

July 2016

Consultation Document And Impact Assessment:

Proposal to adopt (in the UK) ISA 800 (Revised) and ISA 805 (Revised)

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Objective

The Financial Reporting Council proposes, subject to consultation, to adopt ISA 800 (Revised) and ISA 805 (Revised) in the UK, without adaptation. This is in response to the PRA's proposed requirement for mandatory external audit of elements of Solvency II public reporting in the insurance sector. The FRC is carrying out this consultation in order to support the provision of high-quality assurance over public regulatory reports, in order to underpin user confidence in the information contained therein

The FRC has completed an impact assessment and does not believe that the adoption of these standards will result in significant additional costs or add to the regulatory burden on business. This is because the PRA is seeking 'reasonable assurance' over Solvency II reports, and has expressed a preference for the use of International Standards on Auditing (ISAs). Adoption of these ISAs in the UK will therefore facilitate this regulatory requirement, and allow the FRC to issue auditor guidance to help auditors apply them in a proportionate way to these engagements.

Comment on the consultation in response to this invitation to comment should be sent to:

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This consultation closes at 5pm on 3rd October 2016

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.

The Financial Reporting Council is consulting on the adoption in the UK of International Standards on Auditing 800 and 805 without adaptation.

We believe it is in the public interest for these standards to be adopted in order to help support auditors in providing assurance over public Solvency II regulatory reports in the UK insurance sector. The Prudential Regulation Authority (PRA) is consulting on rules requiring external audit over elements of these reports, to the level of 'reasonable assurance'. The draft PRA rule requires that there should be mandatory assurance over the following sections of published reports:

“Where Solvency II requires the production of a Solvency and Financial Condition Report (SFCR), the PRA proposes to require the relevant elements to be externally audited, subject to two exemptions. First, the Solvency Capital requirement (SCR) would be exempt if calculated using an approved full or partial internal model (internal model). Secondly, where Solvency II requires information in the SFCR to be produced using sectoral rules, that information would not be subject to external audit.”

The Solvency II Directive itself does not require the provision of independent assurance, however, national regulatory authorities can make this a requirement. The PRA has expressed a strong preference for this assurance to be based on International Standards on Auditing (ISAs).

Based on our stakeholder engagement to date, we believe that auditors may have difficulty in accepting an engagement to audit public Solvency II regulatory returns in accordance with current ISAs (UK). This is because the current UK ISAs are designed for the audit of full sets of general purpose financial statements, rather than elements of special purpose reports.

Our current analysis, and the results of our consultations with audit practitioners, suggests that these (Solvency II public reporting) engagements could be conducted in accordance with ISA 800 (Revised): *Special Considerations – Audits of Financial Statements prepared in accordance with Special Purpose Frameworks* and ISA 805 (Revised): *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

Consultation Questions

1. The FRC welcomes comments on all aspects of the adoption of these standards. However, given the primary objective described in the introduction to this consultation, we would specifically encourage views on the following questions:
 - Do you agree with the proposed adoption of ISA 800 (Revised) and ISA 805 (Revised) in the UK?
 - Do you believe that the FRC should consider any alternative ways of providing assurance over public Solvency II reporting? If so please set out those you consider appropriate and why.
 - Do you agree that ISA 800 (Revised) and ISA 805 (Revised) provide an appropriate framework for the audit of public reports published under the Solvency II prudential regulation regime?
 - Do you foresee any risks associated with the adoption of these standards?
 - Do you agree that these ISAs should be adopted in the UK and Ireland without any specific adaptations or amendments? If you believe that amendments are necessary, please set these out in your response.

