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*Practice  
Note*

**19** *(Revised)*

**THE AUDIT OF BANKS AND  
BUILDING SOCIETIES IN THE  
UNITED KINGDOM**

The Auditing Practices  
Board

## **The Auditing Practices Board**

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

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The purpose of Practice Notes issued by the APB is to assist auditors in applying auditing standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice. Auditors should be aware of and consider Practice Notes applicable to the engagement.

This Practice Note replaces the previous Practice Note 19 which was issued in January 2007.

## PRACTICE NOTE 19

# THE AUDIT OF BANKS AND BUILDING SOCIETIES IN THE UNITED KINGDOM (REVISED)

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## **PREFACE**

This Practice Note contains guidance on the application of International Standards on Auditing (ISAs) (UK and Ireland) issued by the Auditing Practices Board ('the APB') to the audit of banks and building societies in the United Kingdom (UK). In addition a number of other entities, for example consumer finance companies, compete with banks in areas of banking business outside of deposit taking and auditors of such entities may find the guidance in this Practice Note helpful. A bank or building society can also be an 'authorised firm' in the context of regulation under the Financial Services and Markets Act 2000.

The Practice Note is intended to assist auditors in applying the requirements of, and should be read in conjunction with, ISAs (UK and Ireland), that apply to audits of financial statements for periods ending on or after 15 December 2010. This Practice Note sets out the special considerations relating to the audit of banks and building societies which arise from individual ISAs (UK and Ireland) listed in the contents. It is not the intention of the Practice Note to provide step-by-step guidance to the audit of banks and building societies so where no special considerations arise from a particular ISA (UK and Ireland), no material is included.

Auditors of banks need to be aware of the specific regulatory requirements, including capital adequacy requirements, that apply to banks, some of which impact on the auditor. This Practice Note gives guidance on these. Other particular areas of bank accounts that can necessitate special audit considerations are those that require preparers to exercise significant judgement, particularly the valuation of complex financial instruments and the calculation of impairment provisions for loan portfolios. Many banks have extensive trading portfolios of derivatives and other complex financial instruments and so this Practice Note should be read in conjunction with Practice Note 23 (Revised), 'Auditing Complex Financial Instruments – Interim Guidance'. The valuation of complex financial instruments is an area where the auditor may need to consider the use of specialist staff.

One further important area where the nature of banking business requires special consideration is in the assessment of going concern and disclosure of related liquidity risks.

The term 'Investment Bank' is commonly used to refer to entities that are engaged in primary or secondary trading in the debt, equity and commodity markets or in the provision of corporate finance advice. Many of these entities are banks, i.e. they hold an authorisation to accept deposits but some are not and so the term investment bank can be confusing. This Practice Note together with Practice Note 23 (Revised) considers issues relating to the principal secondary market trading activities of such entities but does not include any special considerations relating to primary market activities or the specialist nature of commodity trading.

This Practice Note has been prepared with advice and assistance from staff of the FSA and is based on the legislation and regulations in effect at 1 February 2011.

## ***RESTRUCTURING OF THE FSA***

In June 2010 the UK Government announced that the FSA would be restructured in 2012. In preparation for this the FSA has indicated that it will undertake a reorganisation in 2011. The APB intends to update the references to the FSA within Practice Note 19 at the appropriate time. The APB will only consult on this update if there are associated changes in the regulations that have a substantive effect on the audit.

## **INTRODUCTION**

1. Banks can operate in the UK as:

- a company incorporated in the UK which is authorised<sup>1</sup> by the Financial Services Authority ('FSA') to accept deposits, which is required to comply with BIPRU<sup>2</sup> and is not a building society ('UK bank');
- a UK branch of an entity incorporated outside the EEA, authorised by the FSA to accept deposits and which is required to comply with BIPRU ('non EEA bank');
- a UK branch of a credit institution incorporated in the EEA which has exercised EEA Passport rights<sup>3</sup> to carry on regulated activities in the UK ('EEA bank').

A building society is a mutual society incorporated under the Building Societies Act 1986 ('BS Act 86') – ('building society').

Auditors of entities that carry out similar business to banks and building societies but do not take deposits may find the guidance in this Practice Note useful.

2. This Practice Note addresses the responsibilities and obligations of the auditor concerning:

- the audit of the financial statements in accordance with the Companies Act 2006<sup>4</sup> ('CA2006') and Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008<sup>5</sup> ('Companies and Groups Accounts Regulations 2008') – applicable to UK banks;
- the audit of the financial statements in accordance with BS Act 1986 and Building Societies (Accounts and Related Provisions) Regulations 1998<sup>6</sup> ('BS Accounts Regulations 1998') and related obligations – applicable to building societies;

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1 Authorised under FSMA 2000 to undertake regulated activities.

2 Prudential sourcebook for Banks, Building Societies and Investment Firms.

3 Exercising passport rights entitles an entity incorporated in one EEA member state ('home country') who is authorised to conduct one or more regulated activities subject to the passport rights in the home country to establish a branch and carry out those regulated activities in another EEA member state ('host country') without the need to be authorised by the host country supervisor, (in the UK the FSA) in respect of activities that are subject to the passport rights.

4 Banks which are incorporated in the United Kingdom are subject to the provisions of the Companies Act 2006.

5 SI 2008/410.

6 SI 1998/504 (as amended).

- the right and duty to report direct to the FSA<sup>7</sup> in certain circumstances – applicable to UK banks, non EEA banks, building societies and to EEA banks with top-up permissions<sup>8</sup>;
  - reporting on interim net profits for the purposes of their inclusion in capital resources. This is applicable to UK banks and building societies but required only if requested by the entity; and
  - reporting on a statement of particulars of transactions and arrangements concerning directors under s78(9) BS Act 86 applicable to building societies.
3. Non EEA banks and EEA banks are not subject to the audit provisions of the CA2006 and so the terms of engagement are a matter of contract between the auditor and their client who may, for example, be local or head office management or the EEA/non EEA bank's home country auditor. Such engagements take many different forms: the auditor may be asked to report on the financial statements of the UK branch or only on particular aspects thereof, and the form of their opinion will also vary from case to case. The auditor undertaking such an assignment does not have to apply International Standards on Auditing (ISAs) (UK and Ireland) unless required to by the terms of engagement but, if they are not applied, the auditor may find some of the guidance in this Practice Note of assistance.
4. In addition to accepting deposits, banks and building societies may also undertake other activities regulated under the Financial Services and Markets Act 2000 (FSMA 2000) for which Part IV permissions<sup>9</sup> from the FSA are required. This may include one or more forms of investment business or insurance intermediation. These regulated activities are subject to FSA conduct of business rules and can give rise to auditor reporting responsibilities concerning client assets. This can occur even where the entity is not authorised to hold client assets – a negative assurance report. These reporting responsibilities are addressed in Practice Note 21, 'The Audit of Investment Businesses in the United Kingdom (Revised)'<sup>10</sup>. In addition, banks and building societies may also undertake regulated mortgage activity. While this also requires separate Part IV permissions and is also subject to FSA conduct of business rules, no auditor reporting obligations arise in relation to client assets.

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7 Provided for in s342 and s343 FSMA 2000 and Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587).

8 A Part IV permission granted by the FSA to an EEA bank to enable it to undertake a UK regulated activity in the UK for which authorisation to undertake the activity in the home country is not required by the home country supervisor.

9 A permission granted by FSA under Part IV FSMA 2000 permitting an authorised firm to carry on regulated activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended.

10 Further guidance is included in ICAEW TECH 1/06: Interim guidance for auditors of insurance intermediaries on client asset reporting requirements.



5. The scope of the statutory audit of a UK bank's financial statements is no different from that of the generality of companies incorporated in the UK. Concerning a building society, in addition to the financial statements and the directors' report, the auditor also reports on an annual business statement which accompanies the financial statements. Further, the auditor of a building society is required to report on the summary financial statement that all building societies are obliged to prepare and send to all those members entitled to receive notice of the Annual General Meeting (an option to prepare summary financial statements, rather than a requirement to do so, is available under CA2006 to listed companies including listed UK banks).

## **LEGISLATIVE AND REGULATORY FRAMEWORK**

6. The legal and regulatory framework within which banks and building societies operate in the UK is summarised in the following paragraphs.

### **Financial statements**

7. The form and content of the financial statements of UK banks prepared under UK GAAP is governed by the CA2006, Statements of Standard Accounting Practice ('SSAPs'), Financial Reporting Standards ('FRSs') and Urgent Issues Task Force ('UITF') Abstracts. The prescribed format for a UK banks' financial statements that comply with UK GAAP is set out in the Companies and Groups Accounts Regulations 2008 made under Part 15 CA2006. However, listed UK groups (including listed UK banking groups) must prepare consolidated financial statements in accordance with those International Financial Reporting Standards adopted by the European Union (EU IFRSs)<sup>11</sup> and those parts of CA2006 applicable to companies reporting under EU IFRSs. UK companies or non listed groups, including UK banks and banking groups, are permitted to adopt voluntarily EU IFRSs for their financial statements.
8. The form and content of a building society's financial statements prepared under UK GAAP are prescribed in the BS Accounts Regulations 1998 made under s72C BS Act 1986. These are similar to the Companies and Groups Accounts Regulations 2008 applicable to UK banks. As for UK banks, building societies apply FRSs, SSAPs and UITF abstracts when reporting under UK GAAP. Building societies with listed securities, including permanent interest-bearing shares, are also required to apply EU IFRSs in their consolidated financial statements. Like UK companies, building societies may also voluntarily adopt EU IFRSs for their entity financial statements.
9. In addition to financial statements and a directors' report, building societies are also required, by BS Act 1986, to prepare:

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<sup>11</sup> Article 4 of EC Regulation 1606/2002 as acknowledged in s403 CA2006 – the IAS Regulation.

- an annual business statement – part of the annual report (s74 BS Act 1986); and
  - a summary financial statement (s76 BS Act 1986).
10. The Accounting Standards Board ('ASB') has stated that it intends ultimately to converge UK GAAP with IFRS. Current ASB proposals envisage a differential reporting regime based on public accountability. This will result in all UK banks and building societies having to apply EU IFRS. However these proposals have yet to be finalised and the timetable for this has yet to be determined. In the meantime, UK Accounting Standards covering financial instruments that are consistent with IFRS<sup>12</sup> have been issued but are subject to complex rules as to which entities they apply to and when. As the activities of UK banks and building societies largely comprise financial instruments the auditor considers carefully which of the various accounting standards and BBA SORPs<sup>13</sup> apply to the entity being audited.
11. The British Bankers Association has published a voluntary Code for Financial Reporting Disclosures (the BBA Code). This sets out key principles for disclosure and also establishes a process for banks to consider areas of topical interest that may have an impact on financial reporting disclosures and how to enhance the ability to make comparisons across the banking sector. Each bank subscribing to the BBA Code states as such in its annual report. Auditors need to be alert to any disclosures that will follow from the BBA Code each year.

## **Financial Services and Markets Act 2000**

12. FSMA 2000 sets out the high level regulatory framework for the financial sector more generally and does not relate just to banks and building societies. Appendix 2 sets out the main parts of FSMA 2000 relevant to authorised firms which are banks or building societies.
13. The wide scope of FSMA 2000 reflects the FSA's extensive responsibilities. These are set out in FSMA 2000 as regulatory objectives covering:
- market confidence;
  - financial stability;
  - the protection of consumers; and
  - the reduction of financial crime.

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<sup>12</sup> International Financial Reporting Standards.

<sup>13</sup> Statements of Recommended Practice issued by the British Bankers' Association and Irish Bankers' Federation.

14. FSMA 2000 covers not only the regulation and supervision of financial sector entities but also other issues such as official listing rules, business transfers, market abuse, compensation and ombudsman schemes, investment exchanges and clearing houses.
15. FSMA 2000 is also supported by a large number of statutory instruments. Significant components of the definition and scope of the regulatory framework are contained in the main statutory instruments. A list of important provisions of FSMA 2000 and a list of statutory instruments relevant to the auditor is included in Appendix 3.
16. Under Part X FSMA 2000 the FSA has the power to make 'rules'. The legal effect of a rule varies depending on the power under which it is made and on the language used in the rule. Rules are mandatory unless a waiver has been agreed with the FSA. If an authorised firm contravenes a rule it may be subject to enforcement action and consequent disciplinary measures under Part XIV FSMA 2000. Furthermore, in certain circumstances an authorised firm may be subject to an action for damages under s150 FSMA 2000. In contrast, guidance is generally issued to throw light on a particular aspect of regulatory requirements, and is not binding. However if an authorised firm acts in accordance with it in the circumstances contemplated by that guidance, the FSA will proceed on the basis that the authorised firm has complied with the rule to which the guidance relates.
17. Rules made by the FSA and associated guidance are set out in the FSA Handbook of Rules and Guidance ('the FSA Handbook') (see Appendix 4). The main FSA systems and control requirements are set out in the Senior management arrangements, systems and controls element of the high level standards block of the FSA Handbook ('SYSC').
18. The FSA Handbook is subject to periodic change. The auditor considers carefully which parts of what sourcebook apply to the entity.
19. It is clearly unrealistic to expect members of an audit engagement team to have detailed knowledge of the entire Handbook; rather ISA (UK and Ireland) 250 Section B requires the level of knowledge to be appropriate to an individual's role in the audit and sufficient (in the context of that role) to enable them to identify situations which may give reasonable cause to believe that the matter should be reported to a regulator. ISA (UK and Ireland) 220 requires the auditor to establish procedures to facilitate consultation and, thereby, to draw on the collective expertise and specialist technical knowledge of those beyond the engagement team of the auditor.

## Prudential requirements

20. Banks and building societies are subject to certain prudential requirements which are detailed in GENPRU<sup>14</sup> and BIPRU. These include capital adequacy, liquidity<sup>15</sup>, large exposures (concentration risk) and additional related aspects of systems and controls not covered in SYSC. There are also certain specific prudential measures applied by the FSA which entities are required to report to the FSA via prudential returns. The main measures include:

- capital adequacy – ensuring sufficient capital resources in relation to risk requirements to absorb losses;
- liquidity – ensuring sufficient liquid assets or maturing assets to meet liabilities as they fall due; and
- large exposures – avoiding undue credit risk concentrations.

## The Building Societies Act 1986

21. In addition to FSMA 2000 which applies to FSA authorised firms generally, BS Act 1986 applies to building societies. It sets out the legal framework applicable to building societies. A list of important provisions of BS Act 1986 and related statutory instruments relevant to the auditor is included in Appendix 3. In addition, further guidance on constitutional matters and compliance with BS Act 1986 is set out in the Building Societies Regulatory Guide ('BSOG') and the Building Societies specialist sourcebook ('BSOCS') which forms part of the FSA Handbook. The BS Act 1986 includes, for example:

- s5 principal purpose (paragraph 22);
  - s6 lending limit (paragraphs 23 to 25);
  - s7 funding limit (paragraphs 23 to 25); and
  - s9A restrictions on treasury activities (paragraph 26).
22. A building society's purpose or principal purpose must be to make loans secured on residential property and funded substantially by its members. The lending and funding limits (see paragraph 23 below) are quantitative criteria which help to determine a

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<sup>14</sup> General Prudential sourcebook.

<sup>15</sup> The FSA's new prudential liquidity regime is provided in BIPRU 12; transitional arrangements currently govern the transition from the regime contained in IPRU(BANK) to BIPRU 12.

building society's compliance with this purpose. However, other factors will also be taken into account by the FSA<sup>16</sup> including:

- whether the society is meeting, and is expected to continue to meet, its lending and funding limits;
  - the actual and projected proportion of the society's gross income that is, or is expected to be, derived from activities that are related to the making of loans secured on residential property. (Income from the society's property related insurance and valuation services might be regarded as related to the making of loans secured on residential property, but income from the society's motor insurance business (if any) would not); and
  - all other relevant quantitative and qualitative factors.
23. There are particular quantitative limits specified in BS Act 1986 that are used in the assessment of compliance with this principal purpose criterion – collectively known as 'nature limits'. The BS Act 1986 limits are as follows:
- at least 75% of business assets must be loans fully secured on residential property – the lending limit (s6 BS Act 1986);
  - at least 50% of total funds (i.e. total shareholder funds, wholesale deposits and bills of exchange and debt instruments) must be raised in the form of shares (deposits conferring membership rights) held by individual members – the funding limit (s7 BS Act 1986).
24. These nature limits are additional to the prudential measures referred to in paragraph 20 above. BSOCS 4 provides more guidance on the application of the funding limit and, in practice, most building societies choose to apply both the funding and the lending limits more restrictively. The funding limit and the lending limit as at the end of the financial year must both be reported to members, together with the statutory limits, in the annual business statement, and are also required to be reported to the FSA. The annual business statement is reported on by the auditor and is attached to the annual accounts of the building society (see paragraphs 226 and 227).
25. Both these limits must be calculated on a group basis where that is appropriate. With reference to the lending limit, business assets means total assets, plus provisions for bad and doubtful debts, less fixed assets, less liquid assets and less any long-term insurance funds. Business assets, therefore, typically comprise loans, investments in connected undertakings and sundry debtors and prepayments. Building societies preparing their financial statements in accordance with EU IFRS use the appropriate equivalent balance sheet captions. Residential property is defined as being land at least 40% of which is

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16 BSOG 1.2.4.

normally used as, or in connection with, one or more dwellings, or which has been, is being, or is to be developed or adapted for such use.

26. A building society may undertake almost any activity, provided that such activity is included within its Memorandum<sup>17</sup> and provided that the building society or group as a whole continues to comply with the principal purpose and with the nature limits. However s9A BS Act 1986 includes a number of specific prohibitions on a building society's treasury activities, which are that (subject to certain exceptions) a building society is not permitted to:

- act as a market maker in securities, commodities or currencies;
- trade in commodities or currencies; or
- enter into any transaction involving derivative instruments, except in relation to hedging.

### Reporting direct to the FSA – statutory right and duty

27. Under FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587) the auditor of an authorised firm or the auditor of an entity closely linked to an authorised firm who is also the auditor of that authorised firm has a statutory duty to communicate matters of material significance to the FSA. Under s340 FSMA 2000, 'the auditor' is defined as one required to be appointed under FSA 'rules' or appointed as a result of another enactment. In addition, s342 FSMA 2000 provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the FSA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA. Guidance on the identification of matters to be reported to the regulators is set out in the section dealing with ISA (UK and Ireland) 250 Section B.

28. An EEA bank is not required to appoint an auditor under FSA's rules in respect of its UK branch operations unless it has a top-up permission. Furthermore, a UK branch of a bank incorporated outside the UK is not required to appoint an auditor under CA2006. Consequently, if an EEA bank (without top-up permissions) appoints an auditor to undertake audit procedures at its UK branch this does not fall within the definition of 'auditor' for the purposes of s342/3 FSMA 2000 and SI 2001/2587. As a result the auditor undertaking such work has neither a statutory right nor statutory duty to report direct to the FSA and may not have relief from its duty of confidentiality to its client if the auditor decides to do so. In the event that an auditor of an EEA bank identifies a matter that would be likely to be of material significance to the FSA, the auditor considers whether they have a responsibility to report such matters to the 'head office' auditors of the EEA

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17 A Memorandum within the meaning of Sch 2 BS Act 1986.

bank or to the home country regulator. See Appendix 6 concerning disclosure in the public interest.

29. A non EEA bank is required to appoint an auditor under SUP 3.3.2R in respect of its UK branch operations and therefore an auditor appointed in accordance with this rule has both the right and duty to report. Whilst, in principle, there is a requirement to appoint an auditor, there is no FSA requirement for the auditor to undertake audit procedures and there is no corresponding requirement to report on the results of those procedures. Therefore some non EEA banks with UK operations that are not material to the non EEA bank as a whole may have no need to commission an auditor to undertake audit procedures.

### **Communication between the FSA and the auditor**

30. In February 2011 the FSA published a draft 'Code of Practice for the relationship between the external auditor and the supervisor', with a final version expected later in 2011. The code of practice, which is subject to any changes as a result of the consultation, sets out principles that establish, in the context of a particular regulated firm, the nature of the relationship between the supervisor and the auditor, the form and frequency that communication between the two parties should take, and the responsibilities and scope for sharing information between the two parties. The FSA expects supervisors and auditors of banks and building societies to apply the principles set out in the code having regard to the related guidance within it.
31. Within the legal constraints that apply, the FSA may pass on to the auditor any information which it considers relevant to his function. Auditors are bound by the confidentiality provisions set out in Part XXIII of FSMA 2000 (Public record, disclosure of information and co-operation) in respect of confidential information received from the FSA. An auditor may not pass on such confidential information even to the entity being audited without lawful authority (for example if an exception applies under the FSMA 2000 (Disclosure of confidential information) Regulations 2001<sup>18</sup>) or with the consent of the person from whom the information was received and, if different, to whom the information relates. Further guidance in respect of information communicated to the auditor by the FSA is set out in paragraphs 90 – 93 below.
32. The auditor is required to cooperate with the FSA (SUP3.8.2R). This may involve attending meetings, including routine bilateral meetings, and providing the FSA with information about the authorised firm that the FSA may reasonably request in discharging its functions. For example this can arise in relation to FSA ARROW II risk assessments.

