

AUDIT NEWS

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INTRODUCTION

Welcome to the autumn edition of Audit News where we have prepared a number of articles which we hope you will find informative and relevant.

The first article is an outline of the recent debates about whether auditors are sufficiently sceptical in the performance of audit procedures,

together with commentary on the related FRC Annual Report and the APB Briefing Paper. In addition, ICAS has recently published a 'Professional Judgement Framework' to assist those in applying professional judgement.

There are further articles providing guidance on applying to the Audit

Registration Committee for RI status, ceasing to act as auditor, using the work of an expert to obtain audit comfort, and communication of the Audit Registration Committee's change to the process where hot file reviews are considered necessary after an Audit Monitoring visit.

PROFESSIONAL SCEPTICISM

While professional scepticism is not the distrust of everything you see and hear on an audit, it requires an enquiring mind that is open to the possibility that something may be wrong or not as it seems, and accordingly it is important to consider if what you see and hear is reasonable or appropriate, and if it is supported by appropriate evidence.

FRC Annual report 2011/12

There has been significant, and regular, debate about whether auditors are sufficiently sceptical in the performance of audit procedures. This debate has led to the FRC Audit Quality Review Team (previously known as the Audit Inspection Unit) highlighting its

concerns in its Annual Report. This report was published on 14 June 2012 and can be found at: frc.org.uk/Our-Work/Publications.aspx?page=3

Many of the FRC's findings are consistent with those from previous years. As you may recall from our

Audit News 48B (September 2011), the 2010/11 FRC report outlined the need for the audit profession to focus on professional scepticism, particularly in relation to work on going concern; valuation and impairment of goodwill; the use of experts; and consideration of independence and ethics.

The key aspects to be taken from the 2011/12 Annual Report are that the FRC continues to identify the need for audit teams to exercise appropriate professional scepticism and that:

- Impairment of goodwill and other intangibles is an area where there remains room for improvement and little progress had been achieved;
- The level of challenge by audit teams of key assumptions in such areas is less robust than is appropriate given the current economic environment;
- A more rigorous assessment is needed to support conclusions made by audit teams; and
- There is a need to provide further training to staff covering these types of issues.

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APB Briefing Paper: Professional Scepticism

The difficulty with this area is that professional scepticism is an approach to be adopted, rather than a procedure or a process which can be followed. The APB has acknowledged this and on the 7 June 2012 issued a briefing paper 'Professional Scepticism', which can be found at: (frc.org.uk/Our-Work/Publications.aspx?page=4). This paper highlights the challenge for firms in developing a culture which demonstrates the value of scepticism in the audit and allows the firm to identify, develop and retain people with the necessary skills and to deploy them appropriately. This culture also involves nurturing the conditions that allow professional scepticism to flourish and to promote this behaviour in both individual auditors and engagement teams.

We would advise all firms to read this paper, and consider how they approach professional scepticism and promote the value of scepticism throughout the firm.

In the briefing paper the APB considers the conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism, and states that these are likely to include the following:

Individual auditors

- Develop a good understanding of the entity and its business;
- Have a questioning mind and willing to challenge management assertions;
- Assess critically the explanations obtained and corroborate them;
- Seek to understand management motivations for possible misstatements;
- Investigate the nature and cause of misstatements and avoid 'jumping to conclusions';
- Be alert for evidence that is inconsistent with other evidence obtained; and
- Have the confidence to challenge management and the persistence to follow things through.

Engagement teams

- Have good business knowledge and experience;
- Actively consider in what circumstances management numbers may be misstated;
- Develop a good understanding of the entity and its business;
- Ensure partners and managers are actively involved in assessing risk and planning, actively lead and participate in audit team planning meetings, and are accessible to other staff; and
- Document their key audit judgements and conclusions.

Audit firms

- Ensure the culture within the firm emphasises the importance of:
 - understanding and pursuing the perspective of the shareholders;
 - coaching less experienced staff to foster appropriate scepticism;
 - sharing experiences about difficult audit judgments within the firm;
 - consultation with others about difficult audit judgments; and
 - supporting audit partners when they need to take and communicate difficult audit judgements.
- Ensure scepticism is embedded in the firm's training and competency frameworks;
- Require rigorous engagement quality control reviews;
- Emphasise the importance (via firm methodologies and review processes) of:
 - developing a thorough understanding of the entity's business;
 - identifying issues early in the planning cycle;
 - rigorously taking such steps as are appropriate to identify unusual transactions;
 - changing risk assessments, materiality and the audit plan in response to audit findings; and
 - documenting audit judgements in a 'conclusive' rather than a 'conclusionary' manner.

