

# AUDIT NEWS

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## INTRODUCTION

Welcome to the first 2016 edition of Audit News.

In this edition we have prepared an article on the House of Commons Report into the collapse of Kids Company, and lessons which can be learned by auditors of charities. We have also looked at changes to the small company audit threshold; a reminder about the eligibility requirements for audit firms; an article focussing on the auditor's consideration of the use of a service organisation and

using the work of a management's expert; a look at the FRC review of work performed by engagement quality control reviewers; and a reminder of the approaching deadline for registering as an ATOL Reporting Accountant.

**We are also pleased to announce that our Audit Monitoring Annual Report, which outlines our activities in 2015, and provides a summary of findings from 2015 monitoring visits, will be published in April and available on [icas.com](http://icas.com).**

## Important changes – Authorisation Committee

The Authorisation Committee will be formed on 19 April 2016, following an internal review of governance, which recommended that the previous committee structure be streamlined. The Authorisation Committee will have the powers and duties previously held by the Audit Registration Committee; the Public Practice Committee; the Insolvency Permit Committee; and the CPD Regulatory Committee.

The Authorisation Committee will be one of two regulatory committees that reports to the Regulation Board.

The Committee will be responsible for all aspects of practice licensing and monitoring and the change is to ensure consistency of decision making across the different practice areas and to accommodate a number of new regulatory models which have been introduced including ATOL (see below); Local Audit; and Consumer Credit.

Further information on the new Committee structure can be found in the Audit Monitoring Annual Report.

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## LESSONS TO BE LEARNED FROM KIDS COMPANY

The House of Commons Public Administration and Constitutional Affairs Committee has recently published its report on Kids Company. The report makes a number of negative conclusions about the role of the professional accountancy firms involved.

A copy of the final report can be downloaded from: [publications.parliament.uk/pa/cm201516/cmselect/cmpubadm/433/433.pdf](http://publications.parliament.uk/pa/cm201516/cmselect/cmpubadm/433/433.pdf)

While the report states that the ultimate responsibility for the charity's failure lay in its "negligent" trustees, MPs in the Public Administration and Constitutional Affairs Committee found that professional accountancy firms who undertook work relating to the charity, each failed to report the scale of risk carried by Kids Company to its stakeholders, and this included firms engaged to audit the financial statements, and their right or duty to report to the Charity Commission.

There are a number of key messages in the report in relation to the audit of charities, principally:

- understanding the business and assessing financial risk;
  - assessing and reporting on going concern;
  - how to respond to a persistent failure to address management letter points;
  - exercising the right and duty to report to the regulator;
- and
- the effectiveness of the trustee board.

### Understanding the business and assessing financial risk

Obtaining an understanding of the charity and assessing financial risk is a key requirement of the ISAs, and APB Practice Note 11 provides useful guidance on areas that should be considered. With regard to charities, the financial risks faced depend very much on the size, nature and complexity of the activities it undertakes.

In assessing audit risk, the auditor should consider:

- the accuracy or sufficiency of financial information;
  - adequacy of reserves and cash flow;
  - the suitability of the reserves policy;
  - dependency of the charity on limited income sources;
- and
- the nature and longevity of regular income sources.

The Report on Kids Company raised a number of concerns as to the financial management of the charity, which was constantly operating on low levels of reserves. Examples given in the report include:

- failure of the charity to pay tax bills in a timely manner;
- a history of spending over budget; and
- management letters from auditors, referring to the charity being in a 'potentially insolvent situation'.

Another question for auditors when considering financial risk is whether or not the charity can continue to meet the needs of beneficiaries now and in the future. Financial risk for a charity is likely to increase if there is an unforeseen rise in demand for services. This is particularly true in a period of economic uncertainty.

A significant issue for Kids Company was the reliance on grants and donations from non-public sources. Non-public funding sources traditionally do not contain the stringent conditions attached to public funding but, by their nature, are riskier in terms of maintaining income levels year on year.