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18 SI 2001/2188.

33. The auditor must notify the FSA without delay if the auditor is removed from office, resigns before the term of office expires or is not re-appointed by the authorised firm. Notification to the FSA includes communicating any matters connected with this event that the auditor considers ought to be drawn to the FSA's attention or a statement that there are no such matters (s344 FSMA 2000 and SUP3.8.11R and 12R).



## THE AUDIT OF FINANCIAL STATEMENTS

*This Practice Note provides guidance for auditors applying those ISAs (UK and Ireland) that are effective for audits of financial statements for periods ending on or after 15 December 2010. The purpose of the following paragraphs is to identify the special considerations arising from the application of the 'Requirements' of ISAs (UK and Ireland) to the audit of banks and building societies, and to suggest ways in which these can be addressed (extracts from ISAs (UK and Ireland) are indicated by grey-shaded boxes below). This Practice Note does not contain commentary on all of the requirements included in the ISAs (UK and Ireland) and reading it should not be seen as an alternative to reading the relevant ISAs (UK and Ireland) in their entirety. In addition, where no special considerations arise from a particular ISA (UK and Ireland), no material is included.*

### **ISA (UK AND IRELAND) 200: OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH INTERNATIONAL STANDARDS ON AUDITING (UK AND IRELAND)**

#### **Scope of this ISA (UK and Ireland)**

This International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with ISAs (UK and Ireland). Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the ISAs (UK and Ireland), and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the ISAs (UK and Ireland). The independent auditor is referred to as 'the auditor' hereafter. (paragraph 1)

#### **Overall objectives of the auditor**

In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the ISAs (UK and Ireland), in accordance with the auditor's findings. (paragraph 11)

In all cases, when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the ISAs (UK and Ireland) require that the auditor disclaim an opinion or withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation. (paragraph 12)

The auditor shall plan and perform an audit with an attitude of professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated. (paragraph 15)

34. ISAs (UK and Ireland) include a requirement for the auditor to comply with relevant ethical requirements relating to audit engagements. Auditors in the UK are subject to ethical requirements from two sources: the APB Ethical Standards for Auditors concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body. A fundamental principle is that practitioners should not accept or perform work which they are not competent to undertake. The importance of technical competence is also underlined in the Auditors' Code<sup>19</sup>, issued by the APB, which states that the necessary degree of professional skill demands an understanding of financial reporting and business. Practitioners should not undertake the audit of a bank or building society unless they are satisfied that they have, or can obtain, the necessary level of competence.

### **Professional scepticism**

35. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.

### **Independence**

36. Independence issues can be complex for the auditor of a bank, and to a lesser extent a building society because of banking and other relationships that the auditor and/or its partners and staff may have with the bank. The auditor makes careful reference to the APB's Ethical Standard 2 – Financial, business, employment and personal relationships.

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19 This is appended to the APB's Scope and Authority of Pronouncements.

## **ISA (UK AND IRELAND) 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS**

### **Objective**

The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (a) Establishing whether the preconditions for an audit are present; and
- (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement. (paragraph 3)

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (paragraph 9)

Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content. (paragraph 10)

If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (paragraph 11)

37. Matters which the auditor may decide to refer to in the engagement letter are as follows:

- the responsibility of the directors/senior management to comply with applicable FSMA 2000 legislation and FSA Handbook rules and guidance including the need to keep the FSA informed about the affairs of the entity;
- the statutory right and duty of the auditor to report direct to the FSA in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B);
- the requirement to cooperate with the auditor (SUP3.6.1R). This includes taking steps to ensure that, where applicable, each of its appointed representatives and material outsourcers gives the auditor the same right of access to records, information and explanations as the authorised firm itself is required to provide the auditor (s341 FSMA 2000 and SUP 3.6.2G to 3.6.8G). It is a criminal offence for an authorised firm or its officers, controllers or managers to provide false or misleading information to the auditor (s346 FSMA 2000)<sup>20</sup>;
- the need for the entity to make the auditor aware when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt.

38. In this connection the auditor is aware that:

- the FSA does not need to approve the appointment of an auditor but may seek to satisfy itself that an auditor appointed by a firm is independent and has the necessary skills, resources and experience (SUP 3.4);
- the auditor is required to cooperate with the FSA (SUP3.8.2R); and
- the auditor must notify the FSA if the auditor ceases to be the auditor of an authorised firm.

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<sup>20</sup> An offence is committed also under s501 CA2006 by a person who knowingly or recklessly makes to an auditor of a company a statement (oral or written) that: (a) conveys or purports to convey any information or explanations which the auditor requires, or is entitled to require, under s 499 CA 2006, and (b) is misleading, false or deceptive in a material particular. An equivalent offence is included under s79(9) of the Building Societies Act 1986.

## **ISA (UK AND IRELAND) 220: QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS**

### **Objective**

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and applicable legal and regulatory requirements; and
- (b) The auditor's report issued is appropriate in the circumstances. (paragraph 6)

Reference should also be made to ISQC (UK and Ireland) 1 – *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements*.

The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (paragraph 14)

- 39. The nature of banking business is one of rapidly changing and evolving markets. Often new products and practices are developed which require specialised auditing and accounting responses. It is therefore important that the auditor is familiar with current practice. Audit firms organise training in these specialist areas where necessary and keep audit staff up to date with knowledge of relevant regulations.
- 40. As well as ensuring that the engagement team has an appropriate level of knowledge of the industry and its corresponding products, the engagement partner also satisfies himself that the members of the engagement team have sufficient knowledge of the regulatory framework within which the entity operates commensurate with their roles on the engagement.

41. Under ISQC (UK and Ireland) 1, an audit firm is required to establish a process to monitor the audit firm's quality control policies and procedures<sup>21</sup>. This process is required to include, on a cyclical basis, inspection of at least one completed engagement for each engagement partner. In order to perform an effective review of a completed audit of a bank or building society, those undertaking the review will need an appropriate level of knowledge of the types of banking business undertaken by the entity and the applicable regulatory framework.

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21 ISQC (UK and Ireland) 1, paragraph 48.

## **ISA (UK AND IRELAND) 240: THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS**

### **Objectives**

The objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement of the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to fraud or suspected fraud identified during the audit. (paragraph 10)

In accordance with ISA (UK and Ireland) 200, the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (paragraph 12)

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by ISA (UK and Ireland) 315, the auditor shall perform the procedures in paragraphs 17–24 [of ISA (UK and Ireland) 240] to obtain information for use in identifying the risks of material misstatement due to fraud. (paragraph 16)

The auditor shall make inquiries of management and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (paragraph 18)

In accordance with ISA (UK and Ireland) 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. (paragraph 25)

- 42. As with other entities, fraud in banks and building societies, either fraudulent financial reporting (for example the manipulation of profits or the concealment of losses) or misappropriation of assets, can occur through a combination of management fraud,

employee fraud or fraud perpetrated by third parties. However, various factors make banks and building societies particularly vulnerable to fraud such as:

- They have custody of valuable and fungible assets including money, making them a particular target for fraudsters;
- They handle very large volumes of transactions and collect and disburse large amounts of money on a daily basis, for example in taking deposits, making loans and providing a payments service to customers. This creates more opportunity for fraud unless properly controlled;
- Certain aspects of their businesses are complex both in terms of the risks taken on and the operational risks the activities entail, which makes their operations more difficult to control; and
- Banks and building societies tend to be very heavily dependent on information technology (IT) to manage their businesses. This represents a significant opportunity for computer based fraud.

As a result, fraud is an increased risk in a banking business.

43. In order to mitigate these fraud risks, it is essential for the entity to have very strong internal controls including:
- The right ethical and cultural framework being set by senior management;
  - Appropriate status and authority being given to control functions such as risk and internal audit;
  - Clear lines for reporting control deficiencies and suspicions of misdoings;
  - Thorough procedures for investigating the background of clients and transactions;
  - Strong segregation of duties;
  - Clear control policies and requirements that are checked in detail and monitored by management;
  - Strong IT controls to prevent fraudulent access and manipulation of data and fraudulent access to assets (e.g. via internet banking); and
  - Appropriate measures in place to fight fraudulent activity, both physical and technological.
44. In addition, whilst remuneration policies can create excessive performance pressures in many industries, in certain banks and building societies or divisions of large banks (in particular treasury and investment banking operations) performance related bonuses can be significant, both in absolute terms and in relation to base remuneration. Significant bonus related remuneration often extends beyond senior management to quite junior



members of staff and can lead to more pervasive pressures that increase the risks of fraudulent financial reporting as these staff seek to enhance their bonuses or protect their jobs by inflating their reported results. The FSA Remuneration Code (SYSC 19) applies to banks and building societies meeting particular conditions (set out in SYSC 19.1.1) and requires (SYSC 19.2.1) that an authorised firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.

45. Principle 3 of the FSA Principles for Businesses (PRIN 2.1) requires a firm to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. SYSC 6.1.1 requires a firm to maintain adequate policies and procedures to ensure compliance with its obligations under the regulatory system and for countering the risk that it might be used to further financial crime<sup>22</sup>. Whilst the inherent risk of fraud may continue to exist, the establishment of accounting and internal control systems sufficient to meet these requirements frequently reduces the likelihood of fraud giving rise to material misstatements in the financial statements. Guidance on the auditor's consideration of accounting systems and internal control is provided in ISA (UK and Ireland) 315 and the section of this Practice Note that covers that standard. Examples of deficiencies in control that could give rise to fraud risk factors are also set out in that section.
46. In considering how to respond to the threat of misstatement by fraud the auditor considers the following:
- A thorough understanding of the nature of the entity's business, and in particular how profits and losses can arise in relation to particular products and transactions, is very important in detecting fraud, because it enables unusual patterns and trends that may indicate fraud to be more easily identified. An auditor considers how to enhance his/her knowledge of the entity's business, for example by:
    - Interviewing a wide range of management, including business as well as financial management;
    - Discussing findings with control functions such as risk, legal, compliance and internal audit together with considering reviews undertaken by third parties such as skilled person's reports prepared under s166 FSMA 2000<sup>23</sup>;
    - Using experts to help improve understanding;

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22 Further, record keeping requirements are set out in SYSC 9.

23 Under S166 FSMA 2000 provides the FSA with the power to require a firm to appoint a skilled person to provide a report on any matter that the FSA may reasonably require in connection with the exercise of the functions conferred on it by or under FSMA 2000. The requirements concerning skilled persons are set out in SUP5.

- Comparing the entity to peers in the market where feasible to identify unusual trends.
- Auditors of all entities familiarise themselves with the control environment as a whole and controls designed to prevent fraud that might affect the financial statements. They also assess the robustness of their design. Deficiencies in control are taken into account when planning audit procedures and reported to those in charge of governance. This is a particularly important aspect of the audit of a bank or building society because of the nature of the fraud risks they face and the complexity of the systems and controls required to combat them. The auditor ensures that the engagement team has the appropriate skills available to undertake this task, including the necessary information technology expertise.
- Many basic audit tests also help address audit fraud risk and the auditor considers the implications of the results of such tests for the risk of fraud. In particular, fraud usually has to be concealed through the use of fictitious or misleading balances. These can be revealed through:
  - Comparing balances to external sources, for example through bank and depository reconciliations;
  - Ensuring that suspense and transit accounts (the latter being accounts through which the progress of payments are monitored) are properly reviewed and promptly cleared;
  - Checking that the contents of all balance sheet accounts are properly understood and validated;
  - Verifying valuations to external sources.
- Much fraud is brought to the attention of companies through complaints and other more confidential means of reporting. An auditor considers checking the results of whistleblowing and complaints procedures within the entity, including how the entity ensures that these procedures are robust.
- An entity's regulators may also be aware of suspicious activity and the auditor considers maintaining a dialogue with them.
- The expectations of investors and other third parties and management compensation policies can indicate areas of particular pressure for management, which could lead to management fraud. Understanding these areas can help an auditor focus work in particularly vulnerable areas.

## Revenue recognition

When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue

recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.... (paragraph 26)

47. The auditor considers how revenue recognition can be manipulated:
- Interest and fee income is typically recognized on a systematic basis over the period of a loan or deposit automatically by the bank's IT system. It is likely that the risk of material misstatement due to fraudulent revenue recognition will be reduced where relevant IT controls are strong;
  - Trading income is strongly influenced by period-end valuations, so considering how fraudulent misreporting in this area can be prevented is important;
  - Many entities generate significant fees, the timing of whose recognition can require considerable judgment. The auditor considers how these judgements are made and whether they are influenced by a desire for a fee to be recorded in a particular period.

### Journal entries

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
- (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
  - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
  - (iii) Consider the need to test journal entries and other adjustments throughout the period. (paragraph 32)
48. Banks and building societies will typically have high numbers of journal entries relating to the financial reporting process. When identifying and selecting journal entries for testing, the auditor ensures the complete population is identified and is alert for non-standard and unusual journal entries for further investigation.

## Communication

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (paragraph 40)

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- (a) management;
- (b) employees who have significant roles in internal control; or
- (c) others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (paragraph 41)

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (paragraph 43)

The auditor shall include in the audit documentation communications about fraud made to management, those charged with governance, regulators and others. (paragraph 46)

49. Reduction of financial crime is one of the FSA's statutory objectives. The FSA's rules require authorised firms to report 'significant' fraud, errors and other irregularities to the FSA (SUP15.3.17R). The auditor is aware of the auditor's duty to report direct to FSA in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B).

## **ISA (UK AND IRELAND) 250: SECTION A – CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

### **Objectives**

The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements;
- (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- (c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit. (paragraph 10)

As part of obtaining an understanding of the entity and its environment in accordance with ISA (UK and Ireland) 315, the auditor shall obtain a general understanding of:

- (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- (b) How the entity is complying with that framework. (paragraph 12)

50. FSMA 2000 and related statutory instruments are important elements of the legal and regulatory framework applicable to banks and building societies. Detailed rules and guidance applicable to authorised firms is set out in the FSA Handbook. An overview of this legislation and the FSA Handbook is set out in paragraphs 12 to 19 and 27 to 33 above (and Appendices 2, 3 and 4). In addition to accepting deposits, an entity may also have one or more Part IV permissions from the FSA to undertake one or more types of investment business, insurance intermediation, regulated mortgage activity or other regulated activities. If this is the case, the auditor also considers the laws and regulations (which includes FSMA 2000 and the FSA Handbook) relevant to the entity's ability to conduct these additional regulated activities.

51. The auditor is alert to any indication that the entity is conducting business outside the scope of its Part IV permission or the entity is failing to meet FSMA 2000 Threshold Conditions<sup>24</sup> or contravening any Principles for Businesses<sup>25</sup>. Such action may be a serious regulatory breach, which may result in fines, public censure, suspension or revocation of authorisation. The auditor compares the current activities of the entity with the Scope of Part IV Permission granted by the FSA and considers ISA (UK and Ireland) 250 Section A and where appropriate ISA (UK and Ireland) 250 Section B.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. (paragraph 13)

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (paragraph 14)

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (paragraph 15)

52. Specific areas that the auditor's procedures may address include the following:
- obtaining a general understanding of the legal and regulatory framework applicable to the entity and industry, and of the procedures followed to ensure compliance with the framework;
  - reviewing the entity's Scope of Part IV Permission (an FSA document which sets out the regulated activities that the firm is permitted to engage in, including any limitations and requirements imposed on those permitted activities);

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<sup>24</sup> The minimum standards that a firm needs to meet to become and remain authorised by the FSA – see Appendix 4.

<sup>25</sup> FSA Handbook defines Principles with which authorised firms must comply – see Appendix 4.

- reviewing correspondence with the FSA and other regulators (including that relating to any FSA supervisory visits, requests for information by FSA or progress concerning FSA ARROW II risk mitigation programmes);
- holding discussions with the entity's Compliance Officer and other personnel responsible for compliance;
- reviewing compliance reports prepared for the Board, audit committees and other committees; and
- consideration of work on compliance matters performed by internal audit.

### **Money laundering**

53. As indicated in paragraph A11–1 of ISA (UK and Ireland) 250 Section A, in the UK and Ireland, the auditor is alert for instances of possible or actual non-compliance with laws and regulations including those that might incur obligations for partners and staff in audit firms to report to a regulatory or other enforcement authority. Anti-money laundering legislation in the UK and Ireland imposes a duty on the auditor to report suspected money laundering activity.
54. Authorised firms are subject to the requirements of the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002 as well as FSA rules. These laws and regulations require institutions to establish and maintain procedures to identify their customers, establish appropriate reporting and investigation procedures for suspicious transactions, and maintain appropriate records.
55. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which banks and building societies conduct their business. By the nature of their business, banks and building societies are ready targets of those engaged in money laundering activities. The effect of this legislation is to make it an offence to provide assistance to those involved in money laundering and makes it an offence not to report suspicions of money laundering to the appropriate authorities, usually the Serious Organised Crime Agency ('SOCA'). FSA requirements are set out in SYSC6. In this context, the FSA has due regard to compliance with the relevant provisions of guidance issued by the Joint Money Laundering Steering Group ('JMLSG')(SYSC6.3.5).
56. In addition to considering whether the entity has complied with the money laundering laws and regulations, the auditor has reporting obligations under the Proceeds of Crime Act 2002, and the Money Laundering Regulations 2007, to report knowledge or suspicion of money laundering offences, including those arising from fraud and theft, to SOCA. The auditor is aware of the prohibition on 'tipping off' when discussing money laundering matters with the entity. Given the nature of banking business and the likely frequency of

needing to report to SOCA, the auditor is aware of the short-form<sup>26</sup> of reporting to SOCA that can be used in appropriate circumstances to report minor and usually numerous items. Further guidance for auditors is provided in Practice Note 12 (Revised), 'Money Laundering – Guidance for Auditors on UK Legislation'.

57. The auditor, in the context of money laundering, is aware of the auditor's duty to report direct to FSA in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B).

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26 These are termed limited intelligence value reports.



## **ISA (UK AND IRELAND) 250: SECTION B – THE AUDITOR’S RIGHT AND DUTY TO REPORT TO REGULATORS IN THE FINANCIAL SECTOR**

### **Objective**

The objective of the auditor of a regulated entity is to bring information which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor’s audit responsibilities to the attention of the appropriate regulator as soon as practicable when:

- (a) The auditor concludes that it is relevant to the regulator’s functions having regard to such matters as may be specified in statute or any related regulations; and
- (b) In the auditor’s opinion there is reasonable cause to believe it is or may be of material significance to the regulator. (paragraph 8)

Where an apparent breach of statutory or regulatory requirements comes to the auditor’s attention, the auditor shall:

- (a) Obtain such evidence as is available to assess its implications for the auditor’s reporting responsibilities;
- (b) Determine whether, in the auditor’s opinion, there is reasonable cause to believe that the breach is of material significance to the regulator; and
- (c) Consider whether the apparent breach is criminal conduct that gives rise to criminal property and, as such, should be reported to the specified authorities. (paragraph 12)

### **Auditors’ duty to report to the FSA**

58. Under FSMA 2000 (Communication by Auditors) Regulations 2001 (‘the 2001 Regulations’), auditors have duties in certain circumstances to make reports to the FSA. Information and opinions to be communicated are those meeting the criteria set out below which relate to matters of which the auditor<sup>27</sup> of the authorised person (also referred to below as a ‘regulated entity’)<sup>28</sup> has become aware:

- (i) in his capacity as auditor of the authorised person; and

<sup>27</sup> An ‘auditor’ is defined for this purpose in the Regulations as a person who is, or has been, an auditor of an authorised person appointed under, or as a result of, a statutory provision including Section 340 of FSMA 2000.

<sup>28</sup> In the context of FSA regulation, these terms equate to the term ‘authorised firm’.

- (ii) if he is also the auditor of a person who has close links with the authorised person, in his capacity as auditor of that person.

The 2001 Regulations do not require auditors to perform any additional audit work as a result of the statutory duty to make a report to the FSA, nor are auditors required specifically to seek out breaches of the requirements applicable to a particular authorised person. However, in circumstances where the auditor identifies that a reportable matter may exist, the auditor carries out such extra work, as the auditor considers necessary, to determine whether the facts and circumstances cause the auditor 'reasonably to believe' that the matter does in fact exist. It should be noted that the auditor's work does not need to prove that the reportable matter exists.

