



January 2017

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# Practice Note 20 (Revised)

The audit of Insurers in the United Kingdom

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This Practice Note replaces the previous Practice Note 20 issued in January 2011. The material in this Practice Note also supports the audit of Friendly Societies, and therefore Practice Note 24 issued in July 2011 has been withdrawn.

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Financial Reporting Council

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# **PRACTICE NOTE 20 (REVISED)**

## **THE AUDIT OF INSURERS IN THE UNITED KINGDOM**

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## **SECTION 1: PREFACE**

This Practice Note contains guidance on the application of international standards on auditing UK (ISAs (UK)) issued by the Financial Reporting Council (FRC) to the auditors of insurers and friendly societies carrying on insurance business in the United Kingdom. It also contains guidance on auditor's reports in connection with regulatory reports, including published Solvency and Financial Condition Reports (SFCRs) under Solvency II. Our guidance also covers the auditor's duty to report to regulators and to the Council of Lloyd's. This Practice Note is supplementary to, and should be read in conjunction with, ISAs (UK) that apply to audits of financial statements for periods commencing on or after 17 June 2016. This Practice Note sets out the special considerations relating to the audit of insurers and friendly societies which arise from individual ISAs (UK). It is not the intention of the Practice Note to provide step-by-step guidance to the audit of insurers or friendly societies, so where no special considerations arise from a particular ISA (UK), no material is included.

Audits of Solvency II Pillar 3 public disclosures are conducted in accordance with ISAs (UK), including the requirements of ISA 800 (UK) *Special Considerations – Audits of Financial Statements prepared in accordance with Special Purpose Frameworks* and ISA 805 (UK) *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* which are effective for periods commencing on or after 1 January 2017, with early adoption permitted

The guidance in this Practice Note is applicable to auditors of insurance companies and of Lloyd's syndicates and corporate members, as well as of friendly societies carrying on insurance business in the UK. References to insurers throughout this Practice Note also apply to friendly societies, unless specifically excluded. Particular considerations relating to the audit of Lloyd's syndicates are set out in a separate section.

The following Practice Notes issued by the FRC are also relevant to the audit of insurers:

PN 12 (Revised) Money Laundering – Guidance for auditors on UK legislation

PN 23 Special Considerations in Auditing Financial Instruments

Practice Note 24 (Revised) The Audit of Friendly Societies in the United Kingdom has been withdrawn, and relevant guidance incorporated into this Practice Note.

This Practice Note has been prepared with advice and assistance from staff of the PRA (in so far as the obligations of an insurer and its auditor under the PRA Rulebook are concerned). It is based on the legislation, regulations and byelaws which were in effect at 19 January 2017. The Practice Note does not, however, constitute general guidance given by the PRA or Lloyd's or Industry Guidance. It is not an exhaustive summary of all the obligations that an insurer and its auditor may have under the Financial Services and Markets Act 2000 (FSMA 2000), the PRA Rulebook, the FCA Handbook, European regulations or Lloyd's byelaws.

## **SECTION 2: INTRODUCTION**

1. The term “insurers” in this Practice Note should be taken to refer to the following types of entity (unless specified otherwise in the text):
  - (a) UK insurance companies authorised by the PRA;
  - (b) Lloyd’s syndicates and corporate members;
  - (c) Overseas insurers with UK branches;
  - (d) Friendly societies carrying on insurance business in the UK.
2. This Practice Note applies both to those friendly societies incorporated under the Friendly Societies Act 1992 (the 1992 Act) and those registered under the Friendly Societies Act 1974 (the 1974 Act). It does not apply to other entities registered under the 1974 Act.
3. This Practice Note addresses the responsibilities and obligations of the auditor of an insurer concerning:
  - The audit of the insurer’s financial statements, as required by sections 495 and 496 of the Companies Act 2006 (CA 2006); sections 72 and 73 of the Friendly Societies Act 1992; Article 10 of the EU Audit Regulation 537/2014 (in respect of public interest entities); and in relation to Lloyd’s, the 2008 Regulations<sup>1</sup> and the Syndicate Accounting Byelaw<sup>2</sup>.
  - Reporting on parts of the insurer’s regulatory returns, as required by the PRA Rulebooks for Solvency II directive and non-directive insurers. Guidance on the auditor’s work in relation to such returns is set out in the sections of this Practice Note dealing with regulatory returns.
  - The right and duty to report direct to the PRA and FCA (and, where appropriate, to Lloyd’s) in certain circumstances.<sup>3</sup>

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1 Statutory Instrument SI 2008 No. 1950 “The Insurance Accounts Directive (Lloyd’s Syndicate and Aggregate Accounts) Regulations 2008”.

2 Auditors of Lloyd’s syndicates are required to be “recognised accountants”, that is, registered auditors who have been approved by Lloyd’s and have given an undertaking to the Council of Lloyd’s in a prescribed form.

3 Statutory Instrument SI 2001 No. 2587 “The FSMA 2000 (Communications by Auditors) Regulations 2001 and sections 342 and 343 of FSMA 2000” and the Audit Regulation for auditors of Public Interest Entities. Regulation (EU) 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

Overseas insurers operating in the UK through branches are not subject to the audit provisions of CA 2006 and so the terms of engagement are a matter of contract between the auditor and its engaging party who may, for example, be local or head office management or the insurer'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 its opinion will also vary from case to case. The auditor undertaking such assignments may wish to consider the guidance in this Practice Note where relevant, having regard to the agreed scope of its engagement.

## **SECTION 3: LEGISLATIVE AND REGULATORY FRAMEWORK**

### **Background**

1. The auditor of an insurer needs to be familiar with relevant legal and regulatory requirements. The extent to which an auditor considers compliance with regulatory requirements in the course of auditing an insurer's financial statements is discussed in the section of this Practice Note that addresses ISA (UK) 250 Section B. Guidance on auditor's responsibilities in relation to regulatory reporting is contained in the "Reporting on regulatory returns" sections 6 and 8 of this Practice Note.
2. The framework of regulation in the UK involves regulation of insurance activities established by the Financial Services and Markets Act 2000 and European Directive and Regulation, under which insurance regulators have powers to establish specific requirements as well as to institute investigations into insurers and to suspend or remove authorisation to conduct insurance business where appropriate. The relevant insurance regulators are the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). This Practice Note was written with reference to the framework of law and regulation which existed in January 2017. Practice Note 20 is not intended to provide a complete description of that framework, and nor can it anticipate or reflect changes which have taken place after the date it was written.
3. For the purpose of this Practice Note, references to the auditor of a regulated entity or an authorised person in the context of FCA conduct supervision, and PRA prudential supervision of insurers, includes the auditor of a Friendly Society, of a Lloyd's syndicate or corporate member, unless otherwise stated.
4. Insurance business may not be carried on in the United Kingdom without authorisation to do so. Insurance business may be undertaken by:
  - Companies holding permission under Part 4A of FSMA 2000 to carry on the regulated activities of effecting and/or carrying out contracts of insurance (companies incorporated under CA 2006 and companies with their head offices outside the EU);
  - Members of Lloyd's (see Section 316 of FSMA 2000); and
  - Insurers authorised by other EEA member states which may conduct insurance business in the UK on a "freedom to provide services" basis or through the establishment of branches and which qualify automatically for authorisation under FSMA 2000.
5. In the case of members of Lloyd's, the PRA is the prudential regulator for the Society of Lloyd's, and also of managing agents. The FCA regulates the conduct of the Society of Lloyd's, managing agents and on a prudential and conduct basis, the members' agents and advisors, and Lloyd's brokers.

6. The Financial Services and Markets Act (FSMA) 2000 gives the PRA the power to discipline external auditors and actuaries of PRA authorised firms if they fail to comply with reporting requirements under FSMA or duties imposed by PRA rules. The range of disciplinary powers that the PRA can use includes fines, public censures or disqualification from working in financial services.
7. As well as needing permission under Part 4A of FSMA 2000 to effect or carry out contracts of insurance, an insurer is likely to require additional permissions in respect of its activities relating to marketing, arranging or advising on insurance contracts and to dealing in investments as principal where it uses derivatives as part of its investment policy. Life insurers are likely to require further permissions as many life policies are deemed to represent designated investment business.<sup>4</sup>
8. The principal objective of prudential regulation in the UK is to promote the safety and soundness of firms it supervises and, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders. Policyholders are protected both by the PRA as prudential regulator and by the FCA as conduct regulator.

#### *Friendly Societies*

9. Friendly societies are mutual organisations constituted under specific legislation and are accountable to their members. Friendly societies vary by size and range of activity. Some societies have developed a single product niche. Others offer a range of savings, insurance and banking services. Their focus remains individuals and families (the retail market) rather than commercial customers. They compete with other insurance and banking groups in the financial services market.
10. The directing body of a society or branch is known as the Committee of Management. The Committee carries out equivalent functions to the Board of Directors of a company incorporated under the Companies Acts. ISAs (UK) use the term “those charged with governance” to describe the persons entrusted with the supervision, control and directions 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 PRA Rulebook 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 refer to members of the Committee of Management of a friendly society. The members of the Committee are subject to the regulator’s “Approved Persons” rules and have to be “fit and proper” to hold office.
11. A summary of the legal forms of friendly society now existing and the main legislation applicable to each type is set out in the table below.

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4 Further guidance in connection with insurance intermediaries is included in the FRC Assurance Standard: *Providing Assurance on Client Assets to the Financial Conduct Authority* (November 2015).

<b>Legal Form</b>	<b>Common designation</b>	<b>Applicable legislation</b>
Established prior to the 1992 Act and re-registered under that Act	"Incorporated"	1992 Act
Established prior to the 1992 Act but not re-registered under it, i.e., remains registered under the 1974 Act	"Registered"/"Unincorporated"	1992 Act and the 1974 Friendly Societies Act (as amended by Schedule 16 of 1992 Act)
Established after the 1992 Act	"Incorporated"	1992 Act

12. Other legislation with relevance to certain types of mutual organisations such as Industrial and Provident Societies was being revised at the time this guidance was written. Auditors should therefore take steps to ensure that they are aware of the current legislative and regulatory position for each entity.

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

13. FSMA 2000 sets out the high level regulatory framework for the financial sector more generally and not just insurers and friendly societies.
14. Under Part X FSMA 2000 the PRA and FCA have the power to make "rules" and give guidance. Rules made by the regulators are set out in the PRA rulebook and FCA handbook. 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. If an authorised firm contravenes a rule it may be subject to enforcement action and consequent disciplinary measures under Part XIV FSMA 2000. In certain circumstances an authorised firm may be subject to an action for damages under section 150 FSMA 2000.
15. In contrast, guidance is generally issued to provide context relevant to a proper understanding of the regulatory requirements, and is not binding. However if an authorised firm acts in accordance with it in the circumstances contemplated by that guidance, the regulator will proceed on the basis that the authorised firm has complied with the rule to which the guidance relates. ISA (UK) 250 Section B requires the level of knowledge of the members of the audit engagement team of the provisions of the applicable legislation; regulator's rules and guidance; and other specific requirements placed on the audited entity, to be appropriate to the staff member'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 a matter should be reported to the regulator.<sup>5</sup> ISA (UK) 220 requires the engagement partner, among other things, to:

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<sup>5</sup> ISA (UK) 250 B para.11.

- Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.
- Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.<sup>6</sup>

### *Lloyd's*

16. Under FSMA 2000, Lloyd's is subject to dual regulation by the PRA and the FCA, with the Council of Lloyd's also having certain statutory regulatory duties. Agreements are in place between Lloyd's and both the PRA and FCA which set out the basis on which they will cooperate in the performance of these duties.<sup>7</sup> Lloyd's is therefore subject to the requirements of the Solvency II Directive, PRA Rulebook and FCA Handbook, including those relating to the 'actuarial function'. Much of the Lloyd's market rule structure is embedded in a series of byelaws passed by the Council.
17. Members underwrite insurance business at Lloyd's as a member of one or more syndicates, each syndicate being managed by a managing agent. Syndicates have no legal personality and are merely the vehicle through which the members underwrite insurance risk. Technically, each syndicate is an annual venture. The year during which it writes business is described as an "underwriting year" or a "year of account". Members have no liability for business underwritten by the same syndicate in previous years of account unless they were members in those years or unless they have reinsured the members of that syndicate for the previous years. However, for practical business purposes, syndicates are treated as continuing from one year to the next. Lloyd's maintains central assets, including the Central Fund, which are available to meet a member's underwriting liabilities in the event of any default by the member.

### **Financial Statements**

18. The form and content of the financial statements of UK insurers prepared under UK GAAP is governed by CA 2006 and United Kingdom Accounting Standards. (United Kingdom Accounting Standards comprise Financial Reporting Standards ("FRSs")). The prescribed format for a UK insurer's financial statements that comply with UK GAAP is set out in:
  - (a) Sections 395 and 396 of CA 2006; and
  - (b) Schedules 3 and 6 (part 3) to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (The 2008 Accounts and Reports Regulations).

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6 ISA (UK) 220 para. 18.

7 <https://www.lloyds.com/lloyds/corporate-governance/regulation-of-lloyds>

19. Listed UK groups (including listed UK insurance groups) must prepare consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union (EU-IFRSs)<sup>8</sup> and those parts of CA 2006 applicable to companies reporting under EU-IFRSs. UK companies or non-listed groups, including friendly societies, UK insurers and insurance groups, are permitted to voluntarily adopt EU-IFRSs for their financial statements.

*Friendly Societies*

20. The following Regulations and Orders relating to The Friendly Societies Act 1992 have been promulgated. In this Practice Note they are referred to collectively as “the Accounts Regulations”. The Accounts Regulations apply to all societies.

<b>Regulation/Order</b>	<b>Statutory Instrument No.</b>	<b>Outline Content</b>
The Friendly Societies (Accounts and Related Provisions) Regulations 1994	SI 1994 No.1983	Regulations which prescribe the format and content of the financial statements and committee of management report
The Friendly Societies Act 1992 (International Accounting Standards and Other Accounting Amendments) Order 2005	SI 2005 No. 2211	Amends the 1992 Act to permit friendly societies to use international financial reporting standards as adopted by the EU. It also inserts into the Committee of Management Report additional disclosure requirements such as a Business Review, Principal Risks and Uncertainties and Key Performance Indicators.

<sup>8</sup> Article 4 of EC Regulation 1606/2002 as acknowledged in section 403(1) CA 2006 – the IAS Regulation.

<b>Regulation/Order</b>	<b>Statutory Instrument No.</b>	<b>Outline Content</b>
The Friendly Societies Act 1992 (Accounts, Audit and EEA State Amendments) Order 2008	SI 2008 No. 1140	Amends the 1992 Act to implement parts of both the Audit Directive (2006/43/EC) and the Accounts Directive (2006/46/EC). Requires the auditor of an incorporated society to identify a senior statutory auditor. It also inserted a new Schedule 13F into FSA 1992, with audit fee and other services disclosures.
The Friendly Societies (Accounts and Related Provisions) (Amendment) Regulations 2008	SI 2008 No. 1144	Amendments to the 1994 Regulations to reflect certain requirements of the Accounts Directive (2006/46/EC)

*Lloyd's*

21. The reporting requirements in respect of syndicate activities are set out in "The Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008" ("the 2008 Lloyd's Regulations"). The 2008 Lloyd's Regulations require the preparation by managing agents of:

- (a) Syndicate annual accounts in accordance with CA 2006 and Schedule 3 to The 2008 Accounts and Reports Regulations showing the performance across all years of account of the syndicate during the calendar year;
- (b) Syndicate underwriting year accounts at the closure of a year of account (unless all the relevant members of the syndicate agree otherwise);

and by the Council of Lloyd's

- (c) Aggregate accounts for the Lloyd's market as a whole reflecting an accumulation of the syndicate profit and loss accounts and the balance sheets prepared at (a).
- (d) In addition, the Syndicate Accounting Byelaw 2005 requires the preparation by managing agents of syndicate underwriting year accounts at 31 December each year in respect of each run-off account (unless all the relevant members of the syndicate agree otherwise).

22. Legally, each year of account of a syndicate is a separate venture established to write insurance business in a specific calendar year. As a consequence of each annual venture being a unique trading entity, a mechanism is necessary to enable each such venture to close, normally at the end of three years. Estimated outstanding liabilities as at the date of closure are reinsured, in consideration for a premium, by a subsequent year of account of the same or another syndicate. This reinsurance arrangement is known as a “reinsurance to close” (“RITC”).
23. In certain circumstances, the managing agent may conclude that significant uncertainties (or other factors) exist such that it is not possible to determine an appropriate premium for a RITC at the normal date of closure. When this happens, the relevant year of account is not closed but placed into run-off until such time as the managing agent concludes that this requirement can be satisfied. Technical provisions will be determined for each run-off account and carried forward until the year of account is closed or all its liabilities discharged.
24. Where the Lloyd’s corporate member is a UK company it is required to prepare its financial statements in accordance with the requirements of CA 2006 applicable to UK insurance companies whether drawn up in accordance with EU-IFRSs or UK GAAP.

## **Prudential requirements**

### *Solvency II*

25. The Solvency II prudential regime came into force from 1 January 2016. Insurance firms and friendly societies can be either ‘directive’ or ‘non-directive’ firms, with different regulatory reporting requirements as a consequence. A number of criteria determine whether insurance firms are directive or non-directive, relating primarily to the level of gross premium income and amount of gross technical provisions.<sup>9</sup>

Solvency II, and the related PRA rules, establish a comprehensive new prudential regime and require annual public solvency disclosures by directive firms in the form of a Solvency and Financial Condition Report (SFCR) and linked Quantitative Reporting Templates (QRTs), as well as periodic reporting to the competent supervisor. The PRA requires those disclosures to be subject to external audit, and this Practice Note includes a section setting out guidance on the application of the ISAs (UK) to those engagements. Non-directive firms continue to be required to comply with solvency requirements set by the PRA, and with the related reporting regime.

26. The Solvency II Directive, related Implementation Rules, Technical Standards and Guidelines<sup>10</sup>, as well as PRA rules, provide the framework for prudential regulation for

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<sup>9</sup> The full criteria are set out in the PRA Rulebook.

<sup>10</sup> [http://ec.europa.eu/finance/insurance/solvency/solvency2/index\\_en.htm](http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm)

insurance firms which meet certain criteria (“Directive Firms”), including the level of premiums received and size of technical provisions. That framework is built around “3 pillars”:

- Financial Requirements – including Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR) thresholds; and detailed rules for the valuation of assets and liabilities;
- Governance and Supervision – including the Own Risk and Solvency Assessment (ORSA); and
- Reporting and Disclosure – including private reporting to the regulator and public SFCRs.

27. Solvency II regulations do not require external audit of Pillar 3 public disclosures. The requirement for an audit of the ‘relevant elements of the SFCR’ is contained within the External Audit chapter of the PRA rulebook which relates to Solvency II firms (**‘directive firms’**).<sup>11</sup> There is no formal PRA requirement for the statutory auditor of an insurance entity’s financial statements to also carry out the audit of Pillar 3 public disclosures. **‘Non-directive firms’** are subject to a separate prudential regime, which is set out in the PRA Rulebook for Non-Solvency II firms. Non-directive friendly societies are subject to different requirements than other insurance entities.

#### **Reporting to supervisors, including supervisors of public-interest entities – statutory right and duty**

28. Statutory rights and duties to report to supervisors flow from two main sources: the 2001 Regulations under FSMA 2000<sup>12</sup>, which apply to the auditors of all authorized insurance entities; and Audit Regulation (EU) 537/2014 in respect of the relationship between auditors and supervisors of ‘public interest entities’, which includes certain insurance undertakings.

29. These duties do not require the auditor of an insurer to undertake additional work directed at identifying matters to report over and above the work necessary to fulfil its obligations to report on financial statements and regulatory returns.

#### *Duties under the 2001 Regulations*

30. Under the 2001 Regulations 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 to the competent supervisor, these and other matters of ‘material significance’. Under section 340 FSMA 2000 “the auditor” is defined as one required to be appointed under “rules” or appointed as a result of another enactment. In

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11 <http://www.prarulebook.co.uk/rulebook/Content/Chapter/321290/22-09-2016>

12 SI 2001 No 2587 “The FSMA 2000 (Communications by Auditors) Regulations 2001”.

addition section 342 FSMA 2000 provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the regulator any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the regulator.

31. There is a similar right and duty of the auditor of a Lloyd's syndicate or corporate member to report direct to Lloyd's by the undertaking required from the auditor of a Lloyd's syndicate or corporate member by the Lloyd's Audit Arrangements Byelaw 1998 and the Lloyd's Membership Byelaw No 5 of 2005.
32. The 2001 Regulations do not require the auditor to perform any additional audit work as a result of the statutory duty nor is the auditor required specifically to seek out breaches of the requirements applicable to a particular regulated entity. However, in circumstances where the auditor identifies that a reportable matter may exist, it carries out such extra work, as it 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.
33. ISA (UK) 250 Section B deals with the statutory right and duty of the auditor of a regulated entity to bring information of which the auditor has become aware in the ordinary course of performing work undertaken to the attention of the appropriate regulator as soon as practicable when:
  - 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
  - In the auditor's opinion there is reasonable cause to believe it is or may be of material significance to the regulator.<sup>13</sup>
34. Where an apparent breach of statutory or regulatory requirements comes to the auditor's attention, the auditor shall:
  - Obtain such evidence as is available to assess its implications for the auditor's reporting responsibilities;
  - Determine whether, in the auditor's opinion, there is reasonable cause to believe that the breach is of material significance to the regulator; and
  - Consider whether the apparent breach is criminal conduct that gives rise to criminal property and, as such, should be reported to the specified authorities.<sup>14</sup>

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13 ISA (UK) 250 Section B – Revised June 2016, para 8.

14 ISA (UK) 250 Section B – Revised June 2016, para 12.

14 Practice Note 20 (Revised) (January 2017)

35. The criteria for determining the matters to be reported are as follows:
- (a) 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>15</sup> concerned and that contravention may be of material significance to the regulator in determining whether to exercise, in relation to that person, any of its functions under FSMA 2000; or
  - (b) The auditor reasonably believes that the information on, or its opinion on, those matters may be of material significance to the PRA or FCA in determining whether the person concerned satisfies and will continue to satisfy the relevant “Threshold Conditions”<sup>16</sup>; or
  - (c) The auditor reasonably believes that the person concerned is not, may not be, or may cease to be, a going concern; or
  - (d) The auditor is precluded from stating in its report that the annual accounts have been properly prepared in accordance with CA 2006 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation.
36. In relation to 35(a) 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 FCA/PRA’s rules (other than the Listing Rules) including the PRA’s Fundamental Rules and the FCA’s 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 PRA or FCA have the power to prosecute under FSMA 2000. In relation to 35(b) above the duty to report relates to either information or opinions held by the auditor which may be of significance to the regulators in determining whether the regulated entity satisfies and will continue to satisfy the Threshold Conditions.

*Material significance*

37. 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.
38. ISA (UK) 250 Section B requires that, where an apparent breach of statutory or regulatory requirements comes to the auditor’s attention, it obtains such evidence as is available to assess its implications for the auditor’s reporting responsibilities and determines

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15 In this context the person is an “Authorised Person”.

16 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 4A permission. Firms must comply with both PRA specific and FCA specific Threshold Conditions.

whether, in its opinion, there is reasonable cause to believe that the breach is of material significance to the regulator:

*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 functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator...<sup>17</sup>*

39. “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 regulator’s perception of the entity. The determination of whether a matter is, or is likely to be, of material significance to the PRA and/or FCA inevitably requires the auditor to exercise its 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.
40. The auditor of a regulated entity bases its judgment of “material significance” to the regulator solely on its understanding of the facts of which it is aware without making any assumptions about the information available to the PRA in connection with any particular regulated entity.
41. Minor breaches of the PRA or FCA rules that, for example, are unlikely to jeopardise the entity’s assets or amount to misconduct or mismanagement would not normally be of “material significance”. ISA (UK) 250 Section B however requires the auditor of regulated entities, when reporting on their financial statements, to review information obtained in the course of the audit and to assess whether the cumulative effect is of “material significance” such as to give rise to a duty to report to the regulator. In circumstances where the auditor is uncertain whether it may be required to make a report or not, it may wish to consider taking legal advice.
42. On completion of its investigations, the auditor ensures that the facts and circumstances, and the basis for its conclusion as to whether these are, or are likely to be of “material significance” to the regulator, are adequately documented such that the reasons for its decision to report or not, as the case may be, may be clearly demonstrated.
43. Whilst confidentiality is an implied term of an auditor’s contract with a regulated entity, section 342 FSMA 2000 states that an auditor does not contravene that duty if it reports to the regulator information or its opinion, if it is acting in good faith and reasonably believes

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<sup>17</sup> ISA (UK) 250 Section B, para. 9 (d).

that the information or opinion is relevant to any function of the PRA and/or FCA. The protection afforded is given in respect of information obtained in its capacity as auditor.

#### *Public Interest Entities*

44. 'Public Interest Entities' ('PIEs') are defined<sup>18</sup> as being any one of:
- (a) An issuer whose transferable securities are admitted to trading on a regulated market;
  - (b) A credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, other than those listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms;
  - (c) An insurance undertaking within the meaning given by Article 2(1) of Council Directive 1991/674/EEC of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertaking.
45. An insurance undertaking is a PIE if it meets any of the relevant criteria. In respect of c, which applies specifically to insurance entities, the relevant definition is now set out in the Solvency II Directive 2009/138/EC (which repealed previous relevant Directives). With effect from 17 June 2016 UK insurance and reinsurance undertakings within the scope of the Solvency II Directive are PIEs within the meaning of Audit Directive 2006/43 (as amended by Directive 2014/56). This includes relevant friendly societies and it also includes the Society of Lloyd's (because the society issues securities which are admitted to trading on a regulated market).<sup>19</sup> The auditors of these entities will need to consider the statutory rights and duties set out in both the 2001 Regulations under FSMA 2000 and of the Audit Regulation.

#### **The Audit Regulation (EU) 537/2014**

46. The Audit regulation places responsibility for the effectiveness of the dialogue between auditors and supervisors on both parties:

*An effective dialogue shall be established between competent authorities supervising credit institutions and insurance undertakings, on the one hand, and the statutory auditor (s) and the audit firm (s) carrying out the statutory audit of those institutions and undertakings on the other hand. The responsibility for compliance with this requirement shall rest with both parties to the dialogue.*<sup>20</sup>

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18 ISA (UK) Glossary of Terms (auditing and ethics) 2016.

19 The EU requirements on audits of PIEs have not been implemented for participants in the Lloyd's market and the additional requirements in the FRC's Ethical and Auditing Standards applicable to PIEs (paragraphs with the prefix 'R') do not apply in to the audit of Lloyd's syndicates.

20 Regulation (EU) 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, Article 12, p.2.

47. Article 12 of the Regulation sets out the statutory duty of the auditor or audit firm carrying out the statutory audit of a PIE to report promptly to the competent supervisors<sup>21</sup> any information of which they may have become aware “while carrying out that statutory audit” and which may bring about any of the following (about the PIE or any undertaking having ‘close links’ with the PIE):
- A material breach of the laws, regulations or administrative provisions which lay down, were appropriate, the conditions governing authorization or which specifically govern pursuit of the activities of such public interest entity;
  - A material threat or doubt concerning the continuous functioning of the public-interest entity;
  - A refusal to issue an audit opinion on the financial statements or the issuing of an adverse or qualified opinion.
48. The Audit Regulation defines competent supervisors as “the competent authorities supervising that public-interest entity” (in respect of insurance undertakings in the UK this means the PRA and the FCA) or, “where so determined by the Member State concerned, to the competent authority responsible for the oversight of the statutory auditor or audit firm.” (which in the UK is the FRC).
49. A Memorandum of Understanding sets out the relevant relationship between the PRA and FCA, including in respect of firms subject to dual regulation.<sup>22</sup> Further MoUs exist between the PRA and the FRC, and the FCA and the FRC, which explain how they will exercise their respective statutory roles, and the principles which govern information sharing between them.<sup>23</sup>
50. Dialogue encompasses bodies within the European Union, with the European Systemic Risk Board (ESRB) and the CEAOB being required by the Audit Regulation to organize a meeting “at least once a year....with the statutory auditor (s) and the audit firm (s) carrying out the statutory audit of those institutions and undertakings.” EIOPA<sup>24</sup> and the PRA<sup>25</sup> have policies setting out the principles and procedures underpinning the relationship between auditors and supervisors.

