

Supervisory Statement | SS1/16

Written reports by external auditors to the PRA

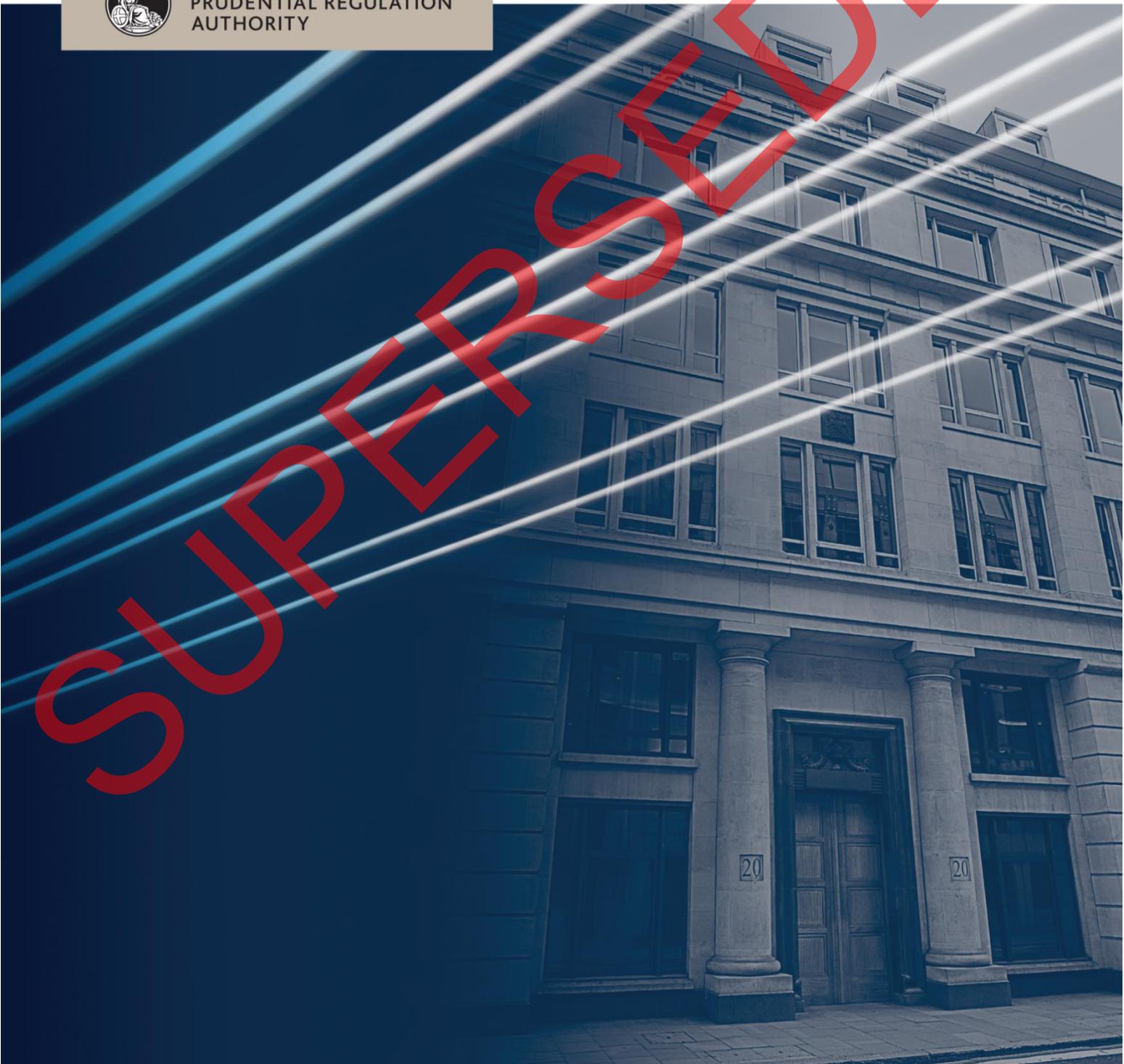
March 2019

(Updating January 2016)



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

SUPERSEDED





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1 Introduction

1.1 This supervisory statement sets out the Prudential Regulation Authority's (PRA) expectation of auditors in relation to the requirement to provide written reports to the PRA concerning the audit of major banks and building societies as laid out in Chapter 8 of the Auditors Part of the PRA Rulebook and should be read in conjunction with that chapter. This supervisory statement was updated following publication of PS 6/19 Responses to Chapters 3-7 of CP24/18 'Occasional Consultation Paper'. The updates take effect for audits related to periods ending on 31 December 2018 or later.