A number of the above areas can be illustrative of 'good auditing' and not necessarily require to be categorised as professional scepticism. As a result, you will undoubtedly recognise a number of these areas as being embedded in the requirements of the ISAs, and prescribed in your audit procedures. However, professional scepticism is considered to be a fundamental part of any audit and, therefore, it is not surprising that it remains an area on which regulators are placing considerable emphasis. Indeed, the need for firms to improve in exercising and documenting their approach to professional scepticism has been a significant recommendation in the last two annual reports of the FRC.

THE ICAS PROFESSIONAL JUDGEMENT FRAMEWORK

ICAS has just published **A Professional judgement framework for financial reporting: An international guide for preparers, auditors, regulators and standard setters**. The guide is intended to assist those involved in making and checking key judgements and applying professional judgement under principles-based standards and is available to download on the ICAS website at icas.org.uk/pjf

Being able to make and challenge judgements is a cornerstone of being a professional accountant but making and challenging a judgement can be difficult and there is not necessarily one correct answer. So how can we help individuals make good judgements? Whilst much depends upon the ability, experience and training of individual accountants, we believe that this new ICAS framework, including an easy to follow process, may assist those making, checking and documenting key judgements.

As highlighted in the previous article there has been much debate recently about the application of professional scepticism by auditors. Professional scepticism is a key attribute for auditors and is closely related to the ability to apply professional judgement. We believe that the use of this framework will assist auditors in applying professional scepticism and challenging client's key judgements.

The framework has been prepared to assist in determining the appropriate accounting treatment for a particular transaction or group of transactions, where:

- there is no specific standard covering the transaction; or
- there is a standard but no detailed provision of how to deal with its implementation in practice; or
- there are accounting principles in a standard but no detailed provision of how to deal with a specific principle in practice; or
- there is more than one set of accounting principles that may apply to the transaction.

The guidance is intended to be applicable internationally, to different sizes of companies, both listed and unlisted, or other entities, and within the context of different governance systems. Whilst this framework has been prepared on the assumption that IFRSs are being followed, it could easily be adapted to other principles-based national GAAPs.

The framework itself comprises of a series of principles which should be followed by:

- preparers in making and documenting a judgement;
- auditors in challenging a judgement; and
- regulators in assessing a judgement.

For auditors they are four principles covering: knowledge gathering and analysis; assessment of accounting and auditing guidance; process for assessing and challenging the client's judgement; and documentation of judgement. The framework then provides illustrative lists of actions which you might undertake to apply the principles in each case.

The framework is not intended to be a pure 'box ticking' exercise, and the lists of actions are not intended to be prescriptive or exhaustive but are there to provide guidance and to be tailored to individual circumstances. Also it is not expected that the framework is used for every judgement made, but we would recommend its use for significant judgements or those which would have a material effect on the financial statements.

We would encourage audit firms to look at this short guide to see if it would be useful for the firm and whether it could be adapted into existing audit procedures and used for training purposes. It may also be helpful to direct clients, as preparers, to the guide which is free to download from the ICAS website.

Please feedback any comments on the guide to accountingandauditing@icas.org.uk

GUIDANCE TO THOSE APPLYING FOR RI STATUS

The Audit Monitoring team, and the Audit Registration Committee, regularly receive questions from firms regarding the process of applying to obtain Responsible Individual (RI) status for one of their partners or employees.

As a reminder, the granting of a practising certificate, admission to partnership, or even just writing to ICAS, does not automatically permit someone to sign audit reports. Before signing an audit report, an individual must be an RI, which is granted by the Audit Registration Committee. In applying for RI status an individual must demonstrate that they have met the necessary criteria and that they are suitably qualified and experienced to act in this capacity.

The Audit Registration Committee wishes to encourage applications for RI status and we have provided further detail on this to assist with the process. The following are the considerations that the Audit Registration Committee takes into account.