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21 Regulation (EU) 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

22 <http://www.fca.org.uk/your-fca/documents/mou/mou-between-the-fca-and-the-pracoordination>

23 <https://frc.org.uk/Our-Work/Publications/FRC-Board/Memorandum-of-Understanding-PRA-and-FRC.pdf>;  
<https://frc.org.uk/Our-Work/Publications/FRC-Board/Memorandum-of-Understanding-PRA-and-FRC.pdf>

24 <https://eiopa.europa.eu/Pages/News/EIOPA-consults-on-the-Guidelines-facilitating-the-dialogue-between-insurance-supervisors-and-auditors.aspx>

25 <http://www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps116.aspx>

51. The Audit Regulation provides that:

*The disclosure in good faith to the competent authorities or to ESRB and the CEAOB, by the statutory auditor or the audit firm or network, where applicable, of any information referred to in paragraph 1. [see paragraph 57 above]..emerging during the dialogue provided for in paragraph 2 shall not constitute a breach of any contractual or legal restriction on disclosure of information.<sup>26</sup>*

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26 Regulation (EU) 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, Article 12, p.3.

## **SECTION 4: THE AUDIT OF FINANCIAL STATEMENTS**

This Practice Note contains guidance on the application to the audits of financial statements of insurers (and friendly societies carrying on insurance business in the UK) of those ISAs (UK) that are effective for periods commencing on or after 17 June 2016. In addition, it contains guidance intended to assist the auditors of insurers and friendly societies in reporting on matters specified by regulators, given the auditor's right and duty to report to regulators. This Practice Note does not contain commentary on all of the requirements included in the ISAs (UK) and reading it should not be seen as an alternative to reading the relevant ISAs (UK) in their entirety. In addition, where no special considerations arise from a particular ISA (UK), no material is included.

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

ISA (UK) 210 sets out the auditor's responsibilities when agreeing the terms of audit engagements. These are to establish whether the 'preconditions for an audit' are present and that there is a common understanding between the auditor and management and, where appropriate, those charged with governance.

1. Where the auditor is appointed to audit both the statutory financial statements and regulatory reports, the auditor may choose to combine into a single letter the terms of engagement in relation for both engagements. In that case, the auditor should have regard to the requirements of ISA (UK) 210 in respect of each separate engagement, and clearly set out the terms and conditions in respect of each engagement included within the letter of engagement. In respect of the audit of the statutory financial statements, 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<sup>27</sup>, the FCA Handbook<sup>28</sup> and PRA Rules<sup>29</sup> including the need to keep the regulators informed about the affairs of the entity.
  - The statutory right and duty of the auditor to report directly to the FCA and/or PRA in certain circumstances (see the section of this Practice Note relating to ISA (UK) 250 Section B and the section on the regulatory context of the audit of insurers).
  - The requirement on the audited entity to cooperate with the auditor contained within the FCA and PRA rules. This includes taking steps to ensure that, where applicable, each of its appointed representatives, tied agents 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.<sup>30</sup> It is a criminal offence for an insurer or its officers, controllers or managers to provide false or misleading information to the auditor.<sup>31</sup>
  - procedures for the insurer 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.

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27 <http://www.legislation.gov.uk/ukpga/2000/8/contents>

28 <https://www.handbook.fca.org.uk/>

29 <http://www.prarulebook.co.uk/>

30 FCA Handbook, *Regulatory Processes: SUP Supervision: SUP 3: 3.6.2G-3.6.8G*. PRA *Solvency II Firms Rulebook: Auditors 5.1-5.2*; PRA *Non-Solvency Firms Rulebook: Auditors 5.1-5.2*.

31 Section 346 FSMA 2000.

2. In this connection the auditor is aware that:
- (a) The appropriate regulator 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>32</sup>;
  - (b) *The auditor is required to cooperate with the regulators*<sup>33</sup>; and
  - (c) *The auditor must notify the appropriate regulator if the auditor ceases to be the auditor of an authorised firm.*<sup>34</sup>

### **Friendly Societies**

3. The auditor's engagement letter additionally refers to the Friendly Societies Act 1992.

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32 FCA Handbook, *Regulatory Processes: SUP Supervision: SUP 3: 3.4.4G; 3.4.7R; 3.4.8G.*

33 FCA Handbook, *Regulatory Processes: SUP Supervision: SUP 3: 3.8.2R; 3.8.3G; 3.8.4R.* PRA Solvency II Firms Rulebook: Auditors 7.1; PRA Non-Solvency Firms Rulebook: Auditors 7.1. For auditors of Public Interest Entities a requirement to report to and to establish an effective dialogue with competent authorities is included in Article 12 of REGULATION (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014.

34 FCA Handbook, *Regulatory Processes: SUP Supervision: SUP 3: 3.8.11R; 3.8.12R.* PRA Solvency II Firms Rulebook: Auditors 7.5 & 7.6; PRA Non-Solvency Firms Rulebook: Auditors 7.5 & 7.6.

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

ISA (UK) 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

4. The following are considered to be significant fraud risks which insurers may be subject to:
  - Policyholder fraud.
  - Fraud by directors and employees, or in the case of friendly societies the committee of management and employees.
  - Fraud by agents, brokers, intermediaries or other related parties.
5. Responsibility for the prevention and detection of fraud and error lies with those charged with governance of an insurer or friendly society, and of the managing agent of a Lloyd's syndicate, even if they have delegated functions to third parties. In carrying out their responsibilities, the directors or Committee of Management have regard to the PRA's Fundamental Rules and the FCA Principles for Businesses (in particular with regard to the criteria for integrity, skill, care and diligence and management and control)<sup>35</sup> and to requirements issued by the Council of Lloyd's. Equivalent provisions apply to directors of managing agents.<sup>36</sup>
6. The PRA's Fundamental Rule 5 and FCA Principle 3 require an insurer to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. The PRA rulebook has specific requirements for insurers in respect of the processes to be followed to ensure that all persons who carry out key functions are fit and proper (including being of good repute and integrity).<sup>37</sup> From 7 March 2016 a new Senior Insurance Managers regime (jointly introduced by the FCA and PRA) came into force which established new requirements in respect of the governance arrangements, responsibilities and individual conduct rules for those working within the authorised insurance sector.<sup>38</sup> The FCA Handbook SYSC 3.2.20R(1) requires a firm to make and retain adequate records of matters and dealings (including accounting

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35 <http://www.bankofengland.co.uk/pradocuments/authorisations/newfirmauthorisations/fundamentalrulesprinciples.pdf>; <https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html>

36 <https://www.lloyds.com/the-market/operating-at-lloyds/lloyds-minimum-standards>

37 <http://www.prarulebook.co.uk/rulebook/Content/Chapter/212602/14-09-2016#212607>; <http://www.prarulebook.co.uk/rulebook/Content/Part/318572/14-09-2016>; <http://www.prarulebook.co.uk/rulebook/Content/Part/302742/14-09-2016>

38 <https://www.fca.org.uk/firms/senior-insurance-managers-regime>

records) which are the subject of requirements and standards under the regulatory system.<sup>39</sup>

7. Whilst the inherent risk of fraud may continue to exist, the establishment of accounting and internal control systems sufficient to meet these requirements (particularly in the case of insurance companies that accept business involving both a high volume of policies and claims of comparatively low value) reduces the likelihood of fraud giving rise to material misstatements in the financial statements.
8. Fraud against insurers, 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, fraud risk factors particularly relevant to insurers may be due to the following, for example:
  - The commission driven nature of many arrangements with business introducers whose interests may be more focused on the volume of business and commission thereon rather than the ultimate profitability and sustainability of the business for the insurer. This may increase the risk of fraud committed by agents and intermediaries.
  - The existence of very large estimated liabilities which may not crystallise for many years.
  - Complex insurance and reinsurance transactions that may provide an opportunity to conceal inappropriate pricing of the risks transferred and to apply inappropriate accounting treatments which may have a significant impact on the results for a given period and the balance sheet position.
  - The transfer of risk under a contract of insurance is not reflected in the passing of any physical asset which may make it difficult for insurers to ensure that all transactions are recorded completely and accurately.
  - The nature of delegated underwriting, coupled with large amounts of cash and near liquid assets often held by agents and other intermediaries with delegated authority, may increase the propensity for fraud.
  - The practice of insurance contracts incepting before all of the terms are agreed and documented may provide the opportunity for fraudulent manipulation of contract wordings.
9. In smaller insurers, a further risk may arise because segregation of duties may be limited as the processing of receipts and payments vest in a few individuals. There may be only one individual responsible for day to day management. As contributions received from an individual member will often only give rise to benefit payments to that individual over the

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39 <https://www.handbook.fca.org.uk/handbook/SYSC/3/2.html>

longer term, there is a risk that amounts may be misappropriated in the interim and escape detection. There is also a risk that related party transactions will be entered into without appropriate review and approval, resulting in non-commercial terms which could be prejudicial to members' interests.

10. ISA (UK) 240 requires that the auditor shall identify and assess risks of material misstatement based on a presumption there are risks of fraud in revenue recognition. In the context of an insurer or friendly society, "revenue" in respect of insurance contracts may take the form of earned premiums. However the auditor also considers the likelihood of fraud in relation to the recognition of income or costs which may have a close relationship to earned premiums, such as reinsurance costs and acquisition costs. Where insurers issue investment contracts that are subject to deposit accounting, "revenue" may be taken as the fees receivable under those contracts. Insurers frequently outsource insurance and accounting functions to service companies. Service companies are considered as agents of the insurance companies and the auditor therefore considers the equivalent risk factors for service companies.
11. The auditor considers reports or information obtained from the insurer's internal audit function, compliance department, legal department, and money laundering reporting officer together with reviews undertaken by third parties such as skilled person's reports prepared under section 166 FSMA 2000.<sup>40</sup>
12. The FCA's rules require authorised firms and friendly societies to report "significant" fraud, errors and other irregularities to the FCA (SUP 15.3.17R) (and, where applicable, to the Council of Lloyd's).<sup>41</sup>

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40 Section 166 FSMA 2000 provides the PRA and the FCA with the power to require a firm to appoint a skilled person to provide a report on any matter that the FCA 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 the FCA handbook and the PRA rulebook.

41 <https://www.handbook.fca.org.uk/handbook/SUP/15/3.html>

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

ISA (UK) 250A deals with the responsibilities of an auditor when considering laws and regulations in an audit of financial statements:

As part of obtaining an understanding of the entity and its environment in accordance with ISA (UK) 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.<sup>42</sup>

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.<sup>43</sup>

13. In the context of insurers and friendly societies, laws and regulations are central to the conduct of business if breaches would have either of the following consequences:
  - (a) Removal of authorisation to carry out insurance business; or
  - (b) The imposition of fines or restrictions on business activities whose significance is such that the ability of the insurer to continue as a going concern is threatened.
14. Non-compliance with laws and regulations that are central to an insurer's activities is likely to give rise to a statutory duty to report to the FCA, the PRA and/or the Council of Lloyd's. Such reports are made in accordance with the requirements of ISA (UK) 250 Section B, following the guidance set out in the relevant section of this Practice Note.
15. Insurers are affected by two types of regulation which are central to their activities and of which the auditor needs to obtain a general understanding:
  - (a) Prudential supervision; and
  - (b) Market conduct rules.
16. The principal purpose of prudential supervision is to ensure the protection of policyholders because of the promissory nature of transactions between insurers and the public. Many of the rules for prudential supervision are based on European

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<sup>42</sup> ISA (UK) 250 Section A (Revised June 2016), para. 12.

<sup>43</sup> ISA (UK) 250 Section A (Revised June 2016), para. 13.

Directives, including the Solvency II framework which became effective from 1 January 2016.

17. Prudential supervision of insurance companies with their head offices in the UK and insurers established outside the EEA with UK branches is carried out by the PRA under rules made by the PRA under FSMA 2000, and in accordance with the Solvency II regime. Ongoing prudential supervision of authorised insurance companies is conducted by means of the regulatory returns submitted by all authorised insurance companies and non-EEA insurers with UK branches. Since 1 January 2016, different reporting rules apply to different categories of insurer:
- Non-directive firms are categorised according to criteria set out in Chapter 2 of the Insurance General Application Part of the PRA Rulebook. In general, they are those with gross premium income below 5 million euro and gross technical provisions of less than 25 million euro. These firms make annual regulatory returns, which are due to the PRA within three months of their balance sheet date for insurers making electronic submissions (otherwise 2 months and 15 days). These returns are subject to audit.
  - Solvency II directive firms submit quarterly and annual regulatory returns including a number of quantitative reporting templates depending on the type of business they conduct. These are set out in the reporting section of the PRA rulebook for Solvency II firms. These returns are not subject to audit. Transitional Measures apply during which the deadlines for submission of annual returns are:
    - 20 weeks after the firm's financial year end in relation to its financial year ending on or after 30 June 2016 before 1 January 2017;
    - 18 weeks after the firm's financial year end in relation to its financial year ending on or after 1 January 2017 but before 1 January 2018;
    - 16 weeks after the firm's financial year end in relation to its financial year ending on or after 1 January 2018 but before 1 January 2019;
    - 14 weeks after the firm's financial year end in relation to its financial year ending on or after 1 January 2019 but before 1 January 2020.<sup>44</sup>
  - Directive firms are also required to publish annually a SFCR, the required content of which is set out in the reporting section of the PRA rulebook for Solvency II firms, and part of which must be audited. Disclosure of the SFCR is required on the same timetable as set out above in respect of annual regulatory returns.

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44 The 14 week deadline continues to apply after 1 January 2020. The deadline for groups is, in each case, 6 weeks later than for solo firms. PRA Solvency II Rulebook, Transitional Measures section, <http://www.prarulebook.co.uk/rulebook/Content/Chapter/213258/14-09-2016#213274>

18. Market conduct regulation is primarily carried out by the FCA, with rules set out in the FCA Handbook, including general requirements for all regulated entities and specific chapters relating to insurance firms.
19. There are, in addition, compensation schemes set up to protect individual policyholders for certain classes of business under the Financial Services Compensation Scheme (FSCS) (established under FSMA 2000), and the Motor Insurers' Bureau (established under the Road Traffic Act 1988). Insurers may be required to contribute to levies raised by these guarantee funds depending on the type of insurance business carried on. There are also competition and consumer affairs bodies, such as the Financial Ombudsman Service (which handles consumer complaints) and the Competition and Markets Authority.
20. ISA (UK) 250A requires the auditor to perform procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. 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.
  - The insurer's compliance with prudential capital requirements (including applicable group capital requirements), including reporting to the PRA.
  - The insurer's compliance with the scope of its permissions or any limits that may be specified in any Permission Notice issued by the PRA or FCA.
  - Reviewing correspondence with the PRA, FCA and other regulators.
  - Holding discussions with the insurer's regulatory compliance officer and other personnel responsible for compliance.
  - Reviewing compliance reports prepared for the Board, audit committee and other committees.
  - Consideration of work on compliance matters performed by internal audit.
  - Results of any complaints monitoring procedures of the entity and any trends that may indicate conduct of business issues.
  - Where an authorised insurer is a parent company, the impact of breaches of local laws and regulations on the trading status of the parent company, and of the overseas subsidiary/branch if they are likely to have a material effect on the financial statements of the parent company or group. Regard is also had to the powers of intervention exercisable by the relevant regulatory authorities and the potential impact on the group financial statements.

## **Taxation**

21. The taxation of insurers and friendly societies is a complex area. Some friendly societies are exempt from tax in respect of business other than long-term insurance and others are not. The treatment of long-term insurance business itself follows that for mutual life insurance companies but with a number of added complications. The most important of these is a society may claim to treat part of its business as “tax exempt”.
22. For smaller friendly societies income and gains relating to policies issued may qualify for exemption from tax. For policies taken out since 1995 this applies to life policies with an annual premium of up to £270 or £25 per month, and annuities of up to £156 per annum. The principles of life insurance taxation also require other classes of business to be separated and ‘ring-fenced’. Each category has a different tax treatment. Societies have reporting responsibilities relating to the taxation of their policyholders, with severe penalties for errors. On the occasion of a transfer of engagements, it is important to check the impact on the tax status of the different business categories.

## **Money Laundering**

23. Anti-money laundering legislation in the UK imposes a duty on the auditor to report suspected money laundering activity. There are similar laws and regulations relating to terrorist financing. The detailed legislation can be summarised as follows:
  - Partners and staff in audit firms are required to report suspicions of conduct which would constitute a criminal offence which gives rise to direct or indirect benefit.
  - Partners and staff in audit firms need to be alert to the dangers of “tipping off”, as this will constitute a criminal offence under anti-money laundering legislation.

Further detail is set out in Practice Note 12 (Revised): *Money Laundering – Guidance for auditors on UK legislation*.

24. Authorised firms including insurers are subject to the requirements of the Money Laundering Regulations 2007 (as amended) and the Proceeds of Crime Act 2002 as well as FCA and PRA 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.
25. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which insurers and friendly societies conduct their business. By the nature of their business, insurers 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 National Crime

Agency (“NCA”). FCA Handbook requirements<sup>45</sup> have due regard to compliance with the relevant provisions of guidance issued by the Joint Money Laundering Steering Group (“JMLSG”).

26. In addition to considering whether an insurer 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 (as amended) to report knowledge or suspicion of money laundering offences, including those arising from fraud and theft, to the NCA. The auditor is aware of the prohibition on “tipping off” when discussing money laundering matters with the insurer. Given the nature of insurance business and the likely frequency of needing to report to the NCA the auditor is aware of the guidance issued by the United Kingdom Financial Intelligence Unit (UKFIU) for submitting Suspicious Activity Reports to the NCA.<sup>46</sup>
27. The auditor, in the context of money laundering, is aware of the auditor’s duty to report direct to FCA and/or PRA in certain circumstances (see the section of this Practice Note relating to ISA (UK) 250 Section B).

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45 FCA Handbook, SYSC 3.2.6 (a)-(k)

46 <http://www.nationalcrimeagency.gov.uk/publications/517-submitting-a-suspicious-activity-report-sar-within-the-regulated-sector/file>

## **ISA (UK) 250: SECTION B – THE AUDITOR’S STATUTORY RIGHT AND DUTY TO REPORT TO REGULATORS OF PUBLIC INTEREST ENTITIES AND REGULATORS OF OTHER ENTITIES IN THE FINANCIAL SECTOR**

This ISA deals with the statutory right and duty of the auditor of a regulated entity to bring information of which the auditor has become aware in the ordinary course of performing work undertaken to the attention of the appropriate regulator as soon as practicable.

### **Auditor’s duty to report to supervisors**

28. Under the 2001 Regulations<sup>47</sup> and (for auditors of Public Interest Entities) the Audit Regulation<sup>48</sup>, the auditor has duties in certain circumstances to make reports to the regulator (supervisor, competent authority)<sup>49</sup>. These responsibilities are set out in detail in the Regulatory context part of this Practice Note.

### **Conduct of the audit**

29. The auditor ensures 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 regulated entity, appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations they encounter which may give reasonable cause to require that a matter be reported to the regulator.<sup>50</sup>

30. Understanding, commensurate with the individual’s role and responsibilities in the audit process, is required of:

- (a) The provisions of the 2001 Regulations concerning the auditor’s duty to report to the regulator, and the provisions of the Audit Regulation in respect of Public Interest Entities;
- (b) The standards and guidance in ISA (UK) 250 Section B, and in this section of this Practice Note;
- (c) Relevant sections of the FCA Handbook and the PRA Rulebook, including the Principles for Businesses and the Threshold Conditions; and
- (d) In the context of Lloyd’s syndicates, the Audit Arrangements Byelaw (AAB), the relevant requirements established by the Council of Lloyd’s.

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47 SI 2001 No 2587 “The FSMA 2000 (Communications by Auditors) Regulations 2001”.

48 EU 537/2014.

49 Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014.

50 ISA (UK) 250 Section B (Revised June 2016), para. 11.

31. The auditor includes procedures within its 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.
32. 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 which could affect the firm's work as auditor. The auditor also requests the regulated entity to advise it when the entity 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**

33. Where the auditor of a regulated entity is also auditor of a closely linked entity<sup>51</sup>, a duty to report arises directly in relation to information relevant to the regulated entity of which the auditor becomes aware in the course of its work as auditor of the closely linked entity.
34. 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:
  - (a) Activities or uncertainties within the closely linked entity which might significantly impair the financial position of the regulated entity;
  - (b) Money laundering; and, if the closely linked entity is itself regulated;
  - (c) Matters that the auditor of the closely linked entity is intending to report to its regulator.
35. 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 closely linked entities the audit firm's responsibilities to report to the regulators under applicable law and regulation. The

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51 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.

engagement team also explains the circumstances that have been identified which, if they exist, might be of material significance to the 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.

36. In circumstances where it is not the auditor of the closely linked entity, the auditor of the regulated entity decides whether there are any matters to be reported to the regulator relating to the affairs of the regulated entity in the light of the information that it 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 to be reported, the auditor 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 the auditor 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 it has identified the auditor of the regulated entity reports those matters, and that it has been unable to obtain further information, direct to the regulator.

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

37. There may be circumstances where it is not clear whether information about a regulated entity 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) 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 or Committee of Management**

38. The Directors or (in the case of friendly societies) the Committee of Management, are the persons 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) 250 Section B emphasises that where the auditor concludes that a duty to report arises it should bring the matter to the attention of the regulator without undue delay. Where the matters identified are reported to the regulator by the directors, it does not relieve the auditor of the statutory duty to report directly to the regulator.

### **Timing of a report**

39. The duty to report arises once the auditor has concluded that it reasonably believes that the matter is or is likely to be of material significance to the regulator's regulatory function. In reaching its conclusion the auditor may wish to take appropriate legal or other advice and consult with colleagues.
40. The report should be made without undue delay 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 without undue delay.

### **Auditor's right to report to the regulator**

41. Section 342 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 regulator information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the regulator. For this purpose, "authorised person" is deemed to include a Lloyd's syndicate.
42. The scope of the duty to report is wide since, under the PRA's Fundamental Rule 7 and the FCA's Principle for Businesses 11, an authorised firm must disclose to the regulator anything relating to the authorised firm of which the regulator 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 it advises the directors of its opinion. Where the auditor is unable to obtain, within a reasonable period, adequate evidence that the directors have properly informed the regulator of the matter, then the auditor makes a report to the regulator without undue delay.
43. The auditor may wish to take legal advice before deciding whether, and in what form, to exercise its right to make a report direct to the regulator in order to ensure, for example, that only relevant information is disclosed and that the form and content of its report is such as to secure the protection of FSMA 2000. 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 regulator to meet its statutory objectives.

**ISA (UK) 265: COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT**

ISA (UK) 265 deals with the responsibilities of the auditor when communicating deficiencies in internal control to those charged with governance and management.

44. The auditor of a friendly society considers ISA (UK) 265 in the context of
- (a) The report on internal control exceptions prepared by management under the FCA's Interim Prudential Sourcebook [IPRU(FSOC) rule 3.1(7) (non-directive societies)]; and
  - (b) The possibility that the society may wish to provide a written communication to a third party such as the regulator.
45. A non-directive society's responsibility to prepare a Rule 3.1 report will be relevant to the timing of communications to those charged with governance.
46. The auditor has no reporting duty to the regulator in connection with the Rule 3.1 report. However, during the audit the auditor enquires as to the society's progress with identifying and updating matters to be reported and discusses them with management in order to assess their impact, if any, on its audit of the financial statements. The auditor considers whether such weaknesses in internal control that have been identified by management have been communicated to those charged with governance.

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

47. ISA (UK) 300 deals with the responsibilities of auditors in respect of planning an audit of financial statements. Particular issues likely to require consideration in planning the audit of an insurance entity are:
- (a) The need to involve auditor's experts. The nature and complexity of insurance businesses increases the likelihood that the auditor may consider it necessary, in order to obtain sufficient appropriate evidence on which to base its report, to involve auditor's experts in the audit process. For example, the auditor may wish to rely on the work of an actuary or a statistician to assist its consideration of an insurer's technical provisions: that actuary may be engaged as an auditor's expert or as a specialist in accordance with paragraph b depending on the nature of the engagement. [See 'Auditor's internal and external experts' at the end of this section of the Practice Note] Other auditor's experts the auditor may consider involving include regulatory, investment, tax and systems specialists. Consequently, the auditor of an insurer considers the need to involve such auditor's experts at an early stage in planning its work. Where such auditor's experts are to be used, they may take part in discussions with the insurer's management and staff, in order to assist in the development of knowledge and understanding relating to the insurer's business. As part of the planning process the auditor agrees in advance the scope of work of the auditor's actuarial and other experts, including the scope of their reports;
  - (b) The need to include in the engagement team persons using expertise in a specialised area of accounting or auditing, whether engaged or employed by the auditing firm who performs audit procedures on the engagement. The application of relevant tax legislation is likely to be complex, and hence the auditor may wish to involve a tax specialist to assist the consideration of provisions for corporation and other taxes included in an insurer's financial statements for the purposes of the audit; and
  - (c) The effect of delegated authorities granted by the insurer, and the sources of evidence available to the auditor for transactions undertaken by those to whom such authority has been given. The auditor of an insurer considers the implications of delegated authorities in planning its work, including the existence of delegated underwriting authority by agents or others on behalf of the entity. This may include the outsourcing of certain functions, such as investment management or the delegation of authority to underwrite and/or administer business, and to process and/or settle claims.
48. Further guidance in respect of the matters set out at (a) and (b) above are included separately in this Practice Note. Guidance in respect of delegated authorities as set out in (c) above is included in the section dealing with ISA (UK) 402: *Audit Considerations Relating to an Entity Using a Service Organization*.

49. In view of its responsibility to report on regulatory returns or audit published SFCRs for 'directive' firms, the auditor of an authorised insurer or friendly society may plan its work so as to carry out procedures necessary both to form an opinion on the financial statements and to report on matters included in the regulatory returns in an efficient and effective manner. The audits of the statutory financial statements and published SFCRs are nevertheless standalone audits under ISAs (UK), and any procedures carried out to cover both requirements need to be clearly documented to support both audit conclusions.

### **Actuarial Function**

50. The Solvency II prudential regulation regime came into force from 1 January 2016. The PRA's rulebook reflects the different requirements for Directive and non-Directive firms. This includes relevant rules in respect of the establishment of an actuarial function under Solvency II.
51. For Directive firms, PRA rules<sup>52</sup> require that:
- (1) A firm must provide for an effective actuarial function to:
    - a. coordinate the calculation of technical provisions;
    - b. ensure the appropriateness of the methodologies and underlying models used, as well as the assumptions made in the calculation of technical provisions;
    - c. assess the sufficiency and quality of the data used in the calculation of technical provisions;
    - d. compare the best estimate against experience;
    - e. inform the governing body of the reliability and adequacy of the calculation of technical provisions;
    - f. oversee the calculation of technical provisions;
    - g. express an opinion on the overall underwriting policy;
    - h. express an opinion on the adequacy of reinsurance arrangements; and
    - i. contribute to the effective implementation of the risk-management system....in particular with respect to the risk modelling underlying the calculation of the SCR and MCR and to the firm's ORSA.
  - (2) The actuarial function must be carried out by persons who have knowledge of actuarial and financial mathematics, commensurate with the nature, scale and complexity of the risks inherent in the firm's business, and who are able to

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52 PRA SII Firms Rulebook, Conditions Governing Business: Actuarial Function: 6.1. <http://www.prarulebook.co.uk/rulebook/Content/Chapter/212975/14-09-2016>

demonstrate their relevant experience with applicable professional and other standards.

52. There is no identical requirement for the population of non-Directive firms. However, paragraph 52 (3) of Schedule 3 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (SI 2008/410) requires that calculation by (within scope) firms of technical provisions:

*....must be made annually by a Fellow of the Institute and Faculty of Actuaries on the basis of recognised actuarial methods.*<sup>53</sup>

53. The auditor discusses elements of its audit plan with the actuary established under the relevant regulation, in order to ensure that its audit procedures have regard to the actuary's work. Where the insurer appoints a separate actuary to fulfil the duties of the actuarial function holder or the with-profits actuary in relation to the insurer's regulatory obligations, the auditor also considers the need for liaison with these individuals.

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53 [http://www.legislation.gov.uk/ukSI/2008/410/pdfs/ukSI\\_20080410\\_en.pdf](http://www.legislation.gov.uk/ukSI/2008/410/pdfs/ukSI_20080410_en.pdf)

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

ISA (UK) 315 sets out the responsibilities of an auditor in respect of identifying and assessing the risks of material misstatement.

54. Insurers and friendly societies may be complex and the auditor seeks to understand the business environment and the regulatory regime in which they operate.