1.2 Auditors should refer to this statement both at the stage where the questions are discussed and agreed and when the report is being prepared and submitted. The regime will give auditors earlier and more consistent insights into regulatory concerns that may be relevant to their statutory audit in advance of their main audit work, and will encourage supervisors to focus on questions which are most relevant to what auditors do during the statutory audit that are also of interest to prudential supervisors. Overall, the purpose is to improve the quality, focus, and discipline of the auditor-supervisor dialogue, so as to identify and address emerging concerns more effectively and so support the PRA's statutory objectives regarding safety and soundness.

2 Logistical and timing issues

2.1 The questions the PRA expects auditors to answer in their reports each year are broadly the same across all the audited firms in scope for that year. The questions can vary from year to year, although some may be repeated. To the extent possible, the PRA will keep the overall expected burden represented by the questions stable from year to year, although in a year of major change, for example the implementation of a major new accounting standard such as International Financial Reporting Standard (IFRS) 9, the number or extensiveness of the questions is likely to rise on a temporary basis. The PRA expects to set questions that are within the scope of a normal high quality audit.

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

2.3 To facilitate effective planning for the reporting, the PRA will discuss with auditors the scope of the report, including the level of application of the requirement, and decide this by the end of the second quarter of each financial year. As to the level of application, the PRA expects auditors to take a pragmatic approach when fulfilling their obligations, by for example preparing a single report in those cases where more than one firm in a group is within the requirement's scope. The timetable for deciding the questions will be sent to the auditors each year in the first quarter and auditors should use their best endeavours to help the PRA reach a decision by the end of the second quarter under their general duty to co-operate with the PRA. When a decision on the scope of the report is reached, no further questions may be added before the report is due to be submitted; if the PRA wishes to raise any other questions with the auditors this will be done orally during the bilateral meeting and only an oral response will be expected.

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

listed entities matches the deadline for issuing the annual report under the FCA's Disclosure and Transparency Rules).¹

2.5 The auditors will nevertheless be expected to submit the report as soon as possible following the completion of their audit. Auditors may consult with the PRA, through the relevant supervisor, before submission of the report, in order to ensure the PRA's expectations about the content will be met and that the report fully covers the agreed scope. This can be at any stage during the audit with the aim of allowing timely clarification on any areas of uncertainty in what is being sought through particular questions. Meetings are arranged to discuss issues arising from the questions if necessary.

2.6 The physical format of the report is not mandated. All questions should be answered, if relevant, and to an appropriate standard (see further below). Reports should be clear, understandable by supervisors broadly on a stand-alone basis, and as concise as a full set of information allows.

3 Scope of questions and content of report

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

3.2 Auditors will use the audit work undertaken for the annual report and accounts to comply with the reporting requirements. The relevant annual report and accounts may be those produced by the ultimate parent company of a firm within scope of the policy ("group"), those of any individual firm within scope of the policy ("firm") and, where relevant, those of a ring-fenced holding company.

3.2A Typically, the PRA will be concerned with the group as a whole and will ask questions related to the group financial statements (or elements thereof). There may also be circumstances where the PRA wishes to ask questions about the audit of the financial statements of one or more firms within a group (eg a ring-fenced body) or of a ring-fenced holding company.² In such circumstances, the PRA might require reporting on the audit of transactions between that entity and other parts of the group, which would be eliminated on consolidation by the ultimate parent company. In some cases the transactions the PRA requires reporting on might be material in the context of the individual accounts but not in the context of the consolidated accounts, which is another reason why the reporting might need to relate specifically to the audit of a firm's own financial statements. Where the PRA asks questions relating to the audit of particular financial statements within a group, the PRA will make this clear to external auditors.