59. The criteria for determining the matters to be reported are as follows:

- (i) the auditor reasonably believes that there is, or has been, or may be, or may have been a contravention of any 'relevant requirement' that applies to the person<sup>29</sup> concerned and that contravention may be of material significance to the FSA in determining whether to exercise, in relation to that person, any of its functions under FSMA 2000 (other than in part 6, i.e. rules relating to official listing); or
- (ii) the auditor reasonably believes that the information on, or his opinion on, those matters may be of material significance to the FSA in determining whether the person concerned satisfies and will continue to satisfy the Threshold Conditions;<sup>30</sup> or
- (iii) the auditor reasonably believes that the person concerned is not, may not be, or may cease to be, a going concern; or
- (iv) the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with the CA2006 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation<sup>31</sup>.

60. In relation to paragraph 59 (i) above, 'relevant requirement' is a requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FSA's

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<sup>29</sup> In this context the person is an 'Authorised Person'.

<sup>30</sup> The Threshold Conditions are set out in Schedule 6 to FSMA 2000 and represent the minimum conditions that a firm is required to satisfy and continue to satisfy to be given and to retain Part IV permission. The FSA's guidance on compliance with the Threshold Conditions is contained in the COND module of the FSA Handbook.

<sup>31</sup> The relevant rules and legislation are set out in article 2(2)(d) of the 2001 Regulations, and include rules made by the FSA under Section 340 of FSMA 2000, and relevant provisions of, and regulations made under, BS Act 1986.

rules (other than the Listing Rules) including the Principles for Businesses. The duty to report also covers any requirement imposed by or under any other Act<sup>32</sup>, the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000.

61. In relation to paragraph 59 (ii) above, the duty to report relates to either information or opinions held by the auditor which may be of significance to the FSA in determining whether the regulated entity satisfies and will continue to satisfy the Threshold Conditions. The duty to report opinions, as well as information, allows for circumstances where adequate information on a matter may not readily be forthcoming from the regulated entity, and where judgments need to be made.

### Material significance

62. Determining whether a contravention of a relevant requirement or a Threshold Condition is reportable under the 2001 Regulations involves consideration both of whether the auditor 'reasonably believes' and that the matter in question 'is, or is likely to be, of material significance' to the regulator.
63. As indicated above, paragraph 12 of ISA (UK and Ireland) 250 Section B requires that, where an apparent breach of statutory or regulatory requirements comes to the auditor's attention, the auditor obtains such evidence as is available to assess its implications for the auditor's reporting responsibilities and determine whether, in the auditor's opinion, there is reasonable cause to believe that the breach is of material significance to the regulator.
64. 'Material significance' is described by paragraph 9(d) of ISA (UK and Ireland) 250 Section B as follows:

*'the term "material significance" requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.'*

65. 'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of an entity, it may be of a nature or type that is likely to change the perception of the regulator. For example, a failure to reconcile client money accounts may not be significant in financial terms but would have a significant effect on the FSA's consideration of whether the regulated entity was satisfactorily controlled and was behaving properly towards its customers.

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32 Examples include The Proceeds of Crime Act 2002 and prescribed regulations relating to money laundering.

66. The determination of whether a matter is, or is likely to be, of material significance to the FSA inevitably requires the auditor to exercise judgment. In forming such judgments, the auditor needs to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered.
67. The auditor of a regulated entity bases the judgment of 'material significance' to the FSA solely on his understanding of the facts of which the auditor is aware without making any assumptions about the information available to the FSA in connection with any particular regulated entity. Appendix 7 gives examples of areas identified by the FSA where the duty to report might arise.
68. Clearly the concept of material significance means that not every breach or suspected breach, however minor, of relevant requirements needs to be reported. However, in considering whether to report minor matters, the auditor will need to consider (amongst other things):
- Whether the breach or suspected breach would relate to the entity's assets or amount to misconduct or mismanagement.
  - That the cumulative effect of matters which come to the auditor's attention may collectively be of material significance, even if particular matters in isolation might not be regarded as being so.
  - In circumstances where the auditor concludes that a matter gives rise to a statutory duty to report, the auditor has a duty to report that matter to the FSA even if the entity has already reported it.
69. On completion of their investigations, the auditor ensures that the facts and circumstances, and the basis for his conclusion as to whether these are, or are likely to be, of 'material significance' to the FSA, are adequately documented such that the reasons for his decision to report or not, as the case may be, may be clearly demonstrated.
70. Section 342 of FSMA 2000 provides that an auditor may communicate matters to the FSA even where this would place the auditor in breach of any duty to which he would ordinarily be subject (such as a duty of confidence to his client). The auditor may communicate information to the FSA which he has become aware of in his capacity as auditor of the regulated entity. He may also communicate his opinion in relation to any such matter. In each case the following conditions must be met: (1) the auditor must be acting in good faith; (2) the auditor must reasonably believe the information or opinion is relevant to any of the functions of the FSA.

## Conduct of the audit

The auditor shall ensure that all staff involved in the audit of a regulated entity have an understanding of:

- (a) The provisions of applicable legislation;
- (b) The regulator's rules and any guidance issued by the regulator; and
- (c) Any specific requirements which apply to the particular regulated entity,

appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator. (paragraph 11)

71. Understanding, commensurate with the individual's role and responsibilities in the audit process, is required of:
- the provisions of the 2001 Regulations concerning the auditors' duty to report to the regulator;
  - the standards and guidance in ISA (UK and Ireland) 250 Section B, and in this section of this Practice Note; and
  - relevant sections of the FSA Handbook including the Principles for Businesses, those provisions relating to the Threshold Conditions, and GENPRU and BIPRU (which contain, amongst other things, the detailed prudential requirements for capital and liquidity).
72. The auditor includes procedures within his planning process to ensure that members of the audit team have such understanding (in the context of their role) as to enable them to recognise potentially reportable matters, and that such matters are reported to the audit engagement partner without delay so that a decision may be made as to whether a duty to report arises.
73. An audit firm appointed as auditor of a regulated entity needs to have in place appropriate procedures to ensure that the audit engagement partner is made aware of any other relationship which exists between any department of the firm and the regulated entity when that relationship could affect the firm's work as auditors. (This matter is covered in more detail in Appendix 2 of ISA (UK and Ireland) 250 Section B.) The auditor also requests the regulated entity to advise him when it appoints a third party (including another department or office of the same firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party

promptly after their receipt. This matter may usefully be referred to in the engagement letter.

### **Closely linked entities**

74. Where the auditor of a regulated entity is also auditor of a closely linked entity<sup>33</sup>, a duty to report arises directly in relation to information relevant to the regulated entity of which he becomes aware in the course of his work as auditor of the closely linked entity.
75. The auditor establishes during audit planning whether the regulated entity has one or more closely linked entities of which the audit firm is also the auditor. If there are such entities the auditor considers the significance of the closely linked entities and the nature of the issues that might arise which may be of material significance to the regulator of the regulated entity. Such circumstances may involve:
- activities or uncertainties within the closely linked entity which might significantly impair the financial position of the regulated entity;
  - money laundering and, if the closely linked entity is itself regulated;
  - matters that the auditor of the closely linked entity is intending to report to its regulator.
76. Following the risk assessment referred to in paragraph 75, the auditor of the regulated entity identifies the closely related entities for which the procedures in this paragraph are necessary. The engagement team of the regulated entity communicates to the engagement team of the selected closely linked entities the audit firm's responsibilities to report to the FSA under the 2001 Regulations and notifies the engagement team of the circumstances that have been identified which, if they exist, might be of material significance to the FSA as regulator of the regulated entity. Prior to completion the auditor of the regulated entity obtains details from the auditor of the closely linked entity of such circumstances or confirmation, usually in writing, that such circumstances do not exist. Where the closely linked entities are part of the inter-auditor group reporting process these steps can be built into that process.
77. Section 343 of FSMA 2000 confers a similar protection on auditors when they report information or opinions to the FSA to that of section 342 (considered above). This enables the auditor to disclose to the FSA information of which he has become aware in his capacity as the auditor of the closely linked entity, or his opinion on such matters. Again two conditions apply: (1) the auditor must be acting in good faith; (2) the auditor

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33 An entity has close links with an authorised person for this purpose if the entity is a:

- (a) parent undertaking of an authorised person;
- (b) subsidiary undertaking of an authorised person;
- (c) parent undertaking of a subsidiary undertaking of an authorised person; or
- (d) subsidiary undertaking of a parent undertaking of an authorised person.

must reasonably believe the information or opinion is relevant to any of the functions of the FSA.

78. No duty to report is imposed on the auditor of an entity closely linked to a regulated entity who is not also auditor of the regulated entity.
79. In circumstances where he is not also the auditor of the closely linked entity, the auditor of the regulated entity decides whether there are any matters to be reported to the FSA relating to the affairs of the regulated entity in the light of the information that he receives about a closely linked entity for the purpose of auditing the financial statements of the regulated entity. If the auditor becomes aware of possible matters that may fall to be reported, he may wish to obtain further information from the management or auditor of the closely linked entity to ascertain whether the matter should be reported. To facilitate such possible discussions, at the planning stage of the audit the auditor of the regulated entity will have considered whether arrangements need to be put in place to allow him to communicate with the management and auditor of the closely linked entity. If the auditor of the regulated entity is unable to communicate with the management and auditor of the closely linked entity to obtain further information concerning the matters he has identified, he reports the matters, and that he has been unable to obtain further information, direct to the FSA.

#### **Information received in a capacity other than as auditor**

80. There may be circumstances where it is not clear whether information about a firm coming to the attention of the auditor is received in the capacity of auditor or in some other capacity, for example as a general adviser to the entity. Appendix 2 to ISA (UK and Ireland) 250 Section B provides guidance as to how information obtained in non-audit work may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit.

#### **Discussing matters of material significance with the directors**

81. The directors<sup>34</sup> are the persons principally responsible for the management of the regulated entity. The auditor will therefore normally bring a matter of material significance to the attention of the directors subject to compliance with legislation relating to 'tipping off' and seek agreement on the facts and circumstances. However, ISA (UK and Ireland) 250 Section B, paragraph 13, emphasises that where the auditor concludes that a duty to report arises, the auditor shall bring the matter to the attention of the regulator as soon as practicable. The directors may wish to report the matters identified to the FSA themselves and detail the actions taken or to be taken. Whilst such a report from the directors may provide valuable information, it does not relieve the auditor of the statutory duty to report directly to the FSA.

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34 This term would include the senior management of branches of EEA or non EEA banks.

### Timing of a report

82. The duty to report arises once the auditor has concluded that he reasonably believes that the matter is or is likely to be of material significance to the FSA's regulatory function.
83. The report should be made as soon as is practicable once a conclusion has been reached. Unless the matter casts doubt on the integrity of the directors this should not preclude discussion of the matter with the directors and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are, however, undertaken on a timely basis to enable the auditor to conclude on the matter as soon as practicable.
84. The FSA has set up a dedicated 'Auditor's duty to report' mailbox<sup>35</sup> for the storage and logging of these reports. Auditors send any such reports to this mailbox and copy in the supervisor of the firm the report relates to.

### Auditors' right to report to the FSA

85. In addition to the duty to report particular information, the auditor has a right to report other information that is relevant to the functions of the FSA. S342 FSMA 2000 provides that no duty to which an auditor of an authorised person is subject shall be contravened by communicating in good faith to the FSA information which he has become aware of in his capacity as auditor of the regulated entity, or his opinion on any such matter. As mentioned above, two conditions apply: (1) the auditor must be acting in good faith; (2) the auditor must reasonably believe the information or opinion is relevant to any of the functions of the FSA.
86. The scope of the duty to report is wide, particularly since, under the FSA's Principle for Businesses 11 (and corresponding application rules and guidance in SUP15.3), an authorised firm must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice. However in circumstances where the auditor concludes that a matter does not give rise to a statutory duty to report but nevertheless should be brought to the attention of the regulator, in the first instance he advises the directors of his opinion. Where the auditor is unable to obtain, within a reasonable period, adequate evidence that the directors have properly informed the FSA of the matter, then the auditor makes a report themselves to the regulator as soon as practicable.

### Taking legal advice

87. In considering when to report (or when a report to the FSA benefits from the protection of FSMA, sections 342(3) and 343(3)<sup>36</sup>), an auditor may wish to take legal advice. An auditor

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<sup>35</sup> Auditor'sdutyore@fsa.gov.uk.

<sup>36</sup> Allowing the auditor to report notwithstanding any duty, such as confidentiality, to which the auditor is subject.



may wish to ensure, for example, that only relevant information is disclosed and that the form and content of his report is such as to secure the protection of FSMA 2000. Appendix 6 provides additional guidance on disclosure in the public interest. This is relevant to both the auditor's consideration of the right to report and also where neither the right nor the duty to report exists – as is the case for EEA banks without top up permissions. However, the auditor recognises that legal advice will take time and that speed of reporting is likely to be important in order to protect the interests of customers and/or to enable the FSA to meet its statutory objectives.

### **Formal bilateral meetings**

88. Formal bilateral meetings between the FSA and auditors vary in frequency according to factors such as the FSA's assessment of systemic risk of the bank concerned.
89. The formal bilateral meeting is intended to provide a forum for frank one-to-one discussions on issues of concern to either the FSA or auditor. The FSA does not, however, expect auditors to make supervisory judgements nor, in the normal course of events, does it expect to base its own supervisory judgements and decisions solely on comments provided by auditors.
90. Although there is no requirement to produce an agenda for a formal bilateral meeting, where the FSA has specific matters which it intends to discuss, it will, where possible, communicate these to the auditor in advance. Similarly, the FSA will not, as a matter of course, circulate minutes of the bilateral meeting to the auditor, although they may provide a summary list of the main items covered. Auditors therefore consider taking their own notes of the formal bilateral meeting (as explained below, the confidentiality restrictions of FSMA 2000 generally prevent such notes being made available to the bank although they can be shared with the FSA if the auditor considers a particular discussion requires clarification).
91. The FSA expects auditors to participate fully in the bilateral meeting, and to discuss views and impressions gained within the audit context as well as factual information. Under sections 342 and 343 of FSMA 2000, auditors are protected from breach of their duty of client confidentiality in communicating matters<sup>37</sup> to the FSA provided that they do so 'in good faith' and reasonably believe that the information or opinion is relevant to any functions of the FSA. In appropriate cases, the auditor may consider obtaining legal advice on the application of this provision. In general terms, it is not essential that conclusive evidence is available to support an opinion expressed in a bilateral meeting but, in communicating matters 'in good faith', the auditor:
  - (a) reports facts in a balanced manner and without selectivity or bias; and

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37 Specifically, information on a matter which the auditor has or had become aware of in his capacity as auditor of the authorised person, or his opinion on such a matter.

(b) expresses any opinions in a neutral and responsible manner, making clear that they are opinions and not facts and explaining the basis for them,

and the auditor's actions must be without malice. In addition, general law provides protection in certain circumstances for disclosing certain matters even where a duty of confidence exists to a proper authority in the public interest.<sup>38</sup>

92. Auditors are bound by the confidentiality regime of FSMA 2000<sup>39</sup> in respect of confidential information<sup>40</sup> communicated to them by the FSA. Under that regime, where confidential information is disclosed to a person by the FSA the information may not be disclosed by that person to any other person unless the requirements of FSMA 2000 are complied with (including to the bank).
93. In practice, the auditor obtains the express consent of the FSA to any onward disclosure of confidential information. This is because normally the consent of the person who provided the information to the FSA, and, if different, the person to whom the information relates is needed before the information may be disclosed. Some information communicated by the FSA to the auditor will relate only to the bank but many matters discussed may be relevant also to other parties, such as customers or employees. Also, where the FSA has received information which it communicates to auditors and reporting accountants from another regulator or in a capacity other than as banking supervisor, there may be other restrictions on disclosure.
94. The auditor can, however, disclose to the bank information which the auditor has communicated *to the FSA* during the bilateral meeting (except where to do so would have the effect of disclosing information communicated by the FSA). If the auditor is uncertain about whether particular information can be communicated to the bank, the auditor considers, for the avoidance of doubt, seeking the consent of the FSA.
95. Matters communicated *by the FSA* during the bilateral meeting may be conveyed by those representatives of an accounting firm who were present at the meeting to other partners, directors and employees of the firm who need to know the information in connection with the firm's performance of its duties as auditor without the FSA's express permission.

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38 Case law provides for when this defence is available, which is not considered in this Practice Note.

39 In Part 23, and in the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (SI 2001/2188).

40 'Confidential information' within the meaning of section 348 of the Act. Note that this is broadly defined (and much broader in scope than information to which a private law duty of confidence would attach), for example, including information relating to the business or affairs of any person or was received by the FSA for the purposes of, or in the discharge of, any of the FSA's functions.

**Other periodic meetings with the FSA**

96. In addition to the formal meetings with the FSA outlined above, the auditor may be involved in other discussions with the FSA on either a trilateral or bilateral basis.

Examples include:

- meetings with the FSA during the risk assessment phase of the supervisory process (often called the 'Arrow visit');
- presentations by the FSA on the results of its risk assessment of a particular bank and the resulting supervisory programme; and
- ad hoc meetings to discuss matters communicated to the FSA by the auditor under the right or duty to report (as discussed above).

97. The normal protections and confidentiality restrictions apply to these meetings in the same way as to formal bilateral meetings.

## **ISA (UK AND IRELAND) 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS**

### **Objective**

The objective of the auditor is to plan the audit so that it will be performed in an effective manner. (paragraph 4)

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. (paragraph 7)

The auditor shall develop an audit plan that shall include a description of:

- (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA (UK and Ireland) 315.
- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA (UK and Ireland) 330.
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK and Ireland). (paragraph 9)

98. Matters the auditor of a bank or building society may consider as part of the planning process for the audit of the financial statements include:
- the nature and scope of the entity's business;
  - the extent of head office control over networks of branches;
  - the entity's relationships with the FSA and any other regulators;
  - changes in applicable laws, regulations and accounting requirements;
  - the need to involve specialists in the audit;
  - the extent to which controls and procedures are outsourced to a third-party provider; and
  - issues relating to the auditor's statutory duty to report.
99. Guidance on the first four of these matters is set out in the section in this Practice Note on ISA (UK and Ireland) 315 'Identifying and assessing the risks of material misstatement through understanding the entity and its environment'. Considerations in relation to the other matters in planning the audit are:

- the nature and complexity of banking business increases the likelihood that the auditor may consider it necessary to involve specialists in the audit process. For example, the auditor may wish to utilise the work of an expert in the valuation of derivative and other financial instruments not traded in an active market. The auditor considers the need to involve such specialists at an early stage in planning their work. Where such specialists are to be used, they may be involved in the development of the audit plan and may take part in discussions with the management and staff, in order to assist in the development of knowledge and understanding relating to the business;
- the auditor considers the implications of the outsourcing of functions by the entity, and the sources of evidence available to the auditor for transactions undertaken by service organisations in planning the audit work. This may include the outsourcing of certain functions, such as the IT function; and
- issues relating to the auditor's statutory duty to report include the adequacy of the audit team's understanding of the law and the identification of closely linked entities.

## **ISA (UK AND IRELAND) 315: IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

### **Objective**

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. (paragraph 3)

100. Banks and building societies can be complex and the auditor seeks to understand the business and the regulatory regime in which they operate. Generally, there is a close relationship between planning and obtaining an understanding of the entity and the control environment, which is covered more fully below.

The auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
- (b) The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

....

(paragraph 11)

101. In assessing the nature and scope of the business and its control environment, the auditor may consider:

- The entity's strategy, risk appetite and capital and liquidity resources and how it manages tensions that are likely to exist between them (for example an entity's

strategic ambition may require an appetite for risk that those in charge of governance regard as imprudent or strain capital and liquidity too far);

- The products it uses and its strategies for making money from them. An auditor might seek to understand how the entity monitors returns on these products and then check that these are reasonable in the light of returns in the rest of the market;
- How the entity is governed and whether it complies with FSA requirements and best practice;
- The quality of the entity's risk analysis and whether there are risks that are not properly analysed and controlled;
- The views of the regulator about the entity;
- The tone set by senior management and those in charge of governance, the quality of what is reported to them and their consequent ability to run the business;
- The quality of controls and in which locations or functions there may be deficiencies.

In making this assessment the auditor considers gathering information from as wide a range of sources as possible in order to compare one source against another for consistency. In particular it can be important to interview business and front office staff as well as back office and finance staff in order to get a full appreciation of the entity's activities.

102. For the largest institutions, the FSA intends to meet the auditor at an early stage in the financial reporting process and identify areas where there may be concerns over key areas of accounting judgment and perceived areas of risk. These meetings take place at least once a year and could cover areas such as fair value estimates and provisions for impairment.