### **Business factors**

55. 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 insurer's systems record and address these risks. Although they may apply to varying degrees, the risks include (but are not limited to):
- Underwriting or insurance risk: which is inherent in any insurance business but will be influenced by, for example, the classes of business underwritten, new products or services introduced and guarantees given.
  - Credit risk: at its simplest, this is the risk that a third party will be unable to meet its obligations (for example, recoveries from reinsurers).
  - Liquidity risk: the risk that arises from the possibility that an insurer has insufficient liquid funds to meet claims.
  - Market risk: 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).
  - Interest rate risk (a subset of market risk): the risk that arises where there is a mismatch between the interest rate reset dates or bases used for asset and liability measurement.
  - Currency risk: the risk that arises from the mismatching of assets, liabilities and commitments denominated in different currencies.
  - Pension obligation risk: the risk that the insurer's obligations towards its pension schemes may lead to the insurer not being able to pay its other liabilities as they fall due; and the risk that an increase in the funding requirements results in a significant reduction in the insurer's capital resources.
  - Operational risk: the risk of loss, arising from inadequate or failed internal processes, people or systems or from external events, including legal risk and risks associated with the secure management and use of data.

- 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 insurer's activities.
  - Failure to manage the risks outlined above can also cause serious damage to an insurer's reputation, potentially leading to loss of confidence in the insurer's business.
56. When obtaining an understanding of the insurer's business, the auditor considers, for example:
- The methods by which business is transacted including whether the insurer participates with others in contracts for large commercial risks, and if so whether it transacts business as "leader" in such contracts or as a "follower".
  - The characteristics of its insurance products, including those written in previous years where exposure remains.
  - The introduction of new categories of products or customers or distribution channels.
  - The reinsurance arrangements.
  - The complexity of the insurer's information systems.
  - The legal and operational structure of the insurer.
  - The number and location of branches.
  - The regulatory capital position.
  - Changes in the market environment (for example, a marked increase in competition).
  - Relevant economic developments.
  - Developments in relevant legislation and changes resulting from new judicial decisions.
57. Insurance policies written in previous years may continue to have an impact upon insurers' financial statements in subsequent years. For example, for general insurance business the terms of the insurance cover provided and the reinsurance arrangements in force in a previous year are factors involved in the determination of technical provisions not only in the year in which the claims are incurred, but also in subsequent periods if the original estimates of the claims in question change. Similarly for life assurance business guarantees and options and other policyholder promises made on the issue of policies in prior years will be one of the key factors in determining estimates for related technical provisions.

## **Regulatory Factors**

58. In obtaining an understanding of the regulatory factors the auditor considers, for example:

- Any formal communications between the FCA and PRA in their capacity as the regulators and the insurer, including any new or interim risk assessments issued and the results of any other supervisory visits conducted.
- The contents of any recent reports prepared by “skilled persons” under section 166 of FSMA 2000 together with any correspondence, minutes or notes of meetings relevant to any recent skilled persons’ report.
- Any formal communications between the insurer and other regulators.
- Discussions with the insurer’s regulatory compliance officer together with others responsible for monitoring regulatory compliance [established under the PRA’s Senior Insurance Managers Regime and/or the Solvency II Key Functions requirements].

## **Accounting Policies**

59. The application of complex accounting standards such as IAS 32 and 39, IFRS 4, 7 and 9 (for insurers using IFRSs) and FRS 103 (for insurers using UK GAAP) may also give rise to significant risk. This arises from the classification, recognition and measurement of insurance and investment contracts, the classification and measurement of financial assets, hedge accounting, classification of assets/liabilities, revenue/expense recognition. In addition significant risk may arise from the adequacy of financial statement disclosures, notably in respect of insurance and financial risk management. Risks may also arise in relation to regulatory requirements by creating incentives for particularly accounting treatments or classifications to achieve a regulatory outcome.

60. Accounting policies of particular relevance may include those in relation to insurance and investment contracts, embedded derivatives in insurance contracts, deferred acquisition costs, classification of assets and liabilities (and thereby their measurement) and revenue recognition (including investment management service contracts).

## **Internal Controls**

61. ISA (UK) 315 requires the auditor to obtain an understanding of internal controls relevant to the audit. As part of that understanding, the auditor shall evaluate their design and determine whether they have been implemented.

62. The PRA’s Senior Insurance Managers Regime (SIMR) establishes a requirement for UK insurers to identify key functions and function holders in the business. These requirements are similar but not identical to the ‘key functions’ identified by the Solvency II Framework Directive for Directive firms. Overall the following key functions should be identifiable within the insurance entity:

- the risk management function;
  - compliance function;
  - internal audit function;
  - actuarial function.
  - the investment function (accordingly, investment managers would be key function holders);
  - the claims management function (especially in general or health insurance firms);
  - the IT function; and
  - the reinsurance function (where this role is different to other key functions such as risk management).
63. 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. The systems of control need to have regard to the requirements of the FCA handbook and the PRA rulebook (for both Directive and non-Directive firms). Although the directors are required to certify that they are satisfied that throughout the financial year the insurer has complied in all material respects with these requirements, auditors of insurers do not have responsibility for reporting on whether systems of control meet regulatory requirements.
64. Systems of internal control of an insurer are important in ensuring orderly and prudent operations of the insurer and in assisting the directors to prepare financial statements which give a true and fair view. The following features of the business of insurers 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 involve the use of information technology. For example, transactions subject to "straight through processing" involve little or no manual intervention after they have been initiated.
  - Proper segregation of duties between those writing the risks, those responsible for establishing claims provisions, those responsible for claims handling, those

responsible for claims settlement and those recording these transactions, is particularly important.

- Equally as important is the proper segregation of duties between and amongst those responsible for the purchase and sale of investments, those recording these transactions and those responsible for the physical security over the documents of title.
- The geographical location of some insurers' operations means that, in order to maintain control over its activities, insurers 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.
- The activities of insurers can result in the use of complex insurance or reinsurance transactions. The assessment as to whether such transactions transfer risk poses risks of misstatement. Consequently, insurers will normally have developed important operational controls to mitigate such risks of misstatement.
- The provisions of UK tax legislation are complex for insurers. 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 provisions arising in any other jurisdictions where the insurer operates.
- The UK regulatory framework is complex for insurers. This may give rise to significant liabilities for compensation to policyholders 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.

### **Insurer Risk Assessments**

65. Insurers and friendly societies will normally be required to produce assessments of their capital requirement, including for Solvency II Directive firms an Own Risk and Solvency Assessment (ORSA). These assessments are designed to quantify risks specific to the entity and to generate and quantify an estimated capital requirement for the entity, and include an assessment of operational risk. The auditor will normally review such documentation in assessing the insurer's approach to addressing risks.

### **Control Activities**

66. The ISA requires that auditors:

....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 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.<sup>54</sup>

67. 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 in internal control 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, insurance or reinsurance contracts.
  - Deficiencies in back office procedures undermining the completeness and accuracy of accounting records.
  - Deficiencies in new product approval procedures.
  - Backlogs in key reconciliations.
  - Inadequate maintenance of suspense or clearing accounts.
  - Delays in the processing of premiums and claims.
68. In the case of small insurers the activities and products supplied may be relatively simple or uniform and the segregation of duties may be less sophisticated or less well developed. The degree to which the auditor decides to test and rely on internal controls may be limited.

Controls relating to outsourcing activities are considered in the ISA (UK) 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.<sup>55</sup>

69. As a result of the type and complexity of transactions undertaken, and records held, by insurers and the need for swift and accurate information processing and retrieval, many insurers are highly automated, including: the accounting function, the processing of premiums, reinsurance and claims, regulatory reporting and the supply of management information.

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54 ISA (UK) 315 (Revised June 2016), para. 20.

55 ISA (UK) 315 (Revised June 2016), para. 21.

70. In addition to providing a basis for preparation of the financial statements and meeting requirements for maintenance of adequate accounting records, a key feature of the information systems maintained by an insurer is the importance of reliable historical statistical data to operate the business. Historical statistical data is important, for example, in calculating technical provisions, and for providing analyses for regulatory returns.
71. Characteristics of IT systems in the insurance industry include:
- (a) High volumes of transactions flowing through IT systems
  - (b) Complex systems, often with multiple systems for different products or transaction cycles (premiums, claims), reinsurance, financial instruments etc.
  - (c) A history of consolidation in the industry yet underlying legacy systems have remained.
  - (d) High degree of reliance on spreadsheets or models, often not managed by IT but by business departments.
72. An effective control system over the administration of insurance business will therefore seek to ensure the accurate collation, processing and storing of large volumes of data relating, for example, to:
- Acceptance of risk.
  - Recording of policy details.
  - Collection of premiums.
  - Recording, investigation, evaluation and payment of claims.
  - Identification of classes of business required to be disclosed in the insurer's regulatory returns.
  - Transfer of data from the administration systems to systems used for calculating technical provisions.
73. The auditor assesses the extent, nature and impact of automation within the insurer and plans and performs work accordingly. In particular the auditor considers:
- (a) The required level of IT knowledge and skills – these may be extensive and may require the auditor to obtain advice and assistance from staff with specialist skills;
  - (b) The extent of the application of audit software and related audit techniques;
  - (c) General controls relating to the environment within which IT based systems are developed, maintained and operated; and
  - (d) General controls around data integrity and security.

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

74. The principles of assessing materiality in the audit of an insurer or friendly 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. ISA (UK) 320 states that:

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 misstatement 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.<sup>56</sup>

75. One key difference of an insurer or friendly society from many other entities is that balance sheet balances tend to be much larger compared to the income statement, so that the application of materiality based on income may be too low when auditing some aspects of elements of the balance sheet.
76. The auditor typically uses materiality based on the income statement if a misstatement in a balance sheet item could affect the 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 identifying and evaluating such misstatements only.
77. When applying a higher balance sheet materiality level for the purpose of identifying and evaluating the effect of such misclassifications the auditor considers other relevant factors such as:
- 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.

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<sup>56</sup> ISA (UK) 320 Materiality in Planning and Performing an Audit, (Revised June 2016), para. 10.

- The effect on individual line items or sub-totals.
  - The effect on key ratios.
78. Examples of items which may have little or no direct effect on an insurer's income may include:
- Reinsurance arrangements that are entered into to reduce the impact of claims on shareholders' funds. The balance sheet of an insurer is required to include the gross amount of technical provisions within liabilities and any reinsurers' shares of technical provisions within assets. However, a misstatement in the recording of these gross assets and liabilities will have a much lesser effect on the insurer's income statement because the insurer does not bear all of the costs of claims.
  - Revenue errors on with-profits business will ordinarily have no impact on income for the year as income is determined by the amount of the bonus distribution.
  - Where liabilities of an insurer are determined directly by reference to the value of assets held (e.g. for unit linked business) any misstatement in such liabilities may be offset by a corresponding misstatement in the associated assets (and vice versa).
79. In the case of many classes of insurance business, uncertainty relating to the ultimate cost of claims is an inherent feature of the business. As a result, whilst quantitative measures of materiality are of assistance in directing the focus of the auditor's work, qualitative factors relating to the extent and nature of disclosures in the financial statements will also be of importance. Where such uncertainty is considered to be significant, insurance entity auditors consider the disclosures made in the financial statements, and the effect upon the auditor's report. This matter is dealt with in the sections in this Practice Note covering ISAs (UK) 450, 540 and 705.

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

ISA (UK) 330 deals with the auditor's responsibilities to design and implement responses to the assessed risks of material misstatement. The ISA states that:

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

- (a) The auditor's assessment of risk of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., 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.<sup>57</sup>
80. In practice the nature and volume of transactions relating to the operations of insurers often means that performing tests of relevant controls is the most efficient means of reducing audit risk to an acceptably low level.
81. Specific accounting standards can require extensive narrative disclosures in the financial statements of insurers; for example, in relation to the nature and extent of risks arising from contracts. In designing and performing procedures to evaluate these disclosures the auditor obtains audit evidence regarding the assertions about presentation and disclosure described in paragraph A124-124a of ISA (UK) 315.<sup>58</sup>

### **Insurance transactions**

82. When considering the completeness and accuracy of processing of insurance transactions, the auditor has regard to the multiple purposes for which an insurer will use data entered into its accounting records. Such data may be used not only for inclusion in the financial statements, but may also be included in the regulatory returns of the insurer and be used as the basis for statistical analysis and extrapolation of past trends and transactions in assessing technical provisions. Errors in the data input may therefore have far reaching impact on the overall reported results. Data input required for such other purposes may therefore require additional detail or higher levels of accuracy of coding and allocation compared with those which might be required solely for the preparation of reliable financial statements.

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<sup>57</sup> ISA (UK) 330, The Auditor's Responses to Assessed Risks, (Revised June 2016), para. 8.

<sup>58</sup> ISA (UK) 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment, (Revised June 2016).

83. For insurance transactions initiated by the insurer, the auditor considers the controls implemented for each material class of business and location, together with overall controls applied by the accounting function and management. Matters for consideration will include the procedures for the setting of and monitoring of compliance with guidelines for underwriting and product development, and controls over completeness of transactions and risks undertaken. Insurers often transact very large volumes of transactions which are subject to extensive IT controls, so the use of computer-assisted audit techniques may be appropriate.
84. The auditor of an insurer also has regard to the procedures implemented by the insurer to ensure the completeness, accuracy and reliability of information provided by third parties, including intermediaries and agents. The auditor assesses the effectiveness of management's controls implemented to ensure that all risks bound by agents under delegated authorities have been included. Procedures include reviewing the insurer's procedures for the approval of such arrangements and the monitoring of the performance of business introduced through such contracts. These may include inspections by the insurer or third parties of the agent's underwriting activities, records and reports to the insurer.
85. The auditor reviews the contractual terms, and assess the extent to which such agents are reporting transactions on a regular and prompt basis and whether the insurer has completely and accurately recorded the reported transactions in the accounting records and statistical databases. Specific consideration will be paid to the terms of the agent's remuneration to ensure for example that all profit commission and expenses recovery entitlements have been recognised.
86. Where significant insurance risks are underwritten through treaty reinsurance contracts, the nature and complexity of the risks written may differ substantially from those written by the insurer directly. The auditor ascertains the insurer's procedures for approving such contracts, whether relevant transactions are reported regularly and promptly (commonly monthly or quarterly), and whether the insurer has included all such transactions in the accounting records.
87. Reinsurers maintain records of all treaties and may receive regular statements from the cedant of premiums received, claims paid and other data relating to the treaty. The reinsurer may be reliant upon the cedant's statements to maintain accounting records of the underlying treaty transactions.
88. Although a reinsurer may have contractual rights to inspect a cedant's books, it is not uncommon for directors to construct the financial records of the reinsurer from cedant statements. The auditor may obtain evidence that controls in relation to treaty reinsurance exist to ensure that:
- (a) Statements from the ceding insurer are received and processed on a regular basis;

- (b) Statements are reconciled to the reinsurer's accounting records where appropriate; and
- (c) A procedure exists for the regular review of major treaty results.
89. An important aspect of an insurer's controls over completeness and accuracy of processing will often be its procedures for the reconciliation of balances with third parties, the settlement of transactions (including their correction where necessary) and the agreement and clearance of old items. Third parties will include policyholders, brokers, underwriting agents and reinsurers, and procedures may vary for each category. The auditor reviews the insurer's processes and monitoring procedures established to ascertain whether such reconciliations and settlements are up to date. The auditor pays particular attention to the use of suspense or similar accounts, and to whether they are reconciled and cleared regularly and promptly.
90. A significant issue in the audit of insurers is the assessment of whether or not contracts to which the insurers are party should be accounted for as contracts of insurance (or reinsurance). In forming this assessment accounting conventions may require consideration of the level of insurance risk transferred.
91. The auditor obtains sufficient, appropriate audit evidence that insurers have properly assessed the level of insurance risk for the purpose of determining whether material contracts or groups of contracts should be accounted for as insurance (or reinsurance), taking into account the applicable accounting requirements.
92. In evaluating the insurer's mechanism for assessing the level of insurance risk, the auditor may consider the following:
- The process adopted by the insurer.
  - The likelihood of loss falling to both insurer and reinsurer under different loss scenarios and the probability of occurrence of the scenarios selected for this exercise.
  - The cash flow implications under different loss scenarios.
  - Any penalty, default or adjustable clauses in the contract.
  - The existence and operation of any experience account.
  - The existence and operation of other arrangements, whether or not described as reinsurance, that have the effect of limiting the risk transferred by the reinsurance arrangement under review.

### **Reinsurance**

93. When considering the impact of the insurer's reinsurance arrangements on the financial statements the auditor obtains an understanding of the reinsurance programme,

including both facultative and treaty arrangements. The auditor assesses the procedures for the approval of reinsurance contracts, both in overall terms and in detail.

94. Reinsurance contracts can be complex, and a detailed understanding of individual significant contracts and their inter-relationship with others, as well as an understanding of the programme in total, will be necessary for the auditor to conclude whether the accounting treatment is appropriate and consistent with the substance of the transactions.
95. In addition to considering the controls on the purchasing of reinsurance, the auditor considers the controls exercised by the insurer to ensure that all reinsurance recoveries to which it is entitled have been identified, correctly calculated and collected. As with reinsurance cost, the auditor uses its detailed understanding of the relevant reinsurance contracts to assess whether the appropriate accounting treatment has been followed.
96. An important aspect of the uncertainty to which a particular insurer is exposed is the nature and extent of its reinsurance programme. The auditor considers the nature and coverage of any significant reinsurance programmes and, where material, the procedures adopted by the directors or managing agent to determine the financial stability of reinsurers used. The auditor normally considers the operation of significant reinsurance programmes by reviewing whether the risks ceded and the resulting premium and expense information are in accordance with the reinsurance contract. The auditor may also consider the procedures in place for ensuring that material claims or balances, if any, disputed by reinsurers are resolved. Evidence may be obtained by reviewing correspondence with reinsurers or intermediaries and considering the quality and timeliness of reconciliations of reinsurer balances.
97. The auditor also uses its understanding of the insurer's reinsurance protection programme to assess the extent to which it is appropriate to recognise credit for reinsurance recoveries within the technical provisions. In its consideration the auditor tests the matching of reinsurance recoveries against gross claims provisions to ensure consistency of treatment.

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

ISA (UK) 402 deals with the auditor's responsibilities relating to an entity using a service organization. The key objectives are to:

- (a) To obtain an understanding of the nature and significance of the services provided by the service organization 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.<sup>59</sup>

98. In common with other industries the outsourcing of functions to service organizations by insurers has become common place. Insurers and friendly societies often find this the most economical arrangement, typically involving functions such as investment management, custody of investments and payroll.
99. The relevant regulatory authorities deal with 'outsourcing' or 'delegation' arrangements quite extensively, including through the FCA Handbook and Solvency II implementation guidance. The FCA handbook defines outsourcing as 'the use of a person to provide customised services to a firm' (other than a member of the firm's governing body or an individual employed by the firm) or 'an arrangement of any form between a firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the firm itself'. In the context of insurance entities this means that the 'external delegation' of functions such as underwriting or claims handling fall within the definition of 'outsourcing', in the same way as more common arrangements such as customer call centres, IT or other back office functions.
100. The auditing standards define a 'service organization' as a 'third-party organisation (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting'.<sup>60</sup> The auditor, therefore, gains an understanding of the extent of outsourced functions and their relevance to the financial statements. The insurer is obliged by the FCA Handbook<sup>61</sup> to ensure that the auditor has appropriate access to data related to outsourced activities.
101. Whilst an insurer or friendly society may outsource functions to service organizations the responsibility for these functions remains that of the insurer, both from the perspective of

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59 ISA (UK) 402, para. 7.

60 ISA (UK) 402, para. 8e.

61 FCA Handbook, SYSC 8.1.8 (9).

the financial statement audit and in respect of regulatory requirements. The insurer 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.

102. 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 FCA or PRA.

## **ISA (UK) 450: EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT**

103. In the course of an audit of the financial statements of an insurance entity or friendly society, there may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole. This may be the case even though the misstatement may exceed the materiality level or levels applied in evaluating other misstatements. ISA (UK) 450 states that:

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

- (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence<sup>62</sup>

104. 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. Such qualitative considerations may be relevant when considering certain misstatements in respect of insurers. For example:

- A misstatement of technical provisions may give rise to an offsetting misstatement in reinsurance recoveries to the extent the misstated liabilities have been reinsured.
- A misstatement in respect of revenue from with-profits business may have no direct impact on income where income is determined by the amount of the bonus distribution.

105. Where liabilities of an insurer are determined directly by reference to the value of assets held (e.g. for unit linked business) any misstatement in such liabilities may be offset by a corresponding misstatement in the associated assets (and vice versa).

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62 ISA (UK) 450 (Revised June 2016), para.11a.

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

ISA (UK) 505 sets out the auditor's responsibilities in respect of external confirmation procedures. ISA (UK) 330 The Auditor's Responses to Assessed Risks specifically requires auditor's to consider whether external confirmation procedures are to be performed as substantive audit procedures.<sup>63</sup>

106. In respect of the audit of insurance entities, including friendly societies, external confirmations may not always provide useful audit evidence in relation to insurance balances due to the relative immateriality of individual policyholder balances or transactions. However, external confirmation procedures may be useful as part of the audit of:

- (a) Amounts receivable from reinsurers in respect of claims paid or payable by the entity; and
- (b) Premiums receivable from intermediaries.

107. Amounts receivable from reinsurers may comprise an insurer's calculation of amounts that will be recoverable from reinsurers in respect of the insurer's estimate of incurred claims. The relevant reinsurers are unlikely to be in a position to confirm amounts in relation to these claims until such time as the validity of these claims has been assessed, the amounts payable determined, and this has been communicated to and agreed by the relevant reinsurers. Therefore the relevant reinsurers may not be able to provide sufficient appropriate evidence in response to a confirmation request that includes such amounts. The auditor may, however, determine that confirmation would be an effective procedure in respect of individual material reinsurance recoveries where the reinsurer has agreed the amount involved but the balance has not yet been paid.

108. In deciding to what extent to use external confirmations in respect of premiums receivable from intermediaries, the auditor considers the assessed risk of misstatement together with the characteristics of the environment in which the insurer operates and the practice of potential respondents in dealing with requests for direct confirmation. For example where a captive insurer's premium income comprises solely an annual premium from its parent company and this is due at the year-end then this may be a significant balance and it may be assessed that the parent undertaking is likely to be able to respond to a confirmation request. In these circumstances the auditor may decide to seek positive confirmation from the parent undertaking. Conversely, where premiums receivable comprise a high volume of low value amounts which may be due from individuals or entities that do not have information systems that facilitate external confirmation, the auditor may decide that confirmation may not be an effective audit procedure and may seek to obtain sufficient appropriate evidence from other sources.

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63 ISA (UK) 330 (Revised June 2016), para. 19.

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

ISA (UK) 520 sets the responsibilities for auditors when using analytical procedures as a basis for the identification and assessment of risks of material misstatement; to obtain relevant and reliable substantive audit evidence; and to assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

109. There are a number of potential analytical relationships which may be relevant to the audit of an insurance entity or friendly society, and which the auditor may consider when complying with the requirements of this standard. They include, but may not be limited to the following circumstances:
- The deferral and matching principles applied by insurers mean that there are relationships between the movement in balance sheet items and specific items that affect income (for example deferred acquisition costs, claims provisions and unearned premiums provisions);
  - There are likely to be expected relationships between a number of income statement items such as written and earned premiums, incurred claims and earned premiums and premiums and claims gross and reinsurers' share thereof.
110. The nature of the insurance business means that data supporting financial reporting, and which may be critical to the successful completion of analytical procedures, may have been collected over a long period of time, drawn from legacy systems or simply a diverse range of current operational systems. Poor data management may have a significant impact on the operations of insurance businesses. For this reason the auditor considers the procedures necessary to place reliance on data used as part of analytic procedures – including the controls which underpin the integrity of that data.
111. Given the nature of insurance business, nonfinancial data plays a significant part in managing the pricing and reserving processes. The auditor may consider the usefulness of nonfinancial data such as policy numbers, sums assured, retention levels and claim numbers and their interrelation with financial data in designing analytical review procedures. In addition the auditor may consider measures relating to regulatory compliance – e.g. complaints handling and breaches of conduct of business rules, and operational risk measures – e.g. volumes of unreconciled items.
112. 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) 540: AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES**

ISA (UK) 540 is concerned with the audit of accounting estimates, including fair value estimates.

### **Technical provisions**

For most insurers and friendly societies, the estimation of technical provisions will involve relatively high estimation uncertainty because it will involve significant assumptions about future conditions, transactions or events that are uncertain at the time of the estimation. Changes in estimation approach are likely to have a significant effect on the profit or surplus figure in the financial statements.

113. When designing audit procedures to test how management made the technical provisions estimate, the auditor obtains an understanding of:

- (a) The policies for setting such provisions;
- (b) The complexity and nature of the models or measurement techniques used to estimate the technical provisions;
- (c) The source data;
- (d) The assumptions used to develop those provisions; and
- (e) Management's controls over the development of technical provisions.

114. Matters that the auditor may consider in obtaining an understanding of relevant controls over how management makes the technical provisions estimate include, for example, the experience and competence of those who make the estimates of the technical provisions, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to estimate technical provisions.
- The review and approval of technical provisions, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the insurer to the underlying transactions and those responsible for determining technical provisions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity (for example, in the case of a larger insurer, relevant segregation of duties may include an independent function responsible for estimating technical provisions).

- Where the insurer uses specific models for estimating technical provisions, specific policies and procedures around such models, for example, those established over:
  - The design and development, or selection, of a particular model for a particular purpose.
  - The use of the model, including any relevant testing of outputs.
  - Controls over access to the model.
  - The maintenance of and periodic revalidation of the integrity of the model.
  - Wider developments in the sector, or in the operations of the business, which might indicate that the model is no longer appropriate for the purpose intended.
  - The extent to which the entity retains individuals with the expertise to operate the model effectively.

115. As part of Pillar 2 of Solvency II, directive firms are required to demonstrate that where internal models are used in the calculation of the SCR that this is widely used in, and plays an important role in their system of governance, risk management system, decision making processes and the Own Risk and Solvency Assessment (ORSA). To the extent that common assumptions about the business underpin the calculation of the SCR, the presentation of the ORSA and technical provisions, auditors consider the consistency of these assumptions when assessing technical provisions in the statutory financial statements. Under Pillar 3, directive firms are also required to disclose in the ‘Valuation for Solvency Purposes’ section of the annual Solvency and Financial Condition Report (SFCR): *separately for each material line of business, a quantitative and qualitative explanation of any material differences between the bases, methods and main assumptions used by that undertaking for the valuation for solvency purposes and those used for their valuation in financial statements*. The auditor considers this disclosure, when available, when assessing technical provisions.

116. The models used to estimate the technical provisions are dependent upon the accuracy and completeness of financial and non-financial data and accordingly the audit procedures will need to address the effectiveness of management’s controls over the integrity, use and reliability of such data. As required by auditing standards the auditor exercises professional scepticism when evaluating and testing management’s controls, and the reasonableness of the assumptions being made.

117. The assumptions made by management are integral components of accounting estimates and are intended to provide a reasonable basis for the setting of the technical provisions. The objective of the audit procedures performed for the purpose of evaluating these assumptions is not to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. The auditor’s consideration of management’s assumptions is based only on information available to the auditor at the time of the audit. The auditor is not responsible for predicting future conditions,

transactions or events that, if they had been known at the time of the audit, might have significantly affected management's actions or management's assumptions underlying the technical provisions and related disclosures. However, the auditor is required to obtain an understanding of the assumptions made by management. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about loss adjustment expenses), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of the documentation, if any, supporting the assumptions. Assumptions may be made or identified by an expert to assist management in making the technical provisions. Such assumptions, when used by management, become management's assumptions.

118. The auditor applies its understanding of the assumptions made by management to assess their reasonableness, considering for example:

- Whether individual assumptions appear reasonable
- Whether assumptions are interdependent and internally consistent
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.<sup>64</sup>

119. For life insurers, the valuation of with-profits liabilities uses a range of estimation techniques. The provision will comprise both historic (most likely asset share based) and projected (option and guarantee) information. Options and guarantees are often valued

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64 ISA (UK) 540 (Revised June 2016), para. 13b & A78.

using stochastic modelling techniques. The auditor assesses whether regulatory requirements have been met and whether sufficient scenarios have been run. Any assertions regarding future management and policyholder actions also require careful consideration, including the extent to which management actions are supported by the Principles and Practices of Financial Management (PPFM)<sup>65</sup> or board resolution. Solvency II directive firms are also required to “establish a comprehensive future management actions plan, approved by the administrative, management or supervisory body of the insurance and reinsurance undertaking.”<sup>66</sup>

120. Solvency II Directive firms are required to establish an ‘actuarial function’ in accordance with the Solvency II framework. Non-directive firms are not required to establish such a function, but are likely to engage an actuary to perform a similar review of technical provisions. If an actuary has prepared a formal report on the technical provisions or on the financial soundness of a general insurance undertaking the auditor reviews the report to gain a better understanding of the scope of the work performed and of any limitations on any opinions expressed. If such a report has not been prepared, it is necessary for the auditor to understand the scope of the work carried out by the insurer’s actuary.
121. Given that the calculation of an insurer’s technical provisions is such a significant activity in the preparation of the insurer’s financial statements, once management has selected a specific estimation method, it is important that the insurer applies it consistently. If management has changed the method for calculating technical provisions, the auditor considers whether the method to which it has been changed provides a more appropriate basis of measurement, or that the change is supported by a change in the applicable financial reporting framework, or a change in circumstances.

