative changes in lifetime probability of default (PD)) SICR triggers have been set in accordance with the requirements of the IFRS 9 and result in identification of significant relative changes in credit risk since origination. The auditor also evaluates the criteria for when SICR is no longer identified (often referred to as 'backwards transitions').

196. Where an entity has chosen to rebut the presumption in IFRS 9 that SICR occurs no later than when contractual payments are 30 days past due, the auditor obtains an understanding of the rationale provided by management to support it (for example, the lender operates in an economic environment where flexibility with repayments is considered normal business practice, and therefore 30 days past due status does not indicate SICR) and determines whether adequate evidence exists to support it. For example, this may include a comparative evaluation of historical performance of customers that went 30 days past due and those that did not to understand whether reaching such a status results in a significantly higher propensity to default. Another example of a scenario where the presumption may be rebutted is when a payment date falls over a weekend or bank holiday, this may lead to a loan becoming 30 days past due in the entity's systems, but not necessarily represent SICR.

197. The auditor evaluates whether all reasonable and supportable information, that is available to the entity without undue cost or effort, that is indicative of SICR, has been considered by the entity in identifying SICR. This includes considering whether any portfolio-level events may have resulted in SICR, but have not yet been captured by other SICR criteria. For example, a closure of a coal mine in a region where it is the main employer could result in SICR for mortgages originated in that region.

198. Where SICR criteria include quantitative assessment (for example, a relative change in probability of default since origination may be compared to a set threshold), the auditor considers whether the thresholds have been appropriately calibrated based on the evaluation of parameters such as the proportion of SICR events driven solely by the 30

days past due backstop or proportion of accounts that become credit-impaired prior to a SICR being identified.

199. An entity may use simplifying assumptions in identifying SICR. For example, an entity may use a 1 year PD as a proxy for lifetime PD in monitoring a change of credit risk since origination. The use of a 1 year PD would only be appropriate if the entity has assessed that for a particular portfolio default patterns are not concentrated at a specific point during the expected life of the financial instrument. The auditor evaluates whether management has adequately documented this assessment and seeks evidence supporting or contradicting conclusions reached by management. For example, for an interest only mortgage portfolio this may include an evaluation of the historical time profile of defaults for a given portfolio to establish whether there is an indication of concentration of defaults at maturity dates. Another simplifying assumption relates to the low credit risk exemption, which allows an assumption that SICR has not been identified if the financial instrument has low credit risk at the reporting date. The auditor evaluates the appropriateness of the use of this assumption and may challenge management about its application.

200. Evaluation of management's policy on estimation of ECL could lead the auditor to identify additional risks of material misstatement.

Responding to risks of material misstatement

201. ISA (UK) 540 sets out three different possible approaches for auditing accounting estimates:

- Testing how management made the accounting estimate;
- Developing an auditor's independent point estimate or range; and
- Obtaining audit evidence from events occurring up to the date of the auditor's report.

The high degree of complexity of ECL estimation in banks and building societies, the high volume of data needed to estimate ECL and the long-term nature of ECL projections may make developing an independent estimate or obtaining sufficient evidence from examining subsequent events impractical for the auditor. In this case, the auditor places a greater emphasis on testing how management made the accounting estimate; however, other approaches (developing an independent estimate or evaluating events after the reporting date) may still be used to obtain additional audit evidence if practicable. For example, a retrospective comparison of incurred losses to estimates of losses given default derived from models performed after the reporting date may provide additional supporting or contradictory evidence about assumptions made in loss given default estimation as at the reporting date.

202. Irrespective of the approach selected, when performing procedures the auditor considers whether the ECL estimate, components of it, and changes during the period are consistent with the auditor's understanding of the entity and its environment. In accordance with ISAs (UK) 330 and 540, before the conclusion of the audit, the auditor evaluates, based on the audit procedures performed and audit evidence obtained, whether the assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified.

203. Management's ECL estimation process is often operationally complex and often relies on significant judgments. Entities implement controls and governance processes to address the risks associated with the estimation process. The auditor obtains an understanding of the controls and governance processes, which may include controls over development, monitoring and validation of ECL models, the measurement of credit risk and calibration of SICR, and reviews key judgments and assumptions by management committees and by those charged with governance. The auditor evaluates whether the operating effectiveness of the identified controls relevant to the audit needs to be tested to obtain sufficient appropriate audit evidence over the ECL balance.

204. The ECL estimation process may rely on information obtained from a number of information systems. The auditor evaluates whether involvement of an information technology ('IT') specialist is necessary to identify and assess risks, and to identify and test the relevant IT controls.

205. Estimation of ECL and related disclosures in banks and building societies normally involves the use of credit models. One of the commonly used ECL estimation approaches is based on the following key components:

- Probability of default ('PD') – an estimate of the likelihood of default;
- Loss given default ('LGD') – an estimate of the loss arising on default;
- Exposure at default ('EAD') – an estimate of the exposure at a future default date.

These components are then used to calculate expected cash shortfalls, the present value of which represents an estimate of the ECL.

206. The auditor obtains an understanding of the models developed by the entity to estimate these components for each material portfolio and evaluates whether they are consistent with the requirements of IFRS 9. The auditor may consider involvement of an auditor's expert to be able to perform an evaluation of the models' design.

207. Where management involved a third party to support the development of the models, the auditor evaluates whether sufficient understanding of the models can be obtained from the documentation available and inquiries of management. The auditor engages with management to obtain additional information from the third party if considered necessary. Where models are operated by a third party, the auditor considers whether the third party represents a service organisation and, if applicable, complies with ISA (UK) 402.

208. The auditor may consider performing a peer comparison or benchmarking of the ECL valuation methodology and assumptions used by management to those used by companies holding similar loan portfolios. However, the availability and comparability of data will need to be evaluated on a case-by-case basis. Sufficiently comparable and granular data needs to be obtained for a benchmarking procedure to be effective.

Testing how management made the accounting estimate

Expected credit losses estimated based on models

209. The auditor evaluates how the ECL models developed by the entity have been implemented. In many cases this may require evaluation of complex programming code.

Less sophisticated solutions may be implemented using spreadsheets. The auditor may consider involvement of an auditor’s expert to be able to obtain sufficient and appropriate audit evidence that the implementation of the models is consistent with the model design and achieves the measurement objective of the applicable financial reporting framework. PD models in particular are often more complex than other ECL models.

210. A wide range of data, obtained internally or externally by the entity, may be used in the estimation of PD, LGD and EAD elements of the ECL model. The auditor identifies and assesses risks of material misstatement, the reasons for which may be related to inputs. The auditor may use sensitivity analysis as part of this assessment. Different risks may be identified for different loan portfolios (e.g. residential mortgages, credit cards, car finance, other unsecured retail, commercial and corporate, etc.). The auditor tests the relevant data used in estimating the PDs, LGDs and EADs by performing appropriate procedures, which may include substantive testing (including, where relevant, comparing to an external source) and controls testing. The auditor evaluates the data for relevance and reliability, which includes considerations of completeness and accuracy and whether the data is up to date.

211. Where management made assumptions to address insufficiency or deficiency of data, the auditor evaluates the appropriateness of these assumptions. For example, management may use external data as a proxy when insufficient internal data is available for a particular portfolio. The auditor evaluates whether the proxy data is reflective of the characteristics of the portfolio and therefore whether its use is appropriate.

212. Some parameters may be particularly challenging to estimate for certain types of portfolios. For example, estimating EAD and expected lifetime losses for a credit card portfolio (or any other type of revolving facilities such as credit lines or overdrafts) relies on assumptions related to future behaviour of customers, for which only limited evidence may be available. Similarly, for a loan portfolio where no or little loss has been experienced to date, judgments need to be made as to what information can be used to approximate its expected performance. The auditor evaluates the available supporting and contradictory evidence in relation to these estimated parameters and considers whether there is an indication of inappropriate management bias in the estimate. For example, an assumption that the customers’ future behaviour will be similar to the recently observed behaviour in a period where an economic downturn is anticipated could be indicative of management bias, unless sufficient appropriate evidence exists to support it.

213. IFRS 9 requires management to consider forecasts of future macroeconomic conditions in estimating the ECL and produce a probability-weighted ECL estimate considering different possible outcomes. Where the auditor has identified a risk of material misstatement associated with possible inappropriate forecasts used, the auditor may start by challenging the base case forecast used by management and evaluate if it has any indications of bias. The auditor considers whether the forecast used for the purposes of estimating ECL is consistent with other forecasts used by the entity (such as those used in business planning) and with publicly available forecasts developed by third parties, if available. The auditor also evaluates how management has taken into account the alternative possibilities of future macroeconomic conditions and whether

the approach results in the ECL estimate appropriately capturing the non-linearity of the relationship between the macroeconomic parameters and ECL (for example, a 10% change in a macroeconomic parameter does not necessarily correspond to a 10% change in ECL and the relationship is normally more complex). This includes an evaluation of the weightings assigned to different scenarios, if an approach based on discrete scenarios is used by the entity. A high level example of an approach to testing forward-looking information is set out in Appendix 8.

214. The auditor evaluates whether the model(s) adequately estimate the respective components of ECL; for example, by either reviewing and testing the model performance review and validation performed by the entity or by performing a retrospective review independently from the entity (for example, testing credit risk measures against actual defaults).

215. Management overlays or post-model adjustments ('PMA') can be recognised in addition to the modelled ECL balance to account for known deficiencies of the model or insufficiency of the data. For example, a PMA may be recognised where there is insufficient historical default data to reliably estimate ECL for a portfolio of interest only mortgages. The auditor obtains and reviews management's documentation supporting the PMAs and evaluates their validity and valuation, challenging the reasoning and quantification provided by management. This includes considering the available contradictory evidence and performing substantive testing of the quantification workings. The auditor also evaluates whether any additional PMAs may need to be recognised based on their understanding of the model and the underlying portfolio and challenges management on how they were considered.

Credit-impaired exposures

216. IFRS 9 sets out a list of factors that could indicate that an exposure has become credit-impaired, which includes the following events (similar criteria are used for identification of impaired exposures under IAS 39 or FRS 102):

- significant financial difficulties of the issuer or obligor;
- breach of contract;
- a concession (such as a forbearance arrangement) being granted by the lender for economic or legal reasons relating to the borrower's financial difficulty which the lender would not otherwise consider;
- probability that the borrower will enter bankruptcy or financial reorganisation.

217. Where an entity has chosen to rebut the presumption that credit impairment occurs no later than when contractual payments are 90 days past due, the auditor evaluates the reasons for doing so, challenging management as appropriate, and obtains audit evidence to determine whether it is supportable.

218. The auditor evaluates whether the entity has appropriately identified credit-impaired exposures based on the requirements of IFRS 9 or other applicable framework, for example, by performing an assessment whether any of the credit-impairment triggers have been met for selected exposures. Where an indication of credit impairment has been identified, the auditor evaluates the assumptions made by management in arriving at their estimate of likely cash flows to be received from the credit impaired exposures

(including, where relevant, assumptions about the values of assets provided by way of security). The auditor evaluates whether these assumptions have been made after due consideration and whether they are supported or contradicted by relevant evidence. The auditor may consider involvement of an auditor's expert to assist this evaluation, for example, when it relates to valuation of real estate collateral.

219. As IFRS 9 requires ECL to be based on a probability-weighted assessment of different possible outcomes, the auditor challenges management and seeks audit evidence on whether different possible workout scenarios have been considered and their probability was adequately assessed and are appropriate.

Developing an independent point estimate or range

220. Where the auditor has chosen to develop an independent point or range estimate, the auditor evaluates whether the data, methods and assumptions used to develop the estimate are appropriate. In considering whether it is practicable to develop a point estimate or range, matters the auditor may need to take into account include whether the auditor could do so without compromising independence requirements, including relevant ethical requirements that address prohibitions on assuming management responsibilities. Any tools or models used in developing a point estimate or range by the auditor or auditor's expert need to be subject to appropriate procedures, in line with the requirement of paragraph 28 of ISA (UK) 540, to ensure the appropriateness of the output in the context of the applicable financial reporting framework.

221. The auditor is required to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable.

222. Accounting estimates in banks and building societies, such as the ECL estimate, often involve a high level of estimation uncertainty. It is possible that an acceptable range of reasonable estimates will be wider than the materiality set by the auditor. The auditor obtains an understanding of the key sources of estimation uncertainty, which may include such forward-looking elements of the calculation as estimates of exposures at default for credit card portfolios, forecasts of future macroeconomic conditions under different scenarios and their weightings, limited historical data availability, estimates of expected proceeds from sale of collateral, etc. The auditor designs and performs audit procedures to address the risks associated with the identified sources of uncertainty to determine that the range includes only amounts supported by sufficient appropriate audit evidence. Where the level of uncertainty is high, the auditor evaluates whether adequate disclosures have been included in the financial statements (refer to paragraphs 251 – 256).

