

AUDIT NEWS

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INTRODUCTION

Welcome to the summer edition of Audit News, where we have prepared some articles that we hope you find useful and informative.

Whilst our primary focus is audit, the first article in this edition is a brief announcement of the FRC's publication of FRS 102, which has been designed

to provide more succinct financial reporting requirements.

There are also two articles relating to the FRC, with a summary of their 2012/2013 Report, and their recently raised concerns over 'letterbox' Companies.

In addition, there are further articles on the ethical considerations regarding potential fee dependency; the use of subcontractors to carry out audit work; the audit of regulated and specialist clients; keeping ICAS up to date with changes to your firm; and a reminder on the ICAS mandatory Audit Compliance Partner course.

FRS 102 – THE NEW UK GAAP

Overview of the new framework

In November 2012 the FRC published FRS 100 and FRS 101:

- FRS 100 sets out the application of financial reporting requirements in the UK and Republic of Ireland; and
- FRS 101 outlines the reduced disclosure framework available for use by entities reporting under IFRS.

In March 2013 the FRC published FRS 102, a single Financial Reporting Standard that applies to the financial statements of UK entities that are not applying IFRS, FRS 101 or the FRSSE.

FRS 102 is a complete overhaul of UK GAAP and applies to all unlisted entities, resulting in all current SSAPs, FRSs, and UITFs being withdrawn.

The objective of FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland' is to provide succinct financial reporting requirements and, at 350 pages, it is substantively shorter than existing UK GAAP.

FRS 102 is applicable for accounting periods beginning on or after 1 January 2015, however, early application is permitted for accounting periods ending on or after 31 December 2012.

The FRS is based on the IFRS for SMEs, and brings about a simplified reporting regime, as well as introducing more up-to-date and relevant accounting requirements than those in existing UK GAAP. This is an acknowledgement that current UK GAAP is too complex and practitioners have often complained about the onerous requirements imposed.

In response to consultation, FRS102 has some elements similar to IFRS, some similar to IFRS for SMEs, and some similar to current UK and Irish GAAP. We would therefore recommend that firms ensure this is considered when developing CPD plans for the remainder of 2013 and into 2014.

What are the implications of the new framework?

As outlined above, all entities currently reporting under UK GAAP will be required to report under either IFRS, FRS102, or the FRSSE. For the avoidance of doubt, IFRS will continue to only be mandatory for group accounts of entities with securities admitted to trading on an EU regulated market, and even these groups will have the option to apply FRS102 or FRS101 in their individual entity accounts.

Entities currently applying the FRSSE will continue to be able to do so.

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In summary, the options are:

	FRSSE	FRS 102	EU-adopted IFRS
'Small' entities as defined in the Companies Act.	✓	✓	✓
Entities not defined as 'small', and not required to adopt IFRS.		✓	✓
Entities required to adopt IFRS.			✓

It is therefore anticipated that the majority of large and medium-sized UK entities will apply FRS 102 when preparing their annual financial statements.

What are the main differences to current UK GAAP?

Whilst there will be a number of differences, the following are considered to be those that will have the biggest impact on the majority of entities adopting FRS 102:

- All derivatives to be brought onto the balance sheet at fair value;
- New requirements for defined benefit pension plans, including bringing group plan deficits onto the balance sheet;
- Requiring investment properties to be carried at fair value;

- Requiring more intangible assets to be recognised separately from goodwill when there is a business combination; and
- Presuming that the useful life of goodwill and intangible assets shall not exceed five years when no reliable estimate can be made.

What will be the impact on disclosures in the financial statements?

Whilst reliefs that can be taken differ between IFRS and FRS 102, entities will be able to take advantage of reduced disclosure requirements, including exemption from a cash flow statement, certain financial instruments, and related party and share based payments disclosures.

An entity whose financial statements comply with FRS 102 is required to make an explicit and unreserved statement of such compliance in the notes to the financial statements.

It is also important to note that the financial statements should not be described as complying with FRS 102 unless they comply with all of its requirements.