The requirements under the Audit Regulations

Audit Regulation 4.01 states that a firm's audit compliance principal may designate as a RI any of the firm's principals or employees who:

- has an appropriate qualification;
- is competent to conduct audit work; and
- is allowed to sign audit reports in their name on behalf of the firm.

This effectively means that an applicant will have recent, relevant and sufficient experience in order to be competent to conduct this role.

Application process and considerations of the required skill set

When completing the application to become an RI, each applicant is asked to provide details of their skill set and audit experience in the previous 24 months.

When reviewing an application the Audit Registration Committee will consider the skills and knowledge required by all audit professionals, which should include the following:

- best practice in auditing;
- International Standards on Auditing (ISAs);
- financial accounting and reporting processes and practices;
- other applicable standards and laws (auditing financial reporting, or other laws and regulations);
- information technology systems and frameworks for evaluating controls and assessing risks in accounting systems (note: the training in this area depends on the complexity of the audit engagements allocated to the audit professional), and
- professional skills, values, ethics and attitudes.

What if the applicant has not demonstrated sufficient experience?

If the applicant's recent audit experience is not considered to be sufficient by the Audit Registration Committee, there are two courses of action that may be adopted:

1) Conditions

Conditions may be placed on the granting of the RI status, such as:

- initial assignments as an RI are to be subject to a hot file review, and/or
- further audit training specified by the Audit Registration Committee is undertaken during the forthcoming year.

2) Gain further experience before reapplying

The applicant may be asked to withdraw their application and to gain further experience before reapplying. Further experience may be gained by:

- Attendance at relevant audit training courses; and/or
- Mentoring with an auditor/RI.

Further information

Further information on this process, and the required application form, can be found on the ICAS website at: [icas.org.uk/home/regulation-and-ethics/audit-regulation/audit-registration/](https://www.icas.org.uk/home/regulation-and-ethics/audit-regulation/audit-registration/)

REQUIREMENTS WHEN CEASING TO ACT AS A CLIENT'S AUDITOR

The statements required when an auditor ceases to hold office became more onerous as a result of the Companies Act 2006. While these requirements have now been in place for a few years, the Audit Monitoring team have seen a number of cases in recent months where these statements have not been issued by the outgoing firm. Here is a reminder of the key requirements.

The statement of circumstances

A statement of circumstances is required under s519 of the Act, when the firm ceases to act as auditor for any reason, be it resignation, removal or seeking not to be re-appointed. Issuing such a statement of circumstances assists in avoiding misunderstandings and ensures that the client is informed of relevant responsibilities. One of the important aspects to note here is that this statement should be clear and unambiguous.

The statement should, therefore, disclose:

- The circumstances connected with cessation and whether the auditor considers there are matters to be brought to the attention of shareholders and creditors; or
- That there were no circumstances.

Other aspects for consideration when ceasing to act as auditor:

Major audits

There are also requirements to report to the FRC for cessation from acting as auditor to 'listed' or other 'major' audit clients and we advise any firms with listed clients to become familiar with the requirements in Audit Regulation 3.08 (the Audit Regulations can be found at: icas.org.uk/Audit_Regulation.aspx).

Copy of statement to be sent to Registrar

If there are circumstances set out in the statement, the company must send a copy of the statement to all members of the company unless it makes a successful application to the court to stop this. If the auditor does not receive notification of an application to court within 21 days of depositing the statement with the company, the auditor has a further 7 days to send a copy of the statement to the Registrar for public record.

Resignation out-with the normal term of office

Where a firm resigns from an audit client out-with the normal term of office the firm is also required to write to ICAS to inform it of the circumstances of cessation. The information required is:

- The facts of the cessation;
- A copy of the statement of circumstances under s519; and
- If there were no circumstances, a statement of the reasons for ceasing to hold office.

The definition of the auditor's normal term of office for private companies is set out in section 487 of the Companies Act 2006, and is complicated as there are now deemed reappointment procedures in the Act (see section 487(2)). In simple terms, the normal term of office is between the appointment/reappointment and completion stages of the audit, however we would encourage firms to familiarise themselves with the full definition in the legislation.

Requirements of the client

If the appointment ceased before its normal time, the company is also required to send a notification under s523 of the Act to:

- The FRC, if a 'major' audit; or
- ICAS for all other appointments.