Obtaining audit evidence from events occurring up to the date of the auditor's report

223. Estimation of ECL in banks and building societies is based on judgments related to events that may occur in the relatively distant future. Therefore, not all of them can be validated by the auditor through examining the events occurring up to the date of the auditor's report, given it is normally a much shorter period. However, the auditor may use the information from this period in evaluation of certain assumptions made by the entity. For example, the incurred losses on defaulted exposures could be used to

evaluate the LGD estimates (prior to adjusting for forecasts of macroeconomic conditions). In performing an assessment based on the consideration of audit evidence from events occurring up to the date of the auditor's report, the auditor considers whether the events after the reporting date are reflective of the conditions as at the reporting date or relate to the next reporting period. Matters that are not reflective of the conditions as at the reporting date do not impact the valuation of the ECL as at the reporting date (i.e. where they are non-adjusting events) although there may be disclosure requirements.

Valuation of financial instruments

224. The valuation of financial instruments, including derivatives, which are not quoted in an active market potentially requires the use of valuation models, assumptions and judgments, which can give rise to significant audit risk. Such financial instruments are priced using valuation techniques such as discounted cash flow models, options pricing models or by the inference of key inputs through the use of proxies that are substantially the same as the financial instrument subject to valuation. The guidance presented below focuses on valuations determined in accordance with IFRS, however, the auditing principles illustrated could also apply to valuations prepared under FRS 102.

225. The auditor obtains an understanding of the valuation process and methodologies applied by the entity and uses this understanding to identify and assess risks of material misstatement and identify controls relevant to the audit that address those risks.

226. Controls relevant to the audit and substantive testing the auditor may focus on could include the following:

- Controls over the approval of the valuation technique chosen by the entity, which may include model validation and evaluation of the mathematical integrity of the valuation models used;

- Controls over the calibration procedures used by the entity to test the validity of valuation techniques applied by comparing outputs to observable market transactions;

- Independent valuation testing by a function independent from the preparer to evaluate the adequacy and appropriateness of the entity's chosen valuation techniques, inputs and fair values;

- Controls over independent price verification, including an evaluation of the techniques used, independence of the review, adequacy and reliability of the independent data sources, the frequency of the verification, impact of any balances not in scope of the verification, thresholds for investigation and adjustments and reporting of the results;

- Controls over the determination of uncertainty ranges for level 3 financial instruments;

- Controls over fair value hierarchy classification assessments on a periodic basis;

- Independent assessments by a function independent from the preparer of fair value hierarchy classification for a sample of transactions based on an independent evaluation of the observability and significance of inputs to the valuation;
- Controls over the monitoring and recognition of day 1 P&L, including an evaluation of the observability of valuation inputs;
- Independent evaluation by a function independent from the preparer of the recognition of day 1 P&L on a sample basis based on an evaluation of the observability of inputs and calibration to traded prices of the specific or similar financial instruments;
- Access controls over valuation models;
- Controls over the calculation of valuation adjustments, including periodic evaluation of the calculation methodologies, completeness of the valuation adjustments population and impact on the fair value hierarchy classification of the financial instrument.

227. Testing is performed by individuals with adequate knowledge and experience. The auditor obtains an understanding of the assumptions made and methods used by the entity in calculating a fair value and performs audit procedures over the assumptions and estimates to gain assurance over the reasonableness, consistency and conformity with generally accepted practices. In some cases, the auditor may use their own valuation techniques to independently evaluate the adequacy of the entity's valuations. Given the complexities involved and the subjective nature of the inherent judgments the auditor may involve an expert in elements of this work (see the ISA (UK) 620 section of this Practice Note and ISA (UK) 220).

228. In addition, the auditor evaluates whether the overall valuations appear reasonable based on the auditor's industry knowledge, market trends, the auditor's understanding of other entities' valuations (having regard to client confidentiality) and other relevant price indicators. If the valuations appear to be consistently aggressive or conservative, this may be evidence of management bias (see paragraphs 257 – 262). The auditor takes this into consideration when evaluating the audit evidence obtained.

229. Additional accounting guidance that may help the auditor's understanding is provided in the IASB Expert Advisory Panel Report issued in October 2008 which deals with measuring and disclosing the fair value of financial instruments in markets that are no longer active.

230. Additional guidance is provided for auditors in Practice Note 23 (Revised), 'Special Considerations in Auditing Financial Instruments', in paragraphs 106 – 137 dealing with the valuation of financial instruments. This guidance has not been duplicated in this Practice Note.

231. The auditor may also wish to perform benchmarking of the valuation methodologies and assumptions used by management to those used by companies holding comparable financial instruments, to ensure that there is consistency in the market place and identify any changes in standard market practice over time. However, the availability and

comparability of data will need to be evaluated on a case-by-case basis. Sufficiently comparable and granular data needs to be obtained for a benchmarking procedure to be effective.

Hedge accounting

232. The objective of hedge accounting is to represent the effect of an entity's risk management activities where the entity uses financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income).

233. The application of hedge accounting is elective. An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item. The entity's elections must be documented before hedge accounting commences.

234. Testing is performed by individuals with adequate knowledge and experience. Where hedge accounting techniques are used, the auditor gathers audit evidence to determine whether management's designation of a financial instrument as a hedge is appropriate and the accounting entries are consistent with the relevant accounting standards. The nature and extent of the evidence obtained by the auditor will vary depending on the nature of the hedged items and the hedging instrument. Further guidance is given in Practice Note 23 (Revised) 'Special considerations in auditing financial instruments' (paragraphs 137-3 and 137-4).

235. The complex risk management activities undertaken by banks and building societies often result in a hedge accounting process that is operationally complex and relies on significant judgments and complex inputs, increasing the risks of material misstatement associated with hedge accounting. Examples of such complexities include:

- Dynamic management of interest rate risk on a portfolio basis increases the number and frequency of hedge designations which increases the risk of error in the recording of hedge adjustments, including those relating to derivatives and hedged items with a fair value of other than Nil on the date of hedge designation. An example of such a hedge is a Portfolio Fair Value Hedge of Interest Rate Risk where frequent re-designation of the hedge relationship can result in a large number of hedge adjustments relating to de-designated hedges that must be monitored and amortised on an ongoing basis.

- Certain hedging strategies, such as structural hedging of interest rate insensitive customer deposits or pre-payable mortgages result in the need to apply complex hedge accounting designations with increased estimation uncertainty relating to customer withdrawal and repayment behaviour.

- A banking group's derivative transactions with third parties are often executed by a central treasury function which designates the related hedge relationship including a hedged item that is recorded by a separate component of the banking group. This structure can complicate the ongoing monitoring and management of hedged items on continuing and discontinued hedge relationships, for example for the purpose of ensuring that fair value hedge adjustments are properly derecognised on derecognition of the underlying hedged item; for the purpose of ensuring that hedge adjustments in relation to fair value hedges are properly amortised following hedge discontinuation or that cash flow hedge reserves on discontinued hedges are properly removed from reserves as the hedged transaction occurs; and for the purpose of evaluating whether the occurrence of hedged forecast transactions in relation to both continuing and discontinued cash flow hedge relationships remain highly probable.

Understanding of entity's policy and processes

236. The auditor evaluates the policy adopted by the entity to apply hedge accounting and to estimate the resulting hedge accounting entries, and whether management has properly applied the requirements of the applicable accounting framework (e.g. IFRS 9, FRS 102 or IAS 39). The auditor evaluates each of the entity's judgments and estimates and evaluates available audit evidence supporting or contradictory to each of the judgments made and assumptions used.

237. The auditor evaluates whether the methods for making the hedge related accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

238. As management's hedge accounting process is often operationally complex and often relies on significant judgments and complex inputs, entities normally implement controls and governance processes to address the risks associated with the estimation process. The auditor obtains an understanding of the controls and governance processes, which may include controls over development, monitoring and validation of hedge accounting models and reviews of key judgments and assumptions by management and by those charged with governance. The auditor considers whether operating effectiveness of the identified controls relevant to the audit needs to be tested to obtain sufficient appropriate audit evidence over the hedge accounting balances.

239. The auditor obtains an understanding of the models and calculations developed by the entity to apply hedge accounting and evaluates whether they are consistent with the requirements of the applicable accounting standard (e.g. IFRS 9).

240. The possible approaches that the auditor may apply in auditing accounting estimates are set out in paragraph 201 above.

241. It may be possible for the auditor to develop an independent estimate of the valuation of hedged items and hedging instruments and the relationship between the two (for example by the performance of independent regression testing). However, care must be taken that any independent estimate properly reflects the relevant parameters for the entity's documented hedge relationships. The high degree of complexity of the application of hedge accounting, the high volume of data needed and the long-term nature of many hedge relationships may preclude the auditor obtaining sufficient evidence from examining subsequent events.

Testing how management made the accounting estimate

242. When following this approach, the auditor evaluates how the hedge accounting models developed by the entity have been implemented. Hedge accounting may involve the use of extensive and sometimes complex spreadsheet models or IT applications. The

auditor evaluates the controls over the inputs to the models or applications and the controls that address the consistency and integrity of the model or calculations performed in IT applications. The auditor evaluates models and calculations for consistency and accuracy.

243. A range of data, obtained internally or externally by the entity, may be used in the estimation of the fair value of hedging instruments and hedged items (and the extent of the relationship between the two). The auditor performs risk assessment procedures to identify material inputs and tests the relevant data used. The auditor performs procedures to test the relevance and reliability of the inputs used by management in the identification of each hedging instrument and hedged item (such as the relevant contractual terms of hedging instruments and hedged items and market data relevant to the estimation of fair values and assessment of hedge components) and in the inputs used in the measurement of the fair value of hedging instruments and hedged items.

244. The auditor performs procedures to evaluate whether hedge relationships have been properly designated and documented on a timely basis and whether the components of each hedge relationship are eligible for inclusion in that hedge relationship.

Effective interest rate accounting

245. Under IFRS 9 and FRS 102 the effective interest rate (EIR) method is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. Applying the EIR method may involve complex modelling and a significant degree of judgment, particularly when determining the future cash flows and expected life of mortgage and credit card products with promotional periods.

246. When auditing the effective interest rate calculations prepared by management, procedures the auditor may use include:

- Evaluating the compliance of the model taking into consideration the requirements of the applicable accounting framework[44], including challenging the completeness of the identification of items that are integral part of the effective interest rate;

- Testing the controls that management has established to review and challenge the appropriateness of key judgments and model governance;

- Understanding and challenging the identification of the unit of account and the impact of any modelling simplifications such as modelling on a cohort basis;

- Challenging the expected life of the instrument used in the EIR calculation which may include considering the past behaviour of borrowers in prepaying identical or similar financial instruments and other changes such as regulatory developments and macro-economic factors that could influence borrower behaviour;

- Testing the relevance and reliability of data inputs used in the model including fees and points paid or received between parties to the contract that are an

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44 For example, IFRS 9 paragraphs B5.4.1–B5.4.7 or FRS 102 paragraphs 11.15-11.20

integral part of the effective interest rate, transaction costs, premiums or discounts;

- Testing that interest revenue has been accrued appropriately on gross or net basis in accordance with the requirements of the applicable financial reporting framework (e.g. depending on the stage allocation for ECL purposes under IFRS 9);

- Testing the mechanical accuracy of the model by recalculation or understanding and re-performing the model code.

Provisions related to conduct or regulatory breaches

247. IAS 37 (FRS 102 section 21) requires a provision to be recognised when, and only when, an entity has a present obligation (legal or constructive) as a result of a past event; it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. Such instances would include cash outflows arising from breaches in regulatory and conduct related matters which are particularly prevalent for banks and building societies. Such matters could include financial product mis-selling, failures to treat customers fairly (e.g. inaccurate fees and charges, inappropriate arrears collection behaviour), money market rigging, regulatory rule breaches (e.g. anti-money laundering, client money, etc), and cyber and other operational resilience failures. In evaluating the requirement for a provision related to conduct or regulatory breaches the auditor considers potential outflows including customer remediation and redress, consequential loss claims and regulator financial sanctions. When evaluating whether an outflow is probable, obligations related to similar customer remediation, redress or consequential loss claims are considered together.

248. Procedures the auditor may perform to evaluate the completeness of identification of such obligations could include:

- Understanding and evaluating managements' own processes and controls for identification of conduct issues and regulatory breaches;
- Reviewing customer complaint records and other management information for indicators of misconduct;
- Performing other analytical activity such as evaluating unusual trends in product profitability; and
- Building an understanding, and evaluating the applicability, of other regulatory and conduct issues through considering matters in the public domain such as themes, requirements and areas of enforcement identified in relevant regulator announcements, as well as other relevant sources such as bilateral dialogue with regulators.

The auditor may consider using an auditor's specialist or expert in performing the procedures listed above.