Consider a charity dependent on a significant proportion of income from non-public funding sources (e.g. donations from local businesses, philanthropists etc), and compare to one which relies primarily on public sector funding. In the event of economic downturn both charities may end up dealing with a higher number of beneficiaries than budgeted. However, the charity which depends mostly on public sector funding may have a more secure income stream.

It is important that full risk assessment is made at the planning stage of the audit, in order that any concerns are raised in a timely manner. This will allow the auditor to gather appropriate evidence regarding going concern, and engage in appropriate dialogue with the trustees, particularly if the auditor anticipates modification of the audit opinion.

### Assessing and reporting on going concern

On a charity audit, the assessment of the going concern basis can be complicated by uncertainty as to future income streams or funding. For example, where projections or cash flows are based on funding which has yet to be approved; or where a main funder is expected to, but has not, confirmed future funding at the date of signing.

Significant uncertainty about a charity's ability to continue as a going concern must be disclosed in both the trustees report and in the notes to the financial statements. This would include any doubts in relation to unapproved funding at the date of signing. The trustees are also required to be able to demonstrate that the charity will remain a going concern regardless of the uncertainty. It's the trustees' duty to make these disclosures under current accounting standards. It's then the auditor's duty to refer to them in the audit report.

For the auditors to agree with the Trustees assessment of going concern, they will need to see evidence that can support

this position. Such evidence will include cash flows, forecasts and budgets spanning at least one year from the date of signing the accounts. The auditor should also consider the appropriateness of the assumptions that are being taken with regard to the going concern basis. It is also not only important to consider the regularity and predictability of the funding but also the risk to the charity, especially where the funding in question represents a significant proportion of the charity's total income.

If the auditor believes that significant uncertainty exists in relation to the charity's ability to continue as a going concern, and the uncertainty has been adequately disclosed by the trustees, the auditor should issue an unqualified report, modified by including an 'emphasis of matter' paragraph highlighting those disclosures. If, in the worst case scenario, the auditor believes the going concern basis is not appropriate or that the relevant disclosure given in the accounts is not adequate, then a qualified audit report should be issued. This is likely to create problems in dealing with potential funders who read the accounts and who may have second thoughts about funding a charity with perceived financial issues. It is therefore important to discuss the issue of going concern with the trustees as soon as practicable in the audit process.

It is important to note that, under the new Charity SORPs (applicable for periods beginning on or after 1 January 2015), trustees are required in all cases to provide an explanation of factors supporting the conclusion the charity is a going concern, and if there are material uncertainties about the charity's ability to continue as a going concern these must be disclosed by the trustees. By exception, where there are no material uncertainties about the charity's ability to continue as a going concern this will likewise require to be stated.

**In the case of Kids Company, the auditors had repeatedly issued modified audit reports in relation to emphasis of matter on going concern, and significant warnings were made to the charity about the dependency of the charity upon future grants and emergency funding. Despite these repeated warnings the significance of the auditor's concerns did not translate into action by the trustees or the CEO of the charity.**

It is important then, to remind firms of the actions available to the auditor, where a significant deficiency communicated to the charity has not been remedied in a timely manner.

## How to respond to a persistent failure to address management letter points

The first point to note here, is the fact that the auditor has communicated a significant deficiency to those charged with governance and management in a previous audit does not

eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken.

In the case of more significant or persistent breaches, the auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

In this situation, it is important to communicate with those charged with governance at the reappointment stage of the audit, as this may not only affect the planned approach but depending on the seriousness of the issue whether the auditor accepts reappointment - for example, where there is a serious internal control issue resulting in an imposed limitation of scope over a specific balance or assertion.

It is important that the auditor try to ascertain the reason for the repeated failure to remedy the issue, and document this on the file. This should include consideration as to why the matter is not so materially significant as to affect the audit opinion or the reappointment process. It is not enough to merely accept the issue year on year.

The lack of remedial action can cause obvious challenges and difficulties for the auditor, and the action which can be taken will vary depending on the nature of the issue raised. From experience on monitoring visits, examples of serious action taken by firms have included qualification of audit reports; and resignation from the audit client.

