Financial Reporting Council

January 2017

Feedback Statement and Impact Assessment

- The Revision of Practice Note 20: The Audit of Insurers in the United Kingdom
- The Withdrawal of Practice Note 24 (Revised): The Audit of Friendly Societies in the United Kingdom

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. 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.

Introduction

The FRC is committed to acting as a proportionate and principles-based regulator, and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit.

We proposed the:

- Revision of Practice Note 20 to reflect revisions to the ISAs (UK), legislative and regulatory changes since this Practice Note was last revised in 2011;
- Integration of updated guidance on the audit of Friendly Societies within Practice Note 20 as part of our revision; and
- Consequent withdrawal of Practice Note 24.

A significant driver for part of this work was in response to the Prudential Regulation Authority's (PRA) requirement for mandatory external audit of elements of Solvency II public reporting in the insurance sector. Our proposed revisions to Practice Note 20 were drafted in consultation with an expert working group led by FRC staff and including non-executive members of the FRC, audit practitioners, the PRA as regulator, a preparer and professional and trade bodies.

We launched an 8 week public consultation which closed on 16 December 2016. In addition we conducted targeted additional outreach, speaking to investors in particular, to identify the issues in which they had the greatest interest, and also to understand how audited regulatory returns which will be audited in accordance with this Practice Note, will be used.

Responses to the Consultation

We received 9 written responses from a range of stakeholders comprising audit firms, professional bodies, investors and trade and representative bodies. In line with the FRC's commitment to transparency, these were published on our website unless the respondent requested that their correspondence remained private:

Respondent	**Type**
Association of British Insurers	Trade Body
Association of Financial Mutuals (AFM)	Trade Body
Chartered Accountants Ireland	Professional Body
Institute of Chartered Accountants in England and Wales	Professional Body
Ernst & Young LLP	Audit Firm

KPMG LLP	Audit Firm
Moore Stephens LLP	Audit Firm
PricewaterhouseCoopers LLP	Audit Firm
Investor [private response]	Investor
Website link https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Paper-and-Impact-Assessment-Proposal/Responses-to-consultation.aspx	

The majority of responses to the consultation focused on the material which relates to the audit of public reporting under Solvency II (Sections 6 and 7 of the revised Practice Note), and consequently this is the area where there have been the greatest number of revisions to the text of the exposure draft. These editorial changes do not, however, materially change the substance of the guidance, and in particular the application of ISAs (UK) 800 and 805 to these engagements. They do however provide greater clarity in some specific areas, including the text of the illustrative auditor's reports.

Responses to the questions posed in the consultations were:

1. **Overall do you agree with the revisions to the Practice Note, if not why not?**

   8 of the 9 responses to our consultation agreed with the proposed revisions to Practice Note 20, and stated that it was appropriate to update this guidance in the light of wider developments. We therefore concluded that our approach and detailed revisions to the guidance have met stakeholder needs, and that the exposure draft does not need substantial further revision.

   However, a majority of respondents (7 out of 9) identified areas where they felt the exposure draft could be further enhanced – particularly in respect of the guidance covering the audit of Solvency II public disclosures, and the form of the auditor's reports for those engagements, which we have incorporated into the final version. Our responses to the detailed points on those aspects of the feedback we received are detailed below.

2. **Do you agree with the proposed revisions to section 4 on the Audit of Financial Statements, including:**

   a. **The removal of 'copy out' text from the ISAs (UK)?**
   b. **The extent of insurance sector specific guidance which has been provided?**

   6 of the 9 responses to our consultation answered this question, of whom:

   - 4 agreed with the revisions proposed and material provided;

- 2 agreed with the revisions overall, but made specific editorial comments.

In respect of the detailed comments we have made minor editorial changes to improve cross-referencing within the Practice Note, and to the requirements within the ISAs (ISA 720 (UK) for example). We have also clarified and made more explicit the need for clear documentation of audit evidence both for the audit of the statutory financial statements and the Solvency and Financial Condition Report (SFCR). Some of the comments received related to the extent of the guidance provided on the audit of financial instruments, which we believe are already adequately addressed within Practice Note 23: *Special Considerations in auditing financial instruments*.

3. Does the new material in section 6, which covers the audit of Solvency II Pillar 3 disclosures (SFCRs), provide sufficient guidance on the application of ISAs (UK) 800 and 805 to these engagements?