3.2B Potentially there will be overarching questions about the adequacy of application of key accounting policies or controls and the auditors' assessment of areas at risk of material misstatement. Other than these, all questions will be directed only at portfolios or, where

¹ www.handbook.fca.org.uk/handbook/DTR.pdf.

² Supervisory statement 8/16 'Ring-fenced Bodies (RFBs)' states that ring-fenced bodies are expected to produce audited consolidated (where relevant) financial statements and submit these to the PRA where they would not otherwise be required by the Companies Act 2006. These financial statements may be prepared by a ring-fenced holding company or by a ring-fenced body.

appropriate, line items or account balances that in the auditor's judgement are materially relevant to the circumstances of that firm or group (as defined by auditing standards' reference to assessment of risk of material misstatement).

3.3 Some of the questions may nevertheless cause auditors to decide to undertake more work than originally envisaged in their audit planning. The initial dialogue with the PRA about the questions may lead auditors to reconsider their identification and assessment of risks of material misstatement and their planned responses to those risks. It is the choice of the auditors, however, if they decide to do more work than is necessary to respond to any such reconsideration of the risks of material misstatement in order to become comfortable about providing the report to the PRA.

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

3.5 The PRA will endeavour to respect the fact that some issues are likely to be immaterial in relation to some firms. While the PRA understands that the auditor's opinion is on the truth and fairness of the financial statements as a whole in the context of what is material, paragraph 10 of ISA (United Kingdom and Ireland) 320 Materiality in Planning and Performing an Audit,³ discusses the need to set materiality levels in relation to 'particular classes of transactions, account balances or disclosures' as well. Therefore there may be areas on which the PRA's questions are directed to materiality at this level, depending on the significance of the particular issues, including disclosures, to users of the accounts.

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

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

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

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

³ www.frc.org.uk/Our-Work/Publications/APB/ISA-320-Materiality-in-planning-and-performing-an.aspx.

auditor's judgement, require the performance of further audit procedures in relation to that item, in accordance with auditing standards, for that firm in that year and therefore the auditor expects to do little or no audit work on the item or items as part of their overall audit process beyond making that assessment.

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

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

4 Disclosure of the report

4.1 The PRA expects that the auditor may want to share the report with the audited firm, ultimate parent company or ring-fenced holding company, particularly the audit committee, and discuss its content during both the planning phase and at the final report stage.

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

5.1 Rule 7.11⁴ of the Auditor Part of the PRA Rulebook requires auditors to co-operate with the PRA in the discharge of its functions under any relevant legislation.

5.2 The annual written report by auditors does not negate the existing auditors' duty to notify certain matters to the PRA under Chapter 7 of the Auditors Part of the PRA Rulebook or the auditors' right and duty to report to the PRA under FSMA.⁵

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

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

6 Duties of auditors and firms

6.1 Auditors are expected to conduct the written audit reporting assignment to the same professional standard as that attached to the statutory audit.

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

⁴ Rule 7.1 was amended in Policy Statement 1/16 'Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries' published in January 2016 alongside this supervisory statement; see www.bankofengland.co.uk/pru/Pages/publications/ps/2016/ps116.aspx.

⁵ See section 342(3) FSMA and Statutory Instrument 2001 No. 2587, FSMA 2000 (Communications by Auditors) Regulations 2001. Written reports by external auditors to the PRA January 2016 7

Annex – SS1/16 updates

This annex details changes made to SS1/16 following its initial publication in January 2016 following Policy Statement (PS) 1/16 ‘Engagement between external auditors and supervisors and commencing the PRA’s disciplinary powers’.⁶

2019

5 March 2019

Following publication of PS6/19 ‘Responses to CP24/18 Occasional Consultation Paper – Chapters 3-7’⁷ this SS was updated to clarify how its policy on written reports by external auditors to the PRA applies in group situations. These changes were proposed in light of the implementation of ring-fencing in the UK and to make clear the original intent of the policy’s scope. The proposals made amendments to Chapter 8 of the Auditors Part of the PRA Rulebook (Auditors 8) and SS1/16 ‘Written reports by external auditors to the PRA’.

⁶ <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/engagement-between-external-auditors-and-supervisors-and-commencing-the-pras-disciplinary-powers>.

⁷ <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/occasional-consultation-paper>.