249. Where an obligation arising from past events has been identified, procedures the auditor may perform to evaluate management's view of whether an outflow of resources is probable and their estimate of that outflow could include:

- Building an understanding of the nature and root cause of the issue;
- Understanding and evaluating managements' own processes and controls for estimating the outflow and their range of possible outcomes;
- Testing the mathematical integrity of any models applied by management in forming their estimate;
- Testing the completeness and accuracy of the inputs used by management to form their estimate such as the impacted population and historic complaint and redress experience;
- Understanding and considering the appropriateness of external advice taken by management when assessing their obligations as well as sufficiency of questions asked of the legal counsel to reach a conclusion on the probability of the outflow and its estimate;
- Challenging the reasonableness of management's judgments with reference to historic data and trends, recent relevant correspondence and public announcements, internal budgets, forecasts and resource planning, regulatory sanction for similar breaches and the mechanism used to calculate them, and other relevant inputs where applicable;
- Challenging the estimate of costs to remediate both for completeness and the extent to which they represent an incremental outflow of resource;
- Evaluating the appropriateness of the discount factor applied to cash flows, where the impact could be material; and
- Considering whether the disclosed sensitivities are appropriate, reflect the judgments and inputs that are material to the estimate, and align with those considered internally.

250. IAS 37 (FRS 102 section 21) requires disclosure of a contingent liability if: an obligation is possible but the entity is yet to confirm whether it has a present obligation, or a present obligation exists but an outflow of resources is not probable or, in extremely rare circumstances, a present obligation cannot be reliably estimated. Such disclosures are often required for banks and building societies given the extensive regulatory environment they operate in, and the pattern of regulatory investigation and sanction. Where regulatory and conduct breaches have been identified, the auditor evaluates the adequacy and completeness of the disclosure and challenges management on whether management have performed sufficient procedures to support their assessment that a provision should not be made. Such procedures could include requesting management to obtain additional internal or external legal or regulatory advice.

Disclosures

251. The auditor evaluates the disclosures the entity has made in respect of accounting estimates and whether they are reasonable in the context of the applicable financial reporting framework, including how the estimates were developed and that explain the nature, extent and sources of estimation uncertainty. For a fair presentation framework,

such as IFRS or UK GAAP, the auditor's evaluation includes whether the disclosures achieve a fair presentation or additional disclosures are necessary beyond those specifically required by the framework. For example, the auditor considers the difficult, subjective and complex assumptions made by management and evaluates whether sufficient information is disclosed to enable the users of the financial statements to understand these uncertainties. The auditor considers factors such as the nature of the assumption, the sensitivity of the carrying amount to that assumption, range of reasonably possible outcomes and any explanations as to changes in these assumptions. Examples of these critical accounting estimates typically include the fair valuation of financial instruments, allowances for loan impairments and other credit risk provisions, goodwill, intangible assets, pensions and retirement benefits and deferred taxation.

252. ISA (UK) 540 requires that the auditor’s procedures address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to understand and address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty. In banks and building societies the level of estimation uncertainty associated with some accounting estimates may be significant, often exceeding the level of audit materiality. The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and therefore the more persuasive the audit evidence needs to be to determine whether management’s point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

253. If the auditor’s consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter.

254. The requirements of IFRS 7 (and of FRS 102, applicable for financial institutions only) to disclose information about the financial risks of the entity and how those are managed with reference to how the entity reports internally to key management personnel are a particular focus area for auditors. The auditor evaluates whether the disclosures are complete, appropriate and meet the requirements of the standard. The auditor's considerations may include whether there is sufficient disaggregation and granularity of disclosures reflecting the diversity of accounting estimates and the possible varying nature and sources of estimation uncertainty related to them. Other considerations may include, for example, whether:

- the disclosures are consistent with the bank's or building society's internal risk management reporting (e.g. the key parameters that a credit risk function reports to management and subjects to stress testing);

- the disclosures are consistent with other information presented with the financial statements;

- management has taken account, where relevant, of industry guidance on disclosures, for example “Recommendations on a comprehensive set of IFRS 9

Expected Credit Loss disclosures" issued by the Taskforce on Disclosures about Expected Credit Losses ("DECL" – see paragraph 193).

255. In respect of fair value accounting estimates the auditor may not be able to validate the fair value precisely and may determine a range for which there is an expectation that the entity's value would fall within. The auditor evaluates the ranges that are disclosed as part of IFRS 7/FRS 102 where management has made assumptions or judgments in determining the fair value where significant unobservable inputs have been used. The auditor also evaluates whether the entity is disclosing the relevant assumptions and methodologies that have been employed to determine the fair value of their financial instruments in accordance with IFRS 7/FRS 102. For example, the entity may disclose information about the assumptions relating to prepayment rates, recovery rates, interest rates, credit spreads, estimated credit losses and other discount rates used.

256. The auditor evaluates the reasonableness of the fair value hierarchy that has been prepared by the entity in accordance with IFRS 7/FRS 102 for accuracy and completeness. The auditor may challenge the entity's allocation in the fair value hierarchy by specifically considering the significant inputs used in determining the fair value of the instruments. Where quoted prices in active markets for identical assets or liabilities are used this would be categorised as level 1 (e.g. a corporate bond trading in an active market or a futures contract traded on an exchange). If inputs that are observable for the asset or liability either directly or indirectly are used in the valuation technique this would be regarded as level 2 (e.g. an interest rate swap in a liquid currency for a tenor for which liquid swap curve data is available). Where inputs used in the valuation technique are not based on observable inputs this would imply a level 3 categorisation if these inputs are significant to the fair value measurement in its entirety (e.g. corporate bond trading in an illiquid market where management has had to make an assumption of the implied credit spread to use). The auditor evaluates whether the evidence supports the fair value hierarchy and the levels applied and reviews the additional sensitivity analysis required for changing the unobservable inputs in level 3 to reasonably possible changes and the impact on the carrying amount and profit and loss or equity.

Management bias

257. Management bias, whether unintentional or intentional, may be difficult to detect in an individual estimate. ISA (UK) 540 indicates that examples of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances;
- Selection or development of significant assumptions that yield a point estimate favourable for management objectives; and
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Management bias may be influenced by a position of the regulators of banks and building societies, which may result in an inappropriate bias in the belief it is needed to meet the regulators expectations. Other drivers of bias may include expectations of market analysts and rating agencies.

258. Management bias may be identified when there has been a change in the method for calculating estimates or changes in credit risk factors from the prior period. This may be based on a subjective assessment without evidence that there has been a change in circumstances, when considered in the aggregate of groups of estimates or all estimates, or when observed over a number of accounting periods. It may also be identified if management's assumptions are not consistent across the business (for example the criteria used in credit risk management and in loan origination decisions) or if management selects estimates from the ends of reasonable ranges rather than adopting a more neutral approach.

259. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as ‘pessimistic’ and ‘optimistic’ scenarios. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor’s attention.

260. Although management bias is inherent in subjective decisions, management may have no intention of misleading the users of financial statements. If, however, there is intention to mislead through, for example, the intentional use of unreasonable estimates, management bias is fraudulent in nature. ISA (UK) 240, ‘The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements’, provides requirements and guidance on the auditor’s responsibility to consider fraud in an audit of financial statements.

261. Indicators of management bias are an example of a matter that the auditor may communicate to those charged with governance when fulfilling the requirement in paragraph 16(a) of ISA (UK) 260, ‘Communication With Those Charged With Governance’, to communicate the auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

262. The auditor may conclude that the risk of management bias is present in accounting estimates associated with a high level of estimation uncertainty. In such cases the auditor seeks to address the risk of bias through increased level of professional scepticism and, for example, the use of information external to the entity to evaluate judgments made by management. In relation to such estimates the auditor also focuses on the adequacy of disclosures of estimation uncertainty included by management in the financial statements.

ISA (UK) 550: RELATED PARTIES

263. ISA (UK) 550 deals with the auditor's responsibility relating to related party relationships and transactions.

264. Related party transactions are defined in IAS 24 'Related Party Disclosures' and Section 33 of FRS 102. The potentially overriding impact of law concerning confidentiality in respect of disclosures under IAS 24 or FRS 102 needs to be considered. This is particularly relevant in a banking context: banks and building societies are usually under a strict duty of confidentiality (by operation of statute, contract or common law) regarding the affairs of their clients and, in respect of transactions entered into in certain overseas jurisdictions, this may even preclude a foreign entity from disclosing information to its parent, another group company or their auditor. A provider of finance (in the course of a business in that regard) and its customer are not 'related' simply because of that relationship.

265. Both when applying EU IFRS or UK GAAP, under ISA (UK) 550, the auditor is required to assess the risk that material undisclosed related party transactions may exist. It is in the nature of banking business that transaction volumes are high but this factor will not, of itself, necessarily lead the auditor to conclude that the inherent risk of material undisclosed related party transactions is high.

266. Section 178 of FSMA 2000 requires that a person who decides to acquire or increase control must give the appropriate regulator notice in writing before making the acquisition; and s191D requires notice to be given of a proposed disposition of control. Failure to give such notifications is an offence under s191F. Both the FCA and PRA have specific requirements in relation to changes in control. These include annual reporting obligations in respect of controlling parties and entities that are closely linked to the firm. As a result, it will therefore normally be the case that there are controls in place to ensure that this information is properly collated. However, the definition of 'controller and closely linked' for regulatory purposes is not congruent with the 'related party' definition in FRS 102/IAS 24 and the auditor therefore considers what controls have been put in place by management to capture information on those parties which fall within the accounting definition only.

267. In reviewing related party information for completeness, the auditor may compare the proposed disclosures in the financial statements to information prepared for regulatory reporting purposes (bearing in mind that the population may be different, as noted in the preceding paragraph).

268. Whilst related party transactions can arise generally, in the context of UK banks and building societies, they frequently arise in respect of deposits held by directors and/or persons connected with them and in respect of loans and other transactions with directors and/or persons connected with them. They may also arise in respect of the sale or arrangement of insurance products and in respect of the provision of professional and other services. Whilst there are CA2006 provisions relating to transactions by banking companies with directors, there are separate BS Act 1986 requirements for building societies in respect of transactions with directors (s62–69 BS Act 1986). See paragraphs 329 - 331 below concerning the related auditor's obligation.

269. Ring-fenced banks are required by the PRA's rules to enter into intra-group transactions and arrangements on arms-length terms. The auditor obtains an understanding of the systems and controls for identifying such transactions, pricing them and disclosing them and performs procedures to evaluate whether the disclosures are complete and appropriate. If the auditor identifies non-compliance with the PRA's rules, this would be a matter to consider reporting to the regulator.

270. The auditor is aware that the Sch10A BS Act 1986 contains specific disclosure requirements applicable to the annual accounts of building societies as regards loans and certain other transactions with directors. The auditor is also required to report on the statement that a building society is required to make under s68 BS Act 1986 concerning loans, and certain other transactions with directors, that are subject to s65 BS Act 1986.

ISA (UK) 560: SUBSEQUENT EVENTS

271. ISA (UK) 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

272. Matters specific to banks and building societies which the auditor may consider in the review of subsequent events include:

- an evaluation of material loans and other receivables identified as being in default or potential default at the period end to provide additional evidence concerning period end loan impairment provisions;

- an assessment of material loans and other receivables identified as (potential) defaults since the period end to consider whether any adjustment to the period end carrying value is required;

- a review of movements in market prices and exchange rates in illiquid markets to consider whether prices or rates used in period end valuations were realistic;

- a review of correspondence with regulators and enquiries of management to determine whether any significant breaches of regulations or other significant regulatory concerns have come to light since the period end; and

- a consideration of post year end liquidity reports for indications of funding difficulties.

ISA (UK) 570: GOING CONCERN

273. ISA (UK) 570 deals with the auditor's responsibilities relating to going concern and the implications for the auditor's report.

274. As noted in paragraph 122, it is important for the auditor to understand the multi-dimensional nature and extent of the financial and business risks. The importance of banking funding models means that the approach for assessing the going concern assumption of a bank or building society is different from that likely to be adopted when making the assessment for a non-bank 'Corporate' entity. A going concern assessment for a Corporate would typically involve comparing cash requirements at monthly intervals for a future period (e.g. the next 18 months) with available committed borrowing facilities to determine whether the company had sufficient headroom in its banking facilities to accommodate its foreseeable working capital needs.

275. The working capital of a bank or building society is very different in nature. The daily cash flows passing to and from a bank or building society are large. Banks and building societies cannot rely on committed facilities (loans and overdrafts from other banks) as typically they do not have access to facilities in this form. On a contractual basis, banks and building societies have current liabilities, such as on-demand and short-term retail deposits and wholesale unsecured borrowing, which are typically greater than their current assets (loans and other financial assets due within one year) and thus always have funding gaps. Trading activities are typically funded in a different manner (e.g. by repos) to retail/commercial banking and this funding is normally short term. Where banks have overseas components, there may be legal or regulatory restrictions on access to the funds held by those components.