This brief article merely draws your attention to the publication of FRS 102, and an article in the next issue of The CA magazine will take a more detailed look at certain aspects of the new standard.

We would advise everyone to ensure they undertake appropriate training in advance of application of this standard.

THE FRC ISSUES IT'S 2012/2013 REPORT ON AUDIT QUALITY INSPECTIONS

You may have already spotted that the FRC recently issued its annual report on its audit quality inspections for 2012/2013. Whilst the report focuses on firms with public interest entity (PIE) audits the findings nevertheless make interesting reading, and contain some key messages, that are applicable to all audit firms. This article summarises the main themes in the report.

The good news

The FRC were pleased to announce that the 2012/2013 inspections showed an improvement in the overall quality of audit work. There was a significant increase in the number of files considered good, with an offsetting reduction in audits considered to be acceptable. There was a slight increase in the number of audits needing significant improvement and this was attributed to smaller PIE audits and not FTSE 350 companies.

	2012/2013	2011/12
Good with limited improvements required	59%	46%
Acceptable overall with improvements required	26%	44%
Significant improvements needed	15%	10%

Areas for improvement

The key areas requiring improvement are:

- Focus on audit quality
- Professional scepticism
- Financial Services
- Group audit considerations
- Auditor independence and ethics issues
- Audit quality monitoring

Focus on audit quality

Consistent with our own Audit Monitoring Report for 2012 (as detailed in Audit News 52A at icas.org.uk/regulation/news/regulatorynews/), the FRC found that due to the current economic climate, firms have been making efficiencies in audit work which has sometimes meant 'cutting corners' at the expense of audit quality. This has been particularly marked due to the extent of audit tendering and the reduction in audit tenure. The key findings in this area have been:

- samples not covering the entire period or population;
- an increase in judgemental sampling which reduces sample sizes below statistical sample sizes;
- sampling not always being responsive to areas of significant risk;
- instances of group audits where materiality of business components has been increased which reduces the number of business components subject to full audit procedures; and
- offshoring of audit procedures to reduce costs.

Most of the issues above are self-explanatory, however 'offshoring' merits more explanation and has made a number of financial press headlines in recent years. A number of firms have been moving audit work offshore to countries such as India, where there are cheaper labour costs. The FRC has found that whilst offshoring accounts for generally less than 5% of core audit hours it is becoming increasingly popular. The FRC has reiterated the importance of ensuring that there are appropriate policies and procedures to control audit quality and manage the risks of offshoring. Of particular concern is whether the offshore staff are sufficiently integrated into the audit team and have the competence to address issues significant to the audit.

Professional Scepticism

This finding has been raised in a number of successive FRC annual reports and the FRC notes that recent initiatives at audit firms have been successful in improving behaviour and embedding scepticism into firms' audit approaches. However, the FRC would like to see more improvements in the audit of the assumptions used in impairment testing of good will and other intangibles, and to other key audit judgements.

Financial services

Building society audits have been the focus of 2012/13 and there have been various concerns raised over the audit of loan loss provisions. This will only be relevant to firms who

conduct such audits, and it is recommended that these firms read the full annual report for further details in this respect.

Group audits

The main concerns raised in the FRC report centre around the following areas:

- the sufficiency of the group audit team's involvement in component auditors' risk assessments;
- the extent of review of the group auditor in the component auditors' work;
- there were cases where the group auditor did not take responsibility for, and delegated to component auditors, the audit of the consolidation;
- insufficient justification of component materiality; and
- 'letterboxing' (see separate letterboxing article in this publication).

Auditor independence and ethics

The FRC noted that there has been no substantive improvement in ethical compliance and that a boiler plate approach is often used. Specific issues included:

- there have been cross-selling targets for non-audit services to audit clients in partner appraisals;
- no consultation with the ethics partner on contingent fees for tax services;
- key partners from other network firms being involved in the audit without considering long association;
- shareholdings in audit clients not disposed of on a timely basis;
- movements of partners to senior positions at audit clients and vice versa not being safeguarded against.

