

December 2014

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# Audit Quality Thematic Review

The audit of loan loss provisions and related  
IT controls in banks and building societies

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Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

# Financial Reporting Council

## Audit Quality Thematic Review

The audit of loan loss provisions and related IT controls in banks and building societies

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# 1 Background, scope and key messages

## 1.1 Background and scope

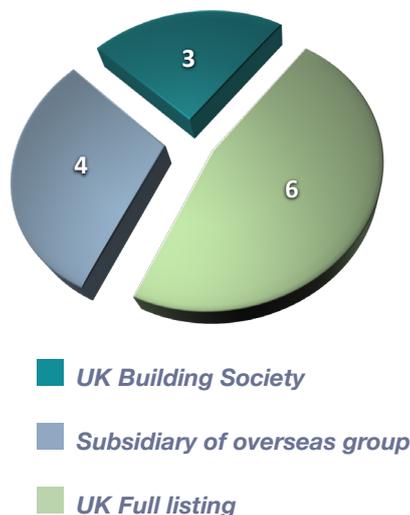
The FRC's 2012-13 Audit Quality Review Annual Report contained a number of key messages arising from our inspections. These messages, which were considered critical to achieving further improvements in audit quality, included a requirement for audit firms to strengthen financial services audit testing, particularly in respect of loan loss provisioning and related IT controls. The pace of improvement in this area had not matched expectations and audit inspections in recent years identified that the quality of bank audits (as indicated by our gradings) required more improvements than other audits. As a result, the FRC published its decision on 12 December 2013 to conduct a thematic review of the audit of loan loss provisions and related IT controls.

In the course of the review we visited seven of the UK's largest audit firms (BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG, Mazars and PwC) to review aspects of their audit methodology and guidance in respect of the audit of loan loss provisions and related IT controls. We also reviewed the application of relevant procedures in 13 individual audits, covering a range of banks and building societies (referred to for the purpose of this report as the 'banks' or 'bank audits'). These reviews related to audits of financial statements for financial years ending between July 2013 and December 2013.

As part of our planning for each review we met the Audit Committee Chair of each of the banks to understand their perspective on audit risk and their perception of the knowledge and experience of the audit team and the quality of the audit performed. We have issued confidential reports on each individual audit reviewed to the relevant engagement leader and Audit Committee Chair in accordance with the FRC's normal practice and procedures.

The types of financial institutions covered by the audits we reviewed are set out below:

Individual audits reviewed by



The observations made in this report are based on our review of firms' procedures and guidance and relevant aspects of the audits we selected. We have discussed our detailed findings with each of the audit firms concerned.

Thematic reviews supplement our annual programme of audit inspections of individual firms. In a thematic review we look at firms' policies and procedures in respect of a specific aspect of auditing, and their application in practice. The reviews are narrow in scope, and the specific aspect may be chosen in order to apply more focus to it than is generally possible in our inspections or because our inspection findings have suggested that there is scope for improvement in the area concerned. A thematic review enables us to make comparisons between firms with a view to identifying both good practice and areas of common weakness. Our findings and recommendations should assist auditors in reviewing current guidance and practice at their firms with a view to better fulfilling their professional responsibilities. They should also assist Audit Committees in discharging their oversight responsibilities.

Four of the banks reviewed were also selected as part of our normal cycle of audit reviews. Accordingly for each of these banks we reviewed other areas of the audit as well as loan loss provisions and related IT controls. These other areas are not relevant to the

thematic review and the relevant findings arising will be addressed in our public reports on individual firms in due course. The overall grades awarded for these reviews may be different from the grade awarded for the thematic review and will be reported to the audit firms and relevant Audit Committee Chairs in accordance with the FRC's normal practices and procedures.

## 1.2 Overview and key messages

This section provides an overview of our principal findings which are set out in detail in section 2; a summary of good practice observed; a number of key messages of relevance to both firms and Audit Committees; and a summary of the areas for improvement.

### 1.2.1 Overview of findings

From this review, we have noted improvements in the quality of certain aspects of the audit of loan loss provisions and related IT controls, particularly at those firms where we have, in recent years, identified significant issues. These firms have in the main demonstrated that, with appropriate focus and resources, good quality audits can be achieved. It is clear that firms with sufficient banking sector experience and access to up-to-date specialist knowledge in IT and other relevant areas, such as real estate valuation, are able to audit loan loss provisions to a good standard with only limited improvements required.

In four of the seven firms included in this thematic review, there were significant improvements in addressing concerns raised previously by Audit Quality Review, either through the introduction of additional initiatives or increased leadership focus on loan loss provisioning and related IT controls. In the three other firms, bank audits had not been a priority for our work in recent years. We had therefore not necessarily identified issues in relation to the audit of loan loss provisions which required significant improvements. Where such issues have been identified in the course of this thematic review, we have communicated these to the relevant firms individually and will monitor the firms' responses as appropriate.

In the significant majority of individual audits reviewed, the planned audit approach was considered to be appropriate, and in all audits loan loss provisioning had been identified as a significant risk (and therefore an area of audit focus).

In the audit of UK groups with significant overseas loan portfolios, the quality of the control and direction of the group audit by the group audit team and the intergroup reporting from component auditors was of a good standard.

Whilst we identified improvements in the quality of certain aspects of the audit of loan loss provisions and related IT controls, we note that in two of the 13 audits we reviewed significant improvements were required. These two audits were audits of UK subsidiaries of foreign banks. In both cases we identified issues with both the quality of the audit work performed and evidence provided through reporting by other group auditors. Whilst we are unable to review the underlying work performed by other group audit teams, we asked the firms to carry out remediation work in relation to both audits. The firms inform us that this work has not identified matters that require adjustment to the financial statements or the audit opinion. The issues identified which determined these grades do not appear to be systemic issues across the population of individual audits reviewed and the assessment that significant improvements were required does not necessarily imply that an inappropriate audit opinion was issued.

Other areas which require improvement are set out in section 1.2.5 below.

The table below shows the number of audits we reviewed falling within each grade.

Grade	Number of audits
Good or Limited improvements required	10
Improvements required	1
Significant improvements required	2
<b>Total</b>	<b>13</b>

The table shows that 77% of audits of loan loss provisions and related IT controls were considered to be good or required limited improvements only. This compares to the average for the past five years where the equivalent percentage for the audits of banks and building societies was 39%.

Where a review has identified a need for more significant improvements, we have asked the firm to determine the underlying causes, including reviewing their procedures and enhancing them as appropriate. In particular, such firms should focus on how rigorously the audit teams challenge management's judgments and explanations and how effectively they carry out the firm's quality control and review procedures in relation to audit work performed.

### 1.2.2 Good practice observed

This section sets out examples of good practice identified during the thematic review. Evidence of good practice was observed in the audit work and firm-wide procedures of a number of firms, however each firm should consider all the examples set out below and adopt them into their methodologies and audit procedures as appropriate:

- IT specialists were used in all the audits we reviewed. Where these specialists were successfully integrated into the audit team, we noted a general increase in overall audit quality
- Recently developed independent testing techniques, such as benchmarking and data analytics, were generally used effectively but we note that such testing techniques still need time to be embedded fully into audit strategies
- Increasingly firms are adopting more sophisticated IT testing techniques, such as code reviews, which enable the audit team to carry out a more rigorous analysis of management's extraction and manipulation of data for statistical purposes
- A number of firms have developed centralised templates to consider completeness and accuracy of reports and data

- The creation of a summary for each in-scope IT application, outlining general IT control conclusions and an evaluation of the impact of each control deficiency, resulted in an improvement in the quality of evidence obtained
- Central resources have been created at certain firms to provide consistency in the assessment of loan loss provisions and in the valuation of the more complex collateral held in the corporate loan book
- Audit teams made increasing use of other specialists, such as real estate valuation experts
- All firms have some form of sector specific audit methodology and provide some sector training that is broadly commensurate with the size and complexity of their banking audit practice.

### 1.2.3 Key messages for audit firms

The thematic review identified areas for improvement which we believe are relevant to all audit firms. To assist firms we have set out below actions which we believe should be considered when performing an audit of loan loss provisions and related IT controls and which should contribute to an overall increase in audit quality:

- Be proactive in monitoring and enhancing bank audit quality, as well as being reactive to regulatory concerns. Ensure that bank audit initiatives and procedures remain fit for purpose and enhance them where significant issues are identified
- Revisit procedures to ensure that all regulatory and market risks are captured by risk assessment methodology and sector training and consider or enhance the use of benchmarking and data analytics as effective audit tools in the audit of loan loss provisions
- Ensure audit teams apply an appropriate degree of challenge and professional scepticism in the audit of loan loss provisions, rather than seeking to corroborate management's views

- Make sector training mandatory for partners and staff engaged in bank audits where this is not already the case and monitor attendance at, and effectiveness of, those training courses
- Fast track the integration of non-IT specialists into the audit team using lessons learned in integrating IT specialists into audit teams
- Perform root cause analysis to understand why current quality control processes did not identify weaknesses highlighted by our reviews.
- Consider the timing of planning with group auditors and check it is sufficiently early in the process to obtain appropriate and relevant information from group or other component auditors.

### 1.2.5 Areas for improvement

In addition to giving consideration to the good practices and key messages set out above, we require that audit firms also develop appropriate responses to the following areas where we have identified that improvements are required.

### 1.2.4 Key messages for Audit Committees

Audit Committees play an essential role in ensuring the quality of financial reporting. In particular their role in discussing with auditors the audit plan and the audit findings can contribute significantly to audit quality. To assist Audit Committees we have summarised below actions which when applied consistently may enhance oversight of the audit process in relation to loan loss provisioning and related IT controls. This should contribute to an overall improvement in audit quality. We acknowledge that in many cases these actions are conducted as a matter of routine.

- Discuss with auditors their proposed actions in response to this thematic review
- Understand the implications of the firm's benchmarking and other data analytics on the quality and robustness of the audit of the financial statements
- Seek assurance annually that the sector expertise and competence levels of the audit team and the firm are appropriate in relation to the bank's business activities
- Consider with the auditors the effectiveness of the bank's relevant internal controls, and the extent to which the auditors review them and are able to place reliance on them
- Ensure management is assessing the impact of current and emerging issues on a timely basis and that the auditor and the bank jointly understand how these issues affect the assessment of significant risk

The two audits requiring most improvement were audits of UK subsidiaries of foreign banks. In both these audits we identified issues with both the quality of the audit work performed and evidence provided through reporting by other group auditors. We asked the firms to carry out remediation work in relation to both audits. The firms inform us that this work has not identified matters that require adjustment to the financial statements or the audit opinion. The issues identified which drive these grades do not appear to be systemic issues across the population of individual audits reviewed.

In the majority of audits we raised certain issues regarding consistency in the quality of audit testing, encompassing controls, substantive and IT testing. In most cases the impact was not significant to the audit overall, but these issues demonstrate that auditors are not applying a sufficient degree of challenge and/or scepticism at all times, and that this is not being identified by internal quality control reviews. On a number of audits we identified examples of thorough, probing audit work with evidence of challenge and review, yet on the same audits found examples of inadequate follow-up of issues raised by the audit team. These included conflicting evidence on a loan review or queries raised by IT or property valuation specialists that had not been followed up or resolved satisfactorily.

Principal findings in relation to the audit of loan loss provisions and related IT controls are set out in Section 2 where further details are provided. The more significant themes are as follows:

- In three of the audits where the audit teams relied on the work of management's controls testing teams, we questioned whether the audit team had done enough to rely on this work in relation to loan loss provisioning
- In five audits the impact of certain IT control deficiencies identified by the IT specialists was not sufficiently or appropriately followed up and evaluated
- In eight of the audits we reviewed, we identified issues of varying significance with the quality control of the audit. Examples of this included:
  - Inconsistencies between, and inadequate review of, audit work papers
  - Issues or scope limitations raised either by specialists or other auditors, that were not addressed by the audit teams
  - Failure to document the basis of key judgments adequately.

### 1.2.6 Conclusion

Overall, we consider that there has been an increase in the quality of the audit of loan loss provisions and related IT controls in banks. In particular, improvements have been noted where significant issues have been raised previously. However we identified certain instances where audit teams were still not appropriately challenging in their audit testing. Nevertheless, whilst significant investment in sector specific audit procedures has been made by firms in response to our previous inspections, we consider that auditors need to be more proactive in ensuring that their procedures across all areas are fit for purpose, rather than implementing changes primarily in response to regulatory findings. A further challenge for audit firms is to be proactive in identifying other areas of bank audit risk where there may be a need for improvement.

We would like to take this opportunity to thank the audit firms for their assistance during our review.

## 1.3 Approach to the audit of loan loss provisions and related IT controls

### 1.3.1 Audit of loan loss provisions

Accounting Standards require an entity to assess whether there is any objective evidence that an asset or group of assets is impaired. Impairment occurs when a loss event has taken place by the period end that has a detrimental impact on the future cash flows of the asset or group of assets being considered for impairment. Due to significant management judgment required over this key business area, there will usually be a significant risk of a material misstatement in this area that requires special audit consideration<sup>1</sup>.

Banks typically split their lending portfolios into retail and corporate lending. Retail loan books (e.g. mortgages, credit cards, unsecured lending) are treated as homogenous populations of small loans that are not considered individually significant. Provisions are therefore based on models, where the design of the model, its testing and the assumptions included in its application, are key factors. Corporate loan books contain larger loans that usually have specific negotiated terms and can be considered individually significant. Banks' approaches to provisioning therefore differ between the different types of lending, and so the audit approach likewise differs.

The audit approach for retail provisioning is to consider the appropriateness of management's judgments in calculating the provision and the accuracy and completeness of historic and current data used in the models. The provisions are calculated using models that consider together all loans within a given lending portfolio. Whilst the model calculations can be relatively straightforward, the inputs into the models are based on assumptions subject to management judgment and also utilise the bank's relevant historical data.

<sup>1</sup> Accounting Standards primarily refer to the requirements of IAS 39 Financial Instruments: Recognition and Measurement (and its UK GAAP counterpart FRS 26). We note that the forthcoming IFRS 9 Financial Instruments introduces an expected loss impairment model that requires recognition of certain expected credit losses. Specifically the standard: requires accounting for expected losses when financial instruments are first recognised; and lowers the threshold for recognition of full lifetime expected losses. With the implementation of IFRS 9 further loan loss provisions may need to be recognised. IFRS 9 is effective for annual periods beginning on or after 1 January 2018.

For corporate lending portfolios the audit approach typically focuses on the identification of the population of loans subject to a detailed review by management, to ensure it includes all relevant loans and judgments taken in determining individual provisions. This approach takes into account management's judgments in relation to collateral valuations, future cash flows and the performance of the borrower. The provisioning approach for corporate lending is typically to perform individual credit reviews for each loan in each portfolio throughout the year, to identify loans that should be more closely monitored and considered further for impairment. A corporate lending book will also have a collective provision in respect of the remaining population of loans not covered by the specific provision, as they may be subject to loss events that are incurred but not reported ('IBNR'). This is audited in a similar way to retail collective provisions.

### 1.3.2 Related IT controls

IT systems are a critical part of financial and operational processes within banks because of the volume of transactions that is characteristic of banks and the complexity of bank products. Planning the IT audit approach is therefore an important aspect of the audit. Auditing Standards explain that substantive testing alone may not be an appropriate response in planning the audit where a significant amount of an entity's information is initiated, recorded, processed, or reported using integrated systems.

'Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk.'

*ISA (UK&I) 315 (paragraph A141)*

Bank audit teams generally seek to place reliance on IT application controls and related general IT control environments. This requires close integration between the IT specialists and the financial audit team. General IT controls support the operation of the

application controls by ensuring appropriate access to, and functioning of, the company's IT systems. Application controls may be either entirely automated or IT dependent manual controls i.e. controls which depend on the completeness and accuracy of information produced by the system.

'General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations
- System software acquisition, change and maintenance
- Program change
- Access security
- Application system acquisition, development, and maintenance.'

*ISA (UK&I) 315 (paragraph 104)*

'Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications.

Examples include:

- Edit checks of input data
- Numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.'

*ISA (UK&I) 315 (paragraph 105)*

The scope of general IT control testing involves an element of judgment and so audit teams have to determine the extent of work to be performed. This can be challenging in complex IT environments where applications share common control features.

## 2 Principal findings

### 2.1 Findings from review of individual audits

In the sections below we have identified the principal findings and key themes arising from our inspection of the 13 individual audits included in this thematic review. The significance of any of the identified deficiencies may vary in the context of the audit in question. In the course of a complex audit, it is acknowledged that there will be certain procedures performed to a higher standard than others. The issues identified and highlighted below are those matters which are considered to be most significant and where improvements should be made by audit firms.

#### 2.1.1 Audit approach

Loan loss provisioning was identified as a significant risk in all audits, although in one audit we considered that certain loan loss provision risk assertions were inappropriately assessed as lower risk.

In all audits reviewed, the firms adopted a controls reliance approach supported by varying degrees of substantive testing depending on the outcome of the controls testing. One firm took an approach where significant reliance was placed on controls in two of its audits, both of which were large operations. The majority of audit evidence was gained through controls testing, with top up substantive work subsequently performed. We also noted one instance where the team appropriately adapted their approach mid-audit in response to the results of their controls testing. Given the circumstances of the individual audits reviewed, we considered that the audit strategy adopted in response to these significant risk assessments was appropriate in all but one audit. In that audit insufficient testing was planned in response to certain risks identified.

While we considered that the planned audit approach was appropriate in most cases, we nevertheless identified certain inconsistencies in the quality of controls and substantive testing performed, and deficiencies in the conduct of quality control and archiving procedures, as described below.

#### 2.1.2 Reliance on the work of others

##### *Using the work of other auditors*

Four of the audits we reviewed were UK subsidiaries of overseas banking groups. In three of these reviews the UK subsidiary audit teams relied on work performed by the group auditors for the purposes of signing the UK statutory audit opinion. In each of these three reviews we identified issues with the quality of the audit work and related reporting provided by the relevant group audit teams to the UK subsidiary audit teams. These included the following:

- The group audit team did not report on all the procedures that they had been asked to perform
- The reports provided were not of sufficient granularity to enable the UK subsidiary audit team to understand what procedures had been performed, or to allow a conclusion to be drawn on the sufficiency and appropriateness of the audit work
- The procedures were stated to have been performed to group materiality rather than the appropriate UK subsidiary materiality.

In one audit the issue was exacerbated by inadequate planning by the UK subsidiary audit team, but in all three instances we considered that either the work performed or the reporting was insufficient.

In two further audits, which were UK listed groups with significant overseas loan portfolios, we reviewed the intergroup reporting from component auditors. This was considered with specific regard to the audit of loan loss provisions, namely whether the quality of this reporting was sufficient to support the conclusions on the loan loss provisions across the group as a whole. It is clear in such cases that the group audit team needs to be assured of the quality of information received from the component auditors. Whilst we are unable to review the underlying work performed by the component audits teams, in both of these audits we found the quality of the control and direction of the group audit by the group audit team and the reporting to be of a good standard.

### **Using the work of management's controls testing teams**

Using the work of management's controls testing teams or internal audit can be an efficient and effective means to gather audit evidence in relation to loan loss provisions. In three audits the audit teams relied to some extent on such management testing of internal controls. In these cases the assessment of the appropriateness of doing so required improvement. In one instance, reliance was placed almost exclusively on management's controls testing team for an audit assertion related to an area of significant risk, which we considered contrary to Auditing Standards.

Before placing reliance on the work of management's controls testing teams, Auditing Standards require the audit team to undertake certain assessment procedures. This often includes re-performance, on a sample basis, of the work of management's controls testing teams to determine whether it is appropriate. In two audits we noted that re-performance procedures were not conducted with sufficient rigour. In one example the group team informed all component audit teams that they could rely on the work of management's controls testing team, but there was no assessment of the work performed by the team throughout the group. In another instance, the re-performance testing carried out by the audit team was insufficient and in particular excluded the sampled items where management's controls testing team had determined that there was a deficiency.

#### **2.1.3 Use of specialists**

The judgmental nature of the calculation of loan loss provisions - such as the valuation of collateral, assumptions inherent in provisioning models and the data requirements to support these areas - lends itself to the use of specialists. We noted the widespread use of internal specialists in these areas, which is to be encouraged.

Over the last few years we have seen the quality of interaction with IT specialists improve as IT teams become more integrated into the audit team. To achieve increased effectiveness, other specialists need to become equally integrated into the audit teams.

All teams used IT specialists and, within those IT teams, additional levels of specialism were observed, such as the use of specialist code reviewers.

Provisioning models may utilise software to extract data from a variety of sources and manipulate it for statistical purposes. Code reviews establish whether the code driving the extraction and manipulation of data addresses business rules and policies as well as identifying errors which may affect the calculation of financial statement balances.

We observed extensive use of real estate specialists in the valuation of collateral within the corporate lending books. Such specialists were engaged by audit teams on six of the audits we reviewed. Further, on three audits the audit teams used other specialists to review the collective provisioning models, covering the audit of inputs such as Probability of Default, Loss Given Default and Exposure at Default.

To make effective use of specialists, the audit team must ensure that appropriate briefing and instructions are provided and that the specialists understand the context and regulatory framework of an audit.

The audit team must also perform an appropriate review of any work performed by specialists. In two audits the specialists based their judgments on information obtained from management without further challenge. In both cases the audit team neither identified these shortcomings on review, nor confirmed that they were addressed by the specialists, to ensure that the evidence obtained was sufficient and appropriate for the purposes of the audit.

In two further cases the specialists had either indicated a limitation in the scope of their work, or noted a number of actions to be followed up by the audit team, which were not adequately addressed.

#### **2.1.4 Alternative testing procedures**

During this review we saw evidence of the emergence of innovative testing techniques to gain more reliable

independent audit evidence over aspects of loan loss provision calculations. Across three firms we noted the use of data analytics and benchmarking.

Data analytics is a term used to refer to both the interrogation of data and the independent calculation and manipulation of data to test calculations.

In all cases, these procedures were being used for the first time and we noted a significant time commitment in ensuring that data was collated appropriately before the relevant analysis was performed. In this the first year of their use, these procedures supplemented other more traditional forms of testing. The value of such procedures, when done well, was demonstrated by the fact that on one audit data analytics resulted in the identification of a significant audit adjustment to increase loan loss provisions, which was accepted by management.

In some cases, however, we identified the need for improvement in the audit teams' assessment of the results of such alternative testing procedures. Benchmarking exercises indicated that the loan loss provisions of certain entities fell outside expected ranges, yet this did not necessarily lead to an appropriate challenge of management or adequate attempts to obtain plausible explanations. In other cases, observations arising from the performance of data analytics were dismissed after discussions with management without further challenge of the explanations provided. Nevertheless, whilst improvements were required, none of these issues were assessed as significant to the overall quality of the audit of loan loss provisions. The aim in subsequent years is to refine these techniques and make them more robust so they can be relied on as a primary source of audit evidence.

IT teams are also using alternative techniques such as the engagement of specialist code reviewers to ensure that the flow and manipulation of loan loss data is being captured appropriately by the bank's systems used in the calculation of loan loss provisions.

### 2.1.5 Quality control

In eight of the 13 audit reviews undertaken, including in the two audits awarded the lowest grades, we identified issues with quality control procedures. Loan loss provisioning is an area of significant judgment and therefore the assessment of evidence considered, judgments made and subsequent conclusions drawn are critical. In most audits there were some inconsistencies between working papers, a lack of sufficient and appropriate audit evidence on file and issues or scope limitations raised either by specialists or other auditors that were not addressed by the audit teams. In one case there was a pervasive failure to document the audit work adequately.

Insufficient recording of audit evidence together with inadequate quality control and review procedures performed by more senior members of the audit team increases the risk that a material misstatement in the financial statements may not be identified.

### 2.1.6 Controls testing

Across the 13 audits we reviewed we identified varying quality in the controls testing performed. The most common issue encountered was in the procedures performed on certain management review controls. These are controls where a committee or individual performs an activity which is then evidenced by approval of minutes or a signature. In five audits we noted multiple examples where the test of control was limited to ensuring that the control had been recorded as performed and reviewed without consideration of how the operation of the control was carried out, the quality of the background information supporting the control, or whether any actions generated by the control were followed up and resolved. These considerations are essential elements of an assessment of the design and operating effectiveness of a control.

Other issues included the following:

- Certain key controls identified were not tested
- Insufficient follow-up of reconciling items

- Sample sizes selected were too small to enable appropriate conclusions to be drawn, resulting in insufficient audit work in one or more aspects of the audit of loan loss provisions
- Where controls work was originally performed at an interim date, insufficient procedures performed to cover the remaining period to the year-end.

### 2.1.7 Substantive testing

The quality of substantive testing was also variable and we identified certain aspects of testing that required improvement in 12 of the 13 audits we reviewed. Audit teams need to ensure that the testing is performed in line with the original design of the test and that there is sufficient review and challenge in place throughout the audit process. The common issues identified included:

- Inadequate testing of key inputs into collective provision models
- Insufficient challenge of management's evidence and conclusions when completing loan file reviews
- Insufficient challenge or follow-up of potentially conflicting evidence arising from the testing performed
- Insufficient sample sizes selected. To focus testing on items with specific risk characteristics, the population from which a sample is selected is sometimes restricted to such items. In these circumstances further audit procedures should be performed to cover the remaining population if this is material.

### 2.1.8 IT controls

IT specialists were engaged on all the audits we reviewed. Where these specialists had been successfully integrated into the audit team there was an overall improvement in audit quality. In these cases there was more evidence that the impact of IT issues raised had been effectively considered by the audit team as a whole and the follow-up procedures were more rigorous.

### *Completeness and accuracy of information*

Auditors are required to consider the completeness and accuracy of system data used in performing audit procedures. Whilst firms' guidance and methodologies cover this, we found that audit teams did not always consider whether it was appropriate to place reliance on system generated reports and data. In addition we noted instances where audit teams did not adequately plan and perform procedures to assess the completeness and accuracy of reports and data extracted from loan loss provisioning systems.

In one audit where reliance was placed on the overseas group team to test the completeness and accuracy of reports used to calculate the loan loss provisions, no communication was received to confirm that the reports had been tested and no alternative procedures were performed by the UK audit team.

We did, however, note examples of good practice including the development of centralised templates to consider completeness and accuracy of reports and data. We expect that the increased use of data analytics may further improve the quality of loan loss provisioning audit work.

### *Evaluating the impact of ineffective general IT controls*

Auditors are required to consider their response to assessed risks of material misstatement at the financial statement level and evaluate the results of further procedures performed. In five audits the audit teams did not adequately assess the nature and impact of all IT deficiencies. In two of these audits, there was insufficient evidence of the additional substantive procedures performed to address individual IT control weaknesses and the impact on related IT application controls. In a further two cases, the audit team performed additional procedures but it was unclear how these specifically addressed the IT deficiencies.

Where there was active communication between the IT specialists and the audit team, we noted an improvement in the evaluation of IT deficiencies. It is important that any general IT control deficiencies are clearly linked to all relevant applications, so that

the impact on each related IT application control can be assessed. On two audits, the IT specialists created a summary for each in-scope application outlining general IT control conclusions and an evaluation of the impact of each control deficiency on related IT application controls. They clearly mapped compensating IT controls, manual controls and the results of other substantive procedures performed to each IT control deficiency. This resulted in an overall enhancement of audit quality.

Audit teams and the IT specialists should jointly draw an overall conclusion relating to the risks of material misstatement due to IT deficiencies, after considering all relevant audit evidence obtained during the audit.

#### ***Reliance on IT application controls work performed in previous periods***

If auditors intend to use audit evidence from a prior period, they are required to consider whether it is appropriate to do so. In a number of audits we reviewed, reliance placed on prior period audit evidence was supported by rotational testing of certain IT application controls, thereby establishing the continuing relevance of that evidence. However on two audits no procedures were performed to establish that reports used for loan loss provisioning continued to be reliable.

#### ***Segregation of duties testing***

‘Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities.’

*ISA (UK&I) 240 (paragraph 31)*

Auditing Standards require management override of controls to be identified as a significant risk while recognising that the level of risk will vary from entity to

entity. We noted that some audit teams have tailored their IT audit approaches in response to segregation of duty risk factors identified in the audit of loan loss provisions. In three audits, however, we identified insufficient procedures performed to identify and test management controls to mitigate relevant segregation of duties risks.

Audit teams should consider whether their audit approach requires tailoring in response to segregation of duty risk factors identified.

## **2.2 Findings from review of firm-wide procedures**

We reviewed aspects of the firms’ audit methodology, guidance and internal communications in relation to the audit of loan loss provisions and related IT controls.

### **2.2.1 Response to prior year findings**

#### ***Response to specific findings at individual firms***

At three of the firms we reviewed, we had identified significant issues in the audit of loan loss provisions in the past two inspection cycles. All three firms had addressed the findings relevant to each of the bank audits, and in addition had responded to our findings by enhancing firm-wide processes.

Two of these firms invested significant time and resources in developing and embedding new initiatives.

The other firm enhanced its leadership focus on audit in this sector and there was a more proactive oversight and monitoring of bank audit quality.

At all three firms, the quality of the audits reviewed by us reflected an improvement in the firm’s audit methodology and procedures in this sector.

#### ***Response to concerns in the sector by individual firms***

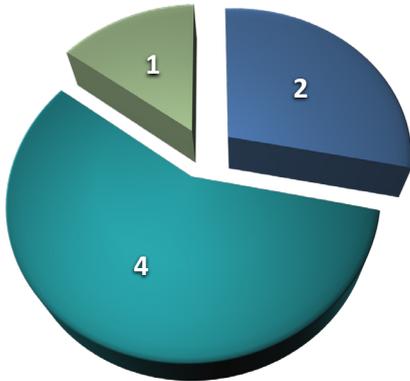
Having overhauled its guidance and methodology for 2012 year-ends in response to communications and findings from the FRC in the past, one firm continued to develop its processes to enhance audit quality. We

had not identified significant issues in the audit of loan loss provisions and related IT controls in the past two inspection cycles at this firm and this continued to be the case in the current year.

**2.2.2 Training**

All firms have sector training, but processes for training bank audit partners and staff vary, with some firms tailoring existing core training for bank audit specialists, whilst other firms have mandatory bank audit training sessions in addition to the core training. We consider that relevant banking sector training should be mandatory for all partners and staff involved in bank audits. In addition, we also found that there was variability in the monitoring of attendance at banking sector training courses. Without appropriate monitoring of attendance, the efficacy of the provision of such training is undermined and firms should introduce appropriate monitoring procedures as required.

Bank audit training provision and monitoring statistics



- **Mandatory bank audit training provided; near full attendance of partners and staff**
- **Mandatory bank audit training provided; some partners and/or staff did not attend or attendance not monitored**
- **Bank audit training arranged; attendance encouraged but not mandatory and attendance statistics not available**

Firms should also consider the need to provide relevant audit training to specialists, such as IT and valuations specialists, who perform procedures on bank audits.

**2.2.3 Methodology**

*Improvements in methodology*

At three firms we identified a series of new initiatives designed to improve the quality of the audit of loan loss provisions and related controls. The following are examples:

- The creation of a central resource to provide consistency in the assessment of loan loss provisions and in the valuation of the more complex collateral held in the corporate loan book
- Enhanced and co-ordinated benchmarking processes covering all bank audits. For this purpose, benchmarking is a comparison of key attributes of the loan loss provisioning process across an industry sector including accounting policies, modelling assumptions, provision coverage and treatment of specific exposures
- Improved templates designed to achieve more robust reviews of controls, increased level of challenge of management’s annual loan reviews and enhancements in the co-ordination between audit and IT specialists
- New or improved knowledge sharing facilities to enable teams to exchange and discuss issues arising and examples of best practice particularly in relation to similar entities.

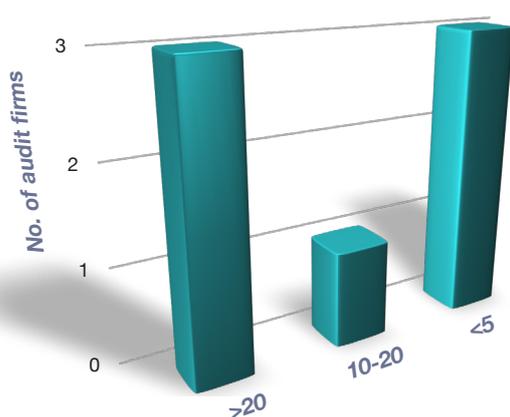
We have noted the use of data analytics on certain audits reviewed. At two firms, the further development of data analytics for the audit of loan loss provisions is planned to be implemented for 2014 or 2015 year-ends.

*Banking capability and experience*

As part of our firm-wide procedures we considered each firm’s sector specific capability and experience to conduct bank audits. Although at the current time, this seems broadly commensurate with the size of

each firm's bank audit practice, we note that certain firms may seek to expand their bank audit practices in future, particularly in the light of increased tender activity. Firms which currently only audit smaller, less complex banks are likely to require additional investment in people and procedures to perform quality audits of larger, more complex banks. This is illustrated by the bar chart below, which shows the current number of audit partners/directors who are bank audit specialists. The bar chart indicates that three of the firms still do not have a critical mass of senior personnel in this area which restricts their ability to undertake major bank audits.

No. of audit partners/directors in the banking practice

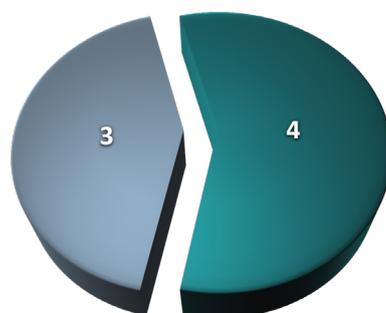


No. of audit partners/directors in the banking practice

### *Pre-issuance review of financial statements*

All firms have processes in place requiring a technical pre-issuance review to be performed of the financial statements of specified public interest entities, which includes all listed companies. Some firms conduct pre-issuance reviews for all bank audits whereas other firms do not mandate such a review as follows:

Requirement for a pre-issuance review of banking audit financial statements ahead of signing the audit report



■ Pre-issuance review required for all bank audits

■ Requirement for pre-issuance review not extended to all bank audits

### **2.2.4 Internal quality reviews**

All firms, except one, undertook internal quality reviews of a sample of bank audits in 2013 as part of their annual internal quality review process. We noted that the internal quality reviews of banks were performed by staff who had banking experience and who were sufficiently senior to assess and challenge the audit teams' work appropriately. Going forward, these internal quality reviews should introduce procedures to consider the issues identified in this thematic report to help prevent recurrence of the findings.

### 2.3 Conclusion and next steps

Overall, we consider that there has been an increase in the quality of the audit of loan loss provisions and related IT controls in banks, however there are still a number of areas for improvement going forward. Accordingly we will keep the audit of loan loss provisions and related IT controls under review. We will continue to identify the banking sector as one of our priority areas and therefore conduct a number of audit reviews as part of our routine inspection work. With regard to the individual audits where significant improvements are required, we will undertake follow-up work as part of next year's inspection cycle to ensure appropriate actions have been taken.



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