276. However, behavioural cash flows impacting a bank or building society are typically very different from that indicated by contractual maturities. Normally, short-term contractual liabilities such as customer demand deposits have much longer behavioural maturities, and certain long-term contractual assets such as mortgages have shorter behavioural maturities (i.e. early redemptions). But this can change in stressed scenarios, making banks' funding models inherently unstable. Hence market confidence in a bank's solvency is normally what sustains their business model.

277. At a simple level, banks are likely to face liquidity problems if the incremental demand for new funds across the various divisions of the bank exceed the supply of funding readily available.

278. Incremental 'demand' for funding is created through a number of channels, for example:

- growth in the business (e.g. more lending to customers);
- drawdowns on committed facilities;
- maturing funding;
- corporate actions (such as acquisitions);
- large losses in trading books and losses more generally;

- significant foreign exchange (FX) movements; and
- additional collateral requirements on outstanding financial instrument - either trading positions or hedging transactions.

279. Behavioural factors are also important when assessing funding demand. For instance if the level of early mortgage redemptions falls, less cash will be received and the funding requirement will increase.

280. The key sources of funding supply on the liability side of the balance sheet are:

- retail and corporate deposits;
- borrowing on wholesale markets/short-term money markets;
- debt securities (typically longer term debt);
- securitisation type arrangements (including covered bonds);
- repos; and
- equity injections from strategic investors (e.g. Sovereign Wealth Funds).

281. Banks and building societies are required to meet liquidity requirements set by the regulator[45]. A failure to comply with these requirements is likely to prompt action by the regulator.

282. A further important consideration in a going concern assessment for a bank or building society is the level of its capital ratios. Failure to maintain the required level of regulatory capital is likely to prompt intervention by the regulator. A sharp fall in capital may also result in a ratings downgrade making funding more expensive and possibly harder to obtain.

283. In reviewing going concern, the auditor may therefore consider the following areas in addition to those set out in ISA (UK) 570:

- capital adequacy and leverage ratios – e.g. review of management's analysis and rationale for ensuring that the entity is capable of maintaining adequate financial resources in excess of the minimum, this would include capital forecasts and a review of stress tests performed by management (including where appropriate those prepared for regulatory Internal Capital Adequacy Assessment Process purposes);
- liquidity indicators – e.g. review of the output of the entity's liquidity risk management processes for signs of undue deterioration, again including a review

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45 For example CRR - Regulation (EU) 575/3013 and related Delegated Regulation (EU) 2015/61 together with PRA Rulebook part: Internal Liquidity Adequacy Assessment, PRA Statement of Policy: Pillar 2 liquidity, PRA Supervisory Statement 24/15: The PRA's approach to supervising liquidity and funding risks.

of stress tests[46] performed by management (including where appropriate, those prepared for regulatory Internal Liquidity Adequacy Assessment Process purposes) and including a review of management's analysis of the entity's ability to meet liquidity requirements set by the regulator;

- liquid assets buffer – e.g. review of the results of compliance with the regulatory requirement that a firm must regularly monetise a sufficiently representative sample of their holdings of high quality liquid assets (with the exception of certain asset classes)[47];
- funding structure and funding plan – e.g. review of management's funding plans (including recovery and liquidity contingency plans) and comparison against recent funding patterns as well as the extent of use and availability of the Bank of England's liquidity insurance facilities;
- operations/profitability indicators – e.g. review of the performance of loans in troubled industry sectors in which the entity has a high concentration of exposure;
- customer behaviour indicators – e.g. review of recent deposit withdrawal experience (including, in exceptional circumstances, a run on the bank or building society) and whether there are indicators of changes in behaviour on the asset side of the balance sheet;
- reputational and other indicators – e.g. review of the financial press and other sources of market intelligence for evidence of deteriorating reputation; review of correspondence with regulators; rating agency downgrades; and
- regulator interventions – e.g. business model adversely affected by restrictions on the ability to trade arising from regulatory breaches or other changes in regulatory requirements.

Further details of possible factors that may indicate going concern issues in these areas are set out in Appendix 5 to this Practice Note.

284. There may be circumstances where funding for an entity is provided by other non-UK national governments or central banks and, where applicable, the auditor considers whether such funding is appropriately committed.

285. For auditors of banks and building societies that prepare a viability statement the auditor uses the knowledge obtained in relation to going concern considerations when undertaking procedures addressing the viability statement[48].

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46 PRA's Rulebook part: Internal Liquidity Adequacy Assessment, PRA Statement of Policy: Pillar 2 liquidity and PRA Supervisory Statement 24/15 addresses stress testing.

47 Delegated Act Article 8(4) - Delegated Regulation (EU) 2015/61.

48 Further guidance for directors is given in the FRC's Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting – September 2014

286. If the auditor has any doubts as to the ability of the entity to continue as a going concern, the auditor considers whether to make a report direct to the PRA and FCA, on which guidance is set out in the section of this Practice Note relating to ISA (UK) 250 Section B.

ISA (UK) 580: WRITTEN REPRESENTATIONS

287. ISA (UK) 580 deals with the auditor's responsibility to obtain written representations from management and where applicable those charged with governance. Written representations on their own do not provide sufficient appropriate audit evidence about any of the matters with which they deal.

288. ISAs (UK) 250 Section A and 550 require the auditor to obtain written confirmation in respect of completeness of disclosure to the auditor of:

- all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements (these include breaches of FSMA 2000, FCA and PRA rules, the Money Laundering Regulations, other regulatory requirements or any other circumstance that could jeopardise the authorisation of the firm under FSMA 2000); and

- the completeness of information provided regarding the identification of related parties and the adequacy of related party disclosures in the financial statements.

289. In addition to the examples of other representations given in ISA (UK) 580, the auditor also considers obtaining confirmation:

- as to the adequacy of provisions for loan impairment (including provisions relating to individual loans if material) and the appropriateness of other accounting estimates (such as complex financial instrument valuations or adequate provisions for compensation concerning upheld complaints by customers);

- that all contingent transactions or commitments have been adequately disclosed and/or included in the balance sheet as appropriate; and

- that all correspondence with regulators has been made available to the auditor.

ISA (UK) 600: SPECIAL CONSIDERATIONS – AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

290. ISA (UK) 600 deals with the special considerations that apply to group audits.

291. Where the entity consists of a group with components, (e.g. subsidiaries, branches or divisions), the requirements and application guidance in ISA (UK) 600 are applicable as for groups in other industries. Similar considerations apply, but there are certain aspects that are particularly challenging for the group audit of a bank or building society.

Assessment of component risk

292. Generally the significance of components will be assessed based on the size of their balance sheets and profit and loss accounts/income statements. However, it is important that the group auditor is also alert to the risk of material misstatement arising from the nature of the entity's activities as well as its geographical location, regulatory environment, macro-economic factors, technological disruptions and other factors. For example a poor control environment in a small remote treasury operation or a small retail bank may lead to errors of a size that are disproportionate to the size of the entity concerned. This risk may be mitigated by testing certain controls in and over the entity, even if a full scope audit is not conducted. Other factors to consider may include operations in foreign jurisdictions that are exposed to factors such as heightened government intervention in areas of trade and fiscal policy and currency and dividend movements and a lack of permissions to conduct certain banking activities in foreign jurisdictions.

293. Practical issues may also present themselves in relation to restrictions on accessing and sharing of information in certain jurisdictions. The group auditor considers such issues in at the planning stage of the group audit and how to mitigate them.

Structured entities / Special purpose entities

294. One aspect of activities of banks and building societies that can present particular challenges is their use of structured entities ('SEs') / special purpose entities ('SPEs'), which are often considerably more numerous than for entities in other industries. The key risks of material misstatement relating to such entities arise from failure:

- to identify all SEs / SPEs established by the group;
- to identify and understand particular risks related to the nature and operation of the SEs / SPEs; and
- to assess appropriately whether the SEs / SPEs are required to be consolidated by the group in accordance with the relevant financial reporting framework.

295. As SEs / SPEs tend to have varying legal forms, for example trusts, partnerships or other vehicles, it can sometimes be challenging to ensure that all SEs / SPEs established by the group have been accurately identified by management. The auditor considers the process established by management for:

- Recording and ongoing monitoring of SEs / SPEs; and

- Understanding changes to SE / SPE structures that might trigger consolidation accounting for unconsolidated SEs / SPEs or vice versa.

296. Audit procedures to address this might include:

- inquiries of the senior management and the Board;
- inspection of set up documents such as an offering circular, deed of charge and assignment, articles, etc
- inspection of committee minutes approving the setting up of such entities;
- inspection of approvals from different functions within the group, for example – Compliance, Regulatory, Risk, Legal, Tax, Finance etc.; and
- reviewing the list/database of SEs / SPEs and changes thereto.

297. Management of group entities usually perform an assessment of whether SEs / SPEs are required to be consolidated or not within the group. This is normally considered as part of the set up process. The assessment is based on whether the group controls the SE / SPE or not and takes into account various factors that are set out in IFRS 10 Consolidated Financial Statements and Section 9 Consolidated and Separate Financial Statements of FRS 102.

298. The auditor evaluates management's assessment of the accounting treatment of the SEs / SPEs in accordance with the applicable reporting framework and challenge the appropriateness of the treatment, where necessary including, for example, if relevant circumstances have changed since management performed its assessment of whether SEs / SPEs are required to be consolidated. The auditor also checks the regulatory treatment of SEs / SPEs to ascertain whether this provides additional evidence for the accounting treatment and also to ensure that any differences can be rationalised.

299. For SEs / SPEs that are consolidated within the group, the auditor applies the same tests as for other components to identify whether the component is significant from a group perspective and to determine the type of work to be performed on the SEs / SPEs (either because of its individual financial significance or because significant risks are present in it).

300. The auditor checks compliance with the disclosure requirements of the applicable financial reporting framework – for example, IFRS 12 Disclosure of Interests in Other Entities and Section 9 Consolidated and Separate Financial Statements of FRS 102, including those relating to SEs / SPEs that are not consolidated.

Offshoring

301. Another aspect of challenge in undertaking the group audit of a bank or building society is their use of offshoring or shared service centres. Large banking groups tend to process a huge volume of generally low value transactions on a day-to-day basis. Many banking institutions have increasingly continued to offshore these high volume transaction processing and related control activities to low cost locations around the

world to obtain competitive cost advantage or centralised them in other locations so as to achieve economies of scale.

302. Offshoring of activities and the use of shared service centres pose a particular risk of breakdown in controls, because processes are broken down into several pieces with different locations potentially looking after each one. If the precise responsibilities of each location are not fully understood and monitored, key aspects of the control process could be omitted or not properly performed. The auditor obtains an understanding of the bank's approach to outsourcing/offshoring of business activities and functions and how internal controls over these activities is maintained.

303. Typical examples of process/control activities that are performed in an offshore location or shared service centre include:

- processing of payments;
- bank and suspense account reconciliations;
- processing of confirmations;
- processing of settlements; and
- remote bookings.

304. The auditor evaluates the clarity of management's ownership of process and control activities in different locations and where appropriate tests the controls for the end-to-end process. This includes instances whereby the offshore location or shared service centre is audited by a firm in another network, with the auditor overseeing that component auditor's work as they would for the work of any other component auditor.

Overseeing component auditors

305. A banking group's operations can involve a high degree of reliance being placed by entities within the group upon activities performed by others. For example it is common for a trade to be originated in one location, processed in another, valued in a third and booked in a fourth. Furthermore, judgmental decisions around areas such as credit can be taken in group or other central locations but affect several entities within the group. Such interdependency requires not just clear allocation of responsibility between the various teams undertaking the audit, but also close ongoing cooperation throughout the work, to ensure that the work undertaken and the judgments made are appropriate for the auditors of all locations affected. The group auditor considers how this can be best achieved.

306. The lead engagement partner of the group audit of a bank or building society is responsible for assessing independence matters for their network of firms, including evaluating the permissibility of services and monitoring of firm and personal independence matters. Those charged with governance are also responsible for evaluating the independence of the firm performing the audit of the financial statements. The FRC's Ethical Standard includes the third party test, whereby the provision of non-audit services is considered through the lens of an objective, reasonable and informed

third party and whether they would consider the auditor's independence to be compromised through the provision of the non-audit services.

307. The group auditor considers the competence and capability of the component auditor having regard to the laws, regulation and industry practice relevant to the component and whether the component auditor has access to relevant expertise, for example in the valuation of financial instruments, appropriate to the component's business.

308. Further procedures may be necessary for a group auditor where the component auditor is not subject to the UK audit regulatory regime. In such a case, the group auditor has due regard to the requirements in the Audit Regulations[49] to ensure all relevant members of the engagement team are and continue to be fit and proper, are and continue to be competent and are aware of and follow the Audit Regulations and any related procedures and requirements established by the audit firm. This includes the auditor's duty to report direct to the FCA in certain circumstances. More detailed consideration of the auditor's duty to report to the FCA is set out in the section of this Practice Note dealing with ISA (UK) 250 Section B.