In the case of a charity, where there are repeated issues raised on the sufficiency of reserves and solvency, it is likely that this will affect the going concern assessment by the auditor. As demonstrated by the failure of Kids Company, it is not enough to issue an emphasis of matter paragraph every year as a form of safeguard. In this regard, where the charity cannot demonstrate that meets the definition of going concern, auditors may have to consider more severe action including resignation or issuing of an adverse audit opinion.

With regard to charities and other regulated entities, it is important to remember that auditors may also exercise a right or duty to report to a Regulator.

## The right and duty to report to a Regulator

The report into Kids Company notes that it was surprising that the auditor did not consider its duty to alert the Charity Commission to the extremely high risk of failure in this charity.

The Charities and Trustee Investment (Scotland) Act 2005 sets out the duty of the auditor of all forms of charity registered in Scotland to report to OSCR, certain matters of which it becomes aware in their capacity as the auditor. This is set out in the Charities Act for charities in England & Wales in respect of the Charity Commission (CCEW).

The auditor of a charity is required to report matters the auditor believes may be of material significance to the regulator.

'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of an entity, it may be of a nature or type that is likely to change the perception of the regulator.

Matters which CCEW and OSCR have indicated are likely to be of material significance are set out on the charity regulators' websites and in Appendix 5 of Practice Note 11, however include:

- matters suggesting dishonesty or fraud involving a significant loss of, or a major risk to, charitable funds or assets;
- failure(s) of internal controls, including failure(s) in charity governance, that resulted in a significant loss or misappropriation of charitable funds, or which leads to significant charitable funds being put at major risk;
- matters leading to the knowledge or suspicion that the charity or charitable funds have been used for money laundering; and
- evidence suggesting that in the way the charity carries out its work relating to the care and welfare of beneficiaries, the charity's beneficiaries have been or were put at significant risk of abuse or mistreatment.

It is important, that these provisions also establish the right to report a matter to the charity regulator which does not appear to fall within the scope of the duty to report but which the auditor has reasonable cause to believe is likely to be relevant to the charity regulator for the purposes of the exercise of any of its functions.

Matters falling within this discretionary category are likely to be indicative of significant risks to charitable funds or their proper application and would therefore normally be relevant to the work of the regulators.

## **The effectiveness of the trustee board**

Finally, the report refers to the Charity Commission guidance which requires trustees to "make decisions solely in the charity's interest so they should not allow their judgement to be swayed by personal prejudices or dominant personalities".

It is essential that trustees of all charities ensure that some members of the board have experience of the area relevant to the charities activities, in addition to the necessary skills that all trustees should possess, including the appropriate attitude towards responsible governance.

While not a direct responsibility of the auditor, the make-up of the board of trustees should be considered in line with the size and complexity of the charity, and recommendations should be made in the auditor's report to those charged with governance if considered appropriate.

On 29 January 2016, The Charity Commission updated its key finance guidance for trustees to show clearly that trustees are ultimately responsible for their charities' finances, and respond to the need to make sure its guidance reflects the most current challenges facing thousands of charities.

While written for trustees, this guidance is useful reading for auditors and covers the importance of having a good reserves policy and states clearly what trustees must do in terms of good practice.

[gov.uk/government/news/trustees-must-engage-with-finance-guidance-says-charity-regulator](http://gov.uk/government/news/trustees-must-engage-with-finance-guidance-says-charity-regulator)

## INCREASE TO THE SMALL COMPANY AUDIT THRESHOLD

Further to its paper on the implementation of the Audit Directive (2014/56/EU) and the Audit Regulation (Regulation 537/2014), the Government has announced an increase in the audit threshold, effective for periods commencing on or after 1 January 2016.