103. When performing procedures to obtain an understanding of the entity, the auditor considers:

- the relative importance to the entity of each of its business activities<sup>41</sup>. This includes an understanding of the type and extent of specialised activities, for example:
  - derivatives and other complex trading activities (where both documentation, accounting and valuation aspects can be difficult);

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41 The auditor of a building society is aware of the BS Act 1986 statutory and the FSA regulatory limitations on funding, lending and treasury activities and considers whether the continuing activities of the society are, for example, within the restrictions of section 9A of the BS Act 1986 and are compliant with the limitations within the society's treasury approach see BSOCS and paragraphs 20-26 of this Practice Note.

- trade finance, invoice discounting and factoring (where the documentation used can be complex and highly specialised); and
- leasing (where there are particular accounting issues, especially relating to income recognition);
- the introduction of new categories of customers, or products or marketing and distribution channels;
- the relevant aspects of the entity's risk management procedures;
- the complexity of the entity's information systems;
- the legal and operational structure of the entity;
- a change in the market environment (for example, a marked increase in competition);
- the complexity of products;
- the consistency of methods and operations in different departments or locations; and
- the respective roles and responsibilities attributed to the finance, risk control, compliance and internal audit functions.

104. Many banks and UK banking groups are managed globally on product/business lines rather than focused around legal structure. Such 'matrix management' structures typically involve local reporting (often on a legal entity basis) on operational and compliance matters; and business/product based reporting (often globally) of activities undertaken. In addition, global trading activities may mean that transactions are entered into in one location but are recorded in another; it may even be the case that they are controlled and settled in a third location. Furthermore, parts of a bank's operations may be undertaken through special purpose entities which may have structures and features that can mean they are excluded from financial statement consolidation. Given these factors, the auditor gains an understanding of how and where transactions are undertaken, recorded and controlled, in order to plan the audit. Further guidance on particular matters arising in the audit of banking groups is given in the section on ISA (UK and Ireland) 600 in this Practice Note.

105. Many banks and building societies operate a network of branches. In such instances, the auditor determines the degree of head office control over the business and accounting functions at branch level and the scope and effectiveness of the entity's inspection and/or internal audit visits. The extent and impact of visits from regulators is also relevant. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty



of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to assessing audit risk.

106. In obtaining an understanding of the regulatory factors the auditor considers:

- any formal communications between the FSA in its capacity as the regulator and the entity, including any new or interim risk assessments issued by the FSA and the results of any other supervisory visits conducted by the FSA;
- the contents of any recent reports prepared by 'skilled persons' under s. 166 FSMA 2000 together with any correspondence, minutes or notes of meetings relevant to any recent skilled persons' report;
- any formal communications between the entity and other regulators; and
- discussions with the entity's compliance officer together with others responsible for monitoring regulatory compliance.

The auditor shall obtain an understanding of ...

- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (paragraph 11)

107. Accounting policies of particular relevance may include allowances for impairment, hedge accounting, classification of assets and liabilities (and thereby their measurement), embedded derivatives, valuation of complex financial instruments, revenue/expense recognition (including effective interest rates), consolidation of special purpose entities, offsetting and derecognition and debt versus equity classification. The auditor undertakes procedures to consider whether the policies adopted are in compliance with applicable accounting standards and gains an understanding of the procedures, systems and controls applied to maintain compliance with them.

The auditor shall obtain an understanding of ...

- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (paragraph 11)

108. It is important for the auditor to understand the multi-dimensional nature and extent of the financial and business risks which are integral to the environment, and how the entity's

systems record and address these risks. Although they may apply to varying degrees, the risks include (but are not limited to):

- credit risk: at its simplest, this is the risk that a borrower or other counterparty will be unable to meet its obligations. However, where credit risk is traded (in the form of secondary market loan trading or credit derivatives, for example), credit risk is often regarded as having two distinct forms:
  - spread risk: the risk arising from day-to-day changes in the price of a credit instrument because of changes in market perceptions about the credit standing of the debtor and the liquidity of the instrument;
  - default risk: the risk that a debtor will default on its obligations; or settlement risk: the risk that a counterparty will be unable to settle its obligations under a transaction (in a securities settlement or payment system, for example) on the due date;
- concentration risk: the risk arising when an entity's exposure is heavily weighted to a particular class or sector of borrower or geographic region and thus runs the risk of disproportionate exposure to problems with that particular class, sector or region;
- liquidity risk: the risk that arises from the possibility that an entity has insufficient liquid funds to meet the demands of depositors or other counterparties;
- interest rate risk: the risk that arises where there is a mismatch between the interest rate reset dates or bases for assets and liabilities;
- currency risk: the risk that arises from the mismatching of assets, liabilities and commitments denominated in different currencies;
- market risk<sup>42</sup>: the risk that changes in the value of assets, liabilities and commitments will occur as a result of movements in relative prices (for example, as a result of changes in the market price of tradable assets or inputs into valuation models for more complex instruments). Market risk is a generic term which, in addition to interest rate and currency risk and, in some environments, spread risk, also includes equity risk and commodity price risk;
- operational risk: the risk of loss, arising from inadequate or failed internal processes, people and systems or from external events including legal risk; and

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42 Some forms of market risk are 'non-linear', i.e. there is not a constant relationship between the profit and loss and the movement in the underlying price. For example, the relationship between an option's price and the price of its underlying instrument is 'non-linear'; the 'delta' measures the change in the price of an option for a unit change in the price of the underlying instrument whilst the 'gamma' indicates the extent of the 'non-linearity' (the change in delta for a unit change in the price of the underlying instrument).

- regulatory risk: the risk of public censure, fines (together with related compensation payments) and restriction or withdrawal of authorisation to conduct some or all of the entity's activities. In the UK this may arise from enforcement activity by the FSA.

Failure to manage the risks outlined above can also cause serious damage to the entity's reputation, potentially leading to loss of confidence in the entity, withdrawal of deposits or problems in maintaining liquidity (this is sometimes referred to as reputational risk or franchise risk).

The auditor shall obtain an understanding of ...

- (e) The measurement and review of the entity's financial performance. (paragraph 11)

109. The auditor obtains an understanding of the measures used by management to review the entity's performance. Further guidance in respect of key performance indicators is given in the section on ISA (UK and Ireland) 520.

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (paragraph 12)

When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (paragraph 13)

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
- (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (paragraph 14)

110. The quality of the overall control environment is dependent upon management's attitude towards the operation of controls. A positive attitude may be evidenced by an

organisational framework which enables proper segregation of duties and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the operation of a control is treated as a matter of concern, the control environment will be stronger and will contribute to effective control systems; whereas a weak control environment will undermine detailed controls, however well designed.

111. In accordance with the requirements of SYSC and PRIN, senior management has a responsibility for establishing and maintaining such systems and controls as are appropriate to the operations of an authorised firm. The FSA can hold senior managers personally accountable for an area or business for which they are responsible. This responsibility extends to personal behaviour not only by senior management but also to other Approved Persons<sup>43</sup>. Statements of Principle and Codes of Practice for Approved Persons (as set out in the FSA Handbook) include acting with integrity, due skill and care and diligence. The fit and proper test applied to Approved Persons includes competence and capability.
112. The FSA requires an authorised firm to maintain systems and controls appropriate for its business<sup>44</sup>. These include (but are not limited to):
- clear and appropriate reporting lines which are communicated within the entity;
  - appropriate controls to ensure compliance with laws and regulations (this may mean a separate Compliance function);
  - appropriate risk assessment process;
  - appropriate management information;
  - controls to ensure suitability of staff;
  - controls to manage tensions arising out of remuneration policies;
  - documented and tested business continuity plans;
  - documented business plans or strategies;
  - an internal audit function (where appropriate);
  - an audit committee (where appropriate); and
  - appropriate record keeping arrangements.

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43 Anyone performing a Controlled Function (an FSA defined term that includes roles beyond senior management such as the head of internal audit or the non-executive directors; see SUP10) must be approved by the FSA (an Approved Person).

44 Most FSA systems and control requirements are set out in SYSC, but additional requirements relating to prudential matters also exist in GENPRU and BIPRU.

113. For large banks and building societies, the volume of transactions can be so great that it may be extremely difficult for the auditor to express an opinion without obtaining considerable assurance from adequate systems of control. Systems of internal control are important in ensuring orderly and prudent operations of the entity and in assisting the directors to prepare financial statements which give a true and fair view. The following features of the business of banks and building societies may be relevant to the auditor's assessment of such internal controls:

- the substantial scale of transactions, both in terms of volume and relative value, makes it important that control systems are in place to ensure that transactions are recorded promptly, accurately and completely and are checked and approved, and that records are reconciled at appropriate intervals in order to identify and investigate differences promptly;
- processing and accounting for complex transactions or high volumes of less complex transactions will almost inevitably involve the use of sophisticated technology. For example, transactions subject to 'straight through processing' involve little or no manual intervention after they have been initiated;
- a bank or building society deals in money or near money instruments. In the case of most commercial organisations, most movements of funds are the result of a related movement of goods and some audit assurance may therefore be obtained by reference to this relationship. This is not available, however, in the case of banks, building societies and similar financial organisations. Management must therefore establish robust systems of control. As the centralised funds transfer departments which exist in larger banks and building societies will often process very high volumes and a high value of transactions each day, the need for strong and effective controls over this area is particularly important. Transactions with customers over the internet are another area requiring strong security controls;
- the fact that banks and building societies deal in money and near money instruments makes proper segregation of duties between and amongst those entering into transactions, those recording the transactions, those settling them and where relevant, those responsible for their physical security particularly important;
- the geographical or organisational dispersal of some entities' operations means that, in order to maintain control over their activities, they need to ensure not only that there are sufficient controls at each location, but also that there are effective communication and control procedures between the various locations and the centre. It is important that there should be clear, comprehensive reporting and responsibility lines, particularly where the business is managed using a 'matrix' structure;
- the activities of banks and building societies can typically result in the creation or use of derivatives and other complex transactions. The fact that the resultant cash flows may not take place for a considerable time creates the risk that wrongly recorded or

unrecorded positions may exist and that these may not be detected for some time, thereby exposing the entity to risk of misstatement. The valuation of these instruments also poses risks of misstatement, particularly as not all instruments are capable of being valued using observable market prices. Consequently, banks and building societies will normally have developed important operational controls to mitigate such risks of misstatement;

- the provisions of the UK tax legislation require banks and building societies to operate various tax deduction and collection arrangements, such as those relating to paying and collecting agents and lower rate tax deducted from interest paid to individuals. In addition, the VAT position can be particularly complex. These may give rise to significant liabilities if not properly dealt with. Accordingly, an effective control system is essential to ensure that the record-keeping requirements of UK tax legislation are satisfied, and that tax is accounted for promptly and accurately. Similar measures may be needed to address similar provisions arising in any other jurisdictions where the entity operates; and
- the UK regulatory framework is both complex and evolving for banks and building societies. This may give rise to significant liabilities for compensation to clients if not properly dealt with. Accordingly, an effective control system is essential to ensure that the requirements of the UK regulators are satisfied. Measures may also be needed to address regulators in other jurisdictions.

The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (paragraph 20)

114. There is a wide variation between different banks and building societies in terms of size, activity and organisation, so that there can be no standard approach to internal controls and risk. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. Examples of deficiencies that may be relevant to the auditor's assessment of the risk of material misstatement are as follows:

- complex products or processes inadequately understood by management; this includes undue concentration of expertise concerning matters requiring the exercise of significant judgment or capable of manipulation such as valuations of financial instruments or allowances for impairment;

- deficiencies in back office procedures underpinning the completeness and accuracy of accounting records such as:
    - backlogs in key reconciliations, particularly those over correspondent bank accounts, settlement accounts and the custody of assets such as securities (either those held on own account or as collateral);
    - inadequate maintenance of suspense or clearing accounts;
    - deficiencies in controls over completeness and accuracy of data for credit provisioning; and
    - backlogs in confirmation processes relating to financial instrument transactions.
  - deficiencies in new product and complex trade approval procedures;
  - lack of segregation of duties such as between critical dealing, operational, control, settlement and accounting functions; and
  - deficiencies in payments systems such as inadequate controls over access to payment systems and data.
115. Some of the control activities which are usually performed by banks and building societies involve reconciliations of balances and positions with other organisations, testing of which may provide a source of assurance for the auditor as to the accuracy and completeness of the recording of transactions. These include reconciliation of:
- balances payable to or from other banks (sometimes referred to as vostro and nostro balances);
  - securities in the course of settlement and the corresponding balances owing to or from the bank with settlement systems such as Euroclear and Crest;
  - centrally cleared derivative transactions and margin balances with clearing houses such as the London Clearing House; and
  - balances and positions with other group entities.
116. Controls relating to outsourcing activities are considered in the ISA (UK and Ireland) 402 section of this Practice Note.

In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (paragraph 21)

117. As a result of the type and complexity of transactions undertaken, and records held, by banks and building societies and the need for swift and accurate information processing and retrieval, many functions are highly automated, including: funds transfer systems,

the accounting function, the processing and recording of customer transactions, trading activities, financial instrument valuations, regulatory reporting and the supply of management information.

118. The auditor assesses the extent, nature and impact of automation within the entity and plans and performs work accordingly. In particular the auditor considers:

- the required level of IT knowledge and skills may be extensive and may require the auditor to obtain advice and assistance from staff with specialist skills;
- the extent of the application of audit software and related audit techniques;
- general controls relating to the environment within which IT based systems are developed, maintained and operated; and
- external interfaces susceptible to breaches of security.

Depending on the size and range of their activities, banks employ a large number of different systems. The auditor identifies and understands the communication between computer systems in order to assess whether appropriate controls are established and maintained to cover all critical systems and the links between them and to identify the most effective audit approach.

119. Banks also commonly use end user applications (applications that sit on the computer of the end user rather than on a centrally managed server), which can involve the use of complex spreadsheets, to generate important accounting and/or internal control information. Such end user applications are not subject to centrally managed general controls and so the auditor assesses the significance of the use of such applications and plans procedures to test the controls around them as appropriate.

The auditor shall identify and assess the risks of material misstatement at:

- (a) the financial statement level; and
- (b) the assertion level for classes of transactions, account balances, and disclosures

to provide a basis for designing and performing further audit procedures. (paragraph 25)

As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment the auditor shall exclude the effects of identified controls related to the risk. (paragraph 27)



If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (paragraph 29)

120. Significant risks are likely to arise in those areas that are subject to significant judgment by management or are complex and properly understood by comparatively few people within the entity.
121. Examples of significant risks requiring special audit consideration may include:
- allowances for impairment (particularly collective assessments of impairment) (see paragraphs 162 to 170);
  - changes to provisions for compensation payable to customers; and
  - valuation of certain derivatives and other financial instruments (see paragraphs 172 to 177).
122. The application of complex accounting standards such as IAS 32, IAS 39 and IFRS 7 (for entities using EU IFRS) and FRS 25, 26 and 29 (for entities using UK GAAP) may also give rise to significant risk with respect to hedge accounting, classification of assets/liabilities, revenue/expense recognition (effective interest rates) and over the adequacy of financial statement disclosure.

## **ISA (UK AND IRELAND) 320: MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

### **Objective**

The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit. (paragraph 8)

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (paragraph 10)

The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (paragraph 11)

123. The principles of assessing materiality in the audit of a bank or building society are the same as those applying to the audit of any other entity. In particular the auditor's consideration of materiality is a matter of professional judgment, and is affected by the auditor's perception of the common information needs of users as a group<sup>45</sup>.
124. Most banking organisations are profit orientated and a profit based measure, such as a percentage of profit before tax is likely to be used in determining materiality for the financial statements as a whole. However, a key difference of a bank or building society from other entities is that balance sheet balances tend to be much larger compared to the profit and loss account/income statement, so that the application of materiality based on profit may be too low when auditing elements of the balance sheet.
125. To deal with this, the auditor typically uses materiality based on the profit and loss account/income statement if a misstatement in a balance sheet item could affect the

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45 For example, the 'Framework for the Preparation and Presentation of Financial Statements' adopted by the International Accounting Standards Board in April 2001 indicates that, for a profit orientated entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meets their needs will also meet most of the needs of other users that financial statements can satisfy.

profit and loss account/income statement or equity and reserves. If, however, a misstatement in a balance sheet item is likely only to lead to a reclassification between line items within assets and liabilities, a higher materiality level can be applied for detecting such misstatements only. Although paragraph 10 of ISA (UK and Ireland) 320 indicates that there can only be one overall measure of materiality for the accounts as a whole, paragraph A15 of ISA (UK and Ireland) 450 states that there may be circumstances involving the evaluation of qualitative considerations where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios. When applying a separate balance sheet materiality level for the purpose of identifying and evaluating the effect of such misclassifications the auditor considers:

- the extent any misstatement of these items would influence the economic decisions of users taken on the basis of the financial statements;
  - the extent any misstatement of these items would affect users' expectations regarding the measurement or disclosure of these items;
  - the effect of the classification misstatement on debt or other contractual covenants;
  - the effect on individual line items or sub-totals; and
  - the effect on key ratios.
126. An example of such an adjustment would be grossing up net counterparty positions into assets and liabilities. The adjustment that is required can only affect the balance sheet; even if wrongly calculated, there will be no case for any write-off or write-back to profit and loss.
127. ISA (UK and Ireland) 320, paragraph 10, also allows the setting of a lower materiality level for a specific class of transactions, account balance or disclosure, if this class of transactions, account balance or disclosure is of a particular interest to the users of the financial statements. The auditor is alert to the wider constituency of users of the financial statements, when considering this requirement and pays attention to the risk profile of the institution concerned. Factors to be taken into consideration include, for example:
- the concerns of regulators; and
  - the attention that may be given to pay and staff and director rewards.

128. The nature of banks and building societies' exposures means that their value or level of impairment can, at times, be subject to considerable uncertainty. The range of acceptable values or provisions can, as a consequence, be wide and sometimes wider than the materiality set by the auditor. Under such circumstances the auditor needs to assess whether management have determined the most appropriate point in the range for the purposes of the financial statements (which may not be the mid point in the range) and whether the extent of the uncertainty is adequately disclosed.
129. This guidance is not intended to cut across the guidance on the auditor's duty and right to report matters to the FSA, where 'material significance' has a different meaning (see ISA (UK and Ireland) 250: Section B and paragraphs 62–70 above).

## **ISA (UK AND IRELAND) 330: THE AUDITOR'S RESPONSES TO ASSESSED RISKS**

### **Objective**

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks. (paragraph 3)

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (paragraph 8)

130. ISA (UK and Ireland) 200, paragraph 17, requires that to obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. In practice the nature and high volume of transactions relating to the operations of banks and building societies often means that performing tests of relevant controls is the most effective means of reducing audit risk to an acceptably low level as an approach based on substantive procedures alone is unlikely to be efficient.

131. Whilst some aspects of the income statements and balance sheets of banks and building societies lend themselves to the application of analytical procedures, income and expense resulting from trading activities is unlikely to be susceptible to these methods because of its inherent unpredictability.

The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (paragraph 24)

132. Specific financial reporting standards can require extensive narrative disclosures in the financial statements of banks and building societies; for example, in relation to the nature and extent of risks arising from financial instruments. In designing and performing

procedures to evaluate these disclosures the auditor obtains audit evidence regarding the assertions about presentation and disclosure described in paragraph A111 of ISA (UK and Ireland) 315.

### **Dual-purpose tests**

133. The auditor may design a test of controls to be performed concurrently with a test of details. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design and evaluate the results of a test to examine the entity's written documentation for a complex financial instrument to determine whether it has been approved and to provide substantive audit evidence of the transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.
134. In addition some of the controls which are usually performed by banks and building societies involve reconciling transactions, balances, securities and derivative positions with other banks, settlement systems, clearing houses and group entities. The auditor may design and evaluate the results of tests of such controls, both to obtain assurance as to the effectiveness of those controls and to provide substantive audit evidence.

### **Disclosure of market risk information under IFRS 7 and FRS 29**

135. IFRS 7/FRS 29 Financial instruments: Disclosures may give rise to particular issues for the auditor, particularly in relation to market risk sensitivity analysis.

#### *Understanding the risk measurement method adopted by the management*

136. An entity applying IFRS 7/FRS 29, where appropriate, discloses a sensitivity analysis for each type of market risk to which the entity is exposed. Where an entity uses sensitivity analysis, such as value at risk ('VAR') that reflects interdependencies between risk variables and this is the method used to manage the financial risks of the business, disclosures based on these measures may be used instead of the standard method prescribed by IFRS 7/FRS 29 paragraph 40.
137. The auditor obtains an understanding of the method adopted by the management to develop the market price risk information to be disclosed. This may be done in conjunction with obtaining an understanding of the entity's accounting and internal control systems. For example, the auditor considers the independence of the entity's risk management function from the front office in the context of their understanding of the control environment.

#### *Considering the skills needed by the audit team*

138. The audit team is assembled on the basis of the skills needed. The auditor's approach to the market price risk disclosures is normally based on reviewing and testing the process used by the management to develop the information to be disclosed, rather than on re-performing the calculations (or making or obtaining an independent assessment).