Areas of greater audit risk

309. Given the size and complexity of banks and building societies, the group auditor may decide that it is necessary to perform their own independent testing in areas of greater audit risk. This may include fully independent audit procedures, re-performance of some elements of the component auditor's testing, or the performance of some audit procedures alongside the component auditor, for instance through attending key meetings such as walkthroughs of financially significant processes.

[49] Audit Regulations and related guidance are issued by the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Scotland and the Institute of Chartered Accountants in Ireland.

ISA (UK) 620: USING THE WORK OF AN AUDITOR'S EXPERT

310. ISA (UK) 620 deals with the auditor's responsibilities relating to using the work of an individual or organisation in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.

311. Given the complexity, subjectivity and specialist nature of the activities of banks and building societies, the auditor may involve an expert[50] in elements of the audit of these areas, including, for example:

- the estimation of credit losses;
- the valuation of derivative and other complex financial instruments;
- the valuation of loan collateral, owner-occupied property and investment property;
- information technology and data;
- cross-border taxes (including transfer pricing and indirect taxes);
- regulatory (including ring fencing, prudential regulation and conduct);
- VaR (or similarly complex) market risk disclosures; and
- pension obligations

Auditor's experts may assist with the planning of the engagement and understanding the risks of material misstatement as well perform tests of controls and substantive procedures and evaluate disclosures in the financial statements.

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[50] ISA (UK) 620 defines an auditor's expert as: 'An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.'

Experts used by the entity to assist in preparing the financial statements are 'management's experts'. The auditor's considerations in relation to management's experts are addressed in ISA (UK) 500.

ISA (UK) 700: FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

312. ISA (UK) 700 deals with the auditor's responsibility to form an opinion on the financial statements and the form and content of the auditor's report.

313. The auditor may report on the financial statements of a branch of a bank incorporated outside the UK. ISA (UK) 700 (or aspects thereof) may remain applicable in these circumstances. However, in agreeing the form of the opinion for a branch audit, the auditor takes into account matters such as the nature and content of the financial statements to which the report relates, the extent to which transactions recorded in the branch may have been initiated in other locations (and, similarly, whether transactions initiated by the branch may have been recorded elsewhere), the specific terms of the engagement as agreed with the party which has commissioned the work (which may be local and/or head office management or the head office auditor, for example) and whether the report will be public or private.

314. The auditor's reporting responsibilities concerning building societies differ from those applicable to a UK bank. The principal differences are:

- a statutory requirement for the publication of income and expenditure accounts (as opposed to profit and loss account/income statements) separately for both the society and its subsidiary undertakings (group accounts) (s72F BS Act 1986) and the society itself (s72B BS Act 1986) where prepared under UK GAAP. S72H and s72D BS Act 1986 respectively apply where prepared under EU IFRS. This contrasts with the s408(2) CA2006 exemption available to UK companies including UK banks from publishing the profit and loss account of the parent company in group accounts;

- a statutory requirement for an annual business statement to be attached to the annual accounts (s74 BS Act 1986), containing information as prescribed by the BS Accounts Regulations 1998: the prescribed content comprises three sections, being section 1, statutory percentages (the lending and funding limits, see paragraph 28 of this Practice Note), disclosing also the statutory limits and an explanation of the basis for each of these ratios, section 2, other percentages (being five operating ratios with their comparatives and an explanation of each ratio), and section 3, information on the directors and officers of the society. The auditor is required to state whether the annual business statement has been prepared in accordance with BS Act 1986 and regulations made thereunder and whether the information given in the annual business statement (excluding the details of directors and officers) gives a true representation of the matters in respect of which it is given (s78(7)(a) BS Act 1986); and

- a statutory requirement for a directors' report to be produced for each financial year (s75 BS Act 1986), containing information as prescribed in s75 and 75A BS Act 1986 and Sch 8 of the BS Accounts Regulations 1998: in addition to consistency with financial statements the auditor is required to state whether the directors' report has been prepared so as to conform to the requirements of s75 BS Act 1986 and the BS Accounts Regulations 1998 (s78(7) BS Act 1986).

315. In relation to the annual business statement the term 'true representation of the matters in respect of which it is given' referred to in paragraph 314 above is the expression drawn directly from the BS Act 1986. It is not defined in BS Act 1986 nor in any related legislation. The part of the annual business statement covered by this opinion comprises data and ratios (see paragraphs 29 to 32) that are almost all derived from audited information within the annual accounts. Procedures undertaken by the auditor usually involve substantive procedures to ensure that:

- the relevant data has been completely and accurately extracted from audited information or from sources that have been subject to audit procedures; and
- the ratios have been accurately calculated in accordance with the statutory definitions within the BS Accounts Regulations 1998.

316. There is also a statutory requirement for a summary financial statement for building societies, in a format as prescribed in the BS Accounts Regulations 1998, which must be sent to all members entitled to receive notice of meetings and which must be provided on request to all new shareholders (s76 BS Act 1986): the auditor is required by s76(5) BS Act 1986 to provide an auditor's statement as to the consistency of the summary financial statement with the accounts, the annual business statement and the directors' report and its conformity with the requirements of s76 BS Act 1986 and the BS Accounts Regulations 1998[51].

317. Examples of other auditor's reports are set out in Appendix 1 of this Practice Note.

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[51] A Listed UK bank may choose to prepare summary financial statements to send to its members, subject to certain conditions.

ISA (UK) 705: MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

319. ISA (UK) 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

320. One of the circumstances in which the FSMA 2000 (Communication by Auditors) Regulations 2001 ('the 2001 Regulations') as amended, requires an auditor to report to the FCA or PRA is when 'the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with the CA2006 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation'. Consequently, where an auditor is considering modifying the auditor's opinion on the financial statements the auditor reports the circumstances requiring the modification to the FCA or PRA as appropriate in advance of issuing the report.

ISA (UK) 706: EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

321. ISA (UK) 706 deals with additional communication in the auditor's report when the auditor considers it necessary to draw attention to a matter or matters that are fundamental to users' understanding of the financial statements, the auditor's responsibilities, or the auditor's report.

322. As explained in paragraph 69 the auditor has a duty to report to the FCA and PRA as appropriate if the auditor becomes aware of a matter that could be of material significance to the regulators in determining whether a bank meets the threshold conditions for authorisation. Any matter considered of such importance as to require an emphasis of matter paragraph may well also be of material significance to the regulators and so the auditor considers whether to make a report to the relevant regulators as appropriate before issuing the auditor's opinion on the financial statements. Similar considerations apply where the auditor is considering including an other matter paragraph.

OTHER REPORTS BY THE AUDITOR

Auditor's review reports on interim profits

323. An authorised firm must maintain at all times capital resources equal to or in excess of its capital resources requirement. Article 26(2) of the Capital Requirements Regulation (CRR) [52] provides that an authorised firm may include interim or year-end profits in Common Equity Tier 1 capital (CET1) before it has taken a formal decision confirming the final profit for the year only with the prior permission from the PRA[53]. This permission must be obtained through the CRR Permission process.

324. CRR Article 26(2) provides that the PRA shall grant an authorised firm the permission to include the interim or year-end profits as CET1 capital where the following conditions are met:

- Those profits have been verified by persons independent of the authorised firm that are responsible for the auditing of the firm's accounts: and

- That the authorised firm has demonstrated to the satisfaction of the PRA that any foreseeable charge or dividend has been deducted from the amount of profits.

325. With regards to the 'verification' of the profits referred to above, Article 26(2) requires that the verification shall provide an adequate level of assurance that those profits have been evaluated in accordance with the principles set out in the applicable accounting framework. What is an "adequate level of assurance" is not specified. However, 'verification' as used in this context is generally understood to indicate a degree of assurance which is lower than that given by a full audit. An engagement to 'verify' interim profits may therefore be taken to be a review[54] engagement, and an opinion may be given in terms of negative assurance. The report makes clear that the review does not constitute an audit performed in accordance with ISAs (UK) and an audit opinion is not expressed. The report is normally addressed to the directors of the entity.

326. As an external 'verification' of interim profits does not require a full scope audit it will be important for the PRA, in considering the adequacy of the 'verification' of interim profits, to be informed of the procedures that have been undertaken by the auditor, in support of the auditor's opinion. This is particularly important in the case of entities where no prescribed procedures have been established by the PRA themselves in rules or

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[52] Regulation (EU) No 575/2013

[53] The process for applying for this permission from the PRA is described on the PRA's website: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/capital-requirements-regulation-permissions/inclusion-of-interim-or-year-end-profits-in-common-equity-tier-1-capital

[54] ISRE (UK and Ireland) 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity,* establishes standards and provides guidance on the auditor's professional responsibilities when undertaking an engagement to review a complete or condensed set of interim financial information of an audit client, and on the form and content of the report. As of July 2019, reviews specifically for the verification of interim profits for the purposes of CRR Article 26(2) are not addressed by ISRE (UK and Ireland) 2410; however, it's scope may be extended in future revisions.

guidance. Consequently the detailed scope of the work undertaken by the auditor in support of the auditor's opinion is listed in the auditor's report.

327. In undertaking the review the auditor normally performs the following procedures:

(a) obtains satisfaction that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records;

(b) reviews the accounting policies used in calculating the interim profits for the period under review so as to obtain comfort that they are consistent with those normally adopted by the entity in drawing up its annual financial statements and are in accordance with either UK GAAP or EU IFRS, as appropriate;

(c) performs analytical procedures on the results to date which form the basis of calculating interim profits, including comparisons of actual performance to date with budget and with the results of the prior period(s);

(d) discusses with management the overall performance and financial position of the entity;

(e) obtains comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities, allowances for loan losses and other impairment provisions have been properly taken into account in arriving at interim profits; and

(f) follows up significant matters of which the auditor is already aware in the course of auditing the entity's most recent financial statements.

The auditor may also consider obtaining appropriate representations from management.

328. There may be some circumstances in which the auditor considers that additional work is required, for example:

- if the control environment surrounding the preparation of the interim profits is evaluated as weak;
- if the results of the procedures undertaken in paragraph 327 above are not fully consistent with the interim profits as reported; or
- if there has been a significant change to the accounting system.

Report on directors' transactions – building societies

329. Under s78(9) BS Act 1986 the auditor is required to report to the members on the annual statement of transactions and arrangements (usually loans falling within s65(1) BS Act 1986) with or to directors and persons connected with them.

330. S78(9) BS Act 1986 requires the auditor to examine the annual statement, as extracted from the Register required to be maintained under s68 BS Act 1986, and that a report

from the auditor be annexed to the statement before it is made available to the members. Under s78(10) BS Act 1986 the auditor reports whether the statement contains the particulars required by s68 BS Act 1986 and, where that is not the case, the auditor includes such particulars in their report, so far as they are reasonably able to do so.

331. The auditor only reports as to whether the statement contains all the matters contained in the Register in the relevant year. The auditor is not required by s78 BS Act 1986 to confirm whether or not the Register of transactions and arrangements with directors or connected persons is complete. However, if the auditor becomes aware of any transaction, arrangement or loan which should be in the Register and is not, then such an occurrence may indicate a deficiency in the system of control over the complete and accurate compilation of the Register. The results of this work could raise issues of relevance to the statutory duty to report to the FCA or PRA. An example of the auditor's report concerning this statement is set out in Appendix 1.2.

APPENDIX 1

ILLUSTRATIVE EXAMPLES OF AUDITOR’S REPORTS

This appendix contains the following example auditor’s reports:

UK Building Societies

1.1 Auditor’s statement on summary financial statement.

1.2 Auditor’s report on the s68 BS Act 1986 statement.

APPENDIX 1.1 AUDITOR'S STATEMENT ON SUMMARY FINANCIAL STATEMENT (BUILDING SOCIETIES)

Independent Auditor's statement to the Members and Depositors of [XYZ] Building Society

We have examined the Summary Financial Statement of [XYZ] Building Society [set out/above on pages x to x][*].

Respective responsibilities of directors and auditors

The directors are responsible for preparing the [Summary Financial Statement/name of document containing summary financial statement][1*], in accordance with applicable United Kingdom law.

Our responsibility is to report to you our opinion on the consistency of the Summary Financial Statement [within the [name of document containing summary financial statement]][1*] with the [full Annual Accounts][2], Annual Business Statement and Directors' Report and its conformity with the relevant requirements of Section 76 of the Building Societies Act 1986 and regulations made under it. [We also read the other information contained in the [name of document containing summary financial statement] and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Summary Financial Statement.][3*]]*. The other information comprises only [the chairman's statement and the corporate governance statement [and the other items listed on the contents page]][3*]

Basis of opinion

We conducted our work in accordance with Bulletin 2008/3 'The auditor's statement on the summary financial statement in the United Kingdom' issued by the Auditing Practices Board. Our report on the [Group and Society's]* [full Annual Accounts][2] describes the basis of our audit opinion[s] on those [Annual Accounts][2].