For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK) 330<sup>67</sup>, 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.

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65 The requirement for with-profit firms to produce a PPFM, as well as the issues it must cover, can be found in COBS 20.3 of the FCA Handbook, <https://www.handbook.fca.org.uk/handbook/COBS/20/>.

66 COMMISSION DELEGATED REGULATION (EU) No .../. of XXX supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), Article 236 (3).

67 ISA (UK) 330 (Revised June 2016), para. 18.

(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.<sup>68</sup>

122. In obtaining an understanding of whether, and if so how, the insurer has assessed the effect of estimation uncertainty on the technical provisions, the auditor considers matters such as:

- Evaluating how, management has considered alternative assumptions or outcomes and why it has rejected them, or how it has otherwise addressed estimation uncertainty by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on the level of technical provisions.
- How management determines the ultimate technical provisions when analysis indicates that there may be a number of outcome scenarios.
- Whether management monitors the outcome of technical provisions made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

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. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statement. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.<sup>69</sup>

123. The review of the outcome or re-estimation of prior period accounting estimates may assist the auditor in identifying circumstances or conditions that could increase the uncertainty of a technical provision.

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

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68 ISA (UK) 540 (Revised June 2016), para. 15.

69 ISA (UK) 540 (Revised June 2016), para. 9.

constitute misstatements for the purposes of drawing conclusions on the reasonableness of accounting estimates.<sup>70</sup>

124. Management bias, whether unintentional or intentional, can be difficult to detect in a particular technical provision. It may only be identified when there has been a change in the method for calculating technical provisions 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. Although some form of management bias is inherent in subjective decisions, management may have no intention of misleading the users of financial statements. However, the intentional use by management of accounting estimates which are known to be unreasonable is fraudulent ISA (UK) 240, provides standards and guidance on the auditor's responsibility to consider fraud in an audit of financial statements.

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.<sup>71</sup>

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.<sup>72</sup>

125. Insurance specific financial reporting standards, which form part of the applicable financial reporting frameworks for insurers, take into account the inherent uncertainty within the insurance industry and the needs of users of financial statements regarding disclosure of estimation uncertainty. The auditor considers the required disclosure of estimation uncertainty by the applicable financial reporting framework and whether the disclosure proposed by management is adequate. In making this determination, the auditor considers whether adequate disclosure is given regarding the sensitivities associated with the significant assumptions underlying the technical provisions, in light of the materiality level established for the engagement.
126. Insurance specific financial reporting standards can require extensive narrative disclosures in the financial statements of insurers; for example, in relation to the nature and extent of risks arising from insurance contracts and the accounting policies applicable to establishing technical provisions in respect of them. In designing and

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70 ISA (UK) 540 (Revised June 2016), para. 21.

71 ISA (UK) 540 (Revised June 2016), para. 19.

72 ISA (UK) 540 (Revised June 2016), para. 20.

performing procedures to evaluate these disclosures the auditor obtains audit evidence regarding the assertions about presentation and disclosure described in paragraphs A124 and 124a of ISA (UK) 315. Guidance on the types of audit procedures that can be used for obtaining audit evidence can be found in paragraphs A14 to A25 of ISA (UK) 500.

127. Consideration of the adequacy of disclosure with regard to sensitivities of significant assumptions is of particular importance where the estimation uncertainty of technical provisions may cast significant doubt about the entity's ability to continue as a going concern. ISAs (UK) 570 and 706 establish standards and provide guidance in such circumstances.

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.<sup>73</sup>

128. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an estimate of the required technical provision 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 at least the difference between management's point estimate and the nearest point of the auditor's range.

### **Derivatives and other financial instruments**

129. Further relevant guidance on auditing financial instruments is provided in the FRC's Practice Note 23 *Special Considerations in auditing financial instruments* (PN23). PN23 includes guidance in respect of the requirements of ISA (UK) 540 in obtaining an understanding of the applicable financial reporting framework. In the context of an insurance entity, and the solvency requirements of the prudential regulation regime, the auditor may consider whether an entity's financial instruments "are part of a structured arrangement designed to achieve a particular accounting or regulatory purpose" when obtaining such an understanding.<sup>74</sup> Further, it may be appropriate for the auditor's understanding of relevant industry and regulatory factors in accordance with ISA (UK) 315 to include inquiry of management as to whether there have been discussions with supervisors or other regulators about its policies in respect of financial instruments. It may also be appropriate for the auditor to discuss matters related to the entity's use and disclosure of financial instruments directly with the regulator.<sup>75</sup>

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73 ISA (UK) 540 (Revised June 2016), para. 18.

74 Practice Note 23 *Special Considerations in auditing financial instruments* (PN23), para.76.

75 Practice Note 23 *Special Considerations in auditing financial instruments* (PN23), para.76-1 and 76-2.

130. Under Solvency II, directive firms are also required to prepare and disclose significant qualitative and quantitative information to the regulator, and in annually published SFCRs, on significant risk concentrations, including the use and management of derivatives and other financial instruments. Where this information is available, the auditor considers it when assessing relevant financial statement disclosures.
131. In respect of insurers the valuation of derivative and other financial instruments which are not traded 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 insurer. Controls and substantive testing could include focusing on:
- Valuation technique approval and testing procedures used by the insurer.
  - The independence of review, sourcing and reasonableness of observable market data and other parameters used in the valuation techniques.
  - Calibration procedures used by the insurer 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 insurer 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.
  - The appropriateness and validity of the particular valuation technique applied to particular financial instruments.
  - The appropriateness and validity of the parameters used by the insurer to designate an instrument as substantially the same as the financial instrument being valued.
  - Mathematical integrity of the valuation models.
  - Access controls over valuation models.

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

132. In order to comply with ISA (UK) 550, the auditor is required to assess the risk that material undisclosed related party transactions may exist. It is in the nature of insurance business, including friendly societies conducting insurance business in the UK, 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.
133. Insurers are likely to have a particularly wide range of contractual arrangements because the nature of insurance is to spread risk. The directors will, in particular, need to consider how best to obtain information on the interests of related parties in policies issued and in reinsurance arrangements. In capturing this data, insurers may decide to establish criteria for evaluating materiality to the individuals concerned; the policies are, in most cases, unlikely to be material to the insurer. The auditor will need to obtain an understanding of the controls that management has established to identify, account for and disclose such related party transactions.
134. Insurers are required to report to the FCA and PRA changes in control (in some instances with the prior approval of the regulator), changes in circumstances of existing controllers and changes in entities that are closely linked to the firm. In addition, there are annual reporting obligations in respect of controllers and entities that are closely linked to the firm. As a result, it will 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 UK GAAP and 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.
135. 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).
136. The auditor inspects, evaluates and obtains audit evidence regarding the authorisation and approval of and significant reinsurance or other funding arrangements with related parties entered into outside the entity’s normal course of business. In gaining an understanding of the business rationale of such transactions that auditor makes appropriate enquiries of management.

### **Additional Considerations in respect of Friendly Societies**

137. Schedule 11 of the 1992 Friendly Societies Act applies sections 62-69 of the Building Societies Act 1986 (the 1986 Act) concerning directors’ loans and transactions to friendly

societies. In the context of friendly societies, the term “director” is applicable to members of the Committee of Management.

138. Section 65 of the 1986 Act lists a number of transactions which a friendly society is either not allowed to make or which are subject to strict limitations. Section 68 of the 1986 Act requires the maintenance of a Register by the society recording details of all permitted transactions with directors and connected persons. Extracts from this Register are required to be included in an unaudited annual statement, and to be made available to the members and to the regulator. Friendly societies are also required to disclose in their financial statements certain details of loans outstanding at the year-end to Committee of Management members and connected persons.
139. In order to comply with statutory requirements, friendly societies should have appropriate systems to ensure that all such loans and transactions are identified, controlled and properly disclosed, both in the Registers and in the financial statements. In order to fulfil these requirements societies normally require each Committee member to confirm, in writing and on an annual basis, the existence and amount of any such matters: negative returns are usually required for completeness.
140. The auditor considers whether loans and transactions recorded by the society in accordance with the requirements of Sections 65, 68 and 69 of the 1986 Act fall within the related parties criteria under accounting standards and legislation for disclosure in the financial statements.
141. If the auditor become aware of breaches of the statutory requirements relating to loans and other transactions by individual Committee members, including a failure to notify the society of any relevant matters, such a matter may be considered to trigger the statutory duty to report to the regulator.

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

ISA (UK) 560 deals with the auditor's responsibilities in respect of events occurring between the date of the financial statements and the date of the auditor's report. The auditor is required to perform audit procedures designed to obtain sufficient appropriate 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.<sup>76</sup>

142. Matters specific to insurance companies and friendly societies conducting insurance business in the UK which the auditor may consider in its review of subsequent events include:

- An evaluation of the impact of any material subsequent events on the capital requirements for both Solvency II and non-Directive insurers.
- An assessment of the influence of new information received relevant to claims provisions.
- An assessment of the impact of any developments in doubtful reinsurance recoveries since the balance sheet date.
- An assessment of the impact of any regulatory developments since the balance sheet date.
- A review of relevant 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.

143. ISA (UK) 560 establishes requirements for situations when facts become known to the auditor:

- (a) After the date of the auditor's report but before the financial statements are issued; and
- (b) After the financial statements have been issued

that may have caused the auditor to amend the auditor's report. If the auditor examines the regulatory return of an insurer, or in the case of entities subject to Solvency II

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76 ISA (UK) 560, para. 6.

requirements the Solvency and Financial Condition Report (SFCR), subsequent to the issuance of its report on the financial statements, the auditor may become aware of subsequent events which, had they occurred or been known of at the date of its report on the financial statements, might have caused the auditor to issue a different report. In such cases the auditor and the directors consider whether the financial statements need to be revised following the statutory provisions relating to the revision of company annual financial statements and directors' reports set out in section 454 of CA 2006 and The Companies (Revision of Defective Accounts and Reports) Regulations 2008.

Where the auditor concludes that this step is appropriate, the matter concerned is likely to be of material significance to the regulator and so gives rise to a duty to report to the regulator.

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

ISA (UK) 570 was revised in June 2016 to reflect changes arising from the EU Audit Regulation and Directive, and from changes to international standards issued by the International Auditing and Assurance Standards Board (IAASB).

The objectives set out in the revised standard are set out below:

ISA (UK) 570 (Revised June 2016)
Objectives: Paragraph 9
(a) To obtain sufficient appropriate audit evidence regarding, <b><u>and conclude on</u></b> , the appropriateness of management's use of the going concern basis of accounting 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) <b><u>To report</u></b> in accordance with this ISA (UK)

144. With reference to insurance companies or friendly societies, specific audit procedures may include:

- Reviewing the means whereby the board of directors and senior management of an insurer satisfy themselves that the insurer will have capital in excess of its capital resources requirement for the foreseeable future, including a review of the insurer's capital assessments prepared for regulatory purposes (whether under Solvency II or other).
- Considering whether the key assumptions underlying the budgets and/or forecasts appear appropriate in the circumstances. Key assumptions will normally include claims projections (numbers, cost and timing), the profitability of business written, investment performance, the volume of new business and the level of provisions required.
- The auditor may wish to consider differences between the assumptions and data underpinning regulatory 'technical provisions' and those provisions included in the financial statements.
- Considering the liquidity of funds to enable the insurer to meet claims and other liabilities as they fall due.
- Reviewing correspondence with the regulators, and considering any actions taken (or likely to be taken) by the regulators.
- Considering the implications of changes in government policy.

- Considering the potential costs of settling claims, (for example uncertainty resulting from judicial decisions) and additional provisions (for example product mis-selling).
- Reviewing any financial condition report produced by the holder of the actuarial function and other actuarial reports.

145. If the auditor has any doubts as to the ability of an insurer or Friendly Society to continue to adopt the going concern basis of accounting, the auditor considers whether it ought to make a report direct to the FCA or PRA.

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

146. ISA (UK) 250 Section A and ISA (UK) 550 require the auditor to obtain written confirmation in respect of:

- (a) The completeness of disclosure to the auditor of all known instances of non-compliance or suspected non-compliance with laws and regulations (including breaches of FSMA 2000, FCA/PRA rules, the Money Laundering Regulations, other regulatory requirements or any other circumstance that could jeopardise the authorisation of the firm under FSMA 2000) whose effects should be considered when preparing financial statements)<sup>77</sup>; and
- (b) The completeness of information provided regarding the identity of related parties, related party relationships and transactions, and the appropriateness of related party disclosures in the financial statements.<sup>78</sup>

147. If, in addition to the requirements in other ISAs (UK) for the auditor to request written 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 specific assertions this ISA (UK) requires that the auditor request such other written representations. For all insurers and friendly societies, it may be appropriate to obtain a specific representation confirming that full disclosure has been made in respect of any side letters, any multiyear reinsurance contracts or any reinsurance contracts with unusual adjustable features, as well as the adequacy of the claims provision and the IBNR. The auditor may also obtain written representations regarding, for example:

- The reasonableness of significant assumptions used by the entity in calculating technical provisions.
- All correspondence with regulators having been made available to the auditor.

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<sup>77</sup> ISA (UK) 250 – Section A (Revised June 2016), para. 16.

<sup>78</sup> ISA (UK) 550, para. 26.

## **ISA (UK) 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.<sup>79</sup>

### **Friendly Societies: Reports to Committee of Management**

148. Auditor's reports for friendly societies are required by Section 73(4A) of the 1992 Act to include an opinion concerning the consistency of the financial statements with the Report of the Committee of Management and the latter's compliance with the 1992 Act and the regulations made under it.

149. In connection with its opinion on the Report of the Committee of Management, the auditor considers whether all of the information called for by Sections 71 and 71A of the Friendly Societies Act 1992 and by Schedule 8 of the Accounts Regulations has been provided. In particular the regulations require the Committee of Management to present a fair review of the activities of the society during the financial year. The Report should give a balanced view of difficulties encountered and issues facing the society as well as achievements and ambitions. The information disclosed includes a Business Review, principal risks and uncertainties and key performance indicators.

150. As the auditors are required to confirm that the Report has been made in accordance with the regulations they need to consider whether it presents a fair review of the activities, taking into account the information and understanding that they have gained in the course of their work on the financial statements and returns and bearing in mind that these Reports are sometimes used by management as a "marketing tool" for the benefit of the society.

### **Non-directive Friendly Societies and registered branches**

151. Non-directive societies and registered branches are required to prepare accounts under the abbreviated format of Schedule 7 of The Friendly Societies (Accounts and Related Provisions) Regulations 1994. Unlike the position for directive societies, this format contains no reference to technical provisions. However, this does not preclude the society or branch from providing additional analysis of the benefit funds to show the amount representing technical provisions. Indeed this disclosure will normally be required for the financial statements to show a true and fair view.

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<sup>79</sup> ISA (UK) 700 – (Revised June 2016), para. 6.

<sup>72</sup> Practice Note 20 (Revised) (January 2017)

### **Mutual Insurers: Corporate Governance**

152. Many mutual insurers voluntarily adhere to either the UK Corporate Governance Code or the annotated version the code periodically published by the Association of Financial Mutuals (AFM). The AFM recommends that members adhere to this a Code. Although any review responsibility is determined by the terms of the auditor's engagement, rather than by law or regulation, it nevertheless falls within the ambit of the requirements in paragraph 43-1 of ISA (UK) 700. (See paragraph A58-1-A58-3 of that ISA). Applying the Annotated Code is effectively voluntary compliance with the UK Corporate Governance Code, and therefore the relevant requirements of ISA (UK) 701 apply.

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

ISA (UK) 705 sets out the auditor's responsibilities in respect of modifications to opinions in the Auditor's Report. The ISA establishes three types of modified opinion – a qualified opinion, an adverse opinion, and a disclaimer of opinion. These requirements are in addition to those set out in ISA (UK) 700.

153. The basis on which an Insurer's or Friendly Society's financial statements are prepared takes account of the extent of the inherent uncertainty in the types of insurance business it underwrites. Uncertainties arising from insurance contracts may include:
- General uncertainties arising where the outcomes for provisioning are within a range which is not unusual for the nature of the business underwritten.
  - Specific uncertainties which are material and subject to a very wide range of outcomes.
  - Uncertainties where the financial reporting framework does not require a provision to be established but where disclosure of a contingent liability may be appropriate.
154. If the auditor concludes that the technical provisions are materially misstated or that the disclosures relating to those provisions and the relevant uncertainties are inadequate or misleading and concludes that the effect is material, but not pervasive, to the view given by the financial statements, it is required to express a qualified opinion.
155. If the auditor concludes that the effect is both material and pervasive it is required to express an adverse opinion. If the auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive the auditor is required to disclaim an opinion.

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

ISA (UK) 706 deals with Emphasis of Matter and Other Matter paragraphs in the Independent Auditor's Report:

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.<sup>80</sup>

156. The standard notes in application material that 'widespread use' of such paragraphs 'diminishes effectiveness' of the auditor's communication of such matters.<sup>81</sup>

157. Determining technical provisions is subject to a high degree of inherent uncertainty and frequently involves significant assumptions, estimations and statistical techniques. When reporting on an insurer's financial statements, including friendly societies conducting insurance business in the UK, the auditor evaluates whether such uncertainties fall within the category of significant, and so require to be disclosed in its report. In making this evaluation, the auditor takes into account whether the financial statements provide a user with general information about the types of business written such that the overall level of inherent uncertainty likely to apply to those financial statements is apparent.

158. The fact that an auditor of an insurer has identified that the high estimation uncertainty associated with the calculation of technical provisions gives rise to a significant risk does not automatically require the auditor to include an emphasis of matter paragraph in its auditor's report to draw attention to the financial statement note that describes the uncertainties inherent in the technical provisions.

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80 ISA (UK) 706 (Revised June 2016), para. 6. Note that the guidance at paragraphs A1-A3 of ISA (UK) 706 sets out the relationship between additional communications in the auditor's report in accordance with this ISA (UK) and a Key Audit Matters section in accordance with ISA (UK) 701.

81 ISA (UK) 706 (Revised June 2016), para. A6.

## **ISA (UK) 720: – THE AUDITOR’S RESPONSIBILITIES RELATING TO OTHER INFORMATION**

ISA (UK) 720 deals with the auditor’s responsibilities in respect of ‘other information’.

159. Insurance companies undertaking long-term business may include supplementary financial statements prepared on an alternative basis to that used in drawing up the financial statements. Without adequate explanation, such supplementary financial statements may appear inconsistent with the audited financial statements. The requirements and application material in ISA (UK) 720 set out how the auditor discharges its’ responsibilities in respect of other information in these circumstances. The auditor also considers whether an adequate explanation of the assumptions and different methodology has been provided in the annual report, and if not, it considers including an “Other matter” paragraph in its report on the financial statements drawing attention to the inadequacy of the explanation.
160. Supplementary financial statements showing performance arising on long-term business calculated on an alternative basis are prepared using different assumptions and methodologies from those applied in preparing the financial statements. There are many aspects of the supplementary statements not affected by the alternative assumptions and methodologies and where material the auditor considers whether they are treated consistently in both the financial statements and the supplementary financial statements. For those material items where different assumptions and methodologies are applied to the same data to produce the supplementary statements the auditor considers whether consistent data has been used.
161. The auditor reads the supplementary financial statements in the light of knowledge acquired during the audit and considers whether there are any apparent misstatements therein. The auditor is not expected to verify or audit the information contained in the supplementary financial statements.
162. The work of the auditor in reporting to the directors on supplementary financial statements prepared on the alternative method of reporting long term business is outside the scope of this Practice Note.
163. From 1 January 2016, under Solvency II, many insurers will also be required to publish a Solvency and Financial Condition Report (SFCR), elements of which will be subject to a separate external assurance opinion. PRA rules require that where the auditor of the statutory financial statements is also the auditor the SFCR, then they need to consider the consistency of information in ‘other information’ for the SFCR with evidence and knowledge obtained in the course of the audit of the statutory financial statements.

## **CONSIDERATIONS RELATING TO WORKING WITH SPECIALISTS AND EXPERTS**

### **Introduction**

164. In the course of an audit of an insurance entity, the auditor will consider the need for specialist skills or knowledge in order to obtain sufficient appropriate audit evidence. In the insurance sector this is likely to include the audit of those parts of the financial statements which are derived using actuarial techniques and assumptions (technical provisions for example) or in respect of taxation. The engagement partner remains responsible for the quality of the audit and:

*....shall be satisfied that the engagement team, and any auditor's experts who are not part of the 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.<sup>82</sup>*

165. As well as ensuring that the engagement team has an appropriate level of knowledge of the industry and its corresponding products and business streams, the engagement partner also satisfies themselves that the members of the engagement team have sufficient knowledge of the regulatory framework within which insurers operate commensurate with their roles on the engagement. They also ensure for example that the team includes members with actuarial expertise or has access to external actuarial expertise appropriate to the entity's insurance business.

166. The PRA's Supervisory Statements in respect of the audit of regulatory reporting for Directive and non-Directive firms sets out the expectation in certain cases that auditors will 'obtain and pay due regard to' the work of a suitably qualified actuary.

167. The level of involvement of an actuary in the audit process will depend on matters such as the level of expertise of other members of the audit team, the availability of independent actuarial advice to the insurer, and the nature and complexity of the audit issues. They may be used in the initial assessment of the level of risk of each financial statement caption, in assessing the effectiveness of the control environment, in establishing the audit procedures to be adopted and in obtaining and assessing the audit evidence obtained.

168. In some cases a suitably qualified individual or individuals, often employed by the audit firm, may be included within the audit engagement team as either 'specialists' or 'internal

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82 ISA (UK) 220 (Revised June 2016), para. 14.

experts'. Their work is fully integrated into and documented within the audit file.<sup>83</sup> Where an individual or individuals providing actuarial expertise are treated as 'auditor's experts' then the requirements and guidance contained within ISA (UK) 620 (Revised June 2016) *Using the Work of an Auditor's Expert* apply. An 'external expert' is not considered to be part of the engagement team, and their working papers are therefore not required to be fully integrated into the audit file. ISA (UK) 620 sets out the documentation requirements in respect of 'external experts'.

### **Auditor's internal and external experts**

169. ISA (UK) 620 (Revised June 2016) sets out the auditor's responsibilities in respect of using the work of an auditor's expert. An auditor's expert is defined as:

*An individual or organization 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.*<sup>84</sup>

170. It is a matter of professional judgement whether the actuarial expertise being employed in support of the audit is in a 'field other than accounting or auditing', and therefore whether the requirements of ISA (UK) 620 apply. 'Expertise in another field' other than accounting or auditing 'may' include expertise in relation to, "the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans."<sup>85</sup> The extent to which an individual with actuarial knowledge conducts audit work on the financial statement disclosures, as distinct from providing advice on actuarial methods and assumptions, is important in assessing whether they are an 'expert' or a 'specialist'.

171. Where the auditor decides to use an actuary as an auditor's expert in relation to the audit of technical provisions, the auditor assesses the following:

- (a) The professional competence and capabilities of the actuary, taking into consideration its professional qualifications, experience and reputation in the market in which the insurer operates;
- (b) The objectivity of the actuary including whether the actuary is connected in some way to the insurer e.g. being financially dependent on the insurer or having a financial interest in the insurer; and
- (c) The scope of the work to be undertaken and degree of reliance that the auditor can place thereon.

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83 ISA (UK) 220 (Revised June 2016), para. 7d.

84 ISA (UK) 620 (Revised June 2016), para. 6a.

85 ISA (UK) 620 (Revised June 2016), para. A1.

172. The auditor seeks to ensure that an actuary engaged as an auditor's expert, although guided by its own profession's standards and guidance and by FRC technical standards (TASs), designs and performs its work to provide the auditor with work that fully meets the objectives agreed between the auditor and the actuary.
173. Where the actuary is an internal expert (i.e. a partner or staff, including temporary staff, of the auditor's firm or a network firm), the auditor will be able to rely on its firm's quality control systems, recruitment and training to determine the actuary's capabilities and competence, rather than having to evaluate them for each audit engagement (unless information provided to the auditor suggests otherwise).
174. Regardless of whether the actuary is an auditor's internal or external expert, ISA (UK) 620 requires the auditor to agree with the actuary:
- (a) The nature, scope and objectives of the actuary's work.
  - (b) The respective roles and responsibilities of the auditor and the actuary;
  - (c) The nature, timing and extent of communication between the auditor and the actuary, including the form of any report to be provided by the actuary; and
  - (d) The need for the actuary to observe confidentiality requirements.
175. Where appropriate, such agreement is in writing. An agreement between the auditor and an auditor's external actuarial expert will often be in the form of an engagement letter.
176. In addition the auditor may wish to arrange to have access to the working papers produced by any actuary who is an auditor's external expert.
177. The auditor evaluates the actuary's working papers to determine whether:
- (a) The actuary's findings are relevant and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures;
  - (b) The methods and assumptions used by the actuary are relevant and reasonable in the circumstances; and
  - (c) The source data used by the actuary is relevant, reasonable, complete and accurate.
178. Although the auditor does not have the same expertise as the actuary this does not preclude the auditor from challenging the actuary's findings.
179. If the actuary's findings are not consistent with other audit evidence, the auditor attempts to resolve the differences by either agreeing with the actuary on the nature and extent of further work to be performed by the actuary or by applying additional audit procedures. If the auditor is not satisfied that it has obtained sufficient appropriate audit evidence to

support the audit opinion and there is no satisfactory alternative source of audit evidence, the auditor considers the implications for the auditor's report.

180. Where the auditor uses an auditor's expert, such as an actuary, as part of the audit, the auditor remains solely responsible for the audit of the insurer's financial statements.

### **Audit documentation**

181. If the auditor uses internal actuarial specialists or experts within the engagement team to assist in the audit process, their working papers form part of the audit working papers. (This would also be the case where an actuary is included with the audit engagement team performing the audit of published or private regulatory reports).
182. Where external actuarial 'auditor's experts' are engaged by the auditor (in practice usually external actuaries not directly employed by the audit firm), then:

*The auditor shall document any request for advice from an auditor's expert, together with the advice received.*<sup>86</sup>

### **Audit evidence**

183. For all insurers, where the work of those with expertise in relation to the actuarial calculation of liabilities is used in the preparation of financial statements then those performing that work are likely to be a management's expert. ISA (UK) 500 states that:

If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes

- (a) Evaluate the competence, capabilities and objectivity of that expert;
- (b) Obtain an understanding of the work of that expert; and
- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.<sup>87</sup>

184. Where the work of management's actuarial expert is to be used as audit evidence by the auditor of an insurer, the auditor performs the procedures set out in ISA (UK) 500 paragraph 8. In performing those procedures the auditor may use an auditor's actuarial expert.
185. In assessing the competence, capability and objectivity of a management's actuarial expert and the appropriateness of that expert's work as audit evidence the auditor has

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<sup>86</sup> ISA (UK) 620 (Revised June 2016), para. 15D-1.

<sup>87</sup> ISA (UK) 500, para. 8.

regard to the relevant standards that apply to the expert and its work. In particular, the auditor evaluates the extent to which data used by management's actuarial expert has been derived from sources that have been the subject of audit testing and whether they are the same sources as used by the insurer in preparing the financial statements. TAS 100 includes the following requirements of actuaries in respect of data:

*Data used in technical actuarial work shall be appropriate for the purpose of that work so that users can rely on the resulting actuarial information.*

*Communications shall describe the data used in the technical actuarial work, the source of the data, the rationale for the selection of the data, whether checks and controls have been applied any material uncertainty in the data, and the approach taken to deal with that uncertainty.*

*Communications shall state any limitations in the actuarial information resulting from the use of insufficient or unreliable data and provide an indication of their impact on the actuarial information.*

#### **Technical actuarial standards**

186. The Institute and Faculty of Actuaries (IFoA) requires compliance with the FRC's Technical Actuarial Standards (TASs). All technical actuarial work done in relation to the UK operations of entities, as well as to any overseas operations which report into the UK, within the context of UK law or regulation fall within the geographical scope of these standards.