The Audit of Public Solvency II Regulatory Reports

2. Solvency II is a new prudential regulation regime for the insurance industry which came into force across the EU on 1 January 2016. One of the key pillars of Solvency II is a new requirement for an annual public report (called the Solvency and Financial Condition Report (SFCR)) by most medium and large insurance companies. Although the Solvency II Directive does not mandate assurance on regulatory returns, the European Insurance and Occupational Pensions Authority (EIOPA) has made public statements in favour of external assurance over these published reports, in order to help build credibility and trust in this information. In the UK, the PRA is currently consulting on rules which require external audit of elements of published SFCRs, and related quantitative templates, to the level of 'reasonable assurance'. The PRA has indicated a strong preference for these audits to be conducted in accordance with ISAs rather than any other assurance framework. The PRA also has a preference for the use of ISAs (UK) in order that the FRC can issue revised guidance to help in the delivery of high quality assurance.
3. The FRC considered three options to support the provision of assurance over public Solvency II regulatory returns:
 - Reasonable assurance provided through International Standard on Assurance Engagement (ISAE) 3000: Assurance Engagements Other than Audits or Reviews of Historical Financial Information;
 - Reasonable assurance provided through an engagement carried out using the ISAs; or
 - A reasonable assurance engagement carried out using a specifically developed assurance standard, like for instance, the CASS Standard to support reporting to the Financial Conduct Authority on client assets.
4. The FRC does not consider that using ISAE 3000 to provide assurance over public reports is likely to meet the expectations set out in the PRA's consultation. Our experience in developing the CASS Standard suggests that this is best done when the regime subject to audit has matured and has reached a stable stage. This is not yet the case for Solvency II reporting. Until the regime beds in, we would not propose to develop a separate standard, however, have asked a specific consultation question to elicit stakeholder views.
5. Based on our stakeholder engagement to date, auditors may have difficulty in accepting an engagement to audit public Solvency II reports in accordance with current ISAs (UK) because:
 - The ISAs (UK) apply only in the context of a complete set of general purpose financial statements;
 - Solvency II public reporting is based on a special purpose financial reporting framework; and
 - The Prudential Regulation Authority (PRA) is asking for assurance to be provided over only specified components of those reports.
6. Our current analysis, and the results of our consultations with audit practitioners, suggests that these engagements could be conducted in accordance with:
 - a. ISA 800 (Revised): *Special Considerations – Audits of Financial Statements prepared in accordance with Special Purpose Frameworks*; and,
 - b. ISA 805 (Revised): *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

Why is the current suite of ISAs (UK) not sufficient?

7. The primary obstacle to performing audits of public Solvency II regulatory returns under the current ISAs (UK) is the nature of the financial reporting framework under which these reports will be prepared. The scope of the assurance engagement proposed by the PRA, which scopes out certain elements (internal models and sectoral rules) from the assurance engagement also poses a further challenge.
8. ISAs (UK) are designed for the performance of audits of general purpose financial statements and hence ISAs 800 and 805 are normally unnecessary. The obstacles to reporting on Solvency II reports under the ISAs (UK) could, in principle, be removed by adopting ISAs 800 and 805 in the UK. These would apply where financial statements are prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances.

The relevance of ISA 800 and 805 to public Solvency II reporting engagements

9. These ISAs are specifically intended to help auditors report on engagements, which are not full sets of general purpose financial statements. They set out requirements and provide application material on how auditors should perform these engagements, and the critical interactions with other auditing standards – including for example ISA 570 (Going Concern) and ISA 700 (Auditor Reporting).

International Standard on Auditing 800 (Revised): *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

10. The purpose of the ISA is to establish standards and provide guidance in connection with 'special purpose engagements'. The definition within the standards is consistent with the nature of the proposed external audits under Solvency II, and also makes it clear that, for the audit of a specific element of a special purpose financial statement, both ISA 800 and ISA 805 would apply.
11. The ISA establishes the basis on which an auditor can accept an engagement of this kind and sets out key considerations the auditor needs to take account of in accepting and conducting an audit.