Notification that the auditor has ceased to hold office must be accompanied by the statement of circumstances received by the auditor. Again, if there were no circumstances, a statement of the reasons should be disclosed. This must be done within 14 days of receipt of the statement of cessation from the auditor.

While ICAS has received statements of circumstances from firms, we are still not receiving as many from companies and would advise outgoing auditors to explain to each company its requirements under the Act. **Similarly, new auditors may wish to check that the company has complied with its obligations.**

A FOCUS ON USING THE WORK OF AN EXPERT: ISA 620 AND ISA 500

In recent months the Audit Monitoring team have had a number of discussions with audit firms on the audit approach to be adopted when considering using the work of an expert. Common matters identified on monitoring visits include:

- documentation of the auditor's considerations in planning to utilise an expert; and
- the differences between experts who have been engaged directly with the auditor and experts appointed by management.

With that in mind, we thought it would be useful to provide a reminder of the key requirements.

The use of an expert was previously covered solely by ISA 620, however, it is important to note that, under the Clarified ISAs, ISA 620 now only refers to an 'auditors' expert, with the use of a 'management' expert now being incorporated into the 'evidence' ISA 500.

ISA 620

The crucial aspect of ISA 620 is that, where an auditor uses an expert to obtain audit comfort, the expert's independence, objectivity, qualifications, scope of work, and form of reporting should be assessed and recorded at the outset of the audit process.

Although the requirements of ISA 620 are largely unchanged, there are some key requirements to re-emphasise, and some new elements to consider:

- **Objectivity** – The auditor still has to assess objectivity of the expert. However, this evaluation shall now include inquiry into interests and relationships that may create a threat to that expert's objectivity.
- **Scope of work** – Previously there was no requirement to agree the scope of the work. However in the new ISA, the auditor shall agree, in writing when appropriate:
 - the nature, scope and objectives of the expert's work;
 - the role and responsibilities of the auditor and the expert;
 - format of communication (including any report to be received); and
 - the need for the expert to observe confidentiality requirements.
- **Evaluation** – Although the previous ISA required the evaluation of the appropriateness of the expert's work, the new ISA expands this. The evaluation should include:
 - the relevance and reasonableness of the expert's findings;
 - the relevance and reasonableness of any assumptions used; and
 - the completeness and accuracy of any source data used.

Guidance on all of the above requirements is provided in the Appendix to the ISA, and we strongly advise firms to ensure that the above considerations are made, fully recorded and concluded upon on the audit file.

ISA 500 'Evidence'

As we have commented above, the use of a 'management' expert has now been incorporated into Clarified ISA 500. A management expert is defined as an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity in preparing the financial statements. For example, this includes organisations such as pension scheme actuaries and investment managers.

The key requirements in this area are very similar to those noted above. If information to be used as audit evidence has been obtained or prepared using the work of a 'management' expert, the auditor must (after considering the significance of the expert's work):

- Evaluate the competence, capabilities and objectivity of the expert – competence and objectivity was a requirement in the original ISA 620 and capabilities have been added;
- Obtain an understanding of the expert's work; and
- Evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion to be tested.

Again, the crucial aspect here is that these considerations are assessed and recorded appropriately on the audit file.

Example of a common issue identified by the Audit Monitoring team

An example of this is where an audit client has used a pension scheme actuary to provide disclosures in the financial statements, but the auditor has not recognised that actuary as a management expert, and therefore the above considerations have not been recorded.

This is particularly relevant where there is a defined benefit pension scheme requiring full disclosure under FRS 17. However, it is also common that an audited entity has a multi-employer defined benefit scheme, where an accurate split of the assets and/or liabilities of the scheme cannot be obtained and therefore is treated in the accounts as a defined contribution scheme. In this situation the auditor will often still rely on the work of the actuary to represent that this is accurate, and therefore there will still be reliance on the work of an expert.

Should you wish to contact ICAS for advice on technical matters, please do so using the following email address:

accountingandauditing@icas.org.uk

HOT FILE REVIEW CONDITIONS SET BY THE AUDIT REGISTRATION COMMITTEE

It is important that ICAS is open and transparent about the monitoring visit and Audit Registration Committee (ARC) process, and our coverage of this area on our audit course (details below) has been well received.