Companies will not be required to have an audit for financial years commencing on or after 1 January 2016 if, at their balance sheet date they satisfy at least two of the three following criteria, in general, for two consecutive financial years, and they are not otherwise excluded from accessing the audit exemption, for example, due to the nature of their business:

- Turnover  $\leq$  £10.2m
- Balance sheet total  $\leq$  £ 5.1m
- Number of employees  $\leq$  50

In response to the consultation, some stakeholders argued that thresholds should either be maintained at the previous level or raised to an intermediate level and that amending the audit exemption threshold will:

- increase the risk of poor financial reporting, and, consequently, the economic prospects for smaller businesses; and
- allow fairly sizeable companies to have no external assurance on their financial statements, many of whom are likely to have an impact on the communities they serve and attract significant local interest.

Others argued, however, for the thresholds rising to the maximum permitted, quoting the erosion of the value of the audit exemption thresholds due to inflationary effects and the need to avoid imposing avoidable regulation on small companies. In light of the views expressed by stakeholders, it

is likely that the Government will keep the changes in the audit exemption thresholds under review.

It is estimated that raising the audit exemption thresholds will bring a further 7,400 companies within scope of the exemption, on current practice the Government anticipates that 4,400 will choose to continue to have an external audit. Of the 3,000 additional companies expected to take up the exemption, some will seek alternative routes to ensure that the company's systems are robust; for example, through assurance reviews or increased oversight of accounts preparation engagements.

The audit exemption changes take effect for accounting periods beginning on or after 1 January 2016. They cannot be early adopted unlike the accounting requirements of the Regulations which may be early adopted for accounting periods beginning on or after 1 January 2015.

### Small company accounts preparation

The Audit Monitoring team have had a number of recent queries on small company accounts preparation in the coming year, so to clarify the requirements:

- The FRSSE (effective April 2008) will continue to be effective for periods commencing before 1 January 2015.
- For periods beginning on or after 1 January 2015, the FRSSE (effective January 2015) will become effective.
- For periods beginning on or after 1 January 2016, the FRSSE will be withdrawn. Entities currently applying the FRSSE will need to transition to either FRS 105 (if they qualify as Micro-entities) or the small entity requirements within FRS 102.

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## ATOL REPORTING ACCOUNTANTS DEADLINE APPROACHES

During 2015, following a consultation process on the re-balancing of the ATOL regime, the Civil Aviation Authority (the 'CAA') announced a range of changes to ATOL Reporting Accountant requirements. From 1 April 2016, only registered and designated ATOL Reporting Accountants (ARAs) working in registered firms will be able to sign ATOL Accountants Reports.

If you conduct ATOL Reporting Accountant work and have not yet applied to ICAS to register your firm and the individual ARAs within your firm, please contact [regulatoryauthorisations@icas.com](mailto:regulatoryauthorisations@icas.com) immediately. More information about the ATOL Reporting Accountant scheme can be found on [icas.com](http://icas.com) by searching on 'ATOL'.

As part of the application process the CAA requires each ARA to have completed two mandatory CAA training modules. The first module is currently available and the second module will be issued in due course. You can register for this training by sending your name, professional body and membership registration number to the following address: [CAA.ARAScheme@caa.co.uk](mailto:CAA.ARAScheme@caa.co.uk)

The Civil Aviation Authority has also set up a dedicated webpage for ATOL Reporting Accountants on their website: [caa.co.uk/ATOL-protection/Trade/Maintain-and-renew-your-ATOL/ATOL-reporting-accountants-scheme/](http://caa.co.uk/ATOL-protection/Trade/Maintain-and-renew-your-ATOL/ATOL-reporting-accountants-scheme/) The ICAS technical team will also be producing guidance for members involved in this area in due course.

## REMINDER: ELIGIBILITY OF AUDIT FIRMS

The Audit Monitoring team have encountered a number of issues recently relating to the continuing eligibility requirements of firms registered with ICAS to conduct audit work, particularly where firms have undertaken a restructure or other significant change.