Opinion on summary financial statement

In our opinion the Summary Financial Statement is consistent with the [full Annual Accounts][2], the Annual Business Statement and Directors' Report of [XYZ] Building Society for the year ended [ ] and complies with the applicable requirements of Section 76 of the Building Societies Act 1986 and regulations made under it[4].

Statutory Auditor
Address
Date

Notes

1 If the summary financial statement is part of a larger document, for example including the Chairman's report or the Chief Executive's Review, then reference is made to the name of that larger document.

2 The Building Societies Act 1986 uses the term ‘annual accounts’ rather than ‘financial statements’. The auditor ordinarily uses the term used by the directors in the Annual Report.

3 If the document comprises only the summary financial statement, then this sentence will not be required.

4 The date of the auditor’s statement on the summary financial statement (‘SFS’) should be the same as the directors’ approval of the SFS and the auditor’s report on the full accounts.

* delete/amend as applicable

APPENDIX 1.2 AUDITOR'S REPORT ON THE S68 BS ACT 1986 STATEMENT (BUILDING SOCIETIES)

Independent auditor's report, under Section 78(9) of the Building Societies Act 1986 ('the Act'), to the members of [XYZ] Building Society on the statement of particulars of transactions and arrangements included in the Section 68(1) Register at any time during the year ended [ ]

We have examined the foregoing statement of transactions and arrangements with directors and persons connected with them, falling within Section 65(1) of the Act.

Respective responsibilities of directors and auditors

It is the responsibility of the directors, under Section 68(1) of the Act, to maintain a register of every existing transaction and arrangement, as defined in Section 65(1) of the Act, with directors or persons connected with directors. Section 68(3) of the Act requires the directors to prepare, for each financial year, a statement containing particulars of all information in the register for the last complete financial year. It is our responsibility, under Section 78(9) and (10) of the Act, to form an independent opinion as to whether the statement accurately contains all the particulars in the register from the last financial year and to report our opinion to you.

Basis of opinion

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence that the statement gives the particulars required by Section 68 of the Act.

Opinion

In our opinion the statement contains the requisite particulars, as required by Section 68 of the Act, in relation to those transactions recorded by the society in the register of transactions and arrangements maintained under Section 68(1) of the Act.

[Signature] *Address*

John Smith (Senior Statutory Auditor) *Date*

for and on behalf of ABC LLP

Statutory Auditor

APPENDIX 2

THE MAIN PARTS OF FSMA 2000 RELEVANT TO BANKS AND BUILDING SOCIETIES

Part 1A (and Schs 1ZA and 1ZB) sets out matters concerning the structure and governance of the FCA and PRA including their regulatory objectives and the principles to be followed in meeting those objectives.

Part II (and Sch 2) sets out the general prohibition on conducting regulated business unless an entity is either authorised or exempt, including restrictions on financial promotions. Regulated activities are defined in SI 2001/544.

Part III (and Schs 3–5) sets out the requirements to become authorised either by receiving a specific permission from the PRA or FCA or through the exercise of EEA passport rights. Exempt persons are listed in SI 2001/1201.

Part 4A (and Sch 6) sets out the arrangements for application for a permission to undertake authorised business and the criteria (Threshold Conditions) that must be met. An applicant who is refused can apply to the Tribunal (s55Z3).

Part V sets out the provisions applying to individuals performing designated functions (controlled functions) in an authorised firm. The FCA and PRA can specify controlled functions and authorised firms must take reasonable care to ensure that only persons approved by the FCA or PRA can undertake these functions. Approved persons must be fit and proper' and comply with the FCA's Statements of Principles and Code of Practice and the PRA's Conduct Standards as applicable for approved persons. Appeals can be made to the Tribunal.

Part VIII gives the FCA powers to impose penalties for market abuse – using information not generally available; creating a false or misleading impression; or, failure to observe normal standards – abuse being judged from the point of view of a regular market user. The FCA's powers extend to all persons – not only authorised firms. The FCA is required to publish a code to provide guidance on behaviours that do and do not constitute market abuse. This forms part of the Market Conduct Sourcebook and is called the Code of Market Conduct.

Part 9A provides the FCA and PRA with general powers to make rules which apply to authorised firms, including rules on specific matters – e.g. client money, money laundering. Rules must be published in draft for consultation. Guidance may be provided individually or generally and may be published. The FCA and PRA may modify rules or waive particular rules for particular authorised firms in certain situations.

[Part 9B establishes legal provisions in relation to ring fencing of bank activities. With effect from 1 January 2019 the largest UK banks must have separated core retail banking from investment Banking.]

Part XI allows the FCA and PRA to gather information from authorised firms, including use of skilled persons' reports under s166, or to commission investigations into authorised firms.

Part XIV sets out the disciplinary measures available to the FCA and PRA which can include public censure, unlimited fines, withdrawal of authorisation.

Part XXII includes provisions relating to auditors and their appointment.

Part XXVI brings together in one place the arrangements applying to warning notices and decision notices concerning possible breaches of various requirements imposed by FSMA 2000 or by FCA or PRA rules. A warning notice has to state the reasons for proposed actions and allow reasonable time for representations to be made. This will be followed by a decision notice with a right to appeal to the Tribunal.

APPENDIX 3

FSMA 2000, BS ACT 1986 AND RELATED STATUTORY INSTRUMENTS: IMPORTANT PROVISIONS FOR AUDITORS

FSMA 2000 provisions and related statutory instruments relevant for the auditor of a bank or building society are set out below. "The appropriate regulator" will be the PRA and/or FCA dependent on the circumstances. The legislation can be found on the legislation.gov.uk website – www.legislation.gov.uk. BS Act 1986 provisions and related statutory instruments relevant only to building societies are also set out below.

FSMA 2000 and statutory instruments as amended

Section/Sch	
19	General prohibition from undertaking regulated activity unless authorised
20	Authorised persons acting without permission
21	Restrictions on financial promotion
455B	Threshold conditions
59	Approval by the appropriate regulator of persons undertaking controlled functions
165	Regulators power to require information
166	Reports by skilled persons
166A	Appointment of skilled person to collect and update information
167	Appointment of persons to carry out general investigations
168	Appointment of persons to carry out investigations in particular cases
178	Obligation to notify the appropriate regulator concerning controllers of an authorised firm
339A	General duties of PRA in relation to auditors
340	Appointment of auditor or actuary by the appropriate regulator
341	Access to books etc (by auditor or actuary)
342	Information given by auditor or actuary to a regulator
343	Information given by auditor or actuary to a regulator: persons with close links
344	Duty of auditor or actuary resigning etc to give notice
345	Disciplinary measures, including disqualification (of auditor or actuary) from acting: FCA)
345A	Disciplinary measures, including disqualification (of auditor or actuary) from acting: PRA
346	Provision of false or misleading information to auditor or actuary
348	Restrictions on disclosure of confidential information by FCA, PRA etc.
349	Exceptions from s348

Section/Sch	
351A	Disclosure under the UCITS directive
352	Offences (contravention of s348 or 350(5))
398	Misleading the FCA or PRA
Sch 6	Threshold Conditions

SI 2001:	
544	Regulated Activities Order
1177	Carrying on Regulated Activities by Way of Business Order
1201	Exemption Order
1857	Disclosure of Information by Prescribed Persons
2188	Disclosure of Confidential Information
2587	Communications by Auditors
1376 and 2511	EEA Passport Rights

BS Act 1986 and statutory instruments as amended

Section/Sch	
5	Constitution and powers including principal purpose
6	The lending limit
7	The funding limit
8	Raising funds and borrowing
9A	Restriction on powers including treasury activities
62–69	Dealings with directors and disclosure and record of related businesses of directors
71	Accounting records
72A	Duty to prepare individual accounts
72B	Building Societies Act individual accounts
72C	Form and content of Building Societies Act individual accounts
72D	IAS individual accounts
72E	Duty to prepare group accounts
72F	Building Societies Act group accounts
72G	Form and content of Building Societies Act group accounts
72H	IAS group accounts
72I	Consistency of accounts

72J	Disclosures relating to directors, other officers and employees of societies required in notes to the accounts
72K	Disclosures about related party undertakings required in the notes to the accounts
72L	Disclosures relating to off-balance sheet arrangements required in notes to accounts
72M	Disclosure of auditor remuneration required in notes to accounts
74	Duty of directors to prepare an annual business statement
75	Directors' report
75A	Business review
76	Summary financial statements for members and depositors
77	Auditors: appointment, tenure, qualifications etc.
78	Auditors' report
78A	Signature of auditors' report
78B	Senior statutory auditor
78C	Names to be stated in copies of auditor's report filed or published
78D	Circumstances in which names may be omitted
79	Auditors' duties and powers
80	Signing of balance sheet – documents to be annexed
81	Laying and furnishing accounts, etc., to members, the FCA and the PRA
81A	Requirements in connection with publication of accounts
81B	Interpretation of Part 8
119	Interpretation
Sch 10A	Disclosures about directors, other officers and employees required in notes to the accounts
Sch 10B	Disclosures about related undertakings required in notes to accounts
Sch 10C	Disclosures about auditor remuneration required in notes to accounts

SI:

1998/504	BS (Accounts and Related Provisions) Regulations 1998 (as amended)
2001/2617	FSMA 2000 (Mutual Societies) Order 2001

APPENDIX 4

THE FCA HANDBOOK AND PRA RULEBOOK

1. The supervision of banks and building societies under the FSMA 2000 is divided between the FCA, PRA and Bank of England. Their roles are codified in a memorandum of understanding between the parties. The FCA Handbook and PRA Rulebook (the "Rulebooks") set out the rules and guidance issued by these regulators.

2. Not all authorised firms are required to comply with all rules contained within the Rulebooks. This varies with the type of permission – the regulated activity an authorised firm is permitted to undertake is set out in the authorised firms Scope of Permission. The following can be viewed on the relevant regulator website:

   - FCA Handbook – a introduction to the Handbook (https://www.fca.org.uk/publication/handbook/readers-guide.pdf) and full Handbook (https://www.handbook.fca.org.uk);
   - PRA Rulebook – overview and frequently asked questions (http://www.prarulebook.co.uk/home/Help) and full Rulebook (https://www.handbook.fca.org.uk);
   - Financial Services register which lists the regulated activities that each authorised firm has permission to undertake (https://register.fca.org.uk/).

3. In gaining an understanding of these Rulebooks the auditor bears in mind the statutory objectives of the supervision of banks and building societies under the FSMA 2000 and the Banking Act 2009, set out in paragraph 19 of the section of this PN that summarises the legislative and regulatory framework.

The FCA Handbook

4. To facilitate usage the FCA Handbook has been structured into a number of blocks and within each block the material has been subdivided into Sourcebooks, Manuals or Guides. The FCA also has rules relevant to auditors set out in the section on Regulatory Process - Supervision.

5. There are Rules, evidential provisions[55] and guidance which are contained within all of the blocks[56]. Contravention of Rules (which includes Principles for Businesses) or evidential provisions can give rise to an obligation on the auditor to report the matter direct to the FCA – see the section of this Practice Note relating to ISA (UK) 250 Section

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[55] An evidential provision is not binding in its own right, but will 'tend to show' compliance or non-compliance (as the case may be). It is therefore indicative, and establishes a rebuttable presumption of compliance or non-compliance with a rule. Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, or to recommend a particular course of action or arrangement.

[56] Rules are set out in emboldened type and are marked with the icon 'R', evidential provisions are marked 'E' and guidance 'G'. Further guidance on the status of the Handbook text is set out in the General Provisions (GEN) Sourcebook Chapter 2.2 and Chapter 6 of the Reader' Guide.

B. Details of the high level standards, which are the overarching requirements for all authorised person (firms) and approved persons, are outlined below.

Principles for Businesses

3. The eleven Principles for Businesses, which are general statements that set out the fundamental obligations of firms under the regulatory system, are set out in the FCA Handbook. They derive their authority from the FCA's rule-making powers as set out in FSMA 2000 and reflect the regulatory objectives. These Principles are as follows:

- an authorised firm must conduct its business with integrity;
- an authorised firm must conduct its business with due skill, care and diligence;
- an authorised firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management;
- an authorised firm must maintain adequate financial resources;
- an authorised firm must observe proper standards of market conduct;
- an authorised firm must pay due regard to the interests of its customers and treat them fairly;
- an authorised firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading;
- an authorised firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client;
- an authorised firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgment;
- an authorised firm must arrange adequate protection for clients' assets when it is responsible for them; and
- n authorised firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the authorised firm of which the FCA would reasonably expect notice.

Senior management arrangements, systems and controls

6. SYSC amplifies Principles for Businesses 3, the requirement for a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The relevant chapters[57]are as follows:

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57 Chapters 13-17 apply only to insurers.

- 2 – senior management arrangements
- 3 – systems and controls
- 4 – general organisational requirements
- 5 – employees, agents and other relevant persons
- 6 – compliance, internal audit and financial crime
- 7 – risk control
- 8 – outsourcing
- 9 – record keeping
- 10 – conflicts of interest (including recording telephone conversations and electronic communications)
- 11 – liquidity risk systems and controls
- 12 – group risk systems and control requirements
- 18 – whistleblowing
- 19 – remuneration code
- 20 – reverse stress testing
- 21 – risk control, additional guidance[58].