In an audit of special purpose financial statements, the auditor shall obtain an understanding of:

- (a) *The purpose for which the financial statements are prepared;*
- (b) *The intended users; and*
- (c) *The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances. [p.8]*

12. A specific example of financial reporting frameworks designed to address the needs of specific users includes:

....a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting

framework is presumed acceptable for special purpose financial statements prepared by such an entity. [p.A6]

International Standard on Auditing 805: *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

13. This ISA can be used in conjunction with ISA 800 where a single financial statement, or specific element, account or item of a financial statement is the subject of an audit. This is relevant to the audit of Solvency II public reporting in the UK since the PRA's current proposals only cover specific sections of the SFCR and some of the quantitative templates. Significant parts of the ISA are concerned with establishing clarity as between the auditor's responsibilities and opinions for this type of engagement, and any related audit of a complete set of financial statements. The ISA states:

This ISA does not override the requirements of the other ISAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. [p.3]

14. However, it also requires the auditor to adapt the application of ISAs to the nature of the engagement – which in the context of SII will not be of a complete set of financial statements prepared in accordance with a general purpose financial reporting framework:

In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all ISAs relevant to the audit as necessary in the circumstances of the engagement. [p.10]

15. Using this ISA, auditors will be required to consider the extent to which the required disclosures are adequate:

...this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element. [p.8]

16. In the context of the current proposals for assurance engagements in respect of elements of the published SFCR:

The individual financial statements that comprise a complete set of financial statements, and many of the specific elements of those financial statements, including their related disclosures notes, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit. [p.A14]

The auditor is also required to consider whether the expected form of opinion is appropriate in the circumstances of the engagement.

Maintaining justifiable confidence in the 'true and fair' audit opinion

17. Stakeholders have raised questions, as did the APB that ISA's 800 and 805 might undermine the confidence that people have in a true and fair audit opinion, if such an opinion can be given on individual financial statements, or components thereof, which are

incompatible with giving a true and fair view on a full set of financial statements. ISAs 800 and 805 address both fair presentation and compliance frameworks. The PRA's intention is that auditor opinions on the SFCR and quantitative templates would be expressed in the form 'properly prepared in accordance with' the relevant financial reporting framework (the form used when opining on financial statements prepared in accordance with a compliance framework under the ISAs).

18. ISA 805 (Revised) requires the auditor to consider whether the expected form of opinion is appropriate in the circumstances. Application material indicates that factors that may affect the auditor's consideration as to whether to use the phrases 'presents fairly, in all material respects,' or 'gives a true and fair opinion', when expressing an opinion on a single financial statement, or a specific element of a financial statement include:

- Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.
- Whether the single financial statement or the specific element of a financial statement will:
 - Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the specific element of a financial statement include the related disclosures; and
 - If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework. [p.A9]

19. We carried out a preliminary review of how these standards are currently used, and did not identify any areas of specific concern. We do not propose to adopt ISA 810: *Engagements to Report on Summary Financial Statements*, where there may be a potentially greater risk to our current conception of 'true and fair'. However, we could further mitigate any risk by adopting ISAs 800 and 805 only for the audit of financial information prepared in accordance with a compliance framework. Engagements to report on Solvency II returns would be permitted by such a requirement, but these standards would not be available for audits of financial information prepared in accordance with a fair presentation framework unless that information comprised a full set of financial statements. We have included a specific consultation question in this respect.

Impact Assessment

20. The FRC has completed an impact assessment and does not believe that the adoption of these standards will result in significant additional costs or add to the regulatory burden on business. This is because the PRA is seeking 'reasonable assurance' over Solvency II reports, and has expressed a preference for the use of International Standards on Auditing (ISAs). Adoption of these ISAs in the UK will therefore facilitate this PRA requirement, and allow the FRC to issue auditor guidance to help auditors apply the standards in a proportionate way to these engagements.
21. Auditors are already free to use the international versions of these standards for assurance engagements – although in doing so they cannot currently claim to be complying with ISAs (UK), and the FRC does not issue guidance on the application of international ISAs.



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