Audit Regulation 2.03 states that, where an audit firm is not a sole practice, then each principal must be a member of ICAS, ICAEW, ICAI, ACCA or an Affiliate of the registered body and the firm must be registered and approved with one of the Recognised Supervisory Bodies (RSBs). It is the ACP's responsibility to ensure that every principal meets these requirements and that appropriate application forms are sent to ICAS for any persons needing to become an Affiliate. Please note that becoming an Affiliate means that the principal has signed up to comply with ICAS's regulations, it conveys no rights and Affiliates are not authorised to sign audit reports or be responsible for audits.

The firm must also ensure that individuals who have an appropriate qualification hold at least a **majority** of the voting rights and at least the majority of the voting rights in the management board, to enable them to direct the firm's overall policy. It should be emphasised that 50% voting rights is not sufficient to meet these requirements.

### What is 'an appropriate qualification' and is this different from RI designation?

The 'appropriate qualification' is commonly known as the 'audit qualification' and must have been obtained from an RSB, which in the UK and ROI refers to the three Institutes and ACCA.

The audit qualification is awarded to ICAS members, and members of other RSBs, who have demonstrated that they have achieved sufficient knowledge and supervisory experience in audit, through examination and work experience gained within an Authorised Training Office.

Initially, the audit qualification was automatically awarded, however the requirements were changed by the 1989 Companies Act, meaning that, since the 30th September 1991, the qualification must be applied for. This is obtained through providing evidence of UK audit experience by recording of such in the ICAS Achievement Log, including at least 210 days of UK audit experience.

#### What if I qualified prior to 1991?

Individuals who held an appropriate qualification under the previous legislation are 'grandfathered in'. In the UK, if you were a member of one of the Institutes or ACCA on both 31 December 1989 and 30 September 1991 you are deemed to hold the audit qualification.

Only a member holding the audit qualification counts towards the control percentage as stipulated in the Audit Regulations. An individual does not, however, have to be a Responsible

Individual (RI). It is important to still note, however, that the audit qualification is not sufficient to authorise an individual to sign audit reports, and this can only be done by those who have been approved as an RI.

Clearly, the impact of not complying with the eligibility requirements can be serious and firms are asked to reconfirm their continued eligibility as part of the firm's annual return, including confirmation that the majority of voting rights are held by those holding an 'appropriate qualification'.

### Recent cases where firms are going wrong

Note that the eligibility requirements under Audit Regulation 2.03(b) require that the audit registered firm should be controlled by an audit qualified individual or an audit registered entity.

This means that, in a group situation where the audit firm is owned or controlled by another entity, the holding entity would also have to be audit registered, even where this entity itself is controlled by audit qualified individuals. In a group structure, this continues up the chain of companies until there are individuals holding the majority of the voting rights.

**The Committee have seen a number of cases recently where firms have restructured, due to tax planning, and introduced a holding company to hold the shares in the audit firm. In such cases, the holding company must also be audit registered, as mentioned above. Failure to register this firm means the firm does not meet the eligibility requirements to be a registered auditor.**

If firms do not want to meet the expense of registering the holding company there are alternative structures to consider. For example, if individuals holding the audit qualification hold 51% of the voting shares with 49% of voting shares, and all non-voting shares, being held through a holding company, there would be no need for the holding company to be audit registered.

Given the serious nature of a failure to comply with the Regulations, we advise all firms to carefully consider the continued eligibility of the firm, not only during the Audit Compliance Review process, but on any change of partners and as part of ongoing succession planning or any organisational changes due to tax planning.

As a useful reference guide, Chapter 4 Schedule 1 of the Audit Regulations sets out a useful flowchart to show the relationship between holders of an appropriate qualification and Responsible Individuals.

Should any firm wish to discuss eligibility, or have any other questions in this regard, please do not hesitate to get in touch with [regulatoryauthorisations@icas.com](mailto:regulatoryauthorisations@icas.com) or phone on 0131 347 0245.

## A FOCUS ON ISAS 402 AND 500

Due to the number of discussions we have had with firms in recent months regarding the audit approach to the use of a service organisation; and the use of a management's expert, we consider that it would be a good time to provide a reminder on the key requirements.