However, obtaining an understanding of that process and assumptions used may require technical knowledge of risk measurement methodologies; these can be complex, especially where a VAR model is adopted. Accordingly, when planning the audit, the auditor considers the skills needed in order to obtain and evaluate audit evidence in this part of the engagement.

139. The nature and extent of any technical knowledge of risk measurement methodologies that are required depends on the circumstances. The auditor takes into account such factors as the complexity of, and control surrounding, the model used and whether the model has received regulatory recognition. Where appropriate, the auditor may involve an expert in elements of this work (ISA (UK and Ireland) 620 covers using the work of an auditor's expert).

*Considering the application of the risk measurement method*

140. The auditor considers whether the risk measurement method adopted has been applied reasonably by, for example:

- reviewing, and where necessary testing, the internal controls relating to the operation of the entity's risk management system, in order to obtain evidence that the data used in developing the market price risk information are reliable. This may be done in conjunction with the auditor obtaining an understanding of control procedures including those over the data fed into the risk management system, pricing, and independent review of the algorithms. If the entity has applied for regulatory recognition of the method used, the auditor reviews correspondence with the regulator regarding such matters;
- reviewing, and where necessary testing, the internal controls relating to changes in the entity's risk management system (for example, controls over changes to algorithms and assumptions);
- if a VAR model is used, performing analytical review of the model's predictions during the year against actual outcomes (a process commonly referred to as 'backtesting'). The auditor normally reviews any comparisons made by the entity as part of its own backtesting procedures (for an entity to receive regulatory recognition of the model used it is required to undertake backtesting procedures);
- agreeing the amount disclosed to the output of the risk management system.

141. If an approach based upon internal controls and backtesting proves to be unsatisfactory, the auditor may wish to consider testing the accuracy of the calculations used to develop the required information. However, this situation may indicate that it would be more appropriate for the entity to make disclosures on the simpler basis described in IFRS 7/FRS 29 paragraph 40.

*Considering the adequacy of disclosures*

142. Market price risk information is subject to a number of significant limitations which are inherent in the risk measurement methods used. For example:

- there are different VAR models and methods of presenting sensitivity analyses. It is to be expected that, in any particular case, the management of the entity will make an informed choice of the method that it considers to be most suitable. Normally, for the purpose of developing the market price risk information to be disclosed, the management will use the risk measurement method that is used in the entity's risk management system. It would, for example, be reasonable to expect the appropriateness of this method in the past to be supported by the entity's own backtesting procedures, where such procedures are performed. However, in the absence of recognised industry standards on VAR, there is no objective benchmark against which to assess the future appropriateness of management's choice;
- both VAR models and sensitivity analyses involve the management making a number of important assumptions in order to develop the disclosures. These are, by their nature, hypothetical and based on management's judgment (for example, when using a VAR model, assumptions are made concerning the appropriate holding period, confidence level and data set);
- both VAR models and, to a limited extent, sensitivity analyses are based on historical data and cannot take account of the fact that future market price movements, correlations between markets and levels of market liquidity in conditions of market stress may bear no relation to historical patterns; and
- each of the methods permitted for developing market price risk information may lead to the entity reporting significantly different information, depending on the choice made by the management. IFRS 7/FRS 29 paragraph 41 requires the market price risk information disclosed to be supplemented by other disclosures, including explanations of:
  - the method used in preparing such sensitivity analysis and of the main parameters and assumptions underlying the data provided in the disclosures; and
  - the objective of the method used and the limitations that may result in the information not fully reflecting the fair values of assets and liabilities involved.

143. The auditor considers the overall adequacy of the disclosures made by the entity in response to the requirements of IFRS 7/FRS 29 and whether the market risk information is presented fairly so that its limitations can be understood. In particular, the auditor considers whether it is sufficiently clear that:

- the market price risk information is a relative estimate of risk rather than a precise and accurate number;



- the market price risk information represents a hypothetical outcome and is not intended to be predictive (in the case of probability-based methods, such as VAR, profits and losses are almost certain to exceed the reported amount with a frequency depending on the confidence interval chosen); and
- future market conditions could vary significantly from those experienced in the past.

144. In many entities and related groups, market price risk is primarily managed at the level of individual business units rather than on a legal entity or group-wide basis. Therefore, the auditor considers the appropriateness of the basis on which the market risk information to be disclosed in the financial statements is to be compiled. It may well be inappropriate simply to aggregate the operating unit information to arrive at the information to be disclosed for the entity or group as a whole.

*Considering the consistency of the risk measurement method adopted*

145. The main purpose of the disclosure of market price risk information is to provide users of an entity's financial statements with a better understanding of the relationship between the entity's profitability and its exposure to risk. For example, an increase in profitability may be achieved by taking on increased risk. IFRS 7/FRS 29 paragraph 40(c) requires disclosure of any changes in the methods and assumptions used and the reasons for the changes. Therefore, the auditor considers the consistency of the method, the main assumptions and parameters with those used in previous years.
146. If the method used for developing the market risk information is also used in the entity's risk management system, modifications will be made to the method as the need arises. If the entity performs its own backtesting procedures, this may lead to modification of, for example, the algorithm used, the assumptions and parameters specified or the parts of the trading book covered. Where modifications have been made, the auditor considers their effect on the market risk measures and whether appropriate disclosures about the changes have been made.
147. In some cases, re-statement may not be possible if the relevant data for the previous year cannot be constructed and in this case the auditor considers whether the disclosures provide sufficient information about the nature and extent of any change in the entity's risk profile. For example, as well as providing the current year figure on the 'new' basis, it may be relevant to show both the current year and the previous year figure on the 'old' basis. In all such cases, the auditor considers whether the disclosures contain sufficient narrative explanation of the change.

## **ISA (UK AND IRELAND) 402: AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION**

### **Objectives**

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

- (a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
- (b) To design and perform audit procedures responsive to those risks. (paragraph 7)

When obtaining an understanding of the user entity in accordance with ISA (UK and Ireland) 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

- (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;
- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- (c) The degree of interaction between the activities of the service organisation and those of the user entity;
- (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation; and
- (e) If the service organisation maintains all or part of a user entity's accounting records, whether those arrangements impact the work the auditor performs to fulfil reporting responsibilities in relation to accounting records that are established in law or regulation. (paragraph 9)

In responding to assessed risks in accordance with ISA (UK and Ireland) 330, the user auditor shall:

- (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

- (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf. (paragraph 15)

The user auditor shall modify the opinion in the user auditor's report in accordance with ISA (UK and Ireland) 705 if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements. (paragraph 20)

148. In common with other industries the outsourcing of functions to third parties is common for banks and building societies, albeit to a more limited degree for building societies. Some of the more common areas, such as customer call centres, may have no direct impact on the audit, while others such as IT functions may have a direct relevance. The auditor therefore gains an understanding of the extent of outsourced functions and their relevance to the financial statements. The entity is obliged to ensure that the auditor has appropriate access to records, information and explanations from material outsourced operations.
149. Whilst an entity may outsource functions to third parties the responsibility for these functions remains that of the entity. The entity should have appropriate controls in place over these arrangements including:
- risk assessment prior to contracting with the service provider, which includes a proper due diligence and periodic review of the appropriateness of the arrangement;
  - appropriate contractual agreements or service level agreements;
  - contingency plans should the provider fail in delivery of services;
  - appropriate management information and reporting from the outsourced provider;
  - appropriate controls over customer information; and
  - right of access of the entity's internal audit to test the internal controls of the service provider.
150. If the auditor is unable to obtain sufficient appropriate audit evidence concerning outsourced operations the auditor considers whether it is necessary to report the matter direct to the FSA – see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B.

## **ISA (UK AND IRELAND) 505: EXTERNAL CONFIRMATIONS**

### **Objective**

The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence. (paragraph 5)

The auditor shall determine whether external confirmation procedures are to be performed as substantive audit procedures. (ISA (UK and Ireland) 330 paragraph 19)

151. In general, external confirmation procedures may be useful as part of the audit of account balances and classes of transactions such as loans and deposits (including other receivables and payables such as settlement balances and nostro/vostro balances), securities held by third party custodians and derivative transactions. Such procedures are likely to be particularly useful when confirmation can be obtained from settlement systems and clearing counterparties of securities in the course of settlement and centrally cleared derivative and other transactions. As banks and building societies normally have well established control procedures to reconcile such transactions, balances, securities and derivative positions, the auditor may consider it to be more effective to perform dual purpose tests on these controls as described in paragraph 133.
152. However, external confirmations may not always provide useful audit evidence in relation to:
- retail loans and deposits; and
  - certain counterparties of wholesale market balances and transactions such as nostro/vostro balances, interbank loans and deposits and derivative transactions.
153. Retail loans and deposits typically comprise high volumes of comparatively low value amounts. Such third parties do not usually maintain independent records of their balances, largely depending on information already provided to them by the entity. Accordingly the auditor may consider the inherent reliability of such responses is comparatively low.
154. Wholesale counterparties incorporated in some jurisdictions outside the UK have countrywide policies of not responding to confirmation requests by auditors at all. Some counterparties will respond to requests to confirm specified balances and transactions but not open requests for unspecified information.

155. If external confirmations are not used, the auditor seeks sufficient appropriate evidence from tests of control and other substantive procedures. For example, in relation to wholesale market balances and transactions most banks and building societies also have well developed transaction confirmation controls within their trading activities as described in paragraph 115. The auditor may consider it more effective to test these controls, in addition to other substantive procedures, rather than carry out their own confirmation procedures.

## **ISA (UK AND IRELAND) 520: ANALYTICAL PROCEDURES**

### **Objectives**

The objectives of the auditor are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (paragraph 3)

In addition to the objectives and requirements established in ISA (UK and Ireland) 520, requirements for analytical procedures are also established in ISA (UK and Ireland) 315.

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (ISA (UK and Ireland) 315 paragraph 5)

The risk assessment procedures shall include the following: ...

- (b) Analytical procedures. ... (ISA (UK and Ireland) 315 paragraph 6)

156. Aspects of the entity's business where there are high volumes of similar transactions or balances, such as interest receivable/payable or interest margins, may lend themselves to analytical procedures to highlight anomalies.

157. The auditor may wish to consider applying analytical procedures to the following, if the procedures are expected to yield useful audit evidence or where they are considered more efficient or effective than alternative procedures:

- asset quality – e.g. ratio of non-performing loans to total loans and provisions for loan impairment to non-performing loans (overall and by portfolio type);

- earnings/profitability – e.g. cost/income ratio, the ratio of interest income or expense to average interest bearing assets or liabilities and the ratio of net interest income to average interest bearing assets;
  - the exposure to and degree of mismatching arising from the market risks below and the comparison of the related risk positions to risk limits set by management. The auditor may find it helpful to consider risk information to be disclosed under IFRS 7/FRS 29:
    - liquidity;
    - interest rates;
    - foreign exchange;
    - other market risks, such as equity and commodity prices;
  - the structure of the loan portfolio/credit exposure by industrial, geographic or other category, or by loan impairment provision;
  - regulatory compliance – e.g. complaints handling or reporting of suspicious transactions under the Money Laundering regulations; and
  - operational risk measures – e.g. failed trade rates, volumes of unreconciled items.
158. Whilst some aspects of the income statement and balance sheet of a bank or building society lend themselves easily to analytical procedures, income and expense resulting from trading activities is unlikely to be susceptible to these methods because of its inherent unpredictability. Analytical procedures on income and expense items such as interest will be most effective if returns are calculated on the basis of average daily (or at least monthly) balance information.
159. When performing their review of the financial statements as a whole for consistency with their knowledge of the entity's business and the results of other audit procedures, the auditor considers transactions occurring either side of the year end, including:
- material short-term deposits which are re-lent on broadly similar terms; loan repayments which are received shortly before the year end then re-advanced shortly afterwards; material sale and repurchase transactions or other financing or linked transactions. Experience and judgment are required to identify and assess the implications, if any, of these transactions; they may, for example, be indicative of 'window dressing'<sup>46</sup> of the balance sheet over the year end date;
  - other transactions around the year end, apparently at rates which are significantly off market including those that appear to give rise to significant profits or losses;

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46 'Window dressing' refers to actions taken or not taken prior to issuing financial statements in order to improve the appearance of the financial statements.

- the value and nature of transactions between related parties/associated undertakings around the year end; and
- the reclassification of balances and transactions to achieve advantageous income recognition and balance sheet treatment/presentation.

160. The auditor assesses evidence of window dressing and other transactions designed to achieve advantageous income recognition or balance sheet presentation and considers the implications for the financial statements (e.g. whether related disclosure is needed in order for the financial statements to give a true and fair view and, if so, given) and the consequences for the auditor's assessment of risks. If the auditor has concerns about such transactions and their treatment in the financial statements, the auditor communicates those concerns to those charged with governance and considers whether the auditor has a duty to, or should otherwise, make a report direct to the FSA, on which guidance is set out in the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B.

161. Where non financial information or reports produced from systems or processes outside the financial statements accounting system are used in analytical procedures, the auditor considers the reliability of that information or those reports.



## **ISA (UK AND IRELAND) 540: AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES**

### **Objective**

The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- (b) related disclosures in the financial statements are adequate,

in the context of the applicable financial reporting framework. (paragraph 6)

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA (UK and Ireland) 315, the auditor shall obtain an understanding of ...:

- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements.
- (c) How management makes the accounting estimates, and an understanding of the data on which they are based ... (paragraph 8)

The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. ... (paragraph 9)

In identifying and assessing the risks of material misstatement, as required by ISA (UK and Ireland) 315, the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (paragraph 10)

The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (paragraph 11)

Based on the assessed risks of material misstatement, the auditor shall determine:

- (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and
- (b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (paragraph 12)

In responding to the assessed risks of material misstatement, as required by ISA (UK and Ireland) 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:

- (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:
  - (i) The method of measurement used is appropriate in the circumstances; and
  - (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.
- (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- (d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose:
  - (i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
  - (ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (paragraph 13)

For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK and Ireland) 330, the auditor shall evaluate the following:

- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

- (b) Whether the significant assumptions used by management are reasonable.
- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (paragraph 15)

The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (paragraph 18)

162. Accounting estimates are used for valuation purposes in a number of areas: the most common examples are impairment calculations, and the fair value measurement of financial instruments where quoted market prices are not available for those instruments, both of which may represent significant risks. Estimates of allowances for impairment or provisions for compensation payable to customers may also represent significant risks.
163. In reviewing the effective interest rate calculations prepared by management the auditor carefully audits the inputs used in the models to determine the estimated cash flows which are then subject to the effective interest rate ('EIR') calculation. The auditor considers the information provided in IAS 39 (and its UK GAAP equivalent FRS 26) Application Guidance as to the reliability of such information being used. When estimating the cash flows management considers all contractual terms of the instrument and includes all reliable estimates of those cash flows. Factors that would be considered include all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, premiums or discounts, the expectation of timing and amount of the interest cash flows and whether the instrument is a floating or fixed instrument. Generally these will be amortised over the expected life of the instrument, however a shorter period is used if this is the period to which they relate and the auditor would assess the conclusion reached by the entity for reasonableness.
164. IAS 39 (FRS 26) requires all financial assets, with the exception of those measured at fair value through profit and loss to be reviewed for impairment. An impairment loss is only recognised when it is incurred, and it is only incurred if there is objective evidence of impairment as a result of one or more events that occurred after initial recognition and that event has an impact on the estimated future cash flows of the asset or group of assets, that can be reliably measured. The auditor evaluates the policy adopted by the entity to assess for impairment on all financial assets (excluding those measured at fair value through profit and loss) including reviewing what is constituted as a loss event and what events will result in an impairment loss being recognised, as one discrete event may not necessarily imply an impairment loss. Similarly the auditor challenges the entity on

those events which have occurred which have not been recognised as a loss event by the entity.

165. IAS 39 (FRS 26) gives guidance on the types of evidence to be considered in identifying whether an event has taken place (a 'loss event') which leads to an impairment calculation. Such factors include observable data about the following loss events:

- significant financial difficulties of the issuer or obligor;
- breach of contract;
- a concession (such as a forbearance arrangement) being granted by the lender for economic or legal reasons relating to the borrower's financial difficulty which the lender would not otherwise consider;
- probability that the borrower will enter bankruptcy or financial reorganisation;
- disappearance of an active market due to financial difficulties; and
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot be observed within individual assets including:
  - adverse changes in the payment status of the borrowers in the group; or
  - national or local economic conditions that correlate with defaults on other assets within the group.

Further factors will apply when considering the impairment of equity investments such as significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates or a significant or prolonged decline in the fair value of the equity instrument.

166. If, following the auditor's consideration of the factors outlined in paragraph 165, it is determined that a loss event has taken place, the auditor evaluates the assumptions made by management in arriving at their estimate of likely cash flows to be received from the impaired loans (including, where relevant, assumptions about the values of assets provided by way of security). The auditor assesses whether these assumptions have been made after due consideration and whether they are supported by relevant evidence, including evidence derived from backtesting. In making these assessments, the auditor considers whether an appropriate degree of caution has been exercised by management in judging anticipated future cash flows. In the case of individual loan impairment calculations such evidence will be specific to the borrower but where impairment is estimated for a portfolio of similar loans the auditor considers observable data across the group of assets as a whole such as arrears statistics or national or local economic conditions.

167. Loan impairments are often calculated using extensive and sometimes complex spreadsheet models and the auditor assesses the control over the inputs to the models and the controls that ensure the consistency and integrity of the model. In doing so, the auditor applies the assessments around management assumptions described in paragraph 166 to model inputs. The auditor evaluates models for consistency and accuracy and looks for evidence to support the assumptions being made in the models. These assumptions would include some or all of the following factors: financial guarantees and collateral, the expectation of timing and amount of the cash flows, probabilities of default, loss given default, emergence periods, whether the instrument is a floating or fixed instrument, prepayment speeds and recovery rates.
168. IAS 39 (FRS 26) does permit an entity to assess for impairment on a group of financial assets but only where an entity first considers whether there is objective evidence of an impairment for financial assets that are 'individually significant'. The auditor evaluates the judgment applied by the entity in assessing what is considered as 'individually significant'. Where this collective impairment assessment is performed by the entity the auditor evaluates the evidence used in determining the cash flows for reasonableness and grouping of assets with similar risk characteristics. This will involve reviewing historical loss experience for similar assets, peer group experience if none available for specific entity losses and reviewing the methodology and assumptions made by the entity.
169. The auditor considers the mechanics of the models particularly where portfolio calculations are performed in respect of tracking impairment charges and reversals of impairments in order to ensure that the correct accounting has been applied depending on the security involved.
170. Additional complexity has been added to impairment models and effective interest rate models as a result of IAS 39 Reclassification of financial assets, specifically from the Fair Value through Profit and Loss category to the Loans and Receivables category at distressed market prices. The auditor may wish to consult with an expert to assist in the audit of these balances as the calculation of EIR and the need to either record an adjustment to Profit and Loss or revise the EIR can be technical in nature.
171. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an estimate that differs from management's estimate, and that the difference between the auditor's estimate or range and management's estimate constitutes a financial statement misstatement. In such cases, where the auditor has developed a range, a misstatement exists when management's estimate lies outside the auditor's range. The misstatement is measured as the difference between management's estimate and the nearest point of the auditor's range.
172. The valuation of derivative and other financial instruments which are not quoted in an active market and so for which valuation techniques are required is an activity that can

give rise to significant audit risk. Such financial instruments are priced using valuation techniques such as discounted cash flow models, options pricing models or by reference to another instrument that is substantially the same as the financial instrument subject to valuation. The auditor reviews the controls, procedures and testing of the valuation techniques used by the entity. Controls and substantive testing could include focusing on:

- valuation technique approval and testing procedures used by the entity;
- the independence of review, sourcing and reasonableness of observable market data and other parameters used in the valuation techniques;
- calibration procedures used by the entity to test the validity of valuation techniques applied by comparing outputs to observable market transactions;
- completeness and appropriate inclusion of all relevant observable market data;
- the observability in practice of data classified by the entity as observable market data;
- the appropriateness and validity of classification of instruments designated as being traded in a non active and in an active market in light of best market practice;
- the appropriateness and validity of the particular valuation technique applied to particular financial instruments;
- the appropriateness and reasonableness of the assumptions used by the entity particularly where these are not supported by observable parameters;
- the appropriateness and validity of the parameters used by the entity to designate an instrument as substantially the same as the financial instrument being valued;
- mathematical integrity of the valuation model; and
- access controls over valuation models.

The auditor performs these procedures in light of their knowledge and experience and of the information readily available to the auditor.