187. In the course of complying with the various requirements of auditing standards when working with actuaries, whether as specialists, auditor's or management's experts, auditors may wish to consider the scope, principles and requirements of the FRC's actuarial standards. TAS 100: Principles for Technical Actuarial Work supports the reliability objective that "the users for whom actuarial information is created should be able to place a high degree of reliance on that information's relevance, transparency of assumptions, completeness and comprehensibility, including the communication of any uncertainty inherent in the information". It does this by setting out key high level principles for actuaries covering:

- Judgement
- Data
- Assumptions
- Models
- Communications
- Documentation

188. TAS 200: Insurance sets more detailed provisions specifically in respect of actuarial work in the insurance sector, including regulatory reporting related to Solvency II. Specific provisions which relate to the insurance sector are set out to support the principles in TAS 100, including for example work in respect of risk modelling underlying the calculation of regulatory capital requirements and the Own Risk Solvency Assessment (ORSA) Where actuaries are involved with audit and assurance engagements then the TAS sets provisions in respect of:

- Scoping the engagement
- Professional scepticism
- Communications

## **SECTION 5: THE AUDIT OF FINANCIAL STATEMENTS: ADDITIONAL CONSIDERATIONS RELATING TO LLOYD'S**

The Society of Lloyd's is a unique institution with its own internal governance and financial reporting arrangements. This section of the Practice Note is concerned with additional considerations for auditors of Lloyd's Syndicates financial statements (other than those required by the Society for regulatory reporting purposes) when conducting an audit in compliance with ISAs (UK). Where no special considerations arise from a particular ISA (UK), no material is included.

Guidance on the audit of regulatory reports is included within the Solvency II directive firms part of this Practice Note.

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

1. Further matters specific to Lloyd's syndicates and Lloyd's corporate members which may be dealt with in the engagement letter include:
  - The responsibilities of the directors of the managing agent or Lloyd's corporate member to keep Lloyd's informed about the affairs of these businesses.
  - The auditor's additional duty to report matters to the Council of Lloyd's of which it has become aware in its capacity as auditor which may be of material significance to Lloyd's in its capacity as market supervisor.
  - The auditor's duty to provide access to its working papers to the Council of Lloyd's in certain circumstances.
2. The engagement letter for a Lloyd's syndicate also refers to the aspects of the auditor's responsibilities, as set out in the Audit Arrangements Byelaw ("AAB")<sup>88</sup>, as the syndicate's "recognised accountant", namely:
  - (a) To report on the syndicate's financial statements and related matters;
  - (b) To report on any syndicate Annual Return as required by or under the Solvency and Reporting Byelaw; and
  - (c) As reporting accountant, if appointed by the Council of Lloyd's to report on other specified matters.

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88 <http://www.lloyds.com/the-market/operating-at-lloyds/regulation/acts-and-byelaws/lloyds-byelaws>

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

3. Examples of fraud by directors or employees of a managing agent include fraudulent recharges of agency expenses to managed syndicates and fraudulent misallocation of transactions to different years of account within those syndicates. Instances of suspected or actual fraud may involve breaches of specific requirements relating to syndicates and their managing agents as prescribed by Lloyd's in its capacity as market supervisor, and are likely to be regarded as being of material significance. Syndicate auditors have a duty to consider reporting all such instances to the Council of Lloyd's without delay in accordance with their undertaking given to Lloyd's. Guidance on such reporting is contained in the section on ISA (UK) 250 Section B below.

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

4. For Lloyd's syndicates, prudential supervision of the Lloyd's market as a whole and of managing agents is carried out by the PRA. Additional supervision of syndicates and managing agents is conducted by Lloyd's. Ongoing prudential supervision of the Lloyd's market is carried out by the PRA on a similar basis to insurance companies including the review of regulatory returns for the market as a whole.
5. In the context of Lloyd's syndicates, and their management, the principal laws and regulations are those relevant to insurers as set out above and in addition the requirements prescribed by the Council of Lloyd's, non-compliance with which may reasonably be expected to result in Lloyd's exercising its powers of intervention so as to require the syndicate to cease accepting new business and procure the close of existing business on an orderly basis into a third party.
6. The process for prudential supervision of the market means that Lloyd's centrally has responsibility for reviewing and agreeing with the managing agent for each syndicate an appropriate amount of prudential capital requirements and for determining how those requirements are to be resourced.
7. In the case of Lloyd's syndicates that undertake business outside the UK, Lloyd's coordinates compliance with the requirements of overseas regulatory authorities, and incorporates relevant provisions as necessary in its own regulatory requirements, thus supporting a global operating licence. The auditor of a Lloyd's syndicate that undertakes business overseas therefore does not need to make a separate assessment of the impact of local laws and regulations over and above those specified by Lloyd's.

**ISA (UK) 250: SECTION B – THE AUDITOR’S STATUTORY RIGHT AND DUTY TO REPORT TO REGULATORS OF PUBLIC INTEREST ENTITIES AND REGULATORS OF OTHER ENTITIES IN THE FINANCIAL SECTOR**

**Lloyd’s syndicates**

8. The auditor of a syndicate needs to consider whether it is under a duty or right to report on a particular matter to the regulator, to the Council of Lloyd’s or to both.
9. The duty to report matters of material significance applies to all engagements carried out by recognised accountants. Recognised accountants are not required to carry out procedures to detect matters of material significance. This applies even when the recognised accountant is reporting on specific issues under paragraph 13 of the AAB<sup>88</sup> such that the focus of the work undertaken is very narrow.
10. The key factor in determining when a duty arises is the existence of circumstances that would either lead to suspension of authorisation to operate in the Lloyd’s market or that warrant use of Lloyd’s power of intervention in an individual entity’s conduct of business.
11. Under paragraph 6(6) of the AAB, any appointment of a recognised accountant shall include the consent and waiver provisions set out in Schedule 3 to the AAB<sup>88</sup>.<sup>88</sup> These require the syndicate’s managing agent to acknowledge and declare that no duty which the recognised accountant might owe to the syndicate or managing agent concerned would be contravened by the recognised accountant communicating in good faith to the Council any information in relation to a matter of which it has become aware in the ordinary course of work undertaken to fulfil its responsibilities as syndicate auditor or reporting accountant and which it considers is relevant to any function of the Council under the Lloyd’s Act 1982 or any byelaws made thereafter.
12. The undertaking given by the recognised accountant as set out in paragraph 4(3) of Schedule 2 of the AAB<sup>88</sup> provides that the recognised accountant undertakes to report to the Council of Lloyd’s without delay information of which it becomes aware in the ordinary course of performing either work undertaken to fulfil its audit responsibilities or work undertaken to fulfil its responsibilities as reporting accountant for a syndicate when in its opinion there is reasonable cause to believe that:
  - (a) The authorisation of the syndicate or managing agent could be withdrawn; or
  - (b) There is or may be a failure to fulfil relevant criteria of sound and prudent management which is or may be of material significance to Lloyd’s in determining whether any of its powers of intervention should be exercised; or
  - (c) There is or may be breach of the provisions of the Lloyd’s Acts 1871 to 1982 (or related byelaws or regulations) which is likely to be of material significance to Lloyd’s, such that its powers of intervention should be exercised; or

- (d) The continuous functioning of the syndicate or managing agent may be affected; or
- (e) The recognised accountant concludes that it cannot issue its report without qualifying its opinion.
13. In accordance with the undertaking given in the form set out in Schedule 2 to the AAB, the recognised accountant agrees to the extent that it may do so lawfully and ethically, to provide the Council with such information, documents and explanations in relation to matters which it has a duty to report of which it has become aware.
14. Taken together, the consent and waiver given by the managing agent of the syndicate and the undertaking given by the recognised accountant provide that a recognised accountant is able to communicate to the Council on any matters which, in the opinion of the recognised accountant, is or may be relevant to any function of Lloyd's as regulator relating to the entity's affairs arising out of the work carried out to fulfil responsibilities as syndicate auditor or reporting accountant. However, the recognised accountant is not protected from any breach of duty if, in making a report to the Council, the reporting accountant does not act in good faith. Accordingly, recognised accountants may wish to take appropriate legal or other professional advice before taking the decision whether, and if so, in what manner, to report to the Council.
15. Furthermore, the recognised accountant undertakes to report information of which it becomes aware in the ordinary course of performing the work carried out to fulfil responsibilities as syndicate auditor or reporting accountant which relates to any other entity regulated by the Council. This extends to any other entity having close links arising from a control relationship with the entity in relation to which the recognised accountant is performing that work.
16. If the recognised accountant, after becoming aware of a matter giving rise to a statutory duty to report, fails to report either without delay or at all, the Council can take action under paragraph 5(3) of the AAB<sup>88</sup> to remove them from the list of recognised accountants. Action could also be taken by the recognised accountants' own regulatory body.
17. The Council accords particular importance to timely notification of matters giving rise to such a report to the Council by recognised accountants. ISA (UK) 250 Section B acknowledges that recognised accountants will normally seek evidence to assess the implications of a suspected breach before reporting a matter. Once they have identified information as being subject to the duty to report, ISA (UK) 250 Section B requires them to bring it to the attention of the regulator without delay. A recognised accountant may fail to discharge its duty to report to the Council if it waits until giving its formal opinion on the financial statements of a syndicate, or (in its capacity as reporting accountant on syndicates appointed under paragraph 13 of the AAB)<sup>88</sup> on other ad hoc reports, or if

they agree to delay making a report until management has had the opportunity to take remedial action.

18. The auditor of a Lloyd's syndicate is required under paragraph 9 of the AAB<sup>88</sup> to give notice to Lloyd's of its resignation, removal or retirement and under paragraph 10 of the AAB<sup>88</sup> such notice shall be accompanied by a statement signed by the auditor to the effect that there are no circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the members of the syndicate or to the managing agent or by a statement by the auditor specifying all such circumstances. In addition the auditor of a Lloyd's syndicate is required to notify the regulator of its resignation, removal or retirement as set out above.

### **Lloyd's corporate members**

19. Auditors of Lloyd's corporate members are required by the Lloyd's Membership Byelaw to give an undertaking to Lloyd's that includes the following clause: "The auditor undertakes to use its best endeavours, to the extent that it may do so lawfully and ethically, having regard to any relevant guidance on confidentiality to provide to the Council such information or opinions in relation to matters of which it has become aware in its capacity as auditor of the Lloyd's corporate member for the purpose of the exercise by the Council of powers contained in Lloyd's Acts 1871 to 1982 or in byelaws or regulations made thereunder whether or not in respect to a request by or under the authority of the Council. Therefore, the auditor of a Lloyd's corporate member needs to consider whether it has a duty or right to report a particular matter to Lloyd's."
20. Auditors of Lloyd's corporate members are not required to carry out procedures to detect matters that may be of material significance to Lloyd's.
21. The key factor in determining whether a duty to report to Lloyd's arises is the existence of circumstances that would either lead to suspension of the Lloyd's corporate member's authorisation to operate in the Lloyd's market or warrant use of Lloyd's power of intervention in the Lloyd's corporate member's conduct of business.
22. The undertaking for a Lloyd's corporate member does not specify the matters described above. However, if the auditor concludes that it cannot issue its report without qualifying the opinion then a duty to report would arise. Reference to an emphasis of matter without qualification of the opinion expressed does not of itself give rise to a duty to report to Lloyd's: however, the factors giving rise to an emphasis of matter may themselves do so.
23. The auditor is not protected from any breach of duty if, in making a report to the Council, the auditor does not act in good faith. Accordingly, the auditor may wish to take appropriate legal or other professional advice before taking the decision whether, and if so, in what manner, to report to the Council.

24. The duty to report to Lloyd's for auditors of Lloyd's corporate members does not extend to any other entity that has close links with the Lloyd's corporate member.
25. The Council accords particular importance to timely notification of matters giving rise to such a report to the Council by auditors of Lloyd's corporate members. ISA (UK) 250 Section B acknowledges that the auditor will normally seek evidence to assess the implications of a suspected breach before reporting a matter. Once it has identified information as being subject to the duty to report, ISA (UK) 250 Section B requires it to bring the matter to the attention of the regulator without delay. An auditor may fail to discharge its duty to report to the Council if it waits until giving its formal opinion on the financial statements of the corporate member or on other ad hoc reports, or if it agrees to delay making a report until management has had the opportunity to take remedial action.

#### **Auditor's right to report to the Regulator**

26. Section 342 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 regulator information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the regulator. For this purpose, "authorised person" is deemed to include a Lloyd's syndicate.

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

27. Much of the business conducted in the Lloyd's market uses central services in areas such as policy preparation, claims adjustment and transaction settlement. The service provider's Independent Service Auditor's Report on the operation of systems of control relates to certain of the relevant accounting information systems. As part of audit planning a syndicate auditor considers the extent to which it intends to place reliance on such reports.

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

28. Responsibility for the establishment and proper operation of systems of control in a Lloyd's syndicate rests with the board of directors of the managing agent.
29. Responsibility for the establishment and proper operation of systems of control for a Lloyd's corporate member rests with its board of directors. In exercising this responsibility, the directors may conclude that it is appropriate to place reliance on the records maintained, and summaries thereof, prepared by the managing agents of the underlying syndicates and on other, third party documentation. Such records and summaries may, therefore, be considered by the directors to form part of the accounting records of the corporate member. In addition, the directors of the corporate member and its auditor may conclude that it is appropriate to have regard to the work done by other

auditors (including syndicate auditors) and to the reports they may issue. Guidance on this matter is set out in the section on ISA (UK) 600.

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

30. Many syndicates use the centrally operated systems for clearing underwriting transactions. The auditor of those systems provides an Independent Service Auditor's Report on the operation of those systems each calendar year. A syndicate auditor considers the proposed scope of this work as part of its audit planning process and assesses the level of reliance it intends to place on the work performed centrally when determining the extent and nature of procedures to be performed at the syndicate.

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

#### **Technical provisions**

31. The Lloyd's Valuation of Liabilities Rules require all Lloyd's syndicates writing general insurance business to provide to the Council of Lloyd's, each year, a Statement of Actuarial Opinion (SAO) on their world-wide reserves, both gross and net of reinsurance.
32. The SAO should cover all the business of the syndicate for all years of account from 1993 to date. Separate figures are required gross and net of reinsurance for each year of account. The Institute and Faculty of Actuaries published Guidance Note 20 "Actuarial Reporting Under the Lloyd's Valuation of Liabilities Rules". The actuary's report given in the SAO is limited to an opinion as to whether the reserves for solvency purposes established by the agent comply with the Lloyd's valuation of liability rules and are not less than the expected future costs of the liabilities for claims, net of anticipated future premiums, claims handling expenses and bad debts.
33. In carrying out its work on the syndicate Annual Return, the auditor considers the extent to which it can use the work of the actuary performed on general insurance business. In making this assessment, the auditor reads the entire SAO and, if available, any related reports; it may also, where appropriate, discuss the contents of the SAO and related reports with the actuary. Factors to be taken into account in assessing the extent of reliance that may be placed on the actuary's work include:
  34. Any limitations of scope of opinion expressed in the actuary's report.
35. The reliability of source data used by the actuary and the adequacy of steps taken by the managing agent to ensure the integrity of that data. Care is necessary to avoid inappropriate reliance if management has supplied data to the actuary, on which reliance has been taken, which has not been considered in the course of the audit of the syndicate's financial statements.

36. The extent of any bias in the actuaries' work as a consequence of the actuarial focus being on sufficiency of reserves.
37. The auditor is also aware that the SAO relates to a particular basis of reserves of the syndicate for each year of account. These may be different to the technical provisions recorded in the annual report of the syndicate or used in determining the closed year profit or loss.
38. In giving its opinion on the syndicate Annual Return, the syndicate auditor has regard to the appropriateness of the allocation of technical provisions between underlying years of account. Such provisions must be determined in accordance with requirements prescribed by Lloyd's.
39. Where a year of account is closed into a subsequent year of account of the same, or another, syndicate, the Syndicate Accounting Byelaw requires technical provisions of the closed year to be shown as a "premium for a reinsurance to close" (RITC) for that account in the underwriting year accounts as at date of closure. This description has the effect, in accounting terms, of enabling the affairs of that year of account to be drawn to a conclusion and the final result for the relevant annual venture determined. Where the year of account has closed by way of a RITC, the syndicate auditor considers whether, in the context of its opinion on the relevant underwriting year accounts, the relationship between the reinsuring and reinsured members of the syndicate gives rise to further materiality considerations.
40. In situations where the annual venture of a syndicate goes into run off provision for any additional costs to be included in a syndicate's annual accounts should be made in the accounting period in which the decision to cease underwriting or not to close a year of account is taken.
41. In order to comply with Lloyd's requirements, technical provisions for life business included in a syndicate Annual Return must be established and certified by an actuary in a prescribed form on a basis set out by Lloyd's.

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

42. Currently the syndicate Annual Return is required to be submitted to Lloyd's before the syndicate annual accounts are issued. If there has been an event after the balance sheet date after the syndicate Annual Return has been signed but before the syndicate annual accounts and (where relevant) personal accounts are signed which is of such significance that it materially affects the view shown in these accounts, then they should be amended. Lloyd's rules may require that an amendment is also made to the syndicate Annual Return.

Other matters that the auditor may consider in its review of subsequent events include an evaluation of the impact of any material subsequent events on the syndicate's ability to continue to write business in the current annual venture or annual ventures yet to be established for subsequent years.

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

43. The managing agent's responsibility for preparing syndicate annual accounts includes the requirement for the financial statements to be prepared on the basis that the syndicate will continue to write future business unless it is inappropriate to presume the syndicate will do so. Syndicate annual accounts present the collective participations of the members of the syndicate in one or more annual ventures. The ability of a syndicate to meet its obligations as they fall due will reflect the ability of the members of the syndicate to meet their obligations to the syndicate when calls are made. However, irrespective of whether information on a syndicate member's ability to meet its obligations as they fall due is available, the ability of a syndicate to meet its obligations as they fall due is underpinned by the support provided by Lloyd's solvency process and its chain of security for any syndicate members who are unable to meet their underwriting liabilities.
44. Unless it is in run-off, at the date the annual accounts are approved the syndicate will have commenced underwriting business through Lloyd's for the new underwriting year, but it will not have established an annual venture for subsequent years. Accordingly an assessment of the available capital resources is not applicable to syndicate annual accounts. However, audit procedures include making enquiries of the managing agent on the plans for the underwriting of business in future annual ventures of the syndicate.

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

#### ***Lloyd's syndicates***

45. The auditor of a syndicate frequently experiences situations where audit evidence is derived from information audited by other auditors, for example, where the audit of the managing agent is carried out by a separate firm from the syndicate's auditor. Consequently, the syndicate's auditor may have regard to the work of the agency's auditor, for example, in respect of recharged expenses. Similarly, in the case of certain service company activities on behalf of the syndicate, the syndicate auditor may have regard to the work of the auditor of the service company.

#### ***Lloyd's corporate members***

46. Lloyd's has established a central facility to assist corporate members in preparing their statutory financial statements. The facility accumulates information from underlying syndicates and then calculates and aggregates each corporate member's share of that

information. The syndicate information is provided to Lloyd's within the syndicate Annual Return together with a syndicate auditor's report thereon.

47. Where corporate members rely on information provided by way of the central facility, the auditor of corporate members applies the principles of ISA (UK) 600 in considering how the work of syndicate auditors affects its audit. Where the auditor of corporate members relies on the work of syndicate auditors, it considers the professional qualifications, experience and resources of the other auditors in the context of its audit of the corporate member in question. It obtains appropriate evidence that the work of the syndicate auditors is sufficient for the purposes of the audit of the corporate member's financial statements.

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

48. The auditor of a Lloyd's syndicate's financial statements is required to report its opinion as to whether the annual accounts comply with the requirements of the 2008 Lloyd's Regulations. Where syndicate underwriting year accounts are prepared for a run-off year of account, the auditor is required to report its opinion as to whether those accounts comply with the requirements of the Syndicate Accounting Byelaw.
49. In addition, its report on the annual accounts includes its opinion on whether they give a true and fair view of the calendar year result and of the state of affairs at the balance sheet date. The report of the auditor on closed year underwriting year accounts includes its opinion on whether they give a true and fair view of the result of the closed year of account.
50. Lloyd's require that the auditor's report on syndicate underwriting year accounts be addressed to the members of the syndicate participating in the year of account to which they relate and not to all members of the syndicate. Different reporting requirements apply to syndicate underwriting year accounts for a closed year of account as apply to syndicate underwriting year accounts for a run-off year of account which is not closing.
51. In preparing underwriting accounts for a closed year of a syndicate, compliance with UK GAAP is normally necessary in order to give a true and fair view of the syndicate's closed year result.
52. ISA (UK) 700 states that:

*If the auditor is required to report on certain matters by exception, the auditor shall describe in the auditor's report the auditor's responsibilities for such matters and incorporate a suitable conclusion in respect of such matters.<sup>89</sup>*

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89 ISA (UK) 700 (Revised June 2016), para.43-1.

53. The auditor of a syndicate's annual and underwriting year accounts is required to report by exception if:
- (a) The managing agent has not maintained proper accounting records in respect of the syndicate;
  - (b) The underwriting year accounts do not agree with the accounting records; and
  - (c) the auditor of the syndicate's annual accounts is additionally required to report by exception if it has not received all the information and explanations that it requires.

***ISA (UK) 701: COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT***

54. The Society of Lloyd's as a whole is a 'public interest entity' within the meaning of the Audit Regulation (EU) No 537/2014, and is within the scope of the Solvency II prudential regulation regime. Lloyd's syndicates are not public interest entities, and therefore the additional reporting requirements contained within ISA (UK) 701 do not apply.

## **SECTION 6: REPORTING ON SOLVENCY AND FINANCIAL CONDITION REPORTS FOR SOLVENCY II ('DIRECTIVE') FIRMS**

1. The Solvency II prudential regulation regime came into force for authorised insurance entities, including Friendly Societies in the UK from 1 January 2016. This established different reporting and assurance requirements for 'Directive' and 'Non-Directive' firms. 'Directive' firms must publish audited annual SFCRs, as well as submitting unaudited reports to the PRA as regulator. 'Non-directive' firms will continue to submit audited regulatory returns, although some of the requirements have been simplified.
2. The PRA Rulebook sets out the full criteria which define which firms are 'Directive' and which are 'Non-Directive'.<sup>90</sup> There are multiple criteria relating predominantly to the size and nature of the insurance (or reinsurance) business undertaken, and the permissions granted by the FCA or PRA under Part4A of FSMA 2000. The Society of Lloyd's falls within the scope of the Solvency II firms' rulebook, and section 3 of the Insurance General Application chapter of the PRA Rulebook for Solvency II firms explains the application of rules to – respectively – the Society and managing agents.<sup>91</sup>
3. This section of PN20 provides guidance for auditors who are providing an opinion on published SFCRs under Solvency II. Section 8 provides guidance for the audit of non-directive firm regulatory reports.
4. The FRC adopted ISA (UK) 800 *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* and ISA (UK) 805 *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* in order to support the PRA's objective of providing reasonable assurance audit opinions on published SFCRs.<sup>92</sup>
5. Whereas the ISAs (UK) are generally concerned with the audit of full sets of financial statements prepared under general purpose financial reporting frameworks (such as IFRS or UK GAAP), SFCRs are prepared in accordance with a special purpose financial reporting framework as defined by ISA (UK) 800:

*For purposes of the ISAs (UK), the following terms have the meanings attributed below:*

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90 PRA, SII firms Rulebook, Insurance General Application Rulebook, Chapter 2.

91 PRA, SII firms Rulebook, Insurance General Application Rulebook, Chapter 3.

92 These ISAs became effective for periods commencing on or after 1 January 2017, although early adoption is allowed. Where these ISAs are adopted early for the audit of Solvency II public disclosures then they are permitted to be used in conjunction with ISAs (UK and Ireland) where the audit of the statutory financial statements for the same period was also conducted in accordance with those ISAs (UK and Ireland). In those circumstances, then references to ISAs (UK) in ISAs (UK) 800 and 805 are deemed to be to the equivalent parts of those ISAs (UK and Ireland).

- (a) *Special purpose financial statements – Financial statements prepared in accordance with a special purpose framework. (Ref: Para. A4)*
- (b) *Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework. (Ref: Para. A1–A4)<sup>93</sup>*
6. ISA (UK) 800 deals with the auditor’s considerations when applying ISAs (UK) in the series 100-700 to the audit of full sets of financial statements prepared in accordance with a special purpose financial reporting framework, including the implications for the auditor’s report. ISA (UK) 805 deals with the application of the ISAs (UK) 100-700 series in the context of the audit of single financial statements, and specific elements, amounts or items of a financial statement. This is relevant to the audit of SFCRs because the PRA audit requirement does not include the complete SFCR or included quantitative reporting templates (QRTs), and includes additional exclusions from scope for specific disclosures. These exclusions are described in more detail below.
7. The ISAs (UK) provide a framework which allows auditors to provide the required assurance and which can be applied to the Solvency II financial reporting framework. That framework, which is based on directly applicable European regulation and PRA rules, is intended to give the users of those financial statements confidence in the quality of the information being reported on the solvency and financial condition of insurance entities.
8. Audits of SFCRs, in accordance with PRA rules, have the character of a ‘second audit’. This is because a close correlation between the information presented in the SFCR and that presented in the statutory financial statements cannot be assumed. By contrast, when an auditor that reports on a non-directive insurer’s regulatory return carries out the audit of its financial statements in accordance with ISAs (UK), the work that the auditor performs on regulatory returns is deemed to be more closely integrated with the statutory audit, and therefore represents a set of additional procedures which enable it to report as required.

### **General Principles**

9. PRA rules require that the auditor’s report on the SFCR must be prepared with “due skill, care and diligence”. An audit conducted in accordance with ISAs (UK) is intended to meet this requirement.

### **Audits of Solvency II public reports (SFCRs)**

10. Pillar 3 of the Solvency II prudential regulation regime requires extensive public and private reporting of the solvency and financial condition of insurance entities, on a different basis to the previous regime requirements. In addition to the greater complexity

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93 ISA (UK) 800, para.6.

of some disclosures, including for example the SCR, Own Funds, Technical Provisions (including risk margin), Solvency II Directive firms and groups are required to publish SFCRs annually. The structure and content of these financial statements are prescribed by the Solvency II Directive (Directive 2009/138/EC), Delegated Act, SFCR Implementing Technical Regulation and PRA rules. PRA rules require an external audit of SFCRs and a 'reasonable assurance' audit report in accordance with ISAs (UK).<sup>94</sup>

11. SFCRs have the following prescribed basic structure which includes both financial and narrative content and information:
  - A Business and Performance
  - B System of Governance
  - C Risk Profile
  - D Valuation for Solvency Purposes
  - E Capital Management
  
12. SFCRs include a series of QRTs which are also prescribed in regulation and by PRA rules. The scope of the 'reasonable assurance' engagement covers sections D 'Valuation for Solvency Purposes' and E 'Capital Management' of the SFCR; as well as some but not all of the QRTs which are published alongside them. The rules set out the elements of the SFCR which are 'relevant' for the purposes of the audit, and the circumstances in which some items are excluded from scope. For example, there are exemptions for elements of the disclosures relating to the SCR when an insurer uses a full or partial internal model, and for group information prepared and disclosed on a sectoral basis. More guidance on the implication of these 'scope exclusions' is provided below.
  
13. In respect of group reporting requirements, auditors should refer to the Group Supervision part of the PRA Rulebook as it applies to Solvency II entities. However, in general participating Solvency II firms, or relevant insurance group undertakings must disclose publically, on an annual basis, a SFCR at group level<sup>95</sup> where:
  - a UK Solvency II firm is a participating undertaking in at least one other Solvency II undertaking, third country insurance undertaking or third country reinsurance undertaking; or
  - a Solvency II undertaking (other than a UK Solvency II firm) is a participating undertaking in a UK Solvency II firm; or

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<sup>94</sup> See the External Audit Part of the PRA Rulebook pertaining to Solvency II firms, and the related Supervisory Statement SS11/16, *Solvency II: external audit of the public disclosure requirement*

<sup>95</sup> PRA, SII firms Rulebook, Group Supervision Chapter, 18.1.1.

- the parent undertaking of a UK Solvency II firm is an insurance holding company or a mixed financial holding company which has its head office in an EEA State<sup>96</sup>; or
  - the parent undertaking of a UK Solvency II firm is an insurance holding company which has its head office in a third country whose group supervision regime is not deemed 'equivalent' and where no 'other methods' waiver has been granted<sup>97</sup>
14. Subject to the agreement of the group supervisor they may provide a single SFCR which must comprise the following:
- *....information at the level of the group which must be disclosed....; and*
  - *....the information for any of the subsidiaries within the group which must be individually identifiable and disclosed....*<sup>98</sup>
15. The group SFCR is subject to the same requirement for an external audit as for a solo SFCR. The information in respect of all subsidiaries is within audit scope. This includes solo level information in respect of EEA insurers outside the UK which would not be subject to the PRA's audit requirements had a single group-wide SFCR not been prepared. When conducting an audit of a single group-wide SFCR the auditor considers the requirements of ISA (UK) 600, including paragraphs 21-23 which relate to materiality.
16. There is also a separate auditor reporting requirement in respect of information included within the 'relevant elements' of the group SFCR (and associated templates). In respect of the audit of a group SFCR where the 'relevant elements' include information which:
- *Pertains to an undertaking that is not a Solvency II undertaking; and*
  - *Information has been prepared in accordance with:*
    - *PRA rules other than those implementing the Solvency II Directive; or*
    - *An EU instrument other than the Solvency II Regulations.*<sup>99</sup>

The external auditor is required to state in their report that the information has been '*properly compiled in accordance with the relevant PRA rule and EU instrument relating to that undertaking from information provided by members of the group and the relevant insurance group undertaking*'.<sup>100</sup>

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96 PRA, SII firms Rulebook, Group Supervision Chapter, 2.1.1 & 2.1.2.

97 PRA, SII firms Rulebook, Group Supervision Chapter, 20.1-20.4

98 PRA, SII firms Rulebook, Group Supervision Chapter, 18.1.2.

99 PRA Rulebook, SII firms, External Audit Chapter, p. 4.2.1-4.2.2.

100 PRA Rulebook, SII firms, External Audit Chapter, p. 4.2.2.

17. The information covered by the 'properly compiled' statement is not within scope of the reasonable assurance opinion. Further guidance on how the auditor complies with this requirement is set out below in the section on 'Forming an opinion and reporting on the engagement'.
18. In order to achieve the PRA's required level of (reasonable) assurance these engagements are conducted in accordance with International Standards on Auditing (UK) (ISAs (UK)), including ISA (UK) 800 and ISA (UK) 805.
19. SFCRs are prepared in accordance with a special purpose financial reporting framework (as set out in the Solvency II Directive, Delegated Act, SFCR Implementing Technical Standard and PRA Rules). The PRA audit requirement does not cover all of the elements of the SFCR or the information in related QRTs. The scope of the 'reasonable assurance' audit engagement therefore requires the auditor to consider the requirements and guidance contained within ISAs (UK) 800 and 805, including their interactions with other ISAs (UK), when accepting, planning, performing and reporting on engagements of this kind. ISA 805 (UK) is the most appropriate source for requirements and guidance in respect of the PRA's requirement that only relevant elements and templates are included within the scope of the audit. That does not mean the auditor is required to issue a separate opinion on each individual statement or element which is being audited.
20. ISA (UK) 800 and ISA (UK) 805 are designed to help auditors apply the requirements of the ISAs (UK) in the specific context of financial statements prepared in accordance with a special purpose financial reporting framework, and audits of single financial statements and specific elements, accounts or items of a financial statement. They do not override the requirements of the other ISAs (UK), nor do they deal with all special considerations of the engagement.<sup>101</sup> The material in this Practice Note is not intended to represent a complete guide to the application of the ISAs (UK) for engagements of this kind, but focusses on areas where there may be specific relevant considerations.

### **Accepting the Engagement**

21. ISA (UK) 210 (revised) sets out the basic preconditions for an audit. These include (but are not limited to):
  - Whether the financial reporting framework is acceptable
  - Obtaining the agreement of management that it acknowledges and understands its responsibility for the preparation of the financial statements in accordance with the financial reporting framework<sup>102</sup>

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101 ISA (UK) 800, para.3; ISA (UK) 805, para.3.

102 ISA (UK) 210 (revised), para.6.

## The Solvency II financial reporting framework

22. In order to comply with the ISAs (UK) the auditor must determine the acceptability of the financial reporting framework applied in the preparation of the financial statements and must obtain an understanding of the purpose for which the financial statements are prepared; the intended users; and steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.<sup>103</sup> Paragraphs 37-42 below, which cover the application of materiality to these engagements, goes into more detail about the auditor's considerations of the intended users of SFCRs.
23. PRA rules, supplemented by a framework of approvals, waivers and supervisory determinations, implements the requirements of the financial reporting framework required by Directive 2009/138/EC ('the Solvency II Directive'). The UK regulatory framework includes:
- Reporting 3 (and in the case of group reporting, Group Supervision 18 and 20) of the PRA Rulebook applicable to Solvency II firms
  - Commission Delegated Regulation (EU) 2015/35 supplementing the Solvency II Directive ('the Delegated Act')
  - Commission Implementing Technical Regulation (EU) 2015/2452 ('the SFCR Implementing Technical Standard')
24. In addition to the formal requirements of the framework, the auditor of a Solvency II public disclosure might reasonably be expected to have regard to supplementary Guidelines in respect of Solvency II, including public reporting and disclosure, which are published by the European Insurance and Occupational Pensions Authority (EIOPA).<sup>104</sup> The PRA also issues Supervisory Statements which set out additional guidance, including SS11/16 '*Solvency II: external audit of the public disclosure requirement*'.<sup>105</sup>
25. The principles which are to be followed in presenting information about the Solvency and Financial Condition of an entity are that:
- (a) *it must reflect the nature, scale and complexity of the business of the undertaking concerned, and in particular the risks inherent in that business;*
  - (b) *it must be accessible, complete in all material respects, comparable and consistent over time; and*

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103 ISA (UK) 800, para.8; ISA (UK) 210 (revised), para. 6 (a).

104 <https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-reporting-and-public-disclosure>.

105 <http://www.bankofengland.co.uk/pr/Pages/publications/ss/default.aspx>

(c) it must be relevant, reliable and comprehensible<sup>106</sup>

26. Paragraph 3.4 of the PRA's Supervisory Statement SS11/16 'Solvency II: external audit of the public disclosure requirement' states that the

*....auditor is not expected to express an opinion on the validity of an approval, waiver or other supervisory determination. Instead approvals, waivers and supervisory determinations provided by the competent authority should be considered as part of the framework against which the audit opinion is being given.*<sup>107</sup>

27. The Solvency II framework sets out those areas where the national supervisor has the right to grant approvals, waivers and other supervisory determinations in respect of the application of Solvency II. Whilst accepting that these are part of the established framework against which the opinion is given, the auditor may nevertheless need to understand, through discussion and ongoing dialogue with the supervisor, the extent to which any relevant approvals, waivers or supervisory determinations are consistent with the Solvency II framework. Further guidance on the auditor's procedures in respect of approvals, waivers and supervisory determinations is set out below.
28. In determining whether the Solvency II financial reporting framework is acceptable, the auditor considers the guidance in ISA (UK) 800 which discusses financial reporting requirements established by the regulator, and which indicates that they may be presumed to be acceptable:

*In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used by management in the preparation of special purpose financial statements for a certain type of entity. For example, a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting framework is presumed acceptable for special purpose financial statements prepared by such entity.*<sup>108</sup>

### Management responsibilities

29. The written acknowledgement by management of their responsibilities, including for the preparation of the financial statements in accordance with the financial reporting framework is a fundamental precondition for an audit.

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106 DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance) Article 35, p.4

107 PRA Supervisory Statement, SS11/16, 'Solvency II: external audit of the public disclosure requirement', p.3.4

108 Article 291, Chapter XII Section 1 of the COMMISSION DELEGATED REGULATION (EU) 2015/35 of 10 October 2014, [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=ENCOMMISSION\\_DELEGATED\\_REGULATION\\_\(EU\)\\_2015/35\\_of\\_10\\_October\\_2014](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=ENCOMMISSION_DELEGATED_REGULATION_(EU)_2015/35_of_10_October_2014)

30. The PRA's Supervisory Statement SS11/16 states that:

*....the PRA expects the governing body to take responsibility for ensuring that the SFCR has been properly prepared in all material respects in accordance with the PRA rules and Solvency II regulations. As well as having a written policy in place to ensure the ongoing appropriateness of any information disclosed, the PRA expects that the governing body should be satisfied that:*

- (a) throughout the financial year in question, the insurer has complied in all material respects with the requirements of the PRA rules and Solvency II regulations as applicable to the insurer; and*
- (b) it is reasonable to believe that, at the date of the publication of the SFCR, the insurer has continued so to comply, and will continue so to comply in future.*

*The PRA expect the governing body to acknowledge and evidence in writing their responsibility for the SFCR and make this available to potential readers of the SFCR by signing the SFCR and attaching the written acknowledgment to the SFCR.<sup>109</sup>*

31. This acknowledgment is intended to be similar in nature to the Directors Certificate which is required to be prepared by non-directive insurers for their regulatory returns and which are described in the PRA Non SII firms rulebook.<sup>110</sup>
32. When considering whether the preconditions for an acceptance of an audit exist therefore, auditors may wish to discuss the Supervisory Statement SS11/16 with management, and where relevant, those charged with governance. Auditors may also wish to convey to management the relevant requirements of the ISAs (UK). If management or the governing body will not provide such a written representation then the auditor considers whether the preconditions for accepting the audit have been met.

### **Planning and Performing the Engagement**

33. ISA 800 provides guidance on the auditor's consideration of whether the application of the ISAs (UK) requires special consideration in the circumstances of the Solvency II engagement.<sup>111</sup> This includes:
- (a) Consideration of whether, in the circumstances of the audit, an entire ISA (UK), or requirement of an ISA (UK) is not relevant because it is conditional, and the condition does not exist.<sup>112</sup>

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109 'Solvency II: external audit of the public disclosure requirement', p.2. Note that in the context of a group SFCR, the statement at (a) does not apply to compliance at the level of components, only to the entity which is preparing the SFCR.

110 PRA Non SII Firms Rulebook 8 Directors Certificate.

111 ISA (UK) 800, para .9.

112 ISA (UK) 800, para. A9.

- (b) In the audit of a special purpose financial statement such as the SFCR, the auditor considers judgements about materiality based on the needs of the intended users of those financial statements, rather than on a consideration of the common financial information needs of users as a group<sup>113</sup>.
- (c) Determining the appropriate person(s) within the entity's governance structure with whom to communicate.<sup>114</sup>

#### Relationship to the audit of statutory financial statements

- 34. There is no requirement for an auditor of a SFCR to have conducted the audit of the statutory financial statements. The audit of the SFCR is a separate engagement to the audit of the statutory financial statements.
- 35. Where the auditor, or audit firm, conducts the audits of both the statutory financial statements and the SFCR then the auditor considers how the risk assessment, planning, performance and reporting for each engagement could inform the other. The PRA rules do require the auditor to adopt this approach in certain areas of the engagement. For example, the PRA requirements go beyond ISA (UK) 720 (revised) in respect of Other Information by explicitly requiring the auditor of the SFCR to consider information and knowledge obtained in the course of the statutory audit when considering matters of consistency.<sup>115</sup>
- 36. There are other areas where there may be scope for the efficient utilization of audit evidence and insight in support of each separate engagement, for example:
  - (a) Going Concern – where the auditor's review of the Viability Statement in the statutory financial statements, for example, may provide evidence to support the audit of the SFCR;
  - (b) Review of information systems, data quality and general IT controls;
  - (c) Review of assumptions and methods underpinning the valuation of assets and liabilities;
  - (d) Review of compliance with law and regulation;
  - (e) Review of the work of the actuarial function within the entity;
  - (f) Review of the work of internal audit.

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113 ISA (UK) 800, para. A10.

114 ISA (UK) 800, para. A12.

115 The PRA have stated that this additional consistency review should be conducted in accordance with the requirements of ISA 720 (UK).

## Materiality

37. The auditor applies the concept of materiality appropriately in planning and performing the audit.<sup>116</sup> ISA (UK) 320 notes that discussion of the concept of materiality within a financial reporting framework provides a frame of reference for the auditor in determining materiality for the audit.<sup>117</sup> Solvency II defines materiality in the context of the SFCR as follows:

*...the information to be disclosed in the solvency and financial condition report shall be considered as material if its omission or misstatement could influence the decision-making or the judgement of the users of that document, including the supervisory authorities.*<sup>118</sup>

38. The PRA has also made pronouncements which indicate that it should be considered one of the users, rather than the only primary user of the SFCR:

*The PRA is comfortable that insurers, auditors and users are clear that the PRA is a primary user of the SFCR and audit report without being included as an addressee and has decided to retain existing practice and not be an addressee to the auditor's report.*<sup>119</sup>

39. The intended users of the SFCR are not restricted to the supervisory authorities alone. The objectives of Solvency II are to engender widespread confidence in the systemic health of the insurance sector across the EU, and the effectiveness of prudential regulation. As a consequence, Pillar 3 has introduced mandatory public reporting – in the form of the SFCR – as well as private reporting to supervisory authorities. In determining materiality for the audit of the SFCR, the auditor needs to understand who the other intended users are, and the resulting implications for judgements on materiality. The auditor needs to understand the factors which might influence the decision-making or judgement of the regulator, as well other identified users.
40. The auditor considers how to apply ISA (UK) 320 in the light of the application guidance in ISA (UK) 800. This describes the different judgements about the users of special purpose financial statements, as opposed to those of general purpose financial statements:

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116 ISA (UK) 320 (Revised June 2016), *Materiality in Planning and Performing an Audit*, para. 8.

117 ISA (UK) 320 (Revised June 2016), *Materiality in Planning and Performing an Audit*, para. 3.

118 Article 291, Chapter XII Section 1 of the COMMISSION DELEGATED REGULATION (EU) 2015/35 of 10 October 2014, [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=ENCOMMISSION\\_DELEGATED\\_REGULATION\\_\(EU\)\\_2015/35\\_of\\_10\\_October\\_2014](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=ENCOMMISSION_DELEGATED_REGULATION_(EU)_2015/35_of_10_October_2014)

119 Consultation Paper | CP23/16 Solvency II: external audit of the public disclosure requirement, July 2016, para.3.1

...in ISA 320, judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special purpose financial statements, however, those judgements are based on a consideration of the financial information needs of the intended users.<sup>120</sup>

41. The auditor may need to consider whether the materiality judgements made in respect of an audit of the statutory financial statements of an entity, based on the common financial information needs of users as a group, are appropriate to the needs of the intended users of published SFCR's. Many auditors of listed insurance firms in the UK currently use profit or income measures as the benchmark for their materiality calculations for the statutory financial statements *audit*. Others, including some auditors of life insurance entities, use an equity or asset based measure. The primary users of statutory financial statements prepared in accordance with IFRS are generally considered to be "*existing and potential investors, lenders and other creditors*"<sup>121</sup> – although they are also important to other users. The auditor considers whether the benchmark used for the audit of the statutory financial statements – whether profit and income, or asset and equity based – are appropriate for the audit of the published SFCR. In doing so, the auditor considers the needs of the users of these reports in accordance with ISAs (UK).
42. A further consideration for the auditor when determining materiality for the audit of the SFCR is the scope of the audit. For example when the external audit opinion does not include the SCR because of the use of an internal or partial internal model, this may need to be reflected in the setting of materiality. The PRA requirement for external audit assurance is limited to the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR, and some but not all of the included QRTs. The auditor considers the requirements of ISA (UK) 805.<sup>122</sup>

#### Approvals, modifications and supervisory determinations

43. In accordance with PRA rules the auditor is not expected to express an opinion on the validity of an approval, modification or other supervisory determination. Instead, they should be considered as being part of the framework against which the audit opinion is being given. The auditor ensures that this framework, including the nature of approvals, modifications and supervisory determinations is adequately described in the auditor's report.
44. Subject to considerations of materiality, where approval is given for a specific number or adjustment included within the regulatory report, or used in the calculation of a number

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120 ISA (UK) 800, para. A10.

121 IASB, *The Conceptual Framework for Financial Reporting*, OB5, OB10.

122 For example, see application guidance at ISA (UK) 805, para. A15.

included within the report, then the auditor confirms the accuracy of the disclosure to the supervisory approval.

45. Where approval is given for the use of a specific methodology then (other than those areas where there is a specific limitation on the scope of the audit – SCRs for partial or full internal model firms for example), the auditor confirms that the methodology used is consistent with the approval, and has been applied correctly.
46. The auditor should consider the adequacy of disclosures in the SFCR which describe the modifications, approvals and determinations which are relevant in each case, and discuss with management any concerns which arise. Where these concerns are not adequately addressed the auditor may consider any implications for the auditor's report.
47. Modifications, approvals and determinations which might be relevant include:

**Modifications granted under section 138A of FSMA ('the modifications')**

- Permission for non-disclosure of information in SFCR
- Permission to publish a single group-wide SFCR
- Permission to exclude entities from the scope of group supervision
- Permission to use deduction and aggregation method in the calculation of group SCR

**Approvals made under The Solvency II Regulations ('the Approvals')**

- Approval of items of ancillary own funds
- Approval to take credit for 'non-standard' items of own funds
- Approval to use the matching adjustment in calculating technical provisions
- Approval to use the volatility adjustment in the calculation of technical provisions
- Approval to use the risk free rate transitional measure in the calculation of technical provisions
- Approval to use the transitional measure on technical provisions
- Approval to use a full or partial internal model
- Approval to use solo or group specific parameters when calculating the SCR

**Determinations made in accordance with the PRA Rules and Solvency II regulations on which they are based ('the determinations')**

- Determination of any capital add-on to the SCR

- Determination of the extent to which own funds of group members cannot effectively be made available to cover the group SCR.

[note that these are indicative of some of the more common items, and this is not intended to represent a comprehensive list]

#### Exclusions from the scope of the audit: Partial and Full Internal Model firms.

48. The PRA Solvency II Firms Rulebook excludes from the scope of the external audit certain information in the SFCR, certain quantitative reporting templates and certain information in other templates where it, “...is, or derives from the SCR” and is calculated using a full or partial internal model.<sup>123</sup> A number of disclosures within the ‘relevant elements of the SFCR’ are derived from the SCR. The auditor therefore considers the implications for the scope of the audit, in accordance with ISA (UK) 805:

*The individual financial statements that comprise a complete set of financial statements, and many of the specific elements of those financial statements, including their related disclosures, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.*<sup>124</sup>

49. Specific examples of items which are related to the SCR, and where an assessment must be made of whether they are in or out of scope of the audit for partial or full internal model firms include:

#### Information In Scope

##### **a. The Minimum Capital Requirement (MCR) ‘corridor’**

Calculated using a prescribed linear formula, and subject to an absolute floor, the MCR must sit within a ‘corridor’ of 25-45% of the SCR (including any capital addition).<sup>125</sup> The application of the corridor is subject to the MCR not being below its absolute floor (which is a fixed euro amount). MCR QRTs 28.01.01 and 28.02.01, include information about the SCR of the entity and the final MCR which must be calibrated within the 25-45% range.

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<sup>123</sup> PRA, SII firms rulebook, External Audit Chapter, 2.2 (3) & 2.2 (4) & PRA: Supervisory Statement SS11/16 ‘Solvency II: external audit of the public disclosure requirement’, Appendix 3.

<sup>124</sup> ISA (UK) 805, para. A14.

<sup>125</sup> Article 129 (3), DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), Article

For composite insurers, the templates also include information about the SCRs which are used to derive separate notional MCRs for the life and non-life components of the business.

In this case the MCR is calculated separately, based on information which is subject to audit. The calibration of the result does not achieve the condition in PRA rules to exclude it from the scope of the audit – namely that it ‘is, or derives from’ the SCR.

#### Information Out of Scope

##### **b. Solvency Capital Ratio for Partial Internal Model firms**

The standard formula element of the SCR for a partial internal model firm is out of scope, since the SCR as a whole is outside the scope of the PRA’s audit requirement for partial internal model firms.

##### **c. Risk Margin**

The risk margin is dependent on the calculation of current and future SCRs (over the lifetime of relevant obligations). For standard formula firms the risk margin is therefore within the audit scope. For partial and full internal model firms unaudited SCR figures are a key input into the calculation of the risk margin – therefore audit procedures which only cover the arithmetic accuracy of the calculation would not provide the necessary level of assurance to support the auditor’s reasonable assurance opinion. The risk margin for partial and full internal model firms would therefore be excluded from the scope of the audit.

##### **d. Restricted Own-funds in ring-fenced funds and matching adjustment portfolios**

Where these funds and/or portfolios are considered material, then an adjustment is required for any restricted own-funds in excess of the notional SCR which has been calculated for that fund or portfolio. Where these funds and/or portfolios are not considered material, then an adjustment may be made for the total amount of restricted own-funds – in which case there is no need to calculate a notional SCR. This adjustment is a line item in the SFCR reporting template S.23.01.01, and may also be referred to within the main sections of the SFCR.

For standard formula firms, the calculation of any notional SCR and the resulting restricted own-funds adjustment would therefore be within scope of the audit. However, for partial or full internal model firms, the calculation of this adjustment ‘is, or derives from’ the SCR’, and is therefore out of scope of the audit.

##### **e. Deductions reflecting the non-availability of own-funds items at a group level**

A deduction is made for non-available own funds in components to restrict their contribution to the extent of the group component’s contribution to the group SCR. As with the examples of the risk margin and restricted own-funds above the deduction, which is included as a line item in the SFCR templates, is calculated using the SCR. This meets the PRA standard of ‘is, or derives from’ the SCR’, and is therefore out of scope of the audit for partial or full internal model firms

**f. Narrative components of the SFCR that relate to or are dependent upon the SCR**

There are five sections of the SFCR as well as included QRTs. Two of these five sections are defined by the PRA's audit requirement as being 'relevant elements of the SFCR'. [Valuation for Solvency Purposes and Capital Management]. These sections include mandatory references to, as well as other quantitative information which relates to or is dependent upon the SCR. In addition, the remaining sections of the SFCR [Business and Performance, System of Governance and Risk Profile] may contain similar information.

This information is not part of the scope of the auditor's reasonable assurance opinion audit, but the auditor applies the requirements and guidance contained within ISA (UK) 720 *The Auditor's Responsibilities Relating to Other Information*.

The transitional measure on technical provisions.

50. The SFCR and relevant QRTs include information about the effect of adjustments in respect of any transitional measure on technical provisions [not all firms will have sought approval to apply this measure]. This information is included within the 'relevant elements' of the SFCR which are subject to audit under PRA rules.
51. Entities may use the transitional measure, subject to supervisory approval, to spread increases in technical provisions under the Solvency II regime. The adjustment is based on a methodology approved by the supervisor, and which initially calculates the difference between technical provisions as at 31st December 2015, and technical provisions under Solvency II as at 1st January 2016.<sup>126</sup> The PRA Supervisory Statement SS11/16 'Solvency II: external audit of the public disclosure requirement' states that, "For the purposes of transitional measures on technical provisions, Pillar 1 and 2 assets, liabilities and capital calculated in accordance with the previous regime, should be treated as part of the framework against which the audit opinion is being given". This information is therefore to be considered out of scope of the audit requirement. The transitional measure on technical provisions is included within the relevant elements of the Solvency and Financial Condition Report, and is therefore within scope of the audit requirement. However, the calculation of the technical measure, when applied, is materially dependent on Pillar 1 and 2 assets, liabilities and capital calculated in accordance with the previous regime which are not subject to audit.
52. The PRA's Supervisory Statement SS11/16 also states that supervisory determinations should be considered as part of the framework against which the audit opinion is being given. In respect of the transitional measure on technical provisions supervisory approval

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<sup>126</sup> PRA Supervisory Statement SS1717/15 para 3.3 states that "Pillar 2 insurance liabilities are the starting point for the transitional deduction. They will capture all relevant features of the liabilities, including those that may not be reflected in a firm's Pillar 1 technical provisions as set out in Chapter 1 of the Prudential Sourcebook for Insurers (INSPRU 1).

provides evidence of the approval of a transitional measure, and of the methodology to be employed in calculating it. It does not provide evidence that the method has been applied correctly and that information disclosed about the transitional measure is free from material error.

53. The exclusion of the underlying calculations based on the previous regime from the PRA's audit requirement means that the auditor cannot give their opinion on the transitional measure on technical provisions, which is dependent upon them. The auditor therefore considers the implications for the form of their report.

#### Exclusions from the scope of the audit: Group SFCR

54. PRA rules establish a separate reporting requirement in respect of information presented in the 'relevant elements' of the group SFCR which is prepared and presented on a sectoral basis. That requirement is in addition to the auditor's requirements under ISAs (UK), and that information is therefore excluded from the scope of the audit. Further guidance on the implications for the auditor's report is provided below.

#### Use of actuaries

55. There is no formal requirement for auditors to use the work of an actuary in the course of an audit of the SFCR. However, the PRA's Supervisory Statement SS11/16 makes reference to the requirements of the ISAs (UK) in respect of assessing the need for an auditor's expert to be engaged. Therefore:

*As a minimum, for firms that write life business, the PRA expects that auditors, in undertaking the external audit, will obtain and pay due regard to the work of a suitably qualified actuary who is independent of the firm.<sup>127</sup>*

56. Sections 4 and 8 of this Practice Note set out guidance in respect of the use of actuaries in the context of the audits of both the statutory financial statements and of non-directive regulatory returns. That guidance is also relevant to the use of an actuary in the course of the audit of the SFCR, including agreeing the scope of the work and assessing the independence of the actuary.

#### Group SFCR

57. The Group SFCR for an insurer may include information derived from third countries where the Solvency II regime does not apply. The Solvency II Directive and the PRA Rulebook sets out the supervisory and reporting arrangements in these circumstances, including the consideration of the equivalence of a third country supervision regime with

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127 'Supervisory Statement', SS11/16, p.4.3.

Solvency II. When conducting an audit of a group SFCR, the auditor considers the requirements and guidance in ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (including the work of component auditors)*. Circumstances specific to the audit of group SFCRs might include:

- The inclusion of information about a material component on a local rules basis, rather than on a Solvency II basis;
- The inclusion of information about a component where that component has not been subject to audit under the rules which apply in the third country (or in an EEA state where there is no equivalent audit regime);
- Differences in filing deadlines for the submission of regulatory reports in different jurisdictions;
- Other inconsistencies in reported information.

### **Forming an opinion and reporting on the engagement**

58. PRA rules require that the auditor produces a *report that includes an opinion addressed to the governing body confirming that the relevant elements of the SFCR are prepared in all material respects in accordance with the PRA rules and Solvency II regulations on which it is based*.<sup>128</sup>
59. These reports are consistent with those prepared in respect of compliance financial reporting frameworks under the ISAs (UK). Illustrative reports are included in section 7 of this Practice Note. In order to comply with the requirements of ISA (UK) 800 the auditor includes in their report an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. The auditor specifically describes the financial reporting framework as a special purpose framework and that the audit has been carried out in accordance with ISAs (UK), including ISA (UK) 800 and/or ISA (UK) 805.<sup>129</sup>

### Capital Add-Ons

60. Under section 55M of FSMA, the PRA can apply a capital add-on in circumstances where there has been a risk profile deviation within a firm related to the standard formula, internal model, system of governance, matching adjustment, volatility adjustment or transitional measures<sup>130</sup>. ISA (UK) 700 requires the auditor to evaluate whether, "in view

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128 PRA Rulebook, SII firms, External Audit Chapter, p. 4.1.2.

129 ISA (UK) 800, para. 14. Note that ISAs require the name of the engagement partner to be stated for listed insurers only [ISA 800 (UK) A18].

130 PRA Supervisory Statement, SS4/15, 'Solvency II: the solvency and minimum capital requirements' (March 2015).

of the requirements of the applicable financial reporting framework....the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.” As part of transitional measures implemented by the PRA, firms have the right to choose not to disclose any such capital add-on in the first years of Solvency II. Preparers are, however, required to disclose whether the UK has made use of the relevant member state option in the SFCR<sup>131</sup>. The auditor therefore considers the adequacy of the disclosure in the SFCR, and considers any implications for their report.

#### Additional Reporting Requirement: Group SFCRs

61. In respect of the audit of a group SFCR where the ‘relevant elements’ include information which:

- *Pertains to an undertaking that is not a Solvency II undertaking; and*
- *Information has been prepared in accordance with:*
  - *PRA rules other than those implementing the Solvency II Directive; or*
  - *An EU instrument other than the Solvency II Regulations*<sup>132</sup>

The external auditor is required to state in their report that the information has been ‘properly compiled in accordance with the relevant PRA rule and EU instrument relating to that undertaking from information provided by members of the group and the relevant insurance group undertaking’.<sup>133</sup>

62. The PRA states in the Supervisory Statement SS11/16 for the external audit requirement that:

*“the group auditor should undertake an assessment of whether that information has been properly extracted in accordance with the relevant sectoral rules, from information provided to the insurer by other undertakings of the insurance group and from the insurer’s own records. An external audit of such information is not required”.*<sup>134</sup>

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131 Article 297 (2) e of the Delegated Regulation 2015/35.

132 PRA Rulebook, SII firms, External Audit Chapter, p. 4.2.1-4.2.2.

133 PRA Rulebook, SII firms, External Audit Chapter, p. 4.2.2.

134 PRA Supervisory Statement, SS11/16, ‘Solvency II: external audit of the public disclosure requirement’. Note that the concepts/terms ‘properly compiled’ or ‘properly extracted’ are not included within ISAs (UK), and that this additional reporting engagement is outside the scope of the SFCR reasonable assurance opinion. However, the auditor may wish to consider other potentially relevant sources of guidance on the process for assessing the ‘proper compilation’ of the sectoral information. SIR 4000 – *Investment Reporting Standards Applicable to Public Reporting Engagements on Pro forma Financial Information* (2006), for example, includes guidance on aspects of the compilation process for pro forma information which may be helpful in this context.

63. This is an separate reporting requirement, other than that required under ISAs (UK). The auditor therefore considers and complies with ISA (UK) 700 by addressing this “requirement under a separate section of the auditor’s report with a heading titled “Report on Other Legal and Regulatory Requirements” or otherwise as appropriate to the content of the section.<sup>135</sup> The auditor clearly identifies which of the ‘relevant elements’ of the SFCR relate to the ‘properly compiled’ statement, and are therefore out of scope of the audit opinion on the SFCR. An illustrative example of such a report is included as an annex to this Practice Note.

### Basis of Preparation

64. ISA (UK) 200 states that, “...an audit in accordance with ISAs (UK) is conducted on the premise that management and, where appropriate, those charged with governance” have acknowledged their responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control they determine to be necessary to enable the preparation of financial statements that are free from material misstatement.<sup>136</sup> The preparation of financial statements “requires”, “The inclusion of an adequate description of..[the]..framework in the financial statements.”<sup>137</sup> ISA (UK) 700 requires that, in forming an opinion on the financial statements, the auditor evaluates whether the, “financial statements appropriately disclose the significant accounting policies selected and applied”, and whether the “financial statements adequately refer to or describe the applicable financial reporting framework.”<sup>138</sup>

### Key Audit Matters, Other Planning and Scoping Matters

65. ISA (UK) 800 states that for audits of special purpose financial statements, the requirements of ISA (UK) 701 only apply when such matters are required to be communicated by law or regulation, or when the auditor otherwise decides to do so. When these matters are communicated in the auditor’s report on special purpose financial statements, ISA (UK) 701 applies in its entirety.<sup>139</sup> The PRA rulebook does not require the auditor to communicate key audit matters, or other planning and scoping matters such as materiality in its report.

### Other Information

66. For the purposes of the audit of the SFCR and the application of ISA (UK) 720, the auditor considers elements of the SFCR which are published alongside the ‘relevant elements of

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135 ISA (UK) 700 (Revised June 2016), para. 43.

136 ISA (UK) 200 (revised), para. A2.

137 ISA (UK) 200 (revised), para. A3.

138 ISA (UK) 700 (revised), para. 13 (a), 15 & A10-A15.

139 ISA (UK) 800, para. A16.

the SFCR' to be 'statutory other information'. This includes information contained within the 'relevant elements' which are out of scope of the opinion because they 'are or are derived from the SCR'.

67. Under PRA rules, where the auditor of the relevant elements of the SFCR is also the auditor of the statutory financial statements, then in addition to the requirements of ISA (UK) 720 it must consider information and knowledge gained in the course of the statutory audit when considering whether the other information is consistent with it.

### **The Society of Lloyd's and Syndicate reporting**

68. The Society of Lloyd's falls within scope of Solvency II, and is therefore subject to Pillar 3 public disclosure requirements. In order to comply with this requirement, the Society has issued instructions to managing agents in respect of syndicate reporting<sup>140</sup>, including an audit requirement. The guidance contained within this section of the Practice Note will therefore have relevance for the auditor of syndicate reports to the Society, although they will need to consider the specific circumstances of Lloyd's, including the specified form of the auditor's report.

69. The Society of Lloyd's collects data from each syndicate to be able to meet its Pillar 3 reporting requirements, using an online data collection system known as Core Market Returns (CMR).

70. Lloyd's collects a Solvency II balance sheet ('QMC') from syndicates twice a year, at 30 June (subject to a reasonable assurance review), and at 31 December (subject to a full external audit). Syndicates are required to submit the following annual forms:

- ASR Annual Solvency Return
- ASB Annual Solvency Return Part B
- AAD Annual Asset Data

71. Only certain forms within the ASR fall within the audit scope equivalent to that being applied by PRA to all supervised undertakings. Lloyd's therefore applies an equivalent audit requirement for the following ASR forms:

- ASR002 – Balance Sheet\* (EIOPA S.02.01.02)
- ASR220 – Own Funds (EIOPA S.23.01.01)
- ASR240 – Non-Life Technical Provisions Part A\* (EIOPA S.17.01.02)

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140 "QMC Return Instructions December 2015 Version 1.0" ('the Instructions'), prepared by the managing agent pursuant to the provisions of the Solvency and Reporting Byelaw (No.5 of 2007) ("the Byelaw") and the requirements referred to by Lloyd's in the Instructions. Auditors should refer to these or any subsequent Lloyd's Solvency II guidance and instructions.

- ASR280 – Life Technical Provisions\* (EIOPA S.12.01.01)
  - ASR283 – Health SLT Technical Provisions\* (EIOPA S.12.01.01)
  - ASR510 – Minimum Capital Requirement (Non-Life) (EIOPA S.28.01.01)
  - ASR511 – Minimum Capital Requirement (Life) (EIOPA S.28.01.01)
  - ASR910 – Managing Agent’s Report (sign off by the Board of the managing agent)
72. The risk margin is not subject to audit where (as in the case of Lloyd’s syndicates) it is dependent on an SCR generated by an internal model.
73. The Society will issue a model auditor’s report for use by the external auditors of these regulatory returns.

## **SECTION 7: ILLUSTRATIVE AUDITOR'S REPORTS – SOLVENCY II ('DIRECTIVE') FIRMS**

### **A: An auditor's report on relevant elements of the SFCR: Solo insurer, standard formula**

For the purpose of this illustrative report the following circumstances are assumed:

- The insurance entity is a solo insurer.
- The auditor is responsible for the audit of the entity's statutory financial statements as well as of the relevant elements of the Solvency and Financial Condition Report.
- The audited entity has calculated the Solvency Capital Requirement using the standard formula. The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.
- The terms of the audit engagement reflect the description of management's responsibility for the Solvency and Financial Condition Report in ISA (UK) 210.
- The auditor has concluded an unmodified (i.e. "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are the FRC Ethical Standards.
- The auditor's report is published with the Solvency and Financial Condition Report.
- The auditor is not required, and has otherwise decided not to communicate key audit matters in accordance with ISA (UK) 701 in the context of the audit of the relevant elements of the Solvency and Financial Condition Report.
- Those elements of the SFCR, including templates, which are not subject to audit, are treated as 'statutory other information' in accordance with the requirements of ISA 720 (UK). The auditor has nothing to report in respect of 'other information'.
- The auditor has 'other reporting responsibilities' as defined by ISA (UK) 700 para. 43. These responsibilities arise from rule 4.1 (3) of the 'External Audit' part of the PRA rulebook pertaining to Solvency II firms, and para 3.5 of the PRA 'Supervisory Statement SS11/16 'Solvency II: external audit of the public disclosure requirement September 2016'. The auditor is required to: "read and consider all information disclosed by the firm in its SFCR that is not a relevant element of the SFCR to identify material inconsistencies with the relevant elements of the SFCR and any knowledge obtained and other information to which the auditor has had access during the course of the audit of the SFCR engagement *and (where applicable) audit of the financial statements.*"

**Report of the external independent auditor to the Directors of [Company Name] ('the Company') pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms**

**Report on the Audit of the relevant elements of the Solvency and Financial Condition Report**

**Opinion**

Except as stated below, we have audited the following documents prepared by ABC Company as at [date]:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of ABC Company as at [date], (**the Narrative Disclosures subject to audit**); and
- Company templates S02.01.02 [S12.01.01, S17.01.02, S22.01.21, S23.01.01, S25.01.21, S28.01.01, S28.02.01<sup>141</sup>] (**the Templates subject to audit**).

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the 'relevant elements of the Solvency and Financial Condition Report'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the Other Information which comprises:

- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;
- Company templates S05.01.02, S05.02.01, S19.01.21;
- Information calculated in accordance with the previous regime used in the calculation of the transitional measure on technical provisions, and as a consequence all information relating to the transitional measures on technical provisions as set out in the Appendix to this report [where disclosed];
- the written acknowledgement by management of their responsibilities, including for the preparation of the solvency and financial condition report (**the Responsibility Statement**).

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of ABC Company as at [date] is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II

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141 The templates referred to should be those actually completed by the Company that are within scope of the audit.

regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

### **Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)), including ISA (UK) 800 and ISA (UK) 805. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report* section of our report. We are independent of the [Company] in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### **Conclusions relating to going concern**

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the SFCR is not appropriate; or
- the directors have not disclosed in the SFCR any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the SFCR is authorised for issue.

### **Emphasis of Matter – Basis of Accounting**

We draw attention to the ['Valuation for solvency purposes'] and/or ['Capital Management'] and/or [other relevant disclosures] sections of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of these matters.

### **Other Information**

The [Directors are][Committee of Management is] responsible for the Other Information.

Our opinion on the relevant elements of the Solvency and Financial Condition Report does not cover the Other Information and, we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the relevant elements of the Solvency and Financial Condition Report or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

### **Responsibilities of [Directors]/[Committee of Management] for the Solvency and Financial Condition Report**

The [Directors are] [Committee of Management is] responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations. [which have been modified by the modifications, and supplemented by the approvals and determinations made by the PRA under section 138A of FSMA, the PRA Rules and Solvency II regulations on which they are based<sup>142</sup>]

The [Directors are] [Committee of Management is] also responsible for such internal control as [they determine]/[it determines] is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report<sup>143</sup>**

It is our responsibility to form an independent opinion as to whether the relevant elements of the Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the

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142 In accordance with guidance in the PN in section 6 paragraphs 43-47 the auditor should consider the adequacy of disclosures in the SFCR in respect of modifications, approvals and determinations when drafting this section of the auditor's report.

143 Note that the auditor may deem it appropriate to refer, in an Other Matter paragraph, to the auditor's report of the complete set of general purpose financial statements (the statutory financial statements). For example to any Material Uncertainty Related to Going Concern. ISA (UK), A.19.

aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the Solvency and Financial Condition Report.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: [*website link*]<sup>144</sup>

### **Report on Other Legal and Regulatory Requirements.**

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook for Solvency II firms we are required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of [ABC Company's] statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.<sup>145</sup>

*Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate*

[*Auditor Address*]

[*Date*]

### **Appendix – relevant elements of the Solvency and Financial Condition Report that are not subject to audit**

#### **Solo standard formula**

The relevant elements of the Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of template S.12.01.02
  - Rows R0110 to R0130 – Amount of transitional measure on technical provisions
- The following elements of template S.17.01.02
  - Rows R0290 to R0310 – Amount of transitional measure on technical provisions
- The following elements of template S.22.01.21
  - Column C0030 – Impact of transitional measure on technical provisions
- Elements of the Narrative Disclosures subject to audit identified as 'unaudited'.

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144 <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Auditors-responsibilities-for-audit/Description-of-auditors-responsibilities-for-audit.aspx>

145 Relevant where the auditor of the Solvency and Financial Condition Report is also auditor of the Company's statutory financial statements.

## **B: An auditor's report on relevant elements of the SFCR: Solo insurer, partial/full internal model**

For the purpose of this illustrative report the following circumstances are assumed:

- The entity is a solo insurer.
- The auditor is responsible for the audit of the entity's statutory financial statements as well as of the relevant elements of the Solvency and Financial Condition Report.
- The audited entity has calculated the Solvency Capital Requirement using the partial or full internal model method.
- The risk margin; restricted own-funds in ring-fenced funds and matching adjustment portfolios; deductions reflecting the non-availability of own-funds items at a group level; narrative components of the relevant elements of the SFCR that relate to or are derived from the SCR; and the transitional measure for technical provisions are all out of the scope of the audit. The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.
- The terms of the audit engagement reflect the description of management's responsibility for the Solvency and Financial Condition Report in ISA (UK) 210
- The auditor has concluded an unmodified (i.e. "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are the FRC's ethical standards.
- The auditor's report is published with the Solvency and Financial Condition Report.
- The auditor is not required, and has otherwise decided not to communicate key audit matters in accordance with ISA (UK) 701 in the context of the audit of the relevant elements of the Solvency and Financial Condition Report.
- Those elements of the SFCR, including templates, which are not subject to audit, are treated as 'statutory other information' in accordance with the requirements of ISA 720 (UK). The auditor has nothing to report in respect of 'other information'.
- The auditor has 'other reporting responsibilities' as defined by ISA (UK) 700 para. 43. These responsibilities arise from rule 4.1 (3) of the 'External Audit' part of the PRA rulebook pertaining to Solvency II firms, and para 3.5 of the PRA 'Supervisory Statement SS11/16 'Solvency II: external audit of the public disclosure requirement September 2016'. The auditor is required to: "read and consider all information disclosed by the firm in its SFCR that is not a relevant element of the SFCR to identify material inconsistencies with the relevant elements of the SFCR and any knowledge obtained and other information to which the auditor has had access during the course of the audit of the SFCR engagement *and (where applicable) audit of the financial statements.*"

**Report of the external independent auditor to the Directors of [Company Name] ('the Company') pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms**

**Report on the Audit of the relevant elements of the Solvency and Financial Condition Report**

**Opinion**

Except as stated below, we have audited the following documents prepared by ABC Company as at [date]:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of ABC Company as at [date], (**the Narrative Disclosures subject to audit**); and
- Company templates S02.01.02 [S12.01.01, S17.01.02, S22.01.21, S23.01.01, S28.01.01, S28.02.01<sup>146</sup>] (**the Templates subject to audit**).

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the '**relevant elements of the Solvency and Financial Condition Report**'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the Other Information which comprises:

- information contained within the relevant elements of the Solvency and Financial Condition Report set out above which are, or derive from the Solvency Capital Requirement, as identified in the Appendix to this report;
- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;
- Company templates S05.01.02, S05.02.01, S19.01.21, S.25.02.21, S.25.03.21;
- Information calculated in accordance with the previous regime used in the calculation of the transitional measure on technical provisions, and as a consequence all information relating to the transitional measures on technical provisions as set out in the Appendix to this report [where disclosed];
- the written acknowledgement by management of their responsibilities, including for the preparation of the solvency and financial condition report (**the Responsibility Statement**).

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146 The templates referred to should be those actually completed by the Company that are within scope of the audit.

To the extent the information subject to audit in the relevant elements of the Solvency and Financial Condition Report includes amounts that are totals, sub-totals or calculations derived from the Other Information, we have relied without verification on the Other Information.

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of ABC Company as at [date] is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

### **Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) including ISA (UK) 800 and ISA (UK) 805, and applicable law. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report* section of our report. We are independent of the [Company] in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### **Conclusions relating to going concern**

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the SFCR is not appropriate; or
- the directors have not disclosed in the SFCR any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the SFCR is authorised for issue.

### **Emphasis of Matter – Basis of Accounting**

We draw attention to the ['Valuation for solvency purposes'] and/or ['Capital Management'] and/or [other relevant disclosures] sections of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

## **Other Information**

The [Directors are] [Committee of Management is] responsible for the Other Information.

Our opinion on the relevant elements of the Solvency and Financial Condition Report does not cover the Other Information and, we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the relevant elements of the Solvency and Financial Condition Report or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

## **Responsibilities of [Directors][Committee of Management] for the Solvency and Financial Condition Report**

The [Directors are] [Committee of Management is] responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations. [which have been modified by the modifications, and supplemented by the approvals and determinations made by the PRA under section 138A of FSMA, the PRA Rules and Solvency II regulations on which they are based<sup>147</sup>]

The [Directors are] [Committee of Management is] also responsible for such internal control as [they determine]/[it determines] is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

## **Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report<sup>148</sup>**

It is our responsibility to form an independent opinion as to whether the relevant elements of the Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

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147 In accordance with guidance in the PN in section 6 paragraphs 43-47 the auditor should consider the adequacy of disclosures in the SFCR in respect of modifications, approvals and determinations when drafting this section of the auditor's report.

148 Note that the auditor may deem it appropriate to refer, in an Other Matter paragraph, to the auditor's report of the complete set of general purpose financial statements (the statutory financial statements). For example to any Material Uncertainty Related to Going Concern. ISA (UK), A.19.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the Solvency and Financial Condition Report.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: [*website link*].<sup>149</sup>

### **Other Matter**

The Company has authority to calculate its [Group] Solvency Capital Requirement using a [partial] internal model ("the Model") approved by the Prudential Regulation Authority in accordance with the Solvency II Regulations. In forming our opinion (and in accordance with PRA Rules), we are not required to audit the inputs to, design of, operating effectiveness of and outputs from the Model, or whether the Model is being applied in accordance with the Company's application or approval order.

### **Report on Other Legal and Regulatory Requirements.**

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook for Solvency II firms we are also required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of [ABC Company's] statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.<sup>150</sup>

*Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate*

[Auditor Address]

[Date]

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149 <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Auditors-responsibilities-for-audit/Description-of-auditors-responsibilities-for-audit.aspx>

150 Relevant where the auditor of the Solvency and Financial Condition Report is also auditor of the Company's statutory financial statements.

## **Appendix – relevant elements of the Solvency and Financial Condition Report that are not subject to audit**

### **Solo partial/internal model**

The relevant elements of the Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of template S.02.01.02:
  - Row R0550: Technical provisions – non-life (excluding health) – risk margin
  - Row R0590: Technical provisions – health (similar to non-life) – risk margin
  - Row R0640: Technical provisions – health (similar to life) – risk margin
  - Row R0680: Technical provisions – life (excluding health and index-linked and unit-linked) – risk margin
  - Row R0720: Technical provisions – Index-linked and unit-linked – risk margin
- The following elements of template S.12.01.02
  - Row R0100: Technical provisions calculated as a sum of BE and RM – Risk margin
  - Rows R0110 to R0130 – Amount of transitional measure on technical provisions
- The following elements of template S.17.01.02
  - Row R0280: Technical provisions calculated as a sum of BE and RM – Risk margin
  - Rows R0290 to R0310 – Amount of transitional measure on technical provisions
- The following elements of template S.22.01.21
  - Column C0030 – Impact of transitional measure on technical provisions
  - Row R0010 – Technical provisions
  - Row R0090 – Solvency Capital Requirement
- The following elements of template S.23.01.01
  - Row R0580: SCR
  - Row R0740: Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds
- The following elements of template [S.28.01.01 / S.28.02.01]
  - Row R0310: SCR
- Elements of the Narrative Disclosures subject to audit identified as ‘unaudited’.

### **C: An auditor's report on relevant elements of the SFCR: Group, partial/full internal model**

For the purpose of this illustrative report the following circumstances are assumed:

- The entity is a group insurer and includes information prepared on a sectoral basis which is subject to the 'properly compiled' statement required by the PRA.
- The auditor is responsible for the audit of the entity's statutory financial statements as well as of the relevant elements of the Solvency and Financial Condition Report.
- The audited entity has calculated the Solvency Capital Requirement using the partial or full internal model method.
- The risk margin; restricted own-funds in ring-fenced funds and matching adjustment portfolios; deductions reflecting the non-availability of own-funds items at a group level; narrative components of the relevant elements of the SFCR that relate to or are derived from the SCR; the transitional measure for technical provisions; and information prepared on a sectoral basis are all out of the scope of the audit. The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.
- The terms of the audit engagement reflect the description of management's responsibility for the Solvency and Financial Condition Report in ISA (UK) 210
- The auditor has concluded an unmodified (i.e. "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are the FRC's ethical standards.
- The auditor's report is published with the Solvency and Financial Condition Report.
- The auditor is not required, and has otherwise decided not to communicate key audit matters in accordance with ISA (UK) 701 in the context of the audit of the relevant elements of the Solvency and Financial Condition Report.
- Those elements of the SFCR, including templates, which are not subject to audit, are treated as 'statutory other information' in accordance with the requirements of ISA 720 (UK). The auditor has nothing to report in respect of 'other information'.
- The auditor has 'other reporting responsibilities' as defined by ISA (UK) 700 para. 43. These responsibilities arise from rule 4.1 (3) of the 'External Audit' part of the PRA rulebook pertaining to Solvency II firms, and para 3.5 of the PRA 'Supervisory Statement SS11/16 'Solvency II: external audit of the public disclosure requirement September 2016'. The auditor is required to: "read and consider all information disclosed by the firm in its SFCR that is not a relevant element of the SFCR to identify material inconsistencies with the relevant elements of the SFCR and any knowledge obtained and other information to which the auditor has had access during the course of the audit of the SFCR engagement *and (where applicable) audit of the financial statements.*"

**Report of the external independent auditor to the Directors of [Company Name] ('the Company') pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms**

**Report on the Audit of the relevant elements of the Group Solvency and Financial Condition Report**

**Opinion**

Except as stated below, we have audited the following documents prepared by ABC Company as at [date]:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Group Solvency and Financial Condition Report of ABC Company as at [date], (**the Narrative Disclosures subject to audit**); and
- Company Group templates S02.01.02 [S22.01.22, S23.01.22, S32.01.22<sup>151</sup>] (**the Templates subject to audit**).

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the '**relevant elements of the Group Solvency and Financial Condition Report**'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the Other Information which comprises:

- information contained within the relevant elements of the Group Solvency and Financial Condition Report set out above which are, or derive from the Solvency Capital Requirement, as identified in the Appendix to this report
- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Group Solvency and Financial Condition Report;
- Group templates S05.01.02, S05.02.01, S.25.02.22, S.25.03.22;
- Information calculated in accordance with the previous regime used in the calculation of the transitional measure on technical provisions, and as a consequence all information relating to the transitional measures on technical provisions as set out in the Appendix to this report [where disclosed]
- the written acknowledgement by management of their responsibilities, including for the preparation of the Group Solvency and Financial Condition Report (**the Responsibility Statement**);

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151 The templates referred to should be those actually completed by the Company that are within scope of the audit.

- Information which pertains to an undertaking that is not a Solvency II undertaking and has been prepared in accordance with PRA rules other than those implementing the Solvency II Directive or in accordance with an EU instrument other than the Solvency II regulations. [**the sectoral information**].<sup>152</sup>

To the extent the information subject to audit in the relevant elements of the Group Solvency and Financial Condition Report includes amounts that are totals, sub-totals or calculations derived from the Other Information, we have relied without verification on the Other Information.

In our opinion, the information subject to audit in the relevant elements of the Group Solvency and Financial Condition Report of ABC Company as at [date] is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

#### **Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) including ISA (UK) 800 and ISA (UK) 805, and applicable law. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the relevant elements of the Group Solvency and Financial Condition Report* section of our report. We are independent of the [Company] in accordance with the ethical requirements that are relevant to our audit of the Group Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### **Conclusions relating to going concern**

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the SFCR is not appropriate; or
- the directors have not disclosed in the SFCR any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the SFCR is authorised for issue.

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<sup>152</sup> See the separate part of our report, 'Other Legal and Regulatory Requirements'.

### **Emphasis of Matter – Basis of Accounting**

We draw attention to the ['Valuation for solvency purposes'] and/or ['Capital Management'] and/or [other relevant disclosures] sections of the Group Solvency and Financial Condition Report, which describe the basis of accounting. The Group Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Group Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

### **Other Information**

The [Directors are][Committee of Management is] responsible for the Other Information.

Our opinion on the relevant elements of the Group Solvency and Financial Condition Report does not cover the Other Information and we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Group Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Group Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the relevant elements of the Solvency and Financial Condition Report or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

### **Responsibilities of [Directors][Committee of Management] for the Group Solvency and Financial Condition Report**

The [Directors are] [Committee of Management is] responsible for the preparation of the Group Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations. [which have been modified by the modifications, and supplemented by the approvals and determinations made by the PRA under section 138A of FSMA, the PRA Rules and Solvency II regulations on which they are based<sup>153</sup>]

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153 In accordance with guidance in the PN in section 6 paragraphs 43-47 the auditor should consider the adequacy of disclosures in the SFCR in respect of modifications, approvals and determinations when drafting this section of the auditor's report.

The [Directors are] [Committee of Management is] also responsible for such internal control as [they determine]/[it determines] is necessary to enable the preparation of a Group Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibilities for the Audit of the relevant elements of the Group Solvency and Financial Condition Report<sup>154</sup>**

It is our responsibility to form an independent opinion as to whether the relevant elements of the Group Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Group Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the Group Solvency and Financial Condition Report.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: [[website link](#)]<sup>155</sup>

### **Other Matter**

The Company has authority to calculate its [Group] Solvency Capital Requirement using a [partial] internal model ("the Model") approved by the Prudential Regulation Authority in accordance with the Solvency II Regulations. In forming our opinion (and in accordance with PRA Rules), we are not required to audit the inputs to, design of, operating effectiveness of and outputs from the Model, or whether the Model is being applied in accordance with the Company's application or approval order.

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154 Note that the auditor may deem it appropriate to refer, in an Other Matter paragraph, to the auditor's report of the complete set of general purpose financial statements (the statutory financial statements). For example to any Material Uncertainty Related to Going Concern. ISA (UK), A.19.

155 <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Auditors-responsibilities-for-audit/Description-of-auditors-responsibilities-for-audit.aspx>

## Report on Other Legal and Regulatory Requirements.

### Sectoral Information

In our opinion, in accordance with Rule 4.2 of the External Audit Chapter of the PRA Rulebook, the **sectoral information** has been properly compiled in accordance with the PRA rules and EU instruments relating to that undertaking from information provided by members of the group and the relevant insurance group undertaking.

### Other Information

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook for Solvency II firms we are also required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of [ABC Company's] statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.<sup>156</sup>

*Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate*

*[Auditor Address]*

*[Date]*

## Appendix – relevant elements of the Group Solvency and Financial Condition Report that are not subject to audit

### Group internal model

The relevant elements of the Group Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of Group template S.02.01.02:
  - Row R0550: Technical provisions – non-life (excluding health) – risk margin
  - Row R0590: Technical provisions – health (similar to non-life) – risk margin
  - Row R0640: Technical provisions – health (similar to life) – risk margin
  - Row R0680: Technical provisions – life (excluding health and index-linked and unit-linked) – risk margin
  - Row R0720: Technical provisions – Index-linked and unit-linked – risk margin

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<sup>156</sup> Relevant where the auditor of the Solvency and Financial Condition Report is also auditor of the Company's statutory financial statements.

- The following elements of Group template S.22.01.22
  - Column C0030 – Impact of transitional on technical provisions
  - Row R0010 – Technical provisions
  - Row R0090 – Solvency Capital Requirement
- The following elements of Group template S.23.01.22
  - Row R0020: Non-available called but not paid in ordinary share capital at group level
  - Row R0060: Non-available subordinated mutual member accounts at group level
  - Row R0080: Non-available surplus at group level
  - Row R0100: Non-available preference shares at group level
  - Row R0120: Non-available share premium account related to preference shares at group level
  - Row R0150: Non-available subordinated liabilities at group level
  - Row R0170: The amount equal to the value of net deferred tax assets not available at the group level
  - Row R0190: Non-available own funds related to other own funds items approved by supervisory authority
  - Row R0210: Non-available minority interests at group level
  - Row R0380: Non-available ancillary own funds at group level
  - Rows R0410 to R0440 – Own funds of other financial sectors
  - Row R0680: Group SCR
  - Row R0740: Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds
  - Row R0750: Other non available own funds
- Elements of the Narrative Disclosures subject to audit identified as 'unaudited'.

## **SECTION 8: REPORTING ON NON SOLVENCY II ('NON-DIRECTIVE') FIRMS**

1. The PRA Rulebook sets reporting requirements for non-directive firms which applies to:
  - (1) all non-directive insurers, other than non-directive friendly societies;
  - (2) Swiss general insurers in respect of the activities of the firm carried on from a branch in the UK<sup>157</sup>; and
  - (3) ....every firm that is a non-directive friendly society other than:
    - *a flat rate benefits business friendly society; and*
    - *a partnership pension society.*

There are no reporting requirements for flat rates benefits business friendly societies and partnership pension societies.

### **Authorised insurers**

2. An insurer regulated by the PRA is required by rule 9.2 of the Insurance Company Reporting section of the non-directive firms rulebook to submit one copy of every form and document comprising the regulatory return to the PRA within three months of each financial year-end.<sup>158</sup> The format of this return is prescribed by the Rulebook.
3. Rule 2.5 requires the regulatory return to be audited in accordance with Chapter 7 of the rulebook, by a person qualified in accordance with the Auditors Part of the PRA Rulebook [with the exception of any directors certificates; form 46; and form 50].<sup>159</sup>

### **Friendly Societies**

4. Non-directive friendly societies are not required to have their regulatory reports to the PRA audited. The remainder of this section of the PN is therefore not relevant to the auditors of non-directive friendly societies.<sup>160</sup>

### **The form and content of the Regulatory Return**

5. The PRA rulebook establishes a requirement for firms to prepare for each 12 month financial year relevant forms, statements and documents; including a revenue account for the year, a balance sheet as at the end of the year and a profit and loss account for the

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157 PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, paras.1.1-1.2.

158 PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, para. 9.2.

159 PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, para. 2.5.

160 Auditors should refer to the PRA rulebook or the requirements in respect of mutual insurers constituted as companies limited by guarantee or as Industrial and Provident Societies.

year; or, in the case of an insurer not trading for profit, an income and expenditure account for the year.<sup>161</sup>

6. This requirement is separate from the requirement for a UK incorporated insurer to prepare financial statements under the Companies Act 2006 (CA 2006). There is, however, deemed to be a close correlation between the figures included. Except where over-ridden by the rules in the PRA rule book, words and expressions used in the 2008 Accounts and Reports Regulations have the same meaning in the rulebook. The rules are drafted so that insurers can apply the same accounting policies in both the regulatory return and the financial statements and require that, except where a rule provides for a different method of recognition or valuation, then the insurer for the purposes of that rule, recognises the asset, liability, equity or income statement item and measures it in accordance with UK GAAP or IFRS as applicable.
7. The principal differences between the regulatory return and financial statements prepared under CA 2006 are as follows:
  - The regulatory return is primarily intended to demonstrate the solvency of an insurer.
  - The balance sheet included in the regulatory return may show items at different values from those shown in the financial statements, arising from the application of rules in respect of: –
    - (a) Assets that can be treated as admissible; assets that are not admissible (for example deferred acquisition costs in respect of long-term business) are left out of account;
    - (b) The basic valuation principles to be applied to admissible assets and to liabilities;
    - (c) Restrictions on the value of assets where the value arrived at by applying the basic valuation principles exceeds the permitted market risk or counterparty exposure limits; and
    - (d) The determination of long-term insurance business liabilities; – the treatment of certain types of hybrid capital; and – a provision for reasonable foreseeable adverse variations where certain commitments are not strictly matched;
  - The income statement, particularly for general business, provides a large volume of detailed segmental information including a breakdown into combined categories and further sub-divisions into material risk categories, which are reported by currency and, in some cases, reporting territory. Deposit accounting must not be used in the income statement for long-term insurance contracts even where these contracts are subject to deposit accounting as investment business in the financial statements.

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<sup>161</sup> PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, paras.2.1-2.3.

- Additional information is provided in the regulatory return on a variety of topics including:
    - (a) The Abstract of the valuation, prepared by the actuarial function holder(s) for an insurer carrying on long-term insurance business;
    - (b) General business reinsurance arrangements;
    - (c) Financial reinsurance and other financing arrangements;
    - (d) Major general business reinsurers and cedants;
    - (e) The use of derivatives.
8. The regulatory return is accompanied by a certificate signed by the directors of the firm, which states that:

*The return has been properly prepared in accordance with the requirements in the Non-Solvency II Firms section of the PRA rule book;*

*The directors are satisfied that throughout the year in question, the firm has complied in all material respects with the rules in the Non-Solvency II Firms sector of the PRA rule book; and it is reasonable to believe that the firm has continued so to comply subsequently, and will do so in the future.*

9. The directors' certificate, Form 46 and Form 50 are outside the scope of the audit.<sup>162</sup>

### **The auditor's responsibilities**

10. The Insurance Company Reporting part of the PRA's rulebook for Non-Solvency II firms sets out the auditor's responsibilities. These include the required elements of the auditor's report, covering whether, in the auditor's opinion:
- (a) the Forms, statements and documents have been properly prepared in accordance with this Part and the Insurance Company – Overall Resources and Valuation Part and any *specific valuation* rule;
  - (b) the methods and assumptions determined by the *firm* and used to perform the *actuarial investigation* (as set out in the valuation reports) appropriately reflect the requirements of Insurance Company – Mathematical Reserves; and,
  - (c) to the extent that any document, form, statement, analysis or report to be audited contains amounts or information abstracted from the *actuarial investigation* performed pursuant to 5.8 and 5.9, the auditor has obtained and paid due regard to advice from a suitably qualified *actuary* who is independent of the *firm*.<sup>163</sup>

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<sup>162</sup> PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, para. 2.5.

<sup>163</sup> PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, para. 7.2.

11. Rule 7.5 requires the auditor to report by exception, in accordance with the Companies Act 2006, if they are of the opinion that:
  - (a) Adequate accounting records have not been kept, or that returns adequate for its audit have not been received from branches not visited by it;
  - (b) The insurer's individual accounts are not in agreement with the accounting records and returns; and
  - (c) It has failed to obtain all the information and explanations which, to the best of the auditor's knowledge and belief, are necessary for the purposes of the audit.

### **Standards to be applied by the auditor**

12. In the case of a UK incorporated insurer, an audit of the financial statements prepared under CA 2006 will be conducted in accordance with ISAs (UK) issued by the FRC to comply with the requirements of section 495 of CA 2006. If an audit of financial statements in accordance with ISAs (UK) has not been undertaken (as may be the case in relation to the UK branch of an insurer incorporated outside the UK) the regulatory return will need to have been audited in accordance with ISAs UK in order to satisfy the reporting requirement.
13. Work specific to the auditor's report on an insurer's regulatory return may be undertaken concurrently with procedures designed to provide evidence for its report on the financial statements or at a later date. In either case, the auditor considers both aspects of the engagement when planning the audit of the financial statements.
14. Although the PRA rulebook does not require the regulatory return to be drawn up to show a true and fair view, rule 6.1 says that it "must fairly state the information provided on the basis required by this Part".<sup>164</sup> This is of a similar qualitative standard to the requirement in company law that financial statements give a true and fair view of a company's state of affairs and profit or loss, hence equivalent considerations of materiality apply. In evaluating whether the requirements of rule 6.1 have been met, the auditor applies materiality in relation to the business as a whole. Following this approach, reliance on analytical review techniques may be appropriate in relation to, for example, the segmental information provided within the regulatory return.

### **General Principles**

15. The auditor:
  - Plans the work to be undertaken so as to perform that work in an effective manner;
  - Familiarises them self with the relevant regulations;

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<sup>164</sup> PRA Rulebook: Non-Solvency II Firms: Insurance Company – Reporting, para.6.1.

- Complies, where relevant, with FRC Ethical Standards for Auditors and with ethical guidance issued by its relevant professional body.
- Agrees the terms of the engagement with the insurer and records them in writing. The auditor may choose to combine the audit requirements with the financial statement engagement letter. This will include reference, where relevant, to the PRA requirement for the auditor to engage a suitably qualified actuary who is independent of the insurer and pay due regard to advice from that actuary.
- Considers materiality and its relationship with the risk of material misstatement in planning its work and in determining the effect of its findings on its report.
- Undertakes its work with an attitude of professional scepticism and performs procedures designed to obtain sufficient appropriate evidence on which to base its opinion. In particular it:
  - Applies analytical procedures in forming an overall conclusion as to whether the regulatory return as a whole is consistent with its knowledge of the insurer's business; and
  - Obtains written confirmation of appropriate representations from management before its report is issued.
- Records in its working papers:
  - Details of the engagement planning relating to its report;
  - The nature, timing and extent of the procedures performed, and the conclusions drawn; and
  - Its reasoning and conclusions on all significant matters which require the exercise of judgment.
- If reporting on financial information on which a component auditor has reported, obtain sufficient appropriate evidence that the work of the component auditor is adequate for its purposes.
- Issues a report containing a clear expression of its opinion on the regulatory return.
- Considers the matters which have come to its attention while performing the audit and whether they should be included in a report to the governing body of the audited entity.
- Makes a report direct to the PRA if it becomes aware of matters of material significance to the regulator. In addition, when issuing its report, the auditor:
  - Considers whether there are consequential reporting issues affecting its opinion which arise from any report previously made direct to the PRA in the course of the auditor's appointment; and

- Assesses whether any matters encountered in the course of its work indicate a need for a further direct report.

### **Key Additional Procedures**

16. Key areas in which the auditor needs to undertake procedures additional to those undertaken to report on the financial statements are:
  - (a) The application of the prescribed valuation and admissibility rules to assets and liabilities for which existence, title, etc. has already been considered as a part of the audit of the insurer's financial statements;
  - (b) The sub-division of general business revenue information into the prescribed categories;
  - (c) Presentation of the information in the prescribed forms; and
  - (d) The specific additional disclosures that fall within the scope of the auditor's report.

### **The Auditor's Procedures on Regulatory Returns Long-term business**

17. Rule 7.4 of the Insurance Company – Reporting part of the PRA's rulebook for Non-Solvency II firms requires that where any part of the regulatory return that is subject to audit contains amounts or information abstracted from an actuarial investigation, the auditor is required to obtain and pay due regard to advice from a suitably qualified actuary who is independent of the firm. Chapter 5 of the relevant rulebook sets out the required content of such a report.
18. The PRA rulebook does not specify the advice to be obtained from the actuary or provide guidance on the nature or extent of the work to be performed in providing that advice. The responsibility for determining the nature of the advice and, consequently, the scope and extent of the actuary's work lies with the auditor, although the auditor discusses the proposed scope of work with the actuary and considers the views of the actuary before finalising the scope of work.
19. The auditor does not have the same expertise as the actuary; however seeks to obtain an understanding of the assumptions and methods used by the firm and to consider whether they are reasonable, based on the auditor's knowledge of the business. If the results of the actuary's work are not consistent with other audit evidence, the auditor attempts to resolve the inconsistency by discussions with the actuary. Applying additional procedures, including possibly engaging another actuary, may also assist in resolving the inconsistency. If the auditor is not satisfied that the work of the actuary provides sufficient appropriate audit evidence to support its opinion on the regulatory returns and there is no satisfactory alternative source of audit evidence, the auditor considers the implications for the auditor's report.
20. This Practice Note includes a section on the application of the auditing standards to the audit of statutory financial statements which is also relevant to the procedures carried out

in respect of the regulatory return. This includes the need to agree the scope of work, the form of report and compliance with the FRC's Technical Actuarial Standards (TASs).

21. In addition to the high level principles set out in TAS 100, TAS 200 includes specific requirements for actuaries who perform technical actuarial work to support the provisions of an auditor's assurance opinion for regulatory reporting. These requirements help the auditor comply with the auditing standards:
  - (a) The initial scope of the technical actuarial work and the reasons for any variances from the initial scope shall be documented.
  - (b) Technical actuarial work undertaken shall be planned and performed with professional scepticism recognizing the circumstances may exist that cause the financial statements or regulatory information to be materially misstated.
  - (c) Communications shall state the nature and extent of any reliance on information prepared by another party and the conclusions of the technical actuarial work including any concerns on material deficiencies or limitations.<sup>165</sup>
  
22. The auditor obtains advice from the actuary on those elements of an actuarial investigation that the auditor believes, for the purpose of the audit of the annual return, require expert actuarial input to assess. The areas of an actuarial investigation that the auditor will seek advice from an actuary include whether:
  - (a) The methods and assumptions used to calculate the mathematical reserves appropriately reflect the requirements of the PRA rulebook ("Mathematical reserves").
  - (b) The statement(s) made under on "Valuation reports on long-term insurance business" are made in accordance with the requirements of the PRA rulebook.
  
23. The auditor obtains advice on all other elements of the actuarial investigation to the extent that they are relevant to the auditable parts of the return. The elements of the actuarial investigation, other than those detailed above, that the auditor may also seek to obtain advice from the actuary on include whether:
  - (a) The data underlying the calculation of the mathematical reserves are reliable.
  - (b) The models used to apply the methods and assumptions underlying the mathematical reserves are operating appropriate.
  - (c) The data contained in Forms 58 and 60 have been correctly abstracted from the actuarial valuation.
  - (d) The data contained in lines 51 and 52 of Form 11 have been correctly abstracted from the actuarial valuation.

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<sup>165</sup> Technical Actuarial Standard 200: Insurance, paras.22-24.

### **Establishing the independence of the suitably qualified independent actuary**

24. The auditor should be satisfied that any suitably qualified actuary will be independent and document the rationale for that conclusion.
25. When planning the audit of the regulatory return, the engagement partner obtains information from the actuary as to the existence of any connections that the Reviewing Actuary has with the engaging party including:
  - Financial interests.
  - Business relationships (including the provision of services).
  - Employment (past, present and future).
  - Family and other personal relationships.
26. The engagement partner assesses the threats to objectivity and independence that arise from any connections disclosed and considers whether the actuary has implemented safeguards to eliminate the threats or reduce them to an acceptable level.
27. When assessing the threats to objectivity and independence which arise from services provided to the engaging party or its affiliates and the effectiveness of safeguards established by the actuarial firm, the engagement partner will consider the following factors:
  - (a) Whether the actuary was the person responsible for the service provided;
  - (b) The materiality and the nature of the services to the actuarial firm; and
  - (c) The extent to which the outcomes of services have been reviewed by another actuarial firm.
28. In certain circumstances, it is unlikely that any safeguards can eliminate the threat to objectivity and independence or reduce it to an acceptable level. The auditor therefore has regard to the requirements of the FRC's ethical standards.
29. The engagement partner requires the actuary to notify him or her immediately of changes in the circumstances on which information was obtained at the start of the engagement, or any others that might reasonably be considered a threat to the actuary's objectivity.
30. Where the engagement partner identifies a significant threat to objectivity and independence which has not been eliminated or reduced to an acceptable level, he/she discusses with the PRA the circumstances that give rise to the threat and what course of action would be appropriate, including obtaining a rule waiver from the PRA. In circumstances where the matter cannot be resolved satisfactorily, the engagement

partner considers making a reference to the independence of the actuary in the report made to the directors.

### **Reporting**

31. Auditor's reports on regulatory returns normally include the following matters:
  - (a) A title identifying the persons to whom the report is addressed (which will normally be the directors of the insurer);
  - (b) An introductory paragraph identifying the documents within the regulatory return which are covered by the report;
  - (c) Separate sections, appropriately headed, dealing with:
    - (i) Respective responsibilities of the insurer and the auditor, and
    - (ii) The basis of the auditor's opinion;
  - (d) The auditor's opinions on the matters required by the rules;
  - (e) The signature of the auditor; and
  - (f) The date of the auditor's report.
32. If the PRA has issued any directions to the insurer, waiving or modifying the application of any rules that affect the audited parts of a regulatory return, the auditor refers to these in the report and expresses the opinions by reference to the rules as modified.
33. Section 9 set out illustrative examples of reports on regulatory returns for composite insurers. This illustrative example needs to be tailored to reflect particular circumstances.

### **Subsequent events**

34. There may be a gap between the date on which an insurer's statutory financial statements are approved and the date on which it's regulatory return is signed. The auditor undertakes a review of events up to the date of its report on the regulatory return before signing that report.

### **Modifying the auditor's opinion**

35. When reporting on an insurer's regulatory returns, the auditor modifies its opinion as appropriate, following the principles in ISA (UK) 705 (revised). It is possible for the auditor's opinion on an insurer's financial statements to be modified whilst that on its regulatory return is unmodified, and vice versa. This may occur where the grounds for modification relate to the treatment of a particular item (for example, if an asset is included in the regulatory return at a value which does not take account of the specific requirements of the rules relating to the valuation or admissibility of assets).
36. When the auditor modifies their report, on the regulatory return, by making reference to an uncertainty, the PRA rulebook requires the auditor to state whether, in its opinion, the

uncertainty is material to determining whether the insurer has available assets in excess of its capital resources requirement.

### **Resubmitted returns**

37. The PRA may require the insurer to resubmit the regulatory return, or part thereof, where the original regulatory return is considered to be inaccurate or incomplete. The auditor is normally required to express an opinion on the amended or additional material. This can be done by either:
  - (a) Withdrawing the original report and issuing a completely new report; or
  - (b) Issuing a supplementary report on the amended material only, but including a reference to the original report.
  
38. The first option is preferable where the nature and volume of changes required gives rise to a resubmission of the complete return. The second option is preferable where the amendments are considered to be relatively minor or are few in number and only the amended forms, supplementary notes and/or statements are resubmitted.

## **SECTION 9: ILLUSTRATIVE AUDIT REPORT – NON-SOLVENCY II FIRM**

[xx INSURANCE COMPANY LIMITED]

[Global business/UK branch business] Financial year ended 31 December 201x

### **Independent auditor's report to the directors pursuant to rules 7.1-7.6 of the Insurance Company – Reporting Part of the Non-Solvency II firms PRA Rulebook.**

We have audited the following documents prepared by the insurer pursuant to the Insurance Company – Reporting Part, the Insurance Company – Overall Resource Part and specific valuation rules set out in the Rulebook for non-Solvency II firms (“the Rules”), made by the Prudential Regulation Authority under section 137G of the Financial Services and Markets Act 2000:

- *Forms [xx], (including the supplementary notes) on pages [...] to [...] (“the Forms”);*
- *the statements required by Insurance Company – Reporting Part rules xx, xx, xx and xx on pages [...] to [...] (“the statements”); and*
- *the valuation report required by Insurance Company – Reporting Part rules 5.8-5.13 on pages [...] to [...] (the valuation report[s]).*

We are not required to audit and do not express an opinion on:

- the directors' certificate pursuant to rule 2.7 of the Insurance Company – Reporting Part, and
- Forms 46 and 50.

### **Respective responsibilities of the insurer and its auditor**

The insurer is responsible for the preparation of an annual return (including the Forms, the statements and the valuation report[s]) under the provisions of the Rules. **[The requirements of the Rules have been modified by [a] direction[s] issued under section 138A of the Financial Services and Markets Act 2000 on .....200X [and .....200X].** Under the Insurance Company – Reporting Part of the Rulebook for non-Solvency II firms the Forms, the statements, and the valuation report[s] are required to be prepared in the manner specified by the Rules and to state fairly the information provided on the basis required by the Rules. The methods and assumptions determined by the insurer and used to perform the actuarial investigation as set out in the valuation report are required to reflect appropriately the requirements of the Insurance Company – Mathematical Reserves Part of the Rulebook for non-Solvency II firms.

It is our responsibility to form an independent opinion as to whether the Forms, the statements, the valuation report[s] meet these requirements, and to report our opinion to you. We also report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the Forms, the statements and the valuation report[s] are not in agreement with the accounting records and returns; or
- we have not received all the information we require for our audit.

### **Basis of opinion**

We conducted our work in accordance with the procedures and guidance set out in Practice Note 20 “The audit of insurers in the United Kingdom (Revised)” issued by the Financial Reporting Council. Our work included examination, on a test basis, of evidence relevant to the amounts and disclosures in the Forms, the statements and the valuation report[s]. The evidence included that previously obtained by us relating to the audit of the financial statements of the insurer for the financial year. It also included an assessment of the significant estimates and judgments made by the insurer in the preparation of the Forms, the statements and the valuation report[s].

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 to give reasonable assurance that the Forms, the statements and the valuation report[s] are free from material misstatement, whether caused by fraud or other irregularity or error and comply with the Insurance Company – Reporting Part, the Insurance Company – Overall Resource Part and any specific valuation rules in the Rulebook for non-Solvency II firms

In accordance with the Insurance Company – Reporting Part rule 7.2 (2), to the extent that any document, Form, statement, analysis or report to be audited contains amounts or information abstracted from the actuarial investigation performed pursuant to the Insurance Company – Reporting Part rules 5.8 and 5.9, we have obtained and paid due regard to advice from a suitably qualified actuary who is independent of the insurer.

### **Opinion**

In our opinion:

- the Forms, the statements and the valuation report[s] fairly state the information provided on the basis required by the Rules [as modified] and have been properly prepared in accordance with the provisions of those Rules; and
- the methods and assumptions determined by the insurer and used to perform the actuarial investigation as set out in the valuation report[s] appropriately reflect the requirements of the Insurance Company – Mathematical Reserves Part of the Rulebook for non-Solvency II firms

*Statutory auditor*

*Address*

*Date*

## SECTION 10: DEFINITION OF TERMS

AAB	Audit Arrangements Byelaw (applicable to the Lloyd's Insurance Market)
ABI	Association of British Insurers
Actuarial Function Holder	An Actuary appointed by an insurer carrying on long-term insurance business to perform the actuarial function.
AFM	Association of Financial Mutuals
Auditor's expert	An individual or organization 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.
Authorised firm	An insurer which has been granted one or more Part 4a permissions by the PRA and so is authorised under FSMA 2000 to undertake regulated activities – an authorised person. Authorised firms include insurers other than Lloyd's corporate members.
Authorised person	Term used throughout FSMA 2000 and related statutory instruments to refer to an authorised firm – see above.
Authorised insurance company	A company registered under CA 2006 that is authorised by the PRA to conduct insurance business, together with UK branches of insurers established outside the EEA.
CA 2006	The Companies Act 2006.
Closely linked entity	As defined in section 343(8) FSMA 2000, an entity has close links with an authorised firm for this purpose if the entity is a: <ul style="list-style-type: none"> <li>(a) Parent undertaking of an authorised firm;</li> <li>(b) Subsidiary undertaking of an authorised firm;</li> <li>(c) Parent undertaking of a subsidiary undertaking of an authorised firm; or</li> <li>(d) Subsidiary undertaking of a parent undertaking of an authorised firm.</li> </ul>
Council of Lloyd's	The Council constituted by section 3 of Lloyd's Act 1982.
EEA	European Economic Area

EU-IFRSs	International Financial Reporting Standards as adopted by the European Union.
FCA	Financial Conduct Authority
Friendly Society	A friendly society is a mutual organisation whose purpose often includes assisting members financially during sickness, unemployment or retirement, and to provide life assurance.
FSMA 2000	The Financial Services and Markets Act 2000.
Fundamental Rules and Principles for Businesses	The PRA have 8 Fundamental Rules.  The 11 FCA principles are included in a stand-alone module of the FCA Handbook – High Level Standards PRIN 2.1.
IBNR	Incurred But Not Reported
Insurers	The term “insurers” is used in this Practice Note to refer to insurance companies authorised by the PRA (insurers with their head offices in the UK and, insurers established outside the EEA with UK branches) as well as to Friendly Societies and Lloyd’s Syndicates and corporate members.
JMLSG	Joint Money Laundering Steering Group
Lloyd’s corporate member	A member of the Society which is a body corporate (including limited liability partnerships) or a Scottish limited partnership.
Management’s expert	An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the insurer to assist in preparing the financial statements.
Matching Adjustment	The Matching Adjustment (MA) is a parallel shift applied to the entire basic risk-free term structure and serves the same purpose as the volatility adjustment. It is calculated based on the match between the insurers’ assets and the liabilities. Subject to supervisory approval.
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.

Minimum Capital Requirement (MCR)	The MCR is defined in the Solvency II Directive as, “a minimum level of security below which the amount of financial resources should not fall”, and corresponds to a minimum amount of basic own funds (or capital) below which policyholders would be exposed to an unacceptable level of risk. The MCR has an absolute floor below which it must not fall, and must also sit within a corridor (“the MCR corridor”) of between 25% and 45% of the SCR.
NCA	National Crime Agency
ORSA	Own Risk and Solvency Assessment – a Solvency II requirement.
Part 4A permission	A permission granted by the PRA or FCA under Part 4A 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.
PPFM	Principles and Practices of Financial Management [see COBS 20.3 of the FCA Handbook]
PRA	Prudential Regulation Authority
Public Interest Entity (PIE)	<p>These are:</p> <ul style="list-style-type: none"> <li>(a) An issuer whose transferable securities are admitted to trading on a regulated market;</li> <li>(b) A credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, other than those listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms;</li> <li>(c) An insurance undertaking within the meaning given by Article 2(1) of Council Directive 1991/674/EEC of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertaking. No other entities have been specifically designated in law in the UK as ‘public interest entities’.</li> </ul> <p>An insurance undertaking is a PIE if it meets any of the relevant criteria. In respect of c, which applies specifically to insurance entities, the relevant definition is now set out in the Solvency II Directive 2009/138/EC (which repealed previous relevant Directives). With effect from 17 June 2016 UK insurance and reinsurance undertakings within the scope of the Solvency II Directive are PIEs within the meaning of Audit Directive 2006/43 (as amended by Directive 2014/56). This includes relevant friendly</p>

	societies and it also includes the Society of Lloyd's (because the society issues securities which are admitted to trading on a regulated market).
Recognised Accountant	An accountant included on the Council of Lloyds' list of individuals and firms identified as recognised accountants. Recognised accountants are engaged either by a syndicate to perform the annual solvency audit or annual syndicate audit or by a syndicate or Lloyd's underwriting agent to act as reporting accountant.
Risk Margin	A Solvency II requirement, this is the calculated cost of providing an amount of eligible own funds equal to support the obligations over their lifetime which is included within technical provisions.
RITC	"reinsurance to close"
Run-off account	A Lloyd's syndicate year of account which has not been closed at the normal date of closure and remains open.
2001 Regulations	SI 2001 No 2587 "The FSMA 2000 (Communications by Auditors) Regulations 2001"
2008 Regulations	SI 2008/1950 Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008
2008 Accounts and Reports Regulations	SI 2008/410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
2008 Lloyd's Regulations	SI 2008/1950 Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008.
Society	The Society incorporated by the Lloyd's Act 1871 by the names of Lloyd's.
Solvency Capital Requirement (SCR)	The SCR is a risk responsive capital measure calibrated to ensure that the insurer will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. It can be calculated using a standard formula, a combination of the standard formula with an internal model (partial internal model), or a fully bespoke internal model. The expectation is that more complex insurers will use a partial or full internal model approach to reflect the particular circumstances of the risks they are exposed to.
Solvency and Financial Condition Report (SFCR)	Pillar 3 public disclosure under Solvency II. 'Relevant elements' of the SFCR are subject to audit in accordance with PRA rules. The 'relevant elements' are defined in the PRA's external audit rules pertaining to Solvency II firms.

Solvency II	An EU wide harmonized insurance regulatory regime, which became effective from 1 January 2016, under the Solvency II (Directive 2009/138/EC), Delegated Act and implementing UK legislation.
The Solvency Byelaw	The Solvency and Reporting Byelaw (No 5 of 2007) (applicable to the Lloyd's Insurance Market).
Lloyd's Syndicate	A group of underwriting members underwriting insurance business at Lloyd's through the agency of a managing agent.
TASs	Technical Actuarial Standards issued by the Financial Reporting Council.
Technical Provisions	The current amount an insurer would have to pay for an immediate transfer of obligations to another insurer. Under Solvency II this is the sum of a best estimate and a risk margin. The best estimate is calculated as a probability-weighted average of future cash flows, discounted using the relevant risk-free interest rate.
Those charged with governance	ISAs (UK) 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 PRA Rulebook 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 includes directors of insurance companies, directors of Lloyd's managing agents, and the members of the Council of Lloyd's.
Threshold conditions	<p>The minimum standards that an authorised firm needs to meet to become and remain authorised by the PRA and FCA.</p> <p>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 4A permission. Firms must comply with both PRA specific and FCA specific Threshold Conditions.</p>
Transitional Measures	Specific provisions in place during the implementation period for Solvency II, including for example on reporting deadlines, the risk-free curve and technical provisions. Details are available in the PRA Rulebook for Solvency II Directive firms 'Transitional measures' part.

UK GAAP	United Kingdom Generally Accepted Accounting Practice. This consists of applicable law, United Kingdom Accounting Standards including FRS103 Insurance Contracts.
Volatility Adjustment	An adjustment to the relevant risk-free interest rate term structure (in accordance with Regulation 43 of the Solvency 2 Regulations 2015. Subject to supervisory approval.





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