### Use of a service organisation (ISA 402)

ISA 402 deals with the auditor's responsibility to obtain sufficient appropriate audit evidence when an entity uses a service organisation. For the purposes of ISA 402, the definition of a 'service organisation' is a third-party organisation that provides services to audit clients that are part of those clients' information systems relevant to financial reporting.

It is becoming increasingly common for businesses to outsource certain functions of their business. As auditors have a duty to gain an understanding of the entity and the environment in which the entity operates, this extends to understanding the nature of the services provided by a service organisation and any effect on the internal control environment.

Common examples of service organisations which an entity may use are:

- Payroll agencies;
- Factoring or invoice discounting entities; and
- Other accounting firms (used for bookkeeping or tax compliance).

The objective here is to consider the risk of material misstatement and design audit procedures which are specifically responsive to those risks.

In the majority of cases, the auditor can gain a sufficient understanding of the nature and significance of the services provided by the service organisation from discussion with the audit client. Matters the auditor needs to consider relating to the service organisation are:

- the nature of the services provided, including contractual terms;
- the extent to which the internal controls of the entity interact with those controls at the service organisation;
- the technical competence of the service organisation;
- the types of transactions being processed; and
- how the client monitors and supervises the service organisation.

The key requirement of the standard is that these considerations are fully documented by the auditor, and there should also be documentation regarding the standard of work performed by the service organisation and the effect on the risk assessment process.

### Use of a management's expert (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.

If information to be used as audit evidence has been obtained or prepared using the work of a 'management' expert, a key requirement of the ISA is that the auditor must (after considering the significance of the expert's work):

- Evaluate the competence, capabilities and objectivity of the expert;
- 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.

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.

**Audit firms must ensure that both of these areas are addressed at the planning stage of the audit, to identify if there are service organisations, or use of a management expert, that will have an impact on the audit plan.**

### Role of engagement quality review highlighted

The Financial Reporting Council Audit Quality Review team has published its review of the work performed by engagement quality control reviewers in the audit of financial statements.

One of the FRC's concerns is that firms' do not maintain a consistently high standard of auditing. Whilst excellent work is performed by many, some in the same firm fall short of expectations. The engagement quality control review process should ensure consistently high quality. Often it does improve quality but evidence was also found in some audits where weaknesses were not identified by the review. Firms can do more to evaluate the effectiveness of the quality control review and implement additional procedures, where appropriate, to reduce the occurrence of audit weaknesses that are not identified.

The full report can be accessed at: [frc.org.uk/News-and-Events/FRC-Press/Press/2016/February/FRC-highlights-role-of-Engagement-Quality-Control.aspx](http://frc.org.uk/News-and-Events/FRC-Press/Press/2016/February/FRC-highlights-role-of-Engagement-Quality-Control.aspx)

## ROLE OF ENGAGEMENT QUALITY REVIEW HIGHLIGHTED

The Financial Reporting Council Audit Quality Review team has published its review of the work performed by engagement quality control reviewers in the audit of financial statements.

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## ICAS AUDIT QUALITY COURSE – MANDATORY ATTENDANCE REQUIRED

### Background

The second cycle of our mandatory audit course has now commenced. As previously communicated, the previous two courses have been consolidated into one single course, lasting three hours, and is called 'Keeping Audit on the Right Track'.

We would like to remind firms of the new mandatory requirement with regards this course, which now stipulates that:

- Each ACP will be required to attend at least once in the three year period from 2016 to 2019 (previously once in the first five year cycle);
- Each Responsible Individual (RI) will be required to attend at least once in the five year period from 2016 to 2021 (no previous requirement);

- Each newly approved RI will be required to attend the course within 12 months of approval; and
- Each RI who was previously inactive, but who has now undertaken an active RI role again, will be required to attend the course within 12 months of becoming active.

We will be presenting four courses in 2016, and you can book a place on one of these courses at [icas.com](http://icas.com):

- 18th May 2016 in Inverness;
- 26th May 2016 in Edinburgh;
- 4th November 2016 in Dundee; and
- 9th November 2016 in Glasgow.