Additional rules relating to systems and controls are also set out in the PRA Rulebook.

The PRA Rulebook

7. The Rulebook applies to all PRA-authorised persons and contains the applicable prudential requirements for PRA-regulated firms. The Rulebook has specific sections depending on the type of business being undertaken by the authorised firms.

8. The PRA also has rules relevant to auditors set out in the Auditors section of the PRA Rulebook.

9. Like the FCA's Principles for Businesses, the PRA set out eight Fundamental Rules in the Rulebook. These are general statements that set out the fundamental obligations of firms under the regulatory system. They derive their authority from the PRA's rule-making powers as set out in FSMA 2000 and reflect the regulatory objectives. These Rules are as follows:

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58 Effective 1 May 2011.

- an authorised firm must conduct its business with integrity;
- an authorised firm must conduct its business with due skill, care and diligence;
- an authorised firm must act in a prudent manner;
- an authorised firm must at all times maintain adequate financial resources;
- an authorised firm must have effective risk strategies and risk management systems;
- an authorised firm must organise and control its affairs responsibly and effectively;
- an authorised firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice; and
- an authorised firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

Threshold Conditions

10. Under s41 and Schedule 6 of FSMA 2000 Threshold Conditions are the minimum requirements that must be met at authorisation and must continue to be met.

11. The PRA's statutory Threshold Conditions for banks are:

    - Legal status – the regulated activities must be bodies corporate or partnerships.
    - Location of offices – A UK incorporated corporate body must maintain its head offices and, if one exists, its registered office in the United Kingdom.
    - Prudent conduct of business – the authorised firm must conduct its business in a prudent matter, which includes having appropriate financial and non-financial resources.
    - Suitability – the authorised firm and its management must satisfy the PRA that they are 'fit and proper' with regard to all circumstances to conduct a regulated activity.
    - Effective supervision – the authorised firm must be capable of being effectively supervised by the PRA.

12. The FCA's Threshold Conditions are:

    - Effective supervision – the authorised firm must be capable of being effectively supervised by the FCA.
    - Appropriate non-financial resources – the authorised firm non-financial resources must be appropriate in relation to the regulated activities it seeks to carry on, having regard to the FCA's operational objectives.

- Suitability – the authorised firm must be a fit and proper person. Its management have adequate skills and experience and act with integrity (fitness and propriety). The firm has appropriate policies and procedures in place and the firm appropriately manages conflicts of interest.

- Business model – the authorised firm's strategy for doing business is suitable for a person carrying on the regulated activities it undertakes or seeks to carry on and does not pose a risk to the FCA's objectives.

APPENDIX 5

POSSIBLE FACTORS THAT MAY INDICATE GOING CONCERN ISSUES

Capital adequacy and leverage ratios

- the entity is operating at or near the limit of its Total Capital Requirement (excluding CRD IV and PRA buffers)[59] or of its leverage ratio , either on a group or solo basis; and
- stress tests indicate that minimum ratios may not be maintained.
- redundancies, layoffs or failure to replace natural wastage of personnel.

Liquidity indicators

- unusually large maturity mismatch in the short term (say up to 3 months), either in total or across currencies;
- exceptional levels of medium-term funding due to mature in the near term;
- maturity mismatch ladders prepared on a basis which fail to recognise/use:
  - expected (as opposed to contractual) cash flows;
  - narrow gaps for near maturities;
  - anticipated defaults on loan repayments;
  - a cushion for market value of volatile investments; or
  - off balance sheet commitments;
- dependence on a few large depositors (which may or may not be connected parties);
- withdrawal of (or reduction in) lines of credit by wholesale counterparties;
- regularly overdrawn nostro accounts;

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59 Total Capital Requirement (TCR) is the minimum amount and quality of capital that the PRA requires firms to maintain at all times to meet the minimum capital requirements under CRR (Pillar 1) and the Pillar 2A requirement. This is supplemented by CRD IV buffers and where applicable a PRA buffer which firms may release in times of stress. Since these buffers are intended to be released by going concern firms when under stress, such a release does not in itself signify a going concern issue (although the underlying reason for the stress may or may not do so). The release of these buffers , however, indicates likely supervisory action including increased intensity of supervision. e Actions will vary according to the firms' progress in executing their recovery plan to restore their buffers and releases of themselves do not necessarily mean that firms will be required to cease trading,

- difficulty in meeting LCR and/or Pillar 2 liquidity requirements set on an individual basis by the PRA;
- very high rates of interest offered to depositors (to prevent outflow of funds, regardless of financial loss);
- special fixed term deposit rate offers which attracted significant funds inflows due to mature;
- stress tests that indicate that regulatory requirements may not be met;
- Indications that a bank's utilisation of its Bank of England's liquidity insurance facilities is becoming or could become beyond 'ordinary market assistance…...on its usual terms'[60]
- evidence of activation of the firm's recovery plan and/or liquidity contingency plan.

Operations/profitability indicators

- marked decline in new lending/dealing volumes during the year or subsequently;
- marked decline in new business margins;
- severe overcapacity in markets leading to low pricing as well as low volumes;
- significant increase in loan defaults or seizure of collateral (e.g. house repossessions);
- excessive exposures to troubled industry sectors;
- unusually aggressive dealing positions and/or regular breaches of dealing or lending limits; and
- redundancies, layoffs or failure to replace natural wastage of personnel.

Reputational and other indicators

- adverse publicity which could lead to loss of confidence or reputation, including fines or public censure by PRA, FCA or other regulators;
- lowering of ratings or issue of negative outlook notices by independent credit agencies;
- urgent attempts to remove assets from the balance sheet, apparently involving material loss of profits or at significant expense;

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[60] Guidance for directors is given in paragraph 45 and 46, FRC's Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting – September 2014.

- deferral of investment plans or capitalisation of expenditure;
- loss of customer data; and
- loss of payment system functionality.

APPENDIX 6

REPORTING DIRECT TO THE REGULATORS – STATUTORY RIGHT AND PROTECTION FOR DISCLOSURE UNDER GENERAL LAW

1 When the auditor concludes that a matter does not give rise to a statutory duty to report direct to the FCA, PRA or Bank of England, the auditor considers the right to report to them. The right to report is available to the auditor of a UK bank, building society and a non-EEA bank but not to the auditor of an EEA bank which has no top up permissions.

2 In cases of doubt, general law provides protection for disclosing certain matters to a proper authority in the public interest.

3 Audit firms are protected from the risk of liability from breach of confidence or defamation under general law even when carrying out work which is not clearly undertaken in the capacity of auditor provided that:

- in the case of breach of confidence:
  - (i) disclosure is made in the public interest; and
  - (ii) such disclosure is made to an appropriate body or person; and
  - (iii) there is no malice motivating the disclosure; and
- in the case of defamation:
  - (i) the information disclosed was obtained in a proper capacity; and
  - (ii) there is no malice motivating the disclosure.

4 The same protection is given even if there is only a reasonable suspicion that non-compliance with law or regulations has occurred. Provided that it can be demonstrated that an audit firm, in disclosing a matter in the public interest, has acted reasonably and in good faith, it would not be held by the court to be in breach of duty to the institution even if, an investigation or prosecution having occurred, it was found that there had been no breach of law or regulation.

5 When reporting to proper authorities in the public interest, it is important that, in order to retain the protection of qualified privilege, the auditor reports only to one who has a proper interest to receive the information.

6 'Public interest' is a concept which is not capable of general definition. Each situation must be considered individually. In general circumstances, matters to be taken into account when considering whether disclosure is justified in the public interest may include:

- the extent to which the suspected non-compliance with law or regulations is likely to affect members of the public;

- whether the directors (or equivalent) have rectified the matter or are taking, or are likely to take, effective corrective action;
- the extent to which non-disclosure is likely to enable the suspected non-compliance with law or regulations to recur with impunity;
- the gravity of the matter;
- whether there is a general management ethos within the entity of disregarding law or regulations; and
- the weight of evidence and the degree of the auditor's suspicion that there has been an instance of non-compliance with law or regulations.

7 Determination of where the balance of public interest lies requires careful consideration. The auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest of disclosure to a proper authority and to use their professional judgment to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.

8 In cases where it is uncertain whether the statutory duty requires or s342 or s343 FSMA 2000 permits an auditor to communicate a matter to the FCA, PRA or Bank of England, it is possible that the auditor may be able to rely on the defence of disclosure in the public interest if it communicates a matter which could properly be regarded as having material significance in conformity with the guidance in ISA (UK) 250 Section B and this Practice Note, although the auditor may wish to seek legal advice in such circumstances.

APPENDIX 7

THE AUDITORS' RIGHT AND DUTY TO REPORT TO THE REGULATORS – EXAMPLES OF REPORTABLE ITEMS

1. This Appendix gives some examples of areas identified where particularly close consideration should be given as to whether the duty to report arises (in other words, where a breach of requirements may tend to be more serious). But it is not intended to be comprehensive, and cannot be relied on as a checklist.

2. Although there are a large number of 'relevant requirements' or matters of concern potentially giving rise to a statutory duty to report, these will normally fall within a number of general themes:

   - controllers, directors and senior managers who may not be 'fit and proper';
   - serious breaches of law/regulations;
   - potential disciplinary action against the firm or directors;
   - undertaking activities outside the scope of their permission;
   - failure to comply with limitations or restrictions on permission or individual requirements;
   - false or misleading information given to the relevant regulator or matters concealed;
   - problems with another 'regulator' e.g. Office of Fair Trading (i.e. regards the Consumer Credit Act) or overseas regulators;
   - breaches of prudential limits and/or any financial limits;
   - significant actual or potential loss by clients e.g. loss of customer assets or breach of client money rules; where there appear to be conflicts of interest; where there appears to be systemic abuse of advice or discretionary decisions; or as identified by complaints or by cases where a customer sues under s150 FSMA;
   - failure to clearly allocate responsibilities between senior managers or to implement clear reporting lines;
   - major systems and control deficiencies (including major reconciliation failures and backlogs);
   - failure to file financial statements or CASS reports by the required deadlines; and
   - possible 'going-concern' issues.

3. The above general themes are intended as a guide – any report would need to be made against a specific relevant requirement (see paragraph 70). If an issue has been identified relating to one of the themes (which might be materially significant to the FCA, PRA or Bank of England and is in a situation where the auditor is under a duty to report), the auditor should identify the relevant requirement. Even if a specific relevant requirement cannot be established, the auditor should consider whether or not the right to report is appropriate.

APPENDIX 8

AUDITING ECL – EXAMPLE APPROACH FOR FORWARD-LOOKING INFORMATION

1. Expected credit losses (ECL) are measured in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. This will involve using forward-looking information, which will require management to make a number of different assumptions about the nature and probability of future events. Forward-looking information features in the nature and probability of future economic scenarios, projected cash flows of the financial instruments being assessed for ECL, default probabilities, loss rates and recovery strategies, and amounts owed to the bank or building society.

2. Set out below are elements of an approach for evaluating the forward-looking information considering the requirements of ISA (UK) 540. This does not describe all the detailed procedures that may be appropriate in an audit of an ECL estimate. Engagement teams for audits of banks and building societies often need specialised skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. The auditor may need to use an auditor's expert.

Risk assessment procedures and related activities

3. The auditor obtains an understanding of how forward-looking information is used by management in making the ECL estimate and identifies and assesses risks of material misstatement. Procedures may include obtaining an understanding of:

   - The ECL methodology, including the data used, management's assumptions and estimation methods; how it incorporates forward-looking information and evaluating whether this is in accordance with the relevant requirements of the applicable financial reporting framework (e.g. IFRS 9). This includes considerations related to how forward-looking information impacts identification of a significant increase in credit risk (SICR) under IFRS 9. Different methodologies may be used for incorporating forward-looking information into the ECL measurement, including those based on selection of discrete scenarios and Monte Carlo modelling.

   - The different forward-looking scenarios. Where an approach based on discrete scenarios was used, this includes an understanding of how they have been selected, the probability weightings given to them, and whether they are consistent with other forecasts used by the entity and market consensus.

   - The nature of the forward-looking information used and evaluating whether it is relevant for the exposures being audited (e.g. are the appropriate macro-economic data points being used). Forward-looking information relevant to one portfolio may not be appropriate for another – for example national unemployment rates may not be relevant if a portfolio is concentrated in an area that has, or is expected to have, unemployment rates higher than the national average. Or, an entity may not have considered variables that are relevant to the characteristics of a particular portfolio.

- The components in the forward-looking information that contribute to estimation uncertainty. Flexing or considering alternative components may provide an understanding of the key drivers of the estimation range and how the range is sensitive to the different components.