8 of the 9 written responses included a response to this question. Key matters raised are set out in the following bullet points, with the **FRC response in bold text**:

- That the Practice Note should include more specific information about disclosures which are out of scope of the audit requirement, including specific cell exclusions.

  We agree with these observations and have amended the guidance to include an appendix to the auditor's report which describes these exclusions in greater detail.

- That the FRC include within Practice Note 20 a form of words for the management statement of responsibility required by the PRA's Rules. Respondents also requested more guidance on how the auditor should fulfil the separate financial reporting responsibilities set by the PRA: for a 'properly compiled' statement in respect of sectoral information; and a consistency statement between the other information and knowledge gained in the course of the statutory audit.

  We have not made any amendments to the Practice Note in response to these observations. In both cases the FRC does not consider that it would be appropriate to interpret the requirements of another regulator (the PRA), as established in the Rules for Solvency II firms.

- That the Practice Note should include more 'practical examples' of how to set materiality for these engagements, with particular reference to the Solvency Capital Requirement and the potential complications relating to scope exclusions. Respondents also requested that the FRC include explicit guidance on how to apply ISAs (UK) when setting materiality levels for a single group SFCR which also discloses information at component level.

  We believe that the existing text of the guidance goes as far as possible in setting out some of the practical issues and considerations which may be relevant to auditors when applying the concept of materiality (and the requirements of ISAs (UK)) to the audits of SFCRs. To provide further material would contradict the FRC's strong commitment to set principles based standards and guidance, and we believe that sufficient material is already provided to support the application of professional judgment by the auditor.

- That the Practice Note risks misrepresenting the PRAs intentions by making reference to the inclusion within the management statement of responsibilities to a wider statement of compliance with regulation.

  We disagree with this observation, and have confirmed with the PRA that the revised Practice Note is consistent with their intentions. We have included a minor clarification in the text in respect of the position for group entities.

4. Do you agree with the content and structure of the illustrative reports for SFCR audits which are set out in section 7?

7 of the 9 respondents raised issues about the proposed form and content of the illustrative reports. These focused on, but were not limited to:

- The description of scope exceptions for partial and full internal model firms, and particularly whether more detail could be added on specific cell exclusions in an appendix to the reports;
- Whether there was sufficient information about the financial reporting framework itself, including a fuller description of the legal and regulatory requirements;
- Whether additional information should be provided in respect of the financial reporting framework, and specifically relating to supervisory waivers, determinations and modifications;
- References to capital add-ons when required by the PRA; and
- Whether there should be a reference to the going concern basis of accounting.

As part of our outreach activity we spoke to a number of potential users of these auditor's reports who told us they found the proposed form and content too detailed, technical and complex – even without the additional material described above.

We have therefore revised the report, with a view to balancing the needs of different stakeholder groups. We have:

- Simplified the description of "other information" which is outside the scope of the audit;
- Developed a separate appendix setting out the specific cells within the reporting templates which are affected by scope limitations;
- Provided guidance in the Practice Note which identifies those areas where the auditor should consider the quality of disclosures in the SFCR which relate to the basis of accounting and financial reporting framework; and
- Included text which explains how scope limitations impact on the auditor's work on PRA approved internal Models.

5. The illustrative auditor's reports in section 7 contain a mandatory Emphasis of Matter paragraph which describes the special purpose financial reporting framework, in accordance with ISA (UK) 800. Do you:

   a. Agree with the content of the EoM?
   b. Believe there is need for additional disclosure – for example in respect of the non-disclosure of the existence of PRA imposed capital add-ons in accordance with the Solvency II member state option?

7 of the 9 responses to our consultation responded to these questions, of whom:

- 1 proposed greater clarity in the guidance about circumstances in which the description by insurers of the bases, methods and main assumptions used for material classes of assets, technical provisions and other liabilities, would lead to the need to report; and
- None considered that there was any need for additional disclosure, particularly in respect of capital add-ons.

We consider that the current Emphasis of Matter is appropriate and that no further 'pro-forma' illustrative wording is required. In respect of capital add-ons, the inclusion of standard proforma wording might have the effect of undermining the UK member state option (to allow a capital add on within the first two years of the Solvency II regime without needing to disclose it), whilst adding little valuable information to the users of the reports. We also believe that the current guidance in respect of the description of the bases, methods and main assumptions used is sufficient to support high quality audit, as this is a critical area of professional judgement by auditors in the context of each engagement and audit client.