173. In the more subjective areas of valuation the auditor obtains an understanding of the assumptions used and undertakes a review of the estimates involved for reasonableness, consistency and conformity with generally accepted practices. In some cases, the auditor may use his own valuation techniques to assess the entity's valuations. See paragraphs 135 to 147 above concerning disclosure of market risk information. Given the complexities involved and the subjective nature of the judgments inherent the auditor may involve an expert in elements of this work (see the ISA (UK and Ireland) 620 section of this Practice Note and ISA (UK and Ireland) 220).

174. In addition, the auditor considers whether the valuations overall appear reasonable based on the auditor's industry knowledge, market trends and the auditor's

understanding of other entities' valuations (having regard to client confidentiality) and other relevant price indicators. If the valuations appear to be consistently overly aggressive or conservative, this may be evidence of management bias (see paragraphs 182–186). The auditor takes this into consideration when evaluating the audit evidence obtained.

175. Additional guidance is also provided in the IASB Expert Advisory Panel Report issued in October 2008 which deals with measuring and disclosing the fair value of financial instruments in markets that are no longer active.
176. Additional guidance is provided for auditors in Practice Note 23 (Revised), 'Auditing Complex Financial Instruments – Interim Guidance', specifically paragraphs 75–80 and 110–142 dealing with the valuation of complex financial instruments. This guidance has not been duplicated in this Practice Note.
177. The auditor may also wish to consider benchmarking the valuation methodologies and assumptions used by management to other comparable companies holding comparable financial instruments to ensure that there is consistency in the market place for such valuation techniques. However, the availability and comparability of data will need to be considered for each case.

## Disclosure

For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (paragraph 20)

178. The auditor assesses the disclosures the entity has made in respect of assumptions they have made about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities in the next financial year. This is a requirement of IAS 1, 'Presentation of Financial Statements'. The auditor considers the difficult, subjective and complex assumptions made by management and assesses whether sufficient information is disclosed to enable the users of the financial statements to understand these uncertainties. The auditor considers factors such as the nature of the assumption, the sensitivity of the carrying amount to that assumption, range of reasonably possible outcomes and any explanations as to changes in these assumptions. Examples of these critical accounting estimates typically include the fair valuation of financial instruments, allowances for loan impairments and other credit risk provisions, goodwill, intangible assets, pensions and retirement benefits and deferred taxation.

179. The requirements of IFRS 7/FRS 29 to disclose information about the financial risks of the entity and how those are managed with reference to how the entity reports internally to key management personnel are a particular focus area for auditors. The auditor evaluates whether the disclosures are complete, appropriate and meet the requirements of the standard.
180. In respect of fair value accounting estimates the auditor may not be able to validate the fair value precisely and should rather determine a range within which there is an expectation that the entity's value would fall within. The auditor also assesses the ranges that are disclosed as part of IFRS 7/FRS 29 where management has made assumptions or judgments in determining the fair value where significant unobservable inputs have been used. The auditor determines whether the entity is disclosing the relevant assumptions and methodologies that have been employed to determine the fair value of their financial instruments in accordance with IFRS 7/FRS 29. For example the entity may disclose information about the assumptions relating to prepayment rates, recovery rates, interest rates, credit spreads, estimated credit losses and other discount rates used.
181. The auditor assesses the reasonableness of the fair value hierarchy that has been prepared by the entity in accordance with IFRS 7/FRS 29 to assess it for accuracy and completeness. The auditor challenges the entity's allocation in the fair value hierarchy by specifically considering the significant inputs used in determining the fair value of the instruments. Where quoted prices in active markets for identical assets or liabilities are used this would be categorised as level 1 (e.g. a corporate bond trading in an active market or a futures contract traded on an exchange). If inputs that are observable for the asset or liability either directly or indirectly are used in the valuation technique this would be regarded as level 2 (e.g. an interest rate swap in a liquid currency for a tenor for which liquid swap curve data is available). Where inputs used in the valuation technique are not based on observable inputs this would imply a level 3 categorisation if these inputs are significant to the fair value measurement in its entirety (e.g. corporate bond trading in an illiquid market where management has had to make an assumption of the implied credit spread to use). The auditor assesses whether there is sufficient evidence supporting the fair value hierarchy and the levels applied and reviews the additional sensitivity analysis required for changing the unobservable inputs in level 3 to reasonably possible changes and the impact on the carrying amount and profit and loss or equity.

## **Management bias**

The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (paragraph 21)



182. Management bias, whether unintentional or intentional, may be difficult to detect in an individual estimate. ISA (UK and Ireland) 540 indicates that examples of possible management bias with respect to accounting estimates include:
- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances;
  - Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions;
  - Selection or construction of significant assumptions that yield a point estimate favourable for management objectives; and
  - Selection of a point estimate that may indicate a pattern of optimism or pessimism.
183. Management bias may be identified when there has been a change in the method for calculating estimates from the prior period based on a subjective assessment without evidence that there has been a change in circumstances, when considered in the aggregate of groups of estimates or all estimates, or when observed over a number of accounting periods. It may also be identified if management consistently select estimates from the ends of plausible ranges rather than adopting a more neutral approach.
184. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as 'pessimistic' and 'optimistic' scenarios. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.
185. Although management bias is inherent in subjective decisions, management may have no intention of misleading the users of financial statements. If, however, there is intention to mislead through, for example, the intentional use of unreasonable estimates, management bias is fraudulent in nature. ISA (UK and Ireland) 240, 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements', provides standards and guidance on the auditor's responsibility to consider fraud in an audit of financial statements.
186. Indicators of management bias are an example of a matter that the auditor may communicate to those charged with governance when fulfilling the requirement in paragraph 16(a) of ISA (UK and Ireland) 260, 'Communication With Those Charged With Governance', to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

## **ISA (UK AND IRELAND) 550: RELATED PARTIES**

### **Objectives**

The objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
  - (i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
  - (ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
    - a. Achieve fair presentation (for fair presentation frameworks); or
    - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework. (paragraph 9)

In meeting the ISA (UK and Ireland) 315 requirement to identify and assess the risks of material misstatement, the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks. (paragraph 18)

187. Related party transactions are defined in FRS 8/IAS 24 'Related Party Disclosures'. Paragraph 16 of FRS 8 states that the 'disclosure provisions do not apply where to comply with them conflicts with the reporting entity's duties of confidentiality arising by operation of law'. IAS 24 contains no explicit corresponding exemption. However the potentially overriding impact of law concerning confidentiality in respect of disclosures under IAS 24 still needs to be considered. This is particularly relevant in a banking context: banks and building societies are usually under a strict duty of confidentiality (by

operation of statute, contract or common law) regarding the affairs of their clients and, in respect of transactions entered into in certain overseas jurisdictions, this may even preclude a foreign entity from disclosing information to its parent, another group company or their auditor. A provider of finance (in the course of a business in that regard) and its customer are not 'related' simply because of that relationship.

188. Both when applying EU IFRS or UK GAAP, under ISA (UK and Ireland) 550, the auditor is required to assess the risk that material undisclosed related party transactions may exist. It is in the nature of banking business that transaction volumes are high but this factor will not, of itself, necessarily lead the auditor to conclude that the inherent risk of material undisclosed related party transactions is high.
189. Authorised firms are required to report to FSA changes in control (in some instances with FSA prior approval), changes in circumstances of existing controlling parties and changes in entities who are closely linked to the authorised firm (SUP 11). In addition, there are annual reporting obligations in respect of controlling parties and entities that are closely linked to the firm (SUP 16). As a result, it will therefore normally be the case that there are controls in place to ensure that this information is properly collated. However, the definition of 'controller and closely linked' for regulatory purposes is not congruent with the 'related party' definition in FRS 8/IAS 24 and the auditor therefore considers what controls have been put in place by management to capture information on those parties which fall within the accounting definition only.
190. In reviewing related party information for completeness, the auditor may compare the proposed disclosures in the financial statements to information prepared for regulatory reporting purposes (bearing in mind that the population may be different, as noted in the preceding paragraph).
191. Whilst related party transactions can arise generally, in the context of UK banks and building societies, they frequently arise in respect of deposits held by directors and/or persons connected with them and in respect of loans and other transactions with directors and/or persons connected with them. They may also arise in respect of the sale or arrangement of insurance products and in respect of the provision of professional and other services. Whilst there are CA2006 provisions relating to transactions by banking companies with directors, there are separate BS Act 1986 requirements for building societies in respect of transactions with directors (s62–69 BS Act 1986). See paragraphs 239 to 241 concerning the related auditor's obligation.
192. The auditor is aware that BSOG provides additional emphasis for proper approval procedures concerning loans to and transactions with directors (BSOG 1.3.15G and 16G). In addition, the auditor is required to report on the statement that a building society is required to make under s68 BS Act 1986 concerning loans, and certain other transactions with directors, that are subject to s65 BS Act 1986. The auditor is also aware

that the Sch10A BS Act 1986 contains specific disclosure requirements applicable to the annual accounts of building societies as regards loans and certain other transactions with directors.

## **ISA (UK AND IRELAND) 560: SUBSEQUENT EVENTS**

### **Objectives**

The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and
- (b) To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report. (paragraph 4)

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (paragraph 6)

193. Matters specific to banks and building societies which the auditor may consider in the review of subsequent events include:

- an evaluation of material loans and other receivables identified as being in default or potential default at the period end to provide additional evidence concerning period end loan impairment provisions;
- an assessment of material loans and other receivables identified as (potential) defaults since the period end to consider whether any adjustment to the period end carrying value is required;
- a review of movements in market prices and exchange rates in illiquid markets to consider whether prices or rates used in period end valuations were realistic;
- a review of correspondence with regulators and enquiries of management to determine whether any significant breaches of regulations or other significant regulatory concerns have come to light since the period end; and
- a consideration of post year end liquidity reports for indications of funding difficulties.

## **ISA (UK AND IRELAND) 570: GOING CONCERN**

### **Objectives**

The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
- (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (c) To determine the implications for the auditor's report. (paragraph 9)

When performing risk assessment procedures as required by ISA (UK and Ireland) 315, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

- (a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
- (b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. (paragraph 10)

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (paragraph 11)

194. The approach for assessing the going concern assumption of a bank or building society is different from that likely to be adopted when making the assessment for a non bank 'Corporate' entity. A going concern assessment for a Corporate would typically involve comparing cash requirements at monthly intervals for a future period (e.g. the next 18

months) with available committed borrowing facilities to determine whether the company had sufficient headroom in its banking facilities to accommodate its foreseeable working capital needs.

195. The working capital of a bank or building society is very different in nature. The daily cash flows passing to and from a bank or building society are large. Banks and building societies cannot rely on committed facilities (loans and overdrafts from other banks) as typically they do not have access to facilities in this form. On a contractual basis, banks and building societies have current liabilities, such as on-demand and short-term retail deposits and wholesale unsecured borrowing, which are typically greater than their current assets (loans and other financial assets due within one year) and thus always have funding gaps. Trading activities are typically funded in a different manner (e.g. by repos) to retail/commercial banking and this funding is normally short term.
196. However, behavioural cash flows impacting a bank or building society are typically very different from that indicated by contractual maturities. Short-term contractual liabilities such as customer demand deposits have much longer behavioural maturities, and certain long-term contractual assets such as mortgages have shorter behavioural maturities (i.e. early redemptions).
197. At a simple level, banks are likely to face liquidity problems if the incremental demand for new funds across the various divisions of the bank exceed the supply of funding readily available.
198. Incremental 'demand' for funding is created through a number of channels, for example:
- growth in the business (e.g. more lending to customers);
  - drawdowns on committed facilities;
  - corporate actions (such as acquisitions);
  - large losses in trading books;
  - significant FX movements; and
  - additional collateral requirements on trading positions.
199. Behavioural factors are also important when assessing funding demand. For instance if the level of early mortgage redemptions falls, less cash will be received and the funding requirement will increase.
200. The key sources of funding supply on the liability side of the balance sheet are:
- retail and corporate deposits;
  - borrowing on wholesale markets/short-term money markets;

- debt securities (typically longer term debt);
- securitisation type arrangements (including covered bonds);
- repos; and
- equity injections from strategic investors (e.g. Sovereign Wealth Funds).

201. Banks and building societies are required to meet liquidity requirements set by the regulator<sup>47</sup>. A failure to comply with these requirements is likely to prompt action by the regulator.

202. A further important consideration in a going concern assessment for a bank or building society is the level of its capital ratios. Failure to maintain the required level of regulatory capital is likely to prompt intervention by the regulator. A sharp fall in regulatory capital may also result in a ratings downgrade making funding more expensive and possibly harder to obtain.

203. In reviewing going concern, the auditor may therefore consider the following areas in addition to those set out in ISA (UK and Ireland) 570:

- capital adequacy ratios – e.g. review of management’s analysis and rationale for ensuring that the entity is capable of maintaining adequate financial resources in excess of the minimum, this would include a review of stress tests performed by management;
- operations/profitability indicators – e.g. review of the performance of loans in troubled industry sectors in which the entity has a high concentration of exposure;
- funding structure and funding plan – e.g. review of management’s funding plans and comparison against recent funding patterns;
- liquidity indicators – e.g. review of the entity’s liquidity management process (e.g. maturity mismatch ladders) for signs of undue deterioration, again including a review of stress tests<sup>48</sup> performed by management and including a review of management’s analysis of the entity’s ability to meet liquidity requirements set by the regulator;
- liquid assets buffer – e.g. review of the results of compliance with the FSA requirement that a firm must periodically realise a proportion of the assets in its liquid assets buffer through repo or outright sale to the market<sup>49</sup>;
- customer behaviour indicators – e.g. review of recent deposit withdrawal experience (including, in exceptional circumstances, a run on the bank or building society) and

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47 For example BIPRU 12 Liquidity Standards.

48 BIPRU 12.4 addresses stress testing and contingency funding.

49 BIPRU 12.7.11.



whether there are indicators of changes in behaviour on the asset side of the balance sheet; and

- reputational and other indicators – e.g. review of the financial press and other sources of market intelligence for evidence of deteriorating reputation; review of correspondence with regulators.

Further details of possible factors that may indicate going concern issues in these areas are set out in Appendix 5 to this Practice Note.

204. There may be circumstances where funding for an entity is provided by national governments or central banks and, where applicable, the auditor considers whether such funding is appropriately committed.
205. If the auditor has any doubts as to the ability of the entity to continue as a going concern, the auditor considers whether to make a report direct to the FSA, on which guidance is set out in the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B.

## **ISA (UK AND IRELAND) 580: WRITTEN REPRESENTATIONS**

### **Objectives**

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs (UK and Ireland); and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor. (paragraph 6)

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (paragraph 9)

Other ISAs (UK and Ireland) require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (paragraph 13)

206. ISAs (UK and Ireland) 250 Section A and 550 require the auditor to obtain written confirmation in respect of completeness of disclosure to the auditor of:

- all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements (these include breaches of FSMA 2000, FSA rules, the Money Laundering Regulations, other regulatory requirements or any other circumstance that could jeopardise the authorisation of the firm under FSMA 2000); and
- the completeness of information provided regarding the identification of related parties and the adequacy of related party disclosures in the financial statements.

207. In addition to the examples of other representations given in ISA (UK and Ireland) 580, the auditor also considers obtaining confirmation:

- as to the adequacy of provisions for loan impairment (including provisions relating to individual loans if material) and the appropriateness of other accounting estimates (such as complex financial instrument valuations or adequate provisions for compensation concerning upheld complaints by customers);
- that all contingent transactions or commitments have been adequately disclosed and/or included in the balance sheet as appropriate; and
- that all correspondence with regulators has been made available to the auditor.

## **ISA (UK AND IRELAND) 600: SPECIAL CONSIDERATIONS – AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)**

### **Objectives**

The objectives of the auditor are:

- (a) To determine whether to act as the auditor of the group financial statements; and
- (b) If acting as the auditor of the group financial statements:
  - (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
  - (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. (paragraph 8)

208. Where the entity consists of a group with components, (e.g. subsidiaries, branches or divisions), the requirements and application guidance in ISA (UK and Ireland) 600 are applicable as for groups in other industries. Similar considerations apply, but there are certain aspects that are particularly challenging for the audits of banks and building societies.

### **Assessment of component risk**

The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. The group engagement team shall:

- (a) Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage; and
- (b) Obtain an understanding of the consolidation process, including the instructions issued by group management to components. (paragraph 17)

The group engagement team shall obtain an understanding that is sufficient to:

- (a) Confirm or revise its initial identification of components that are likely to be significant; and
- (b) Assess the risks of material misstatement of the group financial statements, whether due to fraud or error. (paragraph 18)

209. Generally the significance of components will be assessed based on the size of their balance sheets and profit and loss accounts/income statements. However, it is important also to be alert to the risk of misstatement arising from the nature of the entity's activities. For example a poor control environment in a small remote treasury operation or a small retail bank may lead to errors of a size that are disproportionate to the size of the entity concerned. This risk may be mitigated by testing certain key controls in and over the entity, even if a full scope audit is not conducted.

### **Special purpose entities**

210. One aspect of activities of banks and building societies that can present particular difficulties is their use of special purpose entities ("SPEs"), which are often considerably more numerous than for entities in other industries. The key risks of material misstatement relating to special purpose entities arise from failure:

- to identify all special purpose entities established by the group; and
- to assess appropriately whether the SPEs are required to be consolidated by the group in accordance with the relevant financial reporting framework.

211. As SPEs tend to have varying legal forms, for example trusts, partnerships or other vehicles, it can sometimes be challenging to ensure that all SPEs established by the group have been accurately identified by management. The auditor considers the process established by management for:

- recording and ongoing monitoring of SPEs; and
- understanding changes to SPE structures that might trigger consolidation accounting for unconsolidated SPEs.

212. Audit procedures to address this might include:

- inquiries of the senior management and the Board;
- inspection of committee minutes approving the setting up of such entities;
- inspection of approvals from different functions within the group, for example – Compliance, Risk, Legal, Tax, Finance etc.
- reviewing the list/database of SPEs and changes thereto.

213. Management of group entities usually perform an assessment of whether SPEs are required to be consolidated or not within the group. This is normally considered as part of the set up process. The assessment is based on whether the group controls the SPE or not and takes into account various factors such as the nature of activities of the SPE, who obtains the majority of the benefits, who bears the majority of the risks and so forth.
214. The auditor evaluates management's assessment of the accounting treatment of the SPEs in accordance with the applicable reporting framework and challenge the appropriateness of the treatment, where necessary including, for example, if relevant circumstances have changed since management performed its assessment of whether SPEs are required to be consolidated. The auditor also checks the regulatory treatment of SPEs to ascertain whether this provides additional evidence for the accounting treatment and also to ensure that any differences can be rationalised.
215. For SPEs that are consolidated within the group, the auditor applies the same tests as for other components to identify whether the component is significant from a group perspective and to determine the type of work to be performed on the SPE (either because of its individual financial significance or because it has significant risks).

### **Offshoring**

216. Another aspect of difficulty in undertaking the group audit of a bank or building society is their use of offshoring. Large banking groups tend to process a huge volume of generally low value transactions on a day-to-day basis. Over the past few years, many banking institutions have increasingly offshored these high volume transaction processing and related control activities to low cost locations around the world to obtain competitive cost advantage.
217. Offshoring of activities poses a particular risk of breakdown in controls, because processes are broken down into several pieces with different locations potentially looking after each one. If the precise responsibilities of each location are not fully understood and monitored, key aspects of the control process could be omitted or not properly performed.
218. Typical examples of process/control activities that are performed in an offshore location include:
- processing of payments;
  - bank and suspense account reconciliations;
  - processing of confirmations; and
  - processing of settlements.

219. The auditor evaluates the clarity of management's ownership of process and control activities in different locations and where appropriate tests the controls for the end-to-end process.

### Overseeing other auditors

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following:

- (a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.
- (b) The component auditor's professional competence.
- (c) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
- (d) Whether the component auditor operates in a regulatory environment that actively oversees auditors. (paragraph 19)

220. Where the group auditor uses the work of component auditors from another audit firm in testing the design, implementation and operating effectiveness of the controls in offshore locations, the group engagement team provide clear audit instructions to the component audit team so that all significant processes and key controls are appropriately covered in the testing.

221. A group's operations can involve a high degree of reliance being placed by entities within the group upon activities performed by others. For example it would be possible for a trade to be originated in one location, processed in another, valued in a third and booked in a fourth. In addition judgmental decisions around areas such as credit, can be taken in group or other central locations, but affect several entities within the group. Such interdependency requires not just clear allocation of responsibility between the various teams undertaking the audit, but also close ongoing cooperation throughout the work, to ensure that the work undertaken and the judgments made are appropriate for the auditors of all locations affected. The group auditor considers how this can be best achieved.

222. The group auditor considers the competence and capability of the component auditor having regard to the laws, regulation and industry practice relevant to the component and whether the other auditor has access to relevant expertise, for example in the valuation of financial instruments, appropriate to the component's business.

223. Further procedures may be necessary for a group auditor where the component auditor is not subject to the UK audit regulatory regime. In such a case, the group auditor has due regard to the requirements in the Audit Regulations<sup>50</sup> to ensure all relevant members of the engagement team are and continue to be fit and proper, are and continue to be competent and are aware of and follow the Audit Regulations and any related procedures and requirements established by the audit firm. This includes the auditor's duty to report direct to the FSA in certain circumstances. More detailed consideration of the auditor's duty to report to the FSA is set out in the section of this Practice Note dealing with ISA (UK and Ireland) 250 Section B.

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50 Audit Regulations and related guidance are issued by the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Scotland and the Institute of Chartered Accountants in Ireland.



## **ISA (UK AND IRELAND) 620: USING THE WORK OF AN AUDITOR'S EXPERT**

### **Objectives**

The objectives of the auditor are:

- (a) To determine whether to use the work of an auditor's expert; and
- (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes. (paragraph 5)

224. Given the complexity, subjectivity and specialist nature of the activities of banks and building societies the auditor may involve an expert<sup>51</sup> in elements of the audit of these areas, including, for example:

- the valuation of derivative and other financial instruments not traded in an active market;
- VAR (or similarly complex) market risk disclosures;
- commercial property valuations; and
- information technology.

Auditor's experts may assist with the performance of tests of controls and substantive procedures and evaluating disclosures in the financial statements.

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51 ISA (UK and Ireland) 620 defines an auditor's expert as: 'An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.'  
Experts used by the entity to assist in preparing the financial statements are 'management's experts'. The auditor's considerations in relation to management's experts are addressed in ISA (UK and Ireland) 500.

## **ISA (UK AND IRELAND) 700: THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS**

### **Objectives**

The objectives of the auditor are to:

- (a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- (b) Express clearly that opinion through a written report that also describes the basis for the opinion. (paragraph 7)

The auditor's report shall include a statement that those charged with governance are responsible for the preparation of the financial statements and a statement that the responsibility of the auditor is to audit and express an opinion on the financial statements in accordance with applicable legal requirements and International Standards on Auditing (UK and Ireland). The report shall also state that those standards require the auditor to comply with the APB's Ethical Standards for Auditors. (paragraph 15)

225. The auditor may report on the financial statements of a branch of a bank incorporated outside the UK. ISA (UK and Ireland) 700 (or aspects thereof) may remain applicable in these circumstances. However, in agreeing the form of the opinion for a branch audit, the auditor takes into account matters such as the nature and content of the financial statements to which the report relates, the extent to which transactions recorded in the branch may have been initiated in other locations (and, similarly, whether transactions initiated by the branch may have been recorded elsewhere), the specific terms of the engagement as agreed with the party which has commissioned the work (which may be local and/or head office management or the head office auditor, for example) and whether the report will be public or private.

226. The auditor's reporting responsibilities concerning building societies differ from those applicable to a UK bank. The principal differences are:

- a statutory requirement for the publication of income and expenditure accounts (as opposed to profit and loss account/income statements) separately for both the society and its subsidiary undertakings (group accounts) (s72F BS Act 1986) and the society itself (s72B BS Act 1986) where prepared under UK GAAP. S72H and s72D BS Act 1986 respectively apply where prepared under EU IFRS. This contrasts with the s408(2) CA2006 exemption available to UK companies including UK banks from publishing the profit and loss account of the parent company in group accounts;

- a statutory requirement for an annual business statement to be attached to the annual accounts (s74 BS Act 1986), containing information as prescribed by the BS Accounts Regulations 1998: the prescribed content comprises three sections, being section 1, statutory percentages (the lending and funding limits, see paragraph 21 of this Practice Note), disclosing also the statutory limits and an explanation of the basis for each of these ratios, section 2, other percentages (being five operating ratios with their comparatives and an explanation of each ratio), and section 3, information on the directors and officers of the society. The auditor is required to state whether the annual business statement has been prepared in accordance with BS Act 1986 and regulations made thereunder and whether the information given in the annual business statement (excluding the details of directors and officers) gives a true representation of the matters in respect of which it is given (s78(7)(a) BS Act 1986); and
- a statutory requirement for a directors' report to be produced for each financial year (s75 BS Act 1986), containing information as prescribed in s75 and 75A BS Act 1986 and Sch 8 of the BS Accounts Regulations 1998: in addition to consistency with financial statements the auditor is required to state whether the directors' report has been prepared so as to conform to the requirements of s75 BS Act 1986 and the BS Accounts Regulations 1998 (s78(7) BS Act 1986).

227. In relation to the annual business statement the term 'true representation of the matters in respect of which it is given' referred to in paragraph 226 above is the expression drawn directly from the BS Act 1986. It is not defined in BS Act 1986 nor in any related legislation. The part of the annual business statement covered by this opinion comprises data and ratios (see paragraphs 22 to 25) that are almost all derived from audited information within the annual accounts. Procedures undertaken by the auditor usually involve substantive procedures to ensure that:

- the relevant data has been completely and accurately extracted from audited information or from sources that have been subject to audit procedures; and
- the ratios have been accurately calculated in accordance with the statutory definitions within the BS Accounts Regulations 1998.

228. There is also a statutory requirement for a summary financial statement for building societies, in a format as prescribed in the BS Accounts Regulations 1998, which must be sent to all members entitled to receive notice of meetings and which must be provided on request to all new shareholders (s76 BS Act 1986): the auditor is required by s76(5) BS Act 1986 to provide an auditor's statement as to the consistency of the summary financial statement with the accounts, the annual business statement and the directors' report and its conformity with the requirements of s76 BS Act 1986 and the BS Accounts Regulations 1998<sup>52</sup>.

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52 A Listed UK bank may choose to prepare summary financial statements to send to its members, subject to certain conditions.

229. Illustrative examples of auditors' reports tailored for use with audits conducted in accordance with ISAs (UK and Ireland), including reports on the financial statements of building societies, are provided in various Bulletins issued by the APB<sup>53</sup>. Examples of other auditor's reports are set out in Appendix 1 of this Practice Note.

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<sup>53</sup> At the date of publication of this Practice Note, Bulletin 2010/2 (Revised) 'Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010 (Revised)' was the current Compendium Bulletin relating to private sector financial statements. Example reports 23 and 24 therein cover building societies preparing financial statements under UK GAAP and under IFRSs as adopted in the European Union.

## **ISA (UK AND IRELAND) 705: MODIFICATIONS TO OPINIONS IN THE INDEPENDENT AUDITOR'S REPORT**

### **Objective**

The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.  
(paragraph 4)

230. One of the circumstances in which the FSMA 2000 (Communication by Auditors) Regulations 2001 ('the 2001 Regulations'), requires an auditor to report to the FSA is when 'the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with the CA2006 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation'. Consequently where an auditor is considering modifying the auditor's opinion on the financial statements the auditor reports the circumstances requiring the modification to the FSA in advance of issuing the report.

## **ISA (UK AND IRELAND) 706: EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT**

### **Objective**

The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. (paragraph 4)

231. As explained in paragraph 59 the auditor has a duty to report to the FSA if the auditor becomes aware of a matter that could be of material significance to the FSA in determining whether a bank meets the threshold conditions for authorisation. Any matter considered of such importance as to require an emphasis of matter paragraph may well also be of material significance to the FSA and so the auditor considers whether to make a report to the FSA before issuing the auditor's opinion on the financial statements. Similar considerations apply where the auditor is considering including an other matter paragraph.

## **OTHER REPORTS BY THE AUDITOR**

### **Auditor's review reports on interim net profits**

232. An authorised firm must maintain at all times capital resources equal to or in excess of its capital resources requirement. An authorised firm may include interim net profits in its capital resources, calculated in accordance with GENPRU2 Annex 2R or 3R, provided those interim net profits have been verified by the external auditor (GENPRU2.2.102R) in accordance with the 'relevant Auditing Practices Board's Practice Note' (GENPRU2.2.103G). For this reason the auditor may be asked to report on interim net profits for inclusion in core tier 1 profits for capital adequacy purposes. Authorised firms with a trading book can include net interim trading book profits in lower tier 3 capital without external review (GENPRU2.2.247R).
233. Interim net profits in this context means, net profits of the entity as at a date specified by the entity after the end of its most recently audited financial year end and up to and including its next financial year end, calculated after deductions for tax, foreseeable dividends and other appropriations (GENPRU2.2.102R).
234. GENPRU 2.2.102R does not include specific guidance as to what constitutes an external verification. However, 'verification' as used in the context of GENPRU is understood to indicate a degree of assurance which is lower than that given by a full audit. An engagement to 'verify' interim profits may therefore be taken to be a review engagement, and an opinion may be given in terms of negative assurance. The report is normally addressed to the directors of the entity.
235. As an external 'verification' of interim net profits does not require a full scope audit it will be important for the FSA, in considering the adequacy of the 'verification' of interim profits, to be informed of the procedures that have been undertaken by the auditor, in support of the auditor's opinion. This is particularly important in the case of entities where no prescribed procedures have been established by the FSA themselves in rules or guidance. Consequently the detailed scope of the work undertaken by the auditor in support of the auditor's opinion is listed in the auditor's report or included in the report by reference to the letter of engagement where the programme of work has been laid down.
236. In undertaking the review the auditor normally performs the following procedures:
- (a) obtains satisfaction that the figures forming the basis of the interim net profits have been properly extracted from the underlying accounting records;
  - (b) reviews the accounting policies used in calculating the interim net profits for the period under review so as to obtain comfort that they are consistent with those normally adopted by the entity in drawing up its annual financial statements and are in accordance with either UK GAAP or EU IFRS, as appropriate;

- (c) performs analytical procedures on the results to date which form the basis of calculating interim net profits, including comparisons of actual performance to date with budget and with the results of the prior period(s);
- (d) discusses with management the overall performance and financial position of the entity;
- (e) obtains comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities, allowances for loan losses and other impairment provisions have been properly taken into account in arriving at interim net profits; and
- (f) follows up significant matters of which the auditor is already aware in the course of auditing the entity's most recent financial statements.

The auditor may also consider obtaining appropriate representations from management.

237. There may be some circumstances in which the auditor considers that additional work is required, for example:

- if the control environment surrounding the preparation of the interim net profits is evaluated as weak;
- if the results of the procedures undertaken in paragraph 236 above are not fully consistent with the interim net profits as reported; or
- if there has been a significant change to the accounting system.

238. The report is addressed to the directors of the entity. An example auditor's report on interim profits is set out in Appendix 1.3.

### **Report on directors' transactions – building societies**

239. Under s78(9) BS Act 1986 the auditor is required to report to the members on the annual statement of transactions and arrangements (usually loans falling within s65(1) BS Act 1986) with or to directors and persons connected with them.

240. S78(9) BS Act 1986 requires the auditor to examine the annual statement, as extracted from the Register required to be maintained under s68 BS Act 1986, and that a report from the auditor be annexed to the statement before it is made available to the members and sent to the FSA. Under s78(10) BS Act 1986 the auditor reports whether the statement contains the particulars required by s68 BS Act 1986 and, where that is not the case, the auditor includes such particulars in their report, so far as they are reasonably able to do so.

241. The auditor only reports as to whether the statement contains all the matters contained in the Register in the relevant year. The auditor is not required by s78 BS Act 1986 to



confirm whether or not the Register of transactions and arrangements with directors or connected persons is complete. However, if the auditor becomes aware of any transaction, arrangement or loan which should be in the Register and is not, then such an occurrence may indicate a deficiency in the system of control over the complete and accurate compilation of the Register. The results of this work could raise issues of relevance to the statutory duty to report to the FSA. An example of the auditor's report concerning this statement is set out in Appendix 1.2.

## **ILLUSTRATIVE EXAMPLES OF AUDITOR'S REPORTS**

Illustrative examples of auditor's reports tailored for use with audits conducted in accordance with ISAs (UK and Ireland), including reports on the financial statements of building societies, are provided in various Bulletins issued by the APB<sup>54</sup>.

This appendix contains the following example auditor's reports:

### **UK Building Societies**

1.1 Auditor's statement on summary financial statement.

1.2 Auditor's report on the s68 BS Act 1986 statement.

### **UK Banks and Building Societies**

1.3 Auditor's review report on interim net profits.

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54 At the date of publication of this Practice Note, Bulletin 2010/2 (Revised) 'Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010 (Revised)' was the current Compendium Bulletin relating to private sector financial statements. Example reports 23 and 24 therein cover building societies preparing financial statements under UK GAAP and under IFRSs as adopted in the European Union.

## **APPENDIX 1.1 AUDITOR'S STATEMENT ON SUMMARY FINANCIAL STATEMENT (BUILDING SOCIETIES)**

### **Independent Auditor's statement to the Members and Depositors of [XYZ] Building Society**

We have examined the Summary Financial Statement of [XYZ] Building Society [set out/above on pages x to x] <sup>\*</sup>.

### **Respective responsibilities of directors and auditors**

The directors are responsible for preparing the [Summary Financial Statement/name of document containing summary financial statement] <sup>1\*</sup>, in accordance with applicable United Kingdom law.

Our responsibility is to report to you our opinion on the consistency of the Summary Financial Statement [within the [name of document containing summary financial statement]] <sup>1\*</sup> with the [full Annual Accounts] <sup>2</sup>, Annual Business Statement and Directors' Report and its conformity with the relevant requirements of Section 76 of the Building Societies Act 1986 and regulations made under it. [We also read the other information contained in the [name of document containing summary financial statement] and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Summary Financial Statement.] <sup>3\*</sup> <sup>\*</sup>. The other information comprises only [the chairman's statement and the corporate governance statement [and the other items listed on the contents page]] <sup>3\*</sup>

### **Basis of opinion**

We conducted our work in accordance with Bulletin 2008/3 'The auditor's statement on the summary financial statement in the United Kingdom' issued by the Auditing Practices Board. Our report on the [Group and Society's] <sup>\*</sup> [full Annual Accounts] <sup>2</sup> describes the basis of our audit opinion[s] on those [Annual Accounts] <sup>2</sup>.

### **Opinion on summary financial statement**

In our opinion the Summary Financial Statement is consistent with the [full Annual Accounts] <sup>2</sup>, the Annual Business Statement and Directors' Report of [XYZ] Building Society for the year ended [ ] and complies with the applicable requirements of Section 76 of the Building Societies Act 1986 and regulations made under it <sup>4</sup>.

*Statutory Auditor*

*Address*

*Date*

### *Notes*

- 1 If the summary financial statement is part of a larger document, for example including the Chairman's report or the Chief Executive's Review, then reference is made to the name of that larger document.

- 2 The Building Societies Act 1986 uses the term 'annual accounts' rather than 'financial statements'. The auditor ordinarily uses the term used by the directors in the Annual Report.
- 3 If the document comprises only the summary financial statement, then this sentence will not be required.
- 4 The date of the auditor's statement on the summary financial statement ('SFS') should be the same as the directors' approval of the SFS and the auditor's report on the full accounts.

\* delete/amend as applicable

## **APPENDIX 1.2 AUDITOR'S REPORT ON THE S68 BS ACT 1986 STATEMENT (BUILDING SOCIETIES)**

**Independent auditor's report, under Section 78(9) of the Building Societies Act 1986 ('the Act'), to the members of [XYZ] Building Society on the statement of particulars of transactions and arrangements included in the Section 68(1) Register at any time during the year ended [ ]**

We have examined the foregoing statement of transactions and arrangements with directors and persons connected with them, falling within Section 65(1) of the Act.

### **Respective responsibilities of directors and auditors**

It is the responsibility of the directors, under Section 68(1) of the Act, to maintain a register of every existing transaction and arrangement, as defined in Section 65(1) of the Act, with directors or persons connected with directors. Section 68(3) of the Act requires the directors to prepare, for each financial year, a statement containing particulars of all information in the register for the last complete financial year. It is our responsibility, under Section 78(9) and (10) of the Act, to form an independent opinion as to whether the statement accurately contains all the particulars in the register from the last financial year and to report our opinion to you.

### **Basis of opinion**

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence that the statement gives the particulars required by Section 68 of the Act.

### **Opinion**

In our opinion the statement contains the requisite particulars, as required by Section 68 of the Act, in relation to those transactions recorded by the society in the register of transactions and arrangements maintained under Section 68(1) of the Act.

*[Signature]*

*John Smith (Senior Statutory Auditor)  
for and on behalf of ABC LLP  
Statutory Auditor*

*Address  
Date*

### **APPENDIX 1.3 AUDITOR'S REVIEW REPORT ON INTERIM NET PROFITS (UK BANKS AND BUILDING SOCIETIES)**

#### **Review report by the auditor to the board of directors of [XXXX]**

In accordance with our engagement letter dated [ ], we have reviewed the interim net profits of [XXXX] for the period [ ] to [ ] as reported in the reporting statement ('the Statement') for that period, a copy of which is attached as Appendix A.

The preparation of the Statement is the responsibility of the directors. Our review did not constitute an audit performed in accordance with ISAs (UK and Ireland) and accordingly we do not express an audit opinion on the interim net profits reported therein.

Our review has been carried out having regard to GENPRU 2.2.102R and GENPRU 2.2.103G of the FSA Handbook and Practice Note 19 'The audit of banks and building societies in the United Kingdom (Revised)' issued by the Auditing Practices Board.

On the basis of the results of our review, nothing came to our attention to indicate that:

- (a) the interim net profits as reported in the Statement 'have not been calculated on the basis of the accounting policies adopted by [XXXX] in drawing up its annual financial statements for the year ended [ ] [except for]<sup>1</sup>;
- (b) the accounting policies differ in any material respects from those required by [UK GAAP applicable to [banks/building societies]\*<sup>2 3</sup> /International Financial Reporting Standards adopted by the European Commission in accordance with EC Regulation No 1606/2002]\*[except for]; and
- (c) the interim net profits amounting to £ [ ] as so reported are not reasonably stated.

This report has been prepared for the directors of [XXXX] to comply with their regulatory obligations under GENPRU2.2.102R and for no other purpose. We do not, in providing this report, accept or assume responsibility for any other purpose save where expressly agreed by our prior consent in writing.

*Statutory Auditor*

*Address*

*Date*

#### *Notes*

- 1 Identify any changes, if any, in accounting policies applied for the first time in the interim period under review.
- 2 UK GAAP applicable to banks comprises the Companies and Groups Accounts Regulations 2008 made under Part 15 CA2006, UK Financial Reporting Standards and UITF Abstracts.

- 3 UK GAAP applicable to building societies comprises Building Societies Accounts Regulations 1998, UK Financial Reporting Standards and UITF Abstracts.

\* delete as applicable

## THE MAIN PARTS OF FSMA 2000 RELEVANT TO BANKS AND BUILDING SOCIETIES

Part I (and Sch 1) sets out matters concerning structure and governance of the FSA including its regulatory objectives and the principles to be followed in meeting those objectives.

Part II (and Sch 2) sets out the general prohibition on conducting regulated business unless an entity is either authorised or exempt, including restrictions on financial promotions. Regulated activities are defined in SI 2001/544.

Part III (and Schs 3–5) sets out the requirements to become authorised either by receiving a specific permission from the FSA or through the exercise of EEA passport rights. Exempt persons are listed in SI 2001/1201.

Part IV (and Sch 6) sets out the arrangements for application for a permission to undertake authorised business and the criteria (Threshold Conditions) that must be met. An applicant who is refused can apply to the Financial Services and Markets Tribunal (established under Part IX).

Part V sets out the provisions applying to individuals performing designated functions (controlled functions) in an authorised firm. The FSA can specify controlled functions and authorised firms must take reasonable care to ensure that only persons approved by the FSA can undertake these functions. The FSA can specify qualification, training and competence requirements and approved persons must comply with the FSA's statement of principles and code of conduct for approved persons. Appeals can be made to the Tribunal.

Part VIII gives the FSA powers to impose penalties for market abuse – using information not generally available; creating a false or misleading impression; or, failure to observe normal standards – abuse being judged from the point of view of a regular market user. The FSA's powers extend to all persons – not only authorised firms. The FSA is required to publish a code to provide guidance on behaviours that do and do not constitute market abuse. This forms part of the Market Conduct Sourcebook and is called the Code of Market Conduct.

Part X provides the FSA with general powers to make rules which apply to authorised firms, including rules on specific matters – e.g. client money, money laundering. Rules must be published in draft for consultation. Guidance may be provided individually or generally and may be published. The FSA may modify rules or waive particular rules for particular authorised firms in certain situations.

Part XI allows the FSA to gather information from authorised firms, including use of skilled persons' reports under s166, or to commission investigations into authorised firms.



Part XIV sets out the disciplinary measures available to the FSA which can include public censure, unlimited fines, withdrawal of authorisation.

Part XXII includes provisions relating to auditors and their appointment.

Part XXVI brings together in one place the arrangements applying to warning notices and decision notices concerning possible breaches of various requirements imposed by FSMA 2000 or by FSA rules. A warning notice has to state the reasons for proposed actions and allow reasonable time for representations to be made. This will be followed by a decision notice with a right to appeal to the Tribunal.