- The sources of the forward-looking information, including whether it is from internal or external sources and whether it is consistent with other forecasts used by the entity (for example with management's assessment of significant credit risk; or with forecasts used for management's strategic planning).

- The controls around the entity's use of the forward-looking information, including how it assesses whether it is appropriate and how it is used in the generation of the ECL estimates.

The auditor may undertake sensitivity analysis to evaluate whether using alternative forward-looking information, including alternative probability weightings for discrete scenarios, would lead to a materially different ECL.

Identifying and assessing the risks of material misstatement

4. The auditor separately assesses inherent risk and control risk and determines whether any of the risks of material misstatement identified are, in the auditor's judgment, a significant risk.

5. Forward-looking information by its nature is often highly subjective and complex and requires the exercise of judgment. For example, judgment is necessary in selecting the range of economic variables to be considered, the complex relationships that can exist between the variables and whether relationships that existed in the past will hold in the future. There is typically a significant degree of uncertainty in any output. The complexity of the analysis is increased by the need for the ECL calculation to be a probability weighted outcome of different economic scenarios. IFRS 9 does not state how this can be achieved and so assumptions and judgments need to be made about the number of scenarios to consider and how to assign probability weighting to each of them. These factors may lead to the conclusion that forward-looking information leads to a high inherent risk.

6. The selection of the economic forecast and the means by which that gets incorporated into the ECL calculation affects the measurement of ECL and the valuation of the relevant exposures. For example, the nature of the economic forecast will typically affect the future probability of default of a loan, what recovery options may be realistically available to management, and the amount recovered, all of which are key components in measuring ECL. Default probabilities and recovery options are also forward-looking information. The auditor considers the overall coherence of the different forward-looking information used by management.

7. As part of the assessment of inherent risk, the auditor determines the potential sources of misstatement at the financial statement and assertion level. For example, when forecasting an economic scenario, are management's assumptions appropriate; are

data sets used to build the models complete and accurate? This could affect the accuracy or valuation assertions in relation to ECL. The auditor is alert to the potential for bias, including unconscious bias within the assumptions and models. For example, forward-looking information is often based on past-experience. The auditor considers whether management has sufficiently addressed the risk that past-experience may not predict the future (e.g. when modelling PDs, LGDs, correlations between economic parameters change, or designing downside scenarios) and how data sets have been adjusted for such factors while also taking into consideration factors that are envisaged to impact the ECL estimated but not present in the data set.

8. The auditor also evaluates whether any additional PMAs or management overlays may need to be recognised in respect of idiosyncratic events impacting the economic environment, which have not been fully reflected in the macroeconomic forecasts used by management and therefore not accounted for in the ECL models.

9. The subjective nature of forward-looking information and the potential for a wide range of reasonable outcomes when calculating ECL increase the risk the entity's disclosures are not reasonable in the context of the applicable financial reporting framework and are misstated. For example, the disclosures might not sufficiently explain the inputs, assumptions and estimation techniques used, or provide sufficient information to enable users to understand the effect of credit risk on the amount timing and uncertainty of future cash flows. The auditor also considers whether there are indicators of management bias in the disclosures, for example in relation to what is presented or not presented, or the prominence that is given to different matters. As part of the overall evaluation based on audit procedures performed, the auditor evaluates whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole.

Responses to the assessed risks of material misstatement

10. Where the auditor has identified a risk of material misstatement of the ECL estimate the auditor determines the appropriate audit procedures to address the risk, taking into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. The inherent risk associated with forward-looking information, and the risk of possible management bias, will often be high. The auditor is required to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

11. If the auditor intends to rely on controls relating to the accounting estimate or if substantive procedures alone cannot provide sufficient appropriate evidence at the assertion level, the auditor is required to design and perform tests of controls to obtain sufficient appropriate evidence as to their operating effectiveness.

12. As part of the evaluation of controls related to the ECL estimation, the auditor considers the reviews by management and those charged with governance of the forward-looking information and ECL estimation outcomes.

13. The auditor may consider involvement of auditor's experts or specialists in responding to the identified risks of material misstatement related to forward-looking information. This may include IT or data analytics specialists or credit risk modelling experts.

14. Substantive procedures that the auditor may perform to respond to an identified risk of material misstatement related to the use of forward-looking information include:

- Procedures to evaluate the relevance and reliability of the information, including when it comes from an external information source. These may include evaluating the rigour and robustness of the procedures and controls that management has implemented to ensure the completeness, accuracy and existence of the information. For example, whether there is a review by a function independent from the preparer and validation of the design and implementation of economic forecasting methods; whether there is back-testing of PD and LGD models to assess the reasonableness of their predictive power; whether there are reconciliations to ensure the complete and accurate transfer of data between different systems;

- Evaluating and challenging management's technical and judgmental assumptions used in macroeconomic forecasting models. For example, the auditor may evaluate the relevance and completeness of the variables that describe an economic scenario, the relationships between the variables, and the probabilities assigned to the scenarios. The auditor may also evaluate whether management's economic forecasts have captured key drivers of credit risk for the entity's exposures. The auditor may need to use an auditor's expert for these evaluations.

- Evaluating the base case forecast used by management against publicly available forecasts developed by third parties and against other forecasts used by the entity. This could involve, for example, understanding, quantifying and challenging differences between other forecasts and the entity's base case forecasts.

- Evaluating whether the base case is relevant to the entity's portfolios, as the base case is often the primary driver of the overall ECL estimate. Some entities may use third party economic consultants to produce economic forecasts. In these cases, there is a possible heightened risk that the third party produces a forecast that does not reflect the individual entity's portfolios. Where forecasts have been developed by the entity, the auditor is alert to the potential for bias and may wish to seek external evidence, for example by using the auditor's own experts to assess and challenge management's forecasts and their components, and/or by looking at the forecasts of others in the market.

- Evaluating prior period base case forecasts against actual results to consider the accuracy of management's forecasts. As there is a high degree of uncertainty associated with macroeconomic forecasting, a deviation would not necessarily be indicative on an error; however, forecasts that are consistently period on period overly conservative or overly optimistic may be indicators of possible management bias. Consideration is also be given to whether historic trends and relationships remain relevant if they are being used to justify relationships.

- Evaluating how management has taken into account the alternative possibilities of future macroeconomic conditions (such as by developing alternative upside and downside scenarios) and whether the approach is unbiased. The auditor considers whether the alternative scenarios appropriately capture the non-linearity of the relationship between the macroeconomic parameters and ECL; whether the severity of downside scenarios are sufficient to capture downside risks and that the weighted probabilities assigned to different scenarios appropriately reflect the distribution of potential outcomes (assuming the entity selects a number of discrete scenarios, rather than adopting a Monte Carlo or other approach that seeks to simulate a wide range of outcomes around the base case).

- Evaluating how management has assessed the viability and coherence of proposed recovery options under different economic scenarios. Depending upon economic conditions different recovery options may be pursued. For example, the value of security and the ability to realise it will change under different scenarios. The established credit risk policies of the entity and past practice are likely to provide some evidence of the potential future outcomes, but the auditor may also need to consider the potential response of the broader market to changing economic conditions and, notwithstanding an entity's intention, whether market conditions may preclude management's preferred actions. For example, in a particular scenario, it may be forecast that there would be a surplus of commercial real estate and so the strategies of sale of collateral at current prices or of possession and rentals at current rates may not be viable.

- Evaluating whether the findings from the audit of the forward-looking information is consistent with other information that the auditor has received during the course of the audit, and with the auditor's knowledge and understanding of the business more generally.

APPENDIX 9

DEFINITIONS

Abbreviations and frequently used terms in this Practice Note are set out below.

Authorised firm	An entity which has been granted one or more Part 4A permissions by the PRA or FCA and so is authorised under FSMA 2000 to undertake regulated activities – an authorised person. For banks and building societies it is the PRA that grants such permissions.
Authorised person	Term used throughout FSMA 2000 and related statutory instruments to refer to an authorised firm – see above
Authorised by PRA or FCA	Same as authorised firm or authorised person – see above
BBA SORP	Statements of Recommended Practice issued by the British Bankers Association and the Irish Bankers’ Federation
Bank	An 'authorised firm' with a Part 4A permission to carry on the regulated activity of accepting deposits and is a 'credit institution', but is not a credit union, friendly society or a building society; .
Banking company	Companies Act 2006 definition s1164
BIPRU	Prudential sourcebook, in the FCA Handbook, for banks, building societies and investment firms
BS Act 1986	Building Societies Act 1986
BS Accounts Regulations 1998	Building Societies (Accounts and Related Provisions) Regulations 1998
Building society	A society incorporated under the BS Act 1986
CA2006	Companies Act 2006
Closely linked entity	As defined in s343(8) FSMA 2000, an entity has close links with an authorised firm for this purpose if the entity is a: (a) Parent undertaking of the authorised firm; (b) Subsidiary undertaking of the authorised firm; (c) Parent undertaking of a subsidiary undertaking of the authorised firm; or (d) Subsidiary undertaking of a parent undertaking of the authorised firm
Companies and Groups Accounts Regulations 2008	Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)
COND	Threshold Conditions element of the high-level standards block of the FCA Handbook

CRD IV	Capital Requirements Directive IV – This is made up of the Capital Requirements Directive (CRD) (2013/36/EU) and the Capital Requirements Regulation (CRR)
CRR	The Capital Requirements Regulation (Regulation (EU) No 575/2013). Applies directly to firms across the EU
Credit institution	An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account
Deposit taker	Banks and building societies – authorised firms which under FSMA 2000 have a Part 4A permission to accept deposits
EEA	European Economic Area
EEA Bank	A UK branch of a credit institution incorporated in the EEA which has exercised EEA Passport rights to carry on regulated activities in the UK
EEA Passport rights	Exercising passport rights, an entity incorporated in one EEA member state ('home country') which is authorised to conduct one or more regulated activities subject to the passport rights in the home country to establish a branch and carry out those regulated activities in another EEA member state ('host country') without the need to be authorised by the host country supervisor in respect of activities that are subject to the passport rights
EIR	Effective interest rate
EU IFRS	International Financial Reporting Standards adopted by the European Union
FRS	Financial Reporting Statements
FCA	Financial Conduct Authority
FSMA 2000	Financial Services and Markets Act 2000
JMLSG	Joint Money Laundering Steering Group
MiFID	Markets in Financial Instruments Directive
MiFID II	Made up of MiFID (2014/65/EU) and the Markets in Financial Instruments Regulation (MiFIR – 600/2014/EU)
Material significance	A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator
NCA	National Crime Agency
Non EEA Bank	a UK branch of an entity incorporated outside the EEA, authorised by the PRA to operate as a bank. . Authorisation can be granted only where both the FCA and the PRA are satisfied that their respective requirements have been met.
Part 4A permission	A permission granted by PRA or FCA under Part 4A FSMA 2000 permitting an authorised firm to carry on regulated

	activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended
Permission	Part 4A permission under FSMA 2000 to undertake one or more regulated activities
PRA	Prudential Regulation Authority
Principles for Businesses	FCA Handbook defined principles with which an authorised firm must comply. The 11 principles are included in a stand-alone element of the high-level standards block of the FCA Handbook – PRIN
Regulated activities	Activities as defined in the Regulated Activities Order SI 2001/544 as amended
Relevant requirement	In relation to the auditors' duty to report direct to the FCA, PRA or BoE – requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FCA's rules (other than the Listing Rules) including the Principles for Businesses, and the PRA's rules. The duty to report also covers any requirement imposed by or under any other Act the contravention of which constitutes an offence which the FCA, PRA or BoE has the power to prosecute under FSMA 2000
SICR	Significant increase in credit risk
SUP	Supervision manual of the FCA Handbook
SYSC	Senior management arrangements, systems and controls element of the high-level standards block of the FCA Handbook
The 2001 Regulations	SI 2001/2587 – FSMA 2000 (Communications by Auditors) Regulations 2001, as amended
Those charged with governance	ISAs (UK) use the term 'those charged with governance' to describe the persons entrusted with the supervision, control and direction of an entity, who will normally be responsible for the quality of financial reporting, and the term 'management' to describe those persons who perform senior managerial functions. The term 'governing body' is used in the FRC Handbook and PRA Rulebook to describe collectively those charged with governance. In the context of this Practice Note, references to those charged with governance include directors of banks and building societies.
Threshold Conditions	Conditions set out in or specified under Schedule 6 of FSMA 2000. They are the minimum standards that an authorised firm needs to meet to become and remain authorised by the FCA or PRA. Five conditions are included in a stand-alone element of the high-level standards block of the FCA Handbook – COND.
Top up permission	A Part 4A permission granted by the FCA or PRA to an EEA bank to enable it to undertake a UK regulated activity in the

	UK for which authorisation to undertake the activity in the home country is not required by the home country supervisor.
UK bank	A company incorporated in the UK which is authorised by the PRA to operate as a bank. Authorisation can be granted only where both the FCA and the PRA are satisfied that their respective requirements have been met.

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