6. Do you agree with the revisions to sections 8 and 9 on the audit of regulatory returns for non-directive firms, including the illustrative reports?

4 respondents provided comments in response to this question of whom:

- 2 agreed with the material provided, but proposed with minor amendments on points of detail; and
- 2 agreed with the material but made more substantive comments on the form of the report and proposed a clarification on a specific PRA scope exclusion.

The revised material now includes minor editorial amendments to reflect these comments.

7. Does the revised PN 20 contain sufficient guidance and contextual material in respect of the audit of friendly societies? If not, are there specific areas where this could be enhanced or improved?

6 respondents to our consultation provided responses to this question, of whom:

- 2 agreed with the material provided;
- 3 proposed the addition of an illustrative auditor's report for friendly societies; and
- 2 proposed more detailed but relatively minor observations on the text.

Illustrative auditor's reports were originally included within Practice Notes, but moved into a separate compendium to ensure that periodic updates to reporting requirements could be applied without the need to also revise unrelated guidance. We therefore believe that it would be a retrograde step to include further illustrative reports in Practice Note 20.

Further comments were addressed through minor editorial changes to the text of the Practice Note.

8. Do you agree with the FRC's proposal to withdraw Practice Note 24: The Audit of Friendly Societies in the United Kingdom, having incorporated relevant material into PN20? If not, why not?

5 of the 9 responses to our consultation answered this question, and agreed with our proposal to withdraw Practice Note 24.

We will therefore withdraw Practice Note 24, effective from the date of publication of the revised Practice Note 20.

Other Comments

Additional comments consisted of observations on minor points of fact, including a number relating to Lloyd's and confirming the status to Lloyd's syndicates, all of which have been addressed through minor editorial amendments.

Revisions to the Practice Note

The following revisions have been applied to the exposure draft of Practice Note 20 following the public consultation exercise.

Section 3 Legislative and Regulatory Framework	Minor editorial changes to correct matters of fact in respect of Friendly Societies, including the status of Industrial and Provident Societies.
Section 4 Audit of Financial Statements	Minor editorial changes to improve cross-referencing within the PN, and also to ISA (UK) 720. Greater clarity provided to confirm that the audit of the SFCR and statutory financial statements are separate engagements, with potential consequences for audit documentation in each case. Minor editorial changes to reflect the circumstances of Friendly Societies, including those complying voluntarily with the UK Corporate Governance Code or Annotated version thereof published by the Association of Financial Mutuals.
Section 6 Regulatory Reporting: Solvency II Directive Firms	Guidance on the early adoption of ISAs (UK) 800 and 805 added. Footnote added referencing to the source of the PRA's external audit requirement. Additional material included within the text of the guidance relating to: • Supervisory approvals, modifications and determinations Clarification of the scope of the statement of management responsibilities for group entities.
Section 7 Regulatory Reporting: Solvency II ('directive') Firms: Illustrative Auditor's Reports	Clarified the description of "other information" which is outside the scope of the audit, and included a detailed appendix setting out specific cells within the reporting templates affected by scope limitations; Enhanced guidance in the Practice Note identifying those areas where the auditor considers the quality of disclosures in the SFCR relating to the basis of accounting and financial reporting framework. Included text which explains how scope limitations impact on the auditor's work on PRA approved internal Models. Added an appendix setting out details of scope exclusions.
Glossary of terms	Definition of Friendly Societies updated to better reflect current circumstances, and to include a small number of additional definitions.

Impact Assessment

We completed an impact assessment covering the costs and benefits relating to our proposals. We do not believe that the issuance of guidance on the application of auditing standards to the insurance sector will result in significant additional costs or add to the regulatory burden on business. The audit requirement over Solvency II public reporting and other regulatory reporting arises from PRA rules rather than any requirement under those standards. As the costs and benefits have already been the subject of a PRA impact assessment, carried out in support of its own consultation on proposed Rule changes, we do not consider that there are further measureable costs and benefits that arise as a result of any decisions taken by the FRC.

Adoption of this guidance will assist auditors in the application of auditing standards in a proportionate way to the audit of statutory financial statements, and regulatory reporting engagements, thereby supporting high quality audit.

Financial Reporting Council
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Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk