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Feedback Statement and Impact Assessment

The Revision of Practice Note 19: The Audit of Banks and Building Societies in the United Kingdom

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FEEDBACK STATEMENT AND IMPACT ASSESSMENT

Practice Note 19: The Audit of Banks and Building Societies in the United Kingdom

Introduction

1. In mid-2018, the FRC commenced a project to consider revisions to Practice Note 19: *The Audit of Banks and Building Societies in the United Kingdom* (PN 19), which was last updated in 2011. The proposed revised PN was issued for public consultation in December 2018, and this feedback statement summarises the main changes in the revised PN and also the responses received to the consultation.
2. The main drivers for revising PN 19 were:
 - revisions to UK auditing standards (ISAs (UK)), in particular ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*, which is effective for audits of financial statements for periods beginning on or after 15 December 2019 (early adoption is permitted);
 - changes in relevant legislation and regulation; and
 - the establishment of the of the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA) in place of the Financial Services Authority (FSA).

How we revised the material

3. We established an expert working group to support the project to revise PN 19, including representation from audit firms with bank audit expertise, the banking industry, and the banking regulators. The guiding principles followed in reviewing and updating the guidance included:
 - updating the guidance to address the drivers for revision identified above;
 - taking out material that is a repeat of what is in the relevant ISA (UK) itself;
 - taking out material that an auditor would be able to find elsewhere, for example in accounting standards (in most cases replacing with a cross reference).

Main areas of change

4. The main areas of change in PN 19 are:
 - Legislative and Regulatory Framework: updated. In addition, references throughout the PN to the FSA Handbook have been updated for the PRA Rulebook and FCA Handbook where appropriate;

At the time of publication, there are EU Regulations that apply to directly to UK firms. References continue to be made to these in the revised PN. When the UK ceases to be a member of the EU the references will be updated accordingly.
 - ISA (UK) 200: this section has been deleted after transferring the small amount of guidance specific to banks and building societies to the section on the legal and regulatory framework where it was more appropriately located;

- ISA (UK) 210: content has been reduced to eliminate duplication with guidance in other sections;
- ISA (UK) 220: this section has been deleted as it did not provide additional guidance specific to banks and building societies. A high level of audit quality is important for all audits;
- ISA (UK) 240: content has been reduced to eliminate some material that was duplicative of the ISAs (UK);
- ISA (UK) 250 Section A: content has been rewritten to reflect changes in the legislative and regulatory environment. Material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 250 Section B: edited to reflect the establishment of the PRA and FCA in place of the FSA;
- ISA (UK) 300: edited primarily to reflect the establishment of the PRA and FCA in place of the FSA;
- ISA (UK) 315: material that duplicated the ISAs (UK) has been deleted. Examples of matters the auditor may obtain an understanding of and risks of material misstatement have been updated;
- ISA (UK) 320: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 330: material that was duplicative of the ISAs (UK) has been deleted. The guidance in relation to disclosures has been updated having regard to changes in accounting standards;
- ISA (UK) 402: material that was duplicative of the ISAs (UK) has been deleted. It is identified that 'external information sources' which are not service organisations are considered in ISAs (UK) 500 and 540;
- ISA (UK) 505: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 520: material that was duplicative of the ISAs (UK) has been deleted
- ISA (UK) 540: this section has been rewritten to take account of the revision of ISA (UK) 540 which is effective for audits of financial statements for periods beginning on or after 15 December 2019. New guidance has been added, including to help apply the standard to the audit of expected credit losses (ECL), hedge accounting and effective interest rate accounting which are of particular relevance in banks and building societies, Auditors may find this guidance helpful for the audits of periods ending before 15 December 2019 even if they have not early adopted ISA (UK) 540 (Revised December 2018);
- ISA (UK) 550: material that was duplicative of the ISAs (UK) has been deleted. Some other edits have been made to reflect changes in law and regulation (e.g. in relation to ring fencing);
- ISA (UK) 560: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 570: material that was duplicative of the ISAs (UK) has been deleted. The examples of matters to consider in relation to banks and building societies has been updated (e.g. to include a reference to the FRC's Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting – September 2014);

- ISA (UK) 580: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 600: material that was duplicative of the ISAs (UK) has been deleted. The possible use by the entity of 'structured entities' as well as special purpose vehicles, and shared services centres is recognised;
- ISA (UK) 620: the examples of areas where the auditor may involve an expert has been updated;
- ISA (UK) 700: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 705: material that was duplicative of the ISAs (UK) has been deleted;
- ISA (UK) 706: material that was duplicative of the ISAs (UK) has been deleted;
- Other reports by the auditor: updated to reflect that requirements for such reviews, where applicable, are established in the Capital Requirements Regulation;
- Appendix 1 – illustrative examples of auditor's reports – the example report for a review of interim net profits has been deleted. Auditors are expected to be able to prepare an appropriate report on the basis of the guidance provided without an illustrative example;
- Appendix 2 – the main parts of FSMA 2000 relevant to banks and building societies – updated for changes in the Act since 2011;
- Appendix 3 – FSMA 2000, BS Act 1986 and related statutory instruments: important provisions for auditors -updated for changes since 2011;
- Appendix 4 – the FCA Handbook and PRA Rulebook - updated to reflect the changes as a result of these bodies replacing the FSA;
- Appendix 5 - possible factors that may indicate going concern issues - updated;
- Appendix 6 – reporting direct to the regulators – statutory right and protection for disclosure under general law – minor edits to reflect the PRA and FCA replacing the FSA;
- Appendix 7 – the auditors' right and duty to report to the regulators: examples of reportable items – minor edits to reflect the PRA and FCA replacing the FSA;
- Appendix 8 (new) – auditing ECL – example approach for forward looking information;
- Appendix 9 (formerly appendix 8) – definitions – updated.

Overall this this approach has resulted in a shortening of many sections of the PN, although the section on ISA (UK) 540 is extended.

5. The FRC's consultation closed on 8 March 2019. We received eight responses – one from a professional body, four from audit firms and three from other stakeholders and interested parties (see the Attachment¹).
6. We set out below a summary of the responses received to the questions asked in the consultation, and the FRC's response.

¹ Copies of the responses can be seen at <https://www.frc.org.uk/consultation-list/2018/consultation-paper-and-impact-assessment—proposals>

Q1. *Overall do you agree with the proposed revisions to the Practice Note? If not please explain why.*

Summary of Responses

Six respondents replied to this question – the other two respondents were focussed on the review of interim profits, which is covered under question 5 below. The professional body and the audit firms expressed general support for the proposed revisions, while also providing some suggestions for further enhancement. The other respondent expressed concerns on a range of matters, including about the status of guidance for auditors and that it may put auditors in a compliance mind-set, and other matters such as auditor independence and the regulatory regime for banks and auditors.

FRC Response

The FRC welcomed the editorial suggestions, particularly those that improved clarity and enhanced the guidance, and has reflected them in the final guidance where considered appropriate. The main edits are in the guidance for ISA (UK) 315, highlighting IT related risks; ISA (UK) 540, to improve clarity and further enhance the guidance; the section on other reports by auditors, to reinstate the guidance for review reports on interim profits, updated to reflect changes in the relevant regulations; and Appendix 8, to improve clarity and further enhance the guidance. Further details of the edits are given below. Comments on matters outside the scope of PN 19 have been noted for consideration in due course.

Q2. *Is the included guidance appropriate, in particular that for ISA (UK) 540 (Revised December 2018)? If you believe it should be amended, please explain why and how.*

Summary of Responses

Of the six respondents who replied to this question, five (the professional body and the audit firms) were generally supportive, but included some specific suggestions to further enhance the guidance. The other respondent expressed concerns, including that the guidance should be capable of being read by a non-specialist, that auditors should always make their own estimates to compare with management, and other matters related to the regulatory regime.

FRC Response

As noted above, the FRC has welcomed and reflected suggestions that improve clarity and enhance the guidance. The majority of those related to the guidance for ISA (UK) 540, including emphasising understanding how ECL models have been designed and implemented; increased guidance relating to the consideration of Significant Increase in Credit Risk (SICR); identifying that the auditor may, where sufficient data can be obtained, consider performing a peer comparison or benchmarking ECL valuation methodologies and assumptions with those used by other entities with similar portfolios; emphasising that any tools or models used in developing a point estimate or range by the auditor or auditor's expert need to be subject to appropriate procedures, in line with the requirements of ISA (UK) 540; enhancing the guidance in relation to evaluating whether disclosures are reasonable.

PNs are produced specifically to provide guidance on applying the ISAs (UK), which are of general application, in audits of specialised sectors. They are intended for use by auditors with engagements in those sectors, not non-specialists, and are written accordingly.

Q3. *Is the guidance in Appendix 8, 'Auditing ECL – Example approach for forward looking information' appropriate and at the right level of detail? If you believe it should be amended, please explain why and how.*

Summary of Responses

Of the six respondents who replied to this question, five (the professional body and the audit firms) were generally supportive, but included some specific suggestions to further enhance the guidance. The other respondent did not directly answer the question but commented on a variety of matters, including using methods other than those used by the entity to evaluate estimates, concerns about lack of accessibility to auditors, and other matters related to the regulatory regime.

FRC Response

As noted above, the FRC has welcomed and reflected suggestions that improve clarity and enhance the guidance. These include highlighting that the understanding of the ECL methodology includes considerations related to how forward looking information impacts identification of SICR, and that different methodologies may be used; emphasising being alert to the potential for bias; evaluating whether post model adjustments (PMAs) need to be recognised; the evaluation of controls includes considering reviews by management and those charged with governance of forward looking information and ECL estimation outcomes; and emphasising considering the use of auditor's experts or specialists.

ISA (UK) 540 identifies the different approaches that auditors may take when auditing accounting estimates. These may include methods other than those used by the entity, but also include auditing management's process where that is considered to be an appropriate approach.

Q4. *Are there other aspects of auditing ECL for which examples should be provided? If you believe there are please explain what you believe should be covered and why.*

Summary of Responses

Five respondents answered this question. The professional body and three audit firms expressed the view that further examples were not needed in PN 19 but that reference could be made to examples and guidance available from other sources. The other audit firm suggested that an example could be provided on the subject of Significant Increase in Credit Risk (SICR).

FRC Response

The section on ISA (UK) 540 includes guidance specific to SICR and this has been enhanced. The FRC does not believe that further examples of approaches to auditing other aspects of auditing ECL should be included in PN 19. The FRC is aware that the International Auditing and Assurance Standards Board (IAASB) may later this year issue examples of applying ISA 540 to the audit of some aspects of ECL, which UK auditors may find helpful.

Q5. *Has any extant guidance been deleted that you believe should be retained? If yes, please explain why it should be retained and whether, and if so how, it should be updated.*

Summary of Responses

Seven respondents in effect answered this question – the professional body, the audit firms and the two other respondents who had not answered the other questions. Two audit firms expressed the view that no guidance had been deleted that should be retained. The other five

respondents who answered all expressed the view that guidance on auditors' reports on interim profits, for the purpose of their inclusion in capital resources, should be reinstated. Arguments for this included to facilitate a consistent approach, it is an important matter on which to provide guidance, and the guidance is referred to by the FCA.

FRC Response

The FRC had removed the guidance on the review of interim profits as it was intended that this would be addressed in a revision of the International Standard on Review Engagements (ISRE) (UK and Ireland) 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, which is due to commence later this year, and until then the guidance in the extant PN 19 would remain helpful. Also, the guidance is no longer specifically referred to by the FCA or PRA in the context of banks and building societies. However, in light of the comments received, the FRC has reinstated the guidance in PN 19. The guidance on the auditor's procedures is unchanged but the background guidance has been updated to reflect that requirements for such reviews, where applicable, are now established in the Capital Requirements Regulation rather than the FCA Handbook.

Q6. *Are there any other matters in relation to the audit of banks and building societies that you believe should be covered in the Practice Note and, if so, what do you believe the guidance should address?*

Summary of Responses

The professional body, three audit firms and one of the other respondents suggested that other matters that could be addressed included: the 'senior managers and certification regime' (one respondent), technology risks (three respondents), reporting 'key audit matters' (two respondents) issues related to group audits (one respondent), and Brexit if the position is not clear by the time the PN is finalised (two respondents). Suggestions were also given in relation to a variety of matters related to the regulatory regime for banks and audit (one respondent) and also the style of presentation of the guidance (one respondent).

FRC Response

The senior managers and certification regime is referred to in PN 19 and the FRC believes the description of it is sufficient. As noted above, some additional guidance on technology risks has been added. The FRC does not believe it is necessary to add guidance on reporting key audit matters (KAMs). KAMs are matters of professional judgment and should be considered in the context of each particular audit, having regard to the requirements and guidance in ISA (UK) 701. Providing guidance that may be taken to suggest "expected" KAMs risks detracting from the exercise of professional judgment. The issues identified in relation to group audits, including the impact of auditor rotation and other matters such as access to the working papers of component auditors, are not specific to banks and building societies and accordingly not appropriate to seek to address in PN 19 – the FRC will consider these in the context of audits more generally in due course. Matters related to concerns with the regulatory regime for banks and auditors are outside the scope of PN 19, but the comments made have been noted for consideration when those particular matters are being considered by the FRC.

The main impact of Brexit on the guidance in PN 19 is expected to be to require changes to the references made to specific laws and regulations. The timing of those changes may depend on whether there is a 'hard' Brexit or a transition period. The Bank of England has issued Policy Statements on its approach to amending financial services legislation. The references in PN 19 will be updated in due course once they are known. Brexit is not expected

to require significant substantive changes to the guidance in PN on the practical aspects of auditing a bank or building society.

The style of presentation of PN 19 is consistent with that of other PNs and the FRC does not believe it is necessary to change it at this time.

Other Comments – Effective Date

Summary of Responses

In addition to editorial suggestions from respondents, two audit firms noted that there was no proposed effective date for the revised guidance and that it was unclear whether it was intended that the implementation date is aligned with that of ISA (UK) 540 (Revised 2018) – audits of financial statements for accounting periods commencing on or after 15 December 2019.

FRC Response

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

Conclusion

Following the consultation and having regard to the responses received, the FRC is issuing PN 19.

Impact Assessment

A Practice Note provides guidance to support best practice. Although a Practice Note is not prescriptive, the FRC's Statement on the Scope and Authority of Audit and Assurance Pronouncements states that auditors should be aware of and consider Practice Notes applicable to the engagement. Auditors who do not consider and apply the guidance included in a relevant Practice Note should be prepared to explain how the engagement standards have been complied with. The main changes in PN 19 are driven by the revision of ISA (UK) 540 (Revised December 2018), the impact of which was considered when that standard was revised. The FRC has not identified any additional costs resulting from the revised guidance in PN 19.

Financial Reporting Council

July 2019

Respondents to the December 2018 FRC consultation on the proposed revision of Practice Note 19

Professional Body

ICAEW

Audit Firms

BDO LLP

Deloitte LLP

EY LLP

KPMG LLP

Other

Andrew Lowin (Technical Director, EU Financial Services Regulation, Compliance and Regulatory Consulting, Duff & Phelps)

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