One of the options open to the ARC, where follow-up action to a monitoring visit is considered appropriate, is to require firms to obtain hot file reviews and to submit the results to the ARC. The ARC has now revised the process of implementing, and firms responding to, this condition, and feels that it is appropriate to convey this to all firms.

Firms will also be asked to complete and submit a checklist accompanying their hot file review submissions. The purpose of this checklist is to ensure that the hot file review has been conducted in a manner that covers all of the Committee's requirements and meet the requirements of ISQC1. The main requirements of ISQC1 are:

Key requirements of ISQC1:

The hot file review (called Engagement Quality Control Review) must include:

- a discussion of significant matters with the audit partner;
- a review of financial statements and the proposed audit report;
- a review of selected engagement documentation relating to significant judgments the engagement team made and the conclusions it reached;
- evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate; and
- ensuring the audit report is not signed before the review is completed.

The main requirements of the Committee are explained in the checklist attached as an appendix to this Audit News.

It is the firm's responsibility to appoint an appropriate individual to conduct the hot file review. If the ARC considers that the review is not in full compliance with ISQC 1 or with the instructions set out in the condition, it may request submission of further such reviews, potentially by a different reviewer. We would, therefore, strongly recommend that any required submissions are made in line with the ARC instructions.

REMINDER

Keeping Your Audit Firm and Files on the Right Track

As we communicated in the last Audit News, we have presented our mandatory courses for Audit Compliance Principals (ACPs) in different locations this year, to positive feedback. There is one remaining 2012 date for these courses, 'Keeping Your Audit Firm on the Right Track' and 'Keeping Your Audit Files on the Right Track', and this is the 4 October, to be held in Glasgow. In our next edition of Audit News in December 2012 we will be providing you with dates for 2013 and developments in how we will be delivering this course for the future, including the introduction of webinars, which may be of interest to those of you who are less able to travel to the course venues.

In order to ensure mandatory attendance is not too onerous, ACPs are required to attend only once every five years. In addition, ICAS is subsidising this course for ACPs and the rate is only £80 plus VAT for ACPs for the full day. We have also been keen to open the course up to others involved in audit work and the "Keeping Your Audit Files on the Right Track" is relevant to Responsible Individuals and audit staff as well as ACPs.

Those who have attended who are not ACPs have also found the course to be of benefit, and the course rates for such attendees is £100 plus VAT for a half day course, and £150 plus VAT for the full day course.

Information on how to book, together with an outline of each course, can be found at icas.org.uk/Businesscourses/



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APPENDIX: CHECKLIST FOR SUBMISSION TO ARC ALONGSIDE HFRS

HOT FILE REVIEW INFORMATION CHECKLIST	
To be provided by DATE	Please tick
Confirmation to the Committee that you will arrange for the external hot file review of [details to be provided].	
Confirmation of the name of the intended reviewer and that you will make arrangements immediately with the reviewer in order to ensure that the review is submitted by the deadline.	
Confirm that you have passed a copy of the instructions regarding the Hot File Reviews to your intended Reviewer so that they are in no doubt as to the scope of the review and the required reporting to the Committee.	
Provide a copy of the letter of engagement between your firm and your intended Reviewer.	
Confirm that you agree that the Committee and/or Committee Secretariat can contact your intended reviewer directly if required.	
To be provided no later than one month after the completion of each review	Please tick
A copy of the completed hot file review checklists, including documentation of the review of the significant judgements and the documentation of significant matters discussed with the Responsible Individual.	
All queries raised by the external reviewer, including a summary of key areas of non-compliance.	
(This would include all review points relating to significant matters and judgements, but goes beyond this to include material areas of non-compliance with the ISAs, financial reporting requirements, statutory requirements and Audit Regulations and Guidance.)	
The firm's responses to any findings raised by the external reviewer with details of any actions subsequently taken or planned to remedy any matters found.	
A confirmation from the external reviewer that a full engagement file review has been performed and confirmation that all relevant matters were cleared prior to the signing of the audit report.	
An overall conclusion from the external reviewer on the standard of compliance and conclusions as to how the firm has dealt with the matters raised in the Audit Monitoring report.	