## **FSMA 2000, BS ACT 1986 AND RELATED STATUTORY INSTRUMENTS: IMPORTANT PROVISIONS FOR AUDITORS**

FSMA 2000 provisions and related statutory instruments relevant for the auditor of a bank or building society are set out below. The legislation can be found on the legislation.gov.uk website – [www.legislation.gov.uk](http://www.legislation.gov.uk) (it is published as enacted, i.e. does not take account of subsequent amendments). BS Act 1986 provisions and related statutory instruments relevant only to building societies are also set out below.

### **FSMA 2000 and statutory instruments as amended**

#### **Section/Sch**

19	General prohibition from undertaking regulated activity unless authorised
20	Authorised firms acting without permission
21	Restrictions on financial promotion
41	Threshold conditions
59	Approval by FSA of persons undertaking controlled functions
165	FSA's power to require information
166	Reports by skilled persons
167	Appointment of persons to carry out general investigations
168	Appointment of persons to carry out investigations in particular cases
178	Obligation to notify FSA concerning controllers of an authorised firm
340	Appointment of auditor or actuary by FSA
341	Access to books etc (by auditor or actuary)
342	Information given by auditor or actuary to the FSA
343	Information given by auditor or actuary to the FSA: persons with close links
344	Duty of auditor or actuary resigning etc to give notice
345	Disqualification (of auditor or actuary from acting by FSA)
346	Provision of false or misleading information to auditor or actuary
348	Restrictions on disclosure of confidential information by FSA etc
349	Exceptions from s348
351	Competition information (offence relating to the disclosure of competition information)
352	Offences (contravention of s348 to 350(5))
398	Misleading the FSA
Sch 6	
SI 2001	Threshold Conditions

544	Regulated Activities Order
1177	Carrying on Regulated Activities by Way of Business Order
1201	Exemption Order
1857	Disclosure of Information by Prescribed Persons
2188	Disclosure of Confidential Information
2587	Communications by Auditors
1376 and 2511	EEA Passport Rights

### **BS Act 1986 and statutory instruments as amended**

#### **Section/Sch**

5	Constitution and powers including principal purpose
6	The lending limit
7	The funding limit
8	Raising funds and borrowing
9A	Restriction on powers including treasury activities
62–69	Dealings with directors and disclosure and record of related businesses of directors
71	Accounting records
72A	Duty to prepare individual accounts
72B	Building Societies Act individual accounts
72C	Form and content of Building Societies Act individual accounts
72D	IAS individual accounts
72E	Duty to prepare group accounts
72F	Building Societies Act group accounts
72G	Form and content of Building Societies Act group accounts
72H	IAS group accounts
72I	Consistency of accounts
72J	Disclosures relating to directors, other officers and employees of societies required in notes to the accounts
72K	Disclosures about related party undertakings required in the notes to the accounts
74	Duty of directors to prepare an annual business statement
75	Directors' report
75A	Business review
76	Summary financial statements for members and depositors
77	Auditors: appointment, tenure, qualifications etc.
78	Auditors' report

**Practice Note 19 (Revised) March 2011**

78A	Signature of auditors' report
78B	Senior statutory auditor
79	Auditors' duties and powers
80	Signing of balance sheet – documents to be annexed
81	Laying and furnishing accounts, etc to [members and authority]
81A	Requirements in connection with publication of accounts
81B	Interpretation of Part 8
119	Interpretation
Sch 10A	Disclosures about directors, other officers and employees required in notes to the accounts
Sch 10B	Disclosures about related undertakings required in notes to accounts
Sch 10C	Disclosures about auditor remuneration required in notes to accounts
SI	
1998/504	BS (Accounts and Related Provisions) Regulations 1998 (as amended)
2001/2617	FSMA 2000 (Mutual Societies) Order 2001

## THE FSA HANDBOOK

1. Not all authorised firms are required to comply with all rules contained within the FSA Handbook. This varies with the type of permission – the regulated activity an authorised firm is permitted to undertake is set out in the authorised firms Scope of Permission. The following can be viewed on the FSA website:
  - contents of the FSA Handbook – [www.fsa.gov.uk/Pages/handbook](http://www.fsa.gov.uk/Pages/handbook); and
  - FSA register which lists the regulated activities that each authorised firm has permission to undertake – [www.fsa.gov.uk/Pages/register](http://www.fsa.gov.uk/Pages/register).
  
2. In gaining an understanding of the FSA Handbook the auditor bears in mind the four statutory objectives of the FSA, set out in 13 above, which underpin the content of the FSA Handbook. To facilitate usage the FSA Handbook has been structured into a number of blocks and within each block the material has been subdivided into Sourcebooks, Manuals or Guides. There are Rules, evidential provisions<sup>55</sup> and guidance which are contained within all of the blocks<sup>56</sup>. Contravention of Rules (which includes Principles for Businesses) or evidential provisions can give rise to an obligation on the auditor to report the matter direct to the FSA – see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B. Details of the high level standards, which are the overarching requirements for all authorised person (firms) and approved persons, are outlined below.

### Principles for businesses

3. The eleven Principles for Businesses, which are general statements that set out the fundamental obligations of firms under the regulatory system, are set out in the FSA Handbook. They derive their authority from the FSA's rule-making powers as set out in FSMA 2000 and reflect the regulatory objectives. These Principles are as follows:
  - an authorised firm must conduct its business with integrity;
  - an authorised firm must conduct its business with due skill, care and diligence;

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55 An evidential provision is not binding in its own right, but will 'tend to show' compliance or non-compliance (as the case may be). It is therefore indicative, and establishes a rebuttable presumption of compliance or non-compliance with a rule. Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, or to recommend a particular course of action or arrangement.

56 Rules are set out in emboldened type and are marked with the icon 'R', evidential provisions are marked 'E' and guidance 'G'. Further guidance on the status of the Handbook text is set out in the General Provisions (GEN) Sourcebook Chapter 2.2 and Chapter 6 of the Reader' Guide.

- an authorised firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management;
- an authorised firm must maintain adequate financial resources;
- an authorised firm must observe proper standards of market conduct;
- an authorised firm must pay due regard to the interests of its customers and treat them fairly;
- an authorised firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading;
- an authorised firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client;
- an authorised firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgment;
- an authorised firm must arrange adequate protection for clients' assets when it is responsible for them; and
- an authorised firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice (see for example SUP15 – Notifications to the FSA).

#### **Senior management arrangements, systems and controls**

4. SYSC amplifies Principles for Businesses 3, the requirement for a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The relevant chapters<sup>57</sup> are as follows;
- 3 – systems and controls
  - 4 – general organisational requirements
  - 5 – employees, agents and other relevant persons
  - 6 – compliance, internal audit and financial crime
  - 7 – risk control
  - 8 – outsourcing
  - 9 – record keeping
  - 10 – conflicts of interest
  - 11 – liquidity risk systems and controls

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<sup>57</sup> Chapters 13-17 apply only to insurers.

- 12 – group risk systems and control requirements
- 18 – guidance on Public Interest Disclosure Act – whistle blowing
- 19 – remuneration code
- 20 – reverse stress testing
- 21 – risk control, additional guidance<sup>58</sup>.

### Threshold Conditions

5. Under s41 and Schedule 6 of FSMA 2000 Threshold Conditions are the minimum requirements that must be met at authorisation and must continue to be met. The five statutory Threshold Conditions are:
- legal status: regulated activities must be conducted through a body corporate or partnership – that is, individuals cannot undertake regulated activities;
  - location of offices: the head office of a body corporate must be in the same territory/ member state as the registered office;
  - close links: close links must not prevent effective supervision. Entities are regarded as closely linked if there is a group relationship, i.e. parent/subsidiary/fellow subsidiary (but using the EC 7th Company Law Directive definition of subsidiary). They are also closely linked if one owns or controls 20% or more of the voting rights or capital of the other;
  - adequate resources: the authorised firm must have adequate resources (financial and non financial) for the type of business conducted taking into account the impact of other group entities and having regard to provisions made against liabilities (including contingent and future liabilities) and the approach to risk management; and
  - suitability: the FSA will consider the fitness and propriety of authorised firms, including whether business is conducted with integrity and in compliance with high standards, and whether there is competent and prudent management and exercise of due skill, care and diligence. This will include consideration of whether those subject to the approved persons regime (i.e. those undertaking controlled functions) are, or will be, approved by the FSA.

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58 Effective 1 May 2011.

## POSSIBLE FACTORS THAT MAY INDICATE GOING CONCERN ISSUES

### Capital adequacy ratios

- the entity is operating at or near the limit of its individual capital guidance (excluding capital planning buffer)<sup>59</sup> or limit otherwise set by the FSA, either on a group or solo basis; and
- stress tests indicate that minimum ratios may not be maintained.

### Operations/profitability indicators

- marked decline in new lending/dealing volumes during the year or subsequently;
- marked decline in new business margins;
- severe overcapacity in markets leading to low pricing as well as low volumes;
- significant increase in loan defaults or seizure of collateral (e.g. house repossessions);
- excessive exposures to troubled industry sectors;
- unusually aggressive dealing positions and/or regular breaches of dealing or lending limits; and
- redundancies, layoffs or failure to replace natural wastage of personnel.

### Liquidity indicators

- unusually large maturity mismatch in the short term (say up to 3 months), either in total or across currencies;
- exceptional levels of medium-term funding due to mature in the near term;
- maturity mismatch ladders prepared on a basis which fail to recognise/use:
  - expected (as opposed to contractual) cash flows;

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<sup>59</sup> Individual capital guidance (ICG) is a minimum amount of capital that the FSA requires firms to hold at all times, and it is supplemented by a capital planning buffer (CPB) which firms are required to build up in good times and may release in times of stress. Since CPBs are intended to be released by going concern firms when under stress, such a release does not in itself signify a going concern issue (although the underlying reason for the stress may or may not do so). Similarly, operating near to ICG may be an indicator either of efficient capital management or of financial difficulties, depending on the particular case. Breach of ICG, however, indicates the need for some supervisory action. The action will vary according to the reason for the breach, and a breach does not necessarily mean that a firm will be required to cease trading, but it does trigger this option being actively considered.



- narrow gaps for near maturities;
- anticipated defaults on loan repayments;
- a cushion for market value of volatile investments; or
- off balance sheet commitments;
- dependence on a few large depositors (which may or may not be connected parties);
- withdrawal of (or reduction in) lines of credit by wholesale counterparties;
- regularly overdrawn nostro accounts;
- difficulty in meeting liquidity standards set on an individual basis by the FSA;
- uncompetitively low rates of interest offered to depositors (causing outflow of funds);
- very high rates of interest offered to depositors (to prevent outflow of funds, regardless of financial loss);
- special fixed term deposit rate offers which attracted significant funds inflows due to mature; and
- stress tests that indicate that regulatory requirements may not be met.

#### **Reputational and other indicators**

- adverse publicity which could lead to loss of confidence or reputation, including fines or public censure by FSA;
- lowering of ratings or issue of negative outlook notices by independent credit agencies;
- urgent attempts to remove assets from the balance sheet, apparently involving material loss of profits or at significant expense; and
- deferral of investment plans or capitalisation of expenditure.

## REPORTING DIRECT TO THE FSA – STATUTORY RIGHT AND PROTECTION FOR DISCLOSURE UNDER GENERAL LAW

1. When the auditor concludes that a matter does not give rise to a statutory duty to report direct to the FSA, the auditor considers the right to report to the FSA. The right to report is available to the auditor of a UK bank, building society and a non EEA bank but not to the auditor of an EEA bank which has no top up permissions.
2. In cases of doubt, general law provides protection for disclosing certain matters to a proper authority in the public interest.
3. Audit firms are protected from the risk of liability from breach of confidence or defamation under general law even when carrying out work which is not clearly undertaken in the capacity of auditor provided that:
  - in the case of breach of confidence:
    - (i) disclosure is made in the public interest; and
    - (ii) such disclosure is made to an appropriate body or person; and
    - (iii) there is no malice motivating the disclosure; and
  - in the case of defamation:
    - (i) the information disclosed was obtained in a proper capacity; and
    - (ii) there is no malice motivating the disclosure.
4. The same protection is given even if there is only a reasonable suspicion that non-compliance with law or regulations has occurred. Provided that it can be demonstrated that an audit firm, in disclosing a matter in the public interest, has acted reasonably and in good faith, it would not be held by the court to be in breach of duty to the institution even if, an investigation or prosecution having occurred, it were found that there had been no breach of law or regulation.
5. When reporting to proper authorities in the public interest, it is important that, in order to retain the protection of qualified privilege, the auditor reports only to one who has a proper interest to receive the information. The FSA is the proper authority in the case of an authorised institution.
6. 'Public interest' is a concept which is not capable of general definition. Each situation must be considered individually. In general circumstances, matters to be taken into

account when considering whether disclosure is justified in the public interest may include:

- the extent to which the suspected non-compliance with law or regulations is likely to affect members of the public;
  - whether the directors (or equivalent) have rectified the matter or are taking, or are likely to take, effective corrective action;
  - the extent to which non-disclosure is likely to enable the suspected non-compliance with law or regulations to recur with impunity;
  - the gravity of the matter;
  - whether there is a general management ethos within the entity of disregarding law or regulations; and
  - the weight of evidence and the degree of the auditor's suspicion that there has been an instance of non-compliance with law or regulations.
7. Determination of where the balance of public interest lies requires careful consideration. The auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest of disclosure to a proper authority and to use their professional judgment to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.
8. In cases where it is uncertain whether the statutory duty requires or s342 or s343 FSMA 2000 permits an auditor to communicate a matter to the FSA, it is possible that the auditor may be able to rely on the defence of disclosure in the public interest if it communicates a matter to the FSA which could properly be regarded as having material significance in conformity with the guidance in ISA (UK and Ireland) 250 Section B and this Practice Note, although the auditor may wish to seek legal advice in such circumstances.

## THE AUDITORS' RIGHT AND DUTY TO REPORT TO THE FSA: EXAMPLES OF REPORTABLE ITEMS

1. This Appendix gives some examples of areas identified by the FSA where particularly close consideration should be given as to whether the duty to report arises (in other words, where a breach of requirements may tend to be more serious). But it is not intended to be comprehensive, and cannot be relied on as a checklist.
2. Although there are a large number of 'relevant requirements' or matters of concern potentially giving rise to a statutory duty to report, these will normally fall within a number of general themes:
  - controllers, directors and senior managers who may not be 'fit and proper';
  - serious breaches of law/regulations;
  - potential disciplinary action against the firm or directors;
  - undertaking activities outside the scope of their permission;
  - failure to comply with limitations or restrictions on permission or individual requirements;
  - false or misleading information given to the FSA or matters concealed;
  - problems with another 'regulator' e.g. Office of Fair Trading (i.e. regards the Consumer Credit Act) or overseas regulators;
  - breaches of prudential limits and/or any financial limits;
  - significant actual or potential loss by clients e.g. loss of customer assets or breach of client money rules; where there appear to be conflicts of interest; where there appears to be systemic abuse of advice or discretionary decisions; or as identified by complaints or by cases where a customer sues under s150 FSMA;
  - failure to clearly allocate responsibilities between senior managers or to implement clear reporting lines;
  - major systems and control deficiencies (including major reconciliation failures and backlogs); and
  - possible 'going-concern' issues.
3. The above general themes are intended as a guide – any report would need to be made against a specific relevant requirement (see paragraph 60). If an issue has been identified relating to one of the themes (which might be materially significant to the FSA and is in a situation where the auditor is under a duty to report), the auditor should identify the

relevant requirement. Even if a specific relevant requirement cannot be established, the auditor should consider whether or not the right to report is appropriate.

## DEFINITIONS

Abbreviations and frequently used terms in this Practice Note are set out below.

ARROW II	'Advanced Risk Responsive Operating frameWork'. The term used for FSA's risk assessment process – the application of risk based supervision. It is the mechanism through which the FSA evaluates the risk an authorised firm poses to its statutory objectives enabling it to allocate its resources appropriately and respond to the risks identified
Authorised firm	An entity which has been granted one of more Part IV permissions by the FSA and so is authorised under FSMA 2000 to undertake regulated activities – an authorised person
Authorised person	Term used throughout FSMA 2000 and related statutory instruments to refer to an authorised firm – see above
Authorised by FSA	Same as authorised firm or authorised person – see above
BBA SORP	Statements of Recommended Practice issued by the British Bankers Association and the Irish Bankers' Federation
Bank	UK bank, EEA bank and non EEA bank
Banking company	Companies Act 2006 definition s1164
BIPRU	Prudential sourcebook for bank, building societies and investment firms
BS Act 1986	Building Societies Act 1986
BS Accounts Regulations 1998	Building Societies (Accounts and Related Provisions) Regulations 1998
BSOCS	Building Societies specialist sourcebook
BSOG	Building Societies Regulatory Guide
Building society	A society incorporated under the BS Act 1986
CA2006	Companies Act 2006

Closely linked entity	As defined in s343(8) FSMA 2000, an entity has close links with an authorised firm for this purpose if the entity is a: (a) Parent undertaking of an authorised firm; (b) Subsidiary undertaking of an authorised firm; (c) Parent undertaking of a subsidiary undertaking of an authorised firm; or (d) Subsidiary undertaking of a parent undertaking of an authorised firm
Companies and Groups Accounts Regulations 2008	Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)
COND	Threshold Conditions element of the high level standards block of the FSA Handbook
CRD	Capital Requirements Directive
Credit institution	An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account and to which the Banking Consolidation Directive applies
Deposit taker	Banks and building societies – authorised firms which under FSMA 2000 have a Part IV permission to accept deposits
EEA	European Economic Area
EEA Bank	A UK branch of a credit institution incorporated in the EEA which has exercised EEA Passport rights to carry on regulated activities in the UK
EEA Passport rights	Exercising passport rights, an entity incorporated in one EEA member state ('home country') which is authorised to conduct one or more regulated activities subject to the passport rights in the home country to establish a branch and carry out those regulated activities in another EEA member state ('host country') without the need to be authorised by the host country supervisor, FSA, in respect of activities that are subject to the passport rights
EIR	Effective interest rate
EU IFRS	International Financial Reporting Standards adopted by the European Union
FRS	Financial Reporting Statements
FSA	The Financial Services Authority
FSMA 2000	Financial Services and Markets Act 2000

FRSSE	Financial Reporting Standard for Smaller Entities
GENPRU	General Prudential Sourcebook
IPRU(BANK)	Interim Prudential Sourcebook for banks
IPRU(BSOC)	Interim Prudential Sourcebook for building societies
JMLSG	Joint Money Laundering Steering Group
MiFID	Markets in Financial Instruments Directive
Material significance	A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator
Non EEA Bank	a UK branch of an entity incorporated outside the EEA, authorised by the FSA to accept deposits and which is required to comply with BIPRU
Part IV permission	A permission granted by FSA under Part IV FSMA 2000 permitting an authorised firm to carry on regulated activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended
Permission	Part IV permission under FSMA 2000 to undertake one or more regulated activities
Principles for Businesses	FSA Handbook defined principles with which an authorised firm must comply. The 11 principles are included in a stand alone element of the high level Standards block of the FSA Handbook – PRIN
Regulated activities	Activities as defined in the Regulated Activities Order SI 2001/544 as amended
Relevant requirement	In relation to the auditors' duty to report direct to the FSA – requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FSA's rules (other than the Listing Rules) including the Principles for Businesses. The duty to report also covers any requirement imposed by or under any other Act the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000
SOCA	Serious and Organised Crime Agency
SUP	Supervision manual of the FSA Handbook



SYSC	Senior management arrangements, systems and controls element of the High Level Standards block of the FSA Handbook
The 2001 Regulations	SI 2001/2587 – FSMA 2000 (Communications by Auditors) Regulations 2001
Those charged with governance	ISAs (UK and Ireland) use the term ‘those charged with governance’ to describe the persons entrusted with the supervision, control and direction of an entity, who will normally be responsible for the quality of financial reporting, and the term ‘management’ to describe those persons who perform senior managerial functions. The FSA Handbook of Rules and Guidance (FSA Handbook) uses the term ‘governing body’ to describe collectively those charged with governance. In the context of this Practice Note, references to those charged with governance include directors of banks and building societies
Threshold Conditions	The minimum standards that an authorised firm needs to meet to become and remain authorised by the FSA. The five conditions are included in a stand alone element of the high level Standards block of the FSA Handbook – COND.
Top up permission	A Part IV permission granted by the FSA to an EEA bank to enable it to undertake a UK regulated activity in the UK for which authorisation to undertake the activity in the home country is not required by the home country supervisor.
UK bank	A company incorporated in the UK which is authorised by the FSA to accept deposits, which is required to comply with BIPRU and is not a building society.

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