On the latter point, the FRC intends to conduct a themed review of recent FTSE 350 director appointments to identify further instances of audit partners moving to audit clients.

Audit Quality Monitoring (Audit Compliance Reviews)

The FRC has found that there has been a marked difference between its inspection findings and the firms' compliance review findings, indicating that the firms' compliance reviews require to be more robust.

If you have not yet read the full report, it is available on the FRC website at: www.frc.org.uk

THE FRC RAISES CONCERNS OVER THE AUDIT OF 'LETTERBOX' COMPANIES

A new issue emerging from this year's FRC inspections relates to the audit of 'letterbox' companies. If any of your audit clients meet the criteria of a 'letterbox' company it is important to consider the issues in the article below as your audit approach to such audits could well come under scrutiny on future monitoring visits.

What is a Letterbox Company/Group?

While it is not unusual for many large multinational companies to have the majority of their operations overseas, most have a fully functioning and sizeable head office in the country of registration, which exercises management and financial control.

Letterbox companies, by contrast, are (as defined by the FRC):

Companies or groups that have little more than a registered office or correspondence address in their country of registration, with general, financial and corporate management and all economic activity being based elsewhere.

What are the concerns?

Such entities present a problem for the audit, as the signing auditor is usually based in the country of registration, rather than where management is based.

The FRC has seen many examples where the majority of the audit work has been performed by component auditors, with the signing auditor relying on clearance reports from the (network or non-network) component auditors without being sufficiently involved in the control, supervision and review of the audit work.

Common issues include:

- very limited or no oversight of those overseas operations from the country of registration;
- difficulties for the signing auditor in maintaining a dialogue with the entity's management;
- difficulties in the signing auditor gaining a proper understanding of the business risks and the risks associated with the audit;
- limits in the extent to which the audit approach can place reliance on financial and operational controls;
- the signing auditor performing little of the underlying audit work themselves;
- the delegation of the audit of the consolidation process to component auditors based in the same jurisdiction as management, or the signing auditor being involved in a limited capacity, and not a substantive capacity, in the final consolidation after a component auditor has audited a significant sub consolidation in another jurisdiction.

FRC

The FRC has recently issued a letter to all firms within their primary inspection scope, informing them that the ISAs must be fully applied in such situations, despite some firm's arguments to the contrary. The following points are of particular relevance:

- ISA (UK and Ireland) 220, which applies to both single component and group audits, requires that the signing engagement partner be responsible for the direction, supervision, performance and review of the audit; and
- for audits of more than one component, ISA 600 should be complied with, including the requirements in paras 33-35 regarding the consolidation process. ISA 600 defines a component as 'An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.' The FRC has therefore indicated that the ISA applies to the audit of a letterbox company that is part of a group structure but also to the audit of single entity Letterbox Company which has more than one component that produces financial information for inclusion in the group financial statements; which is usually a company with divisions or branches.

The FRC indicated that it may be appropriate to structure a group audit so that there is an integrated group audit team comprising personnel from both the UK firm and an overseas network firm. However, such an integrated team must be led and supervised by, and report directly to, the group engagement partner.

Single Component Entities

Where there is only one component, and ISA (UK and Ireland) 600 does not apply there can only be one audit engagement team and one set of audit files which should be fully compliant with ISA (UK and Ireland) 230 (Audit Documentation) and available for inspection, in their entirety, at the engagement partner's office upon request. Where audit personnel from an overseas firm are involved, they must form part of an integrated audit team, supervised by and reporting to the engagement partner, not a separate engagement team which provides "inter-office" memoranda or opinions on which the engagement partner relies in signing the audit opinion.

The FRC has required any firms not applying the ISAs in full to make improvements as soon as practicable. We would echo this to any letterbox company auditors within ICAS Audit Monitoring scope.

ETHICAL CONSIDERATIONS – POTENTIAL FEE DEPENDENCY

During the course of recent monitoring visits, and in the recent courses run by the Audit Monitoring team (see reminder at the end of this document), there have been a number of questions regarding what action a firm should take if there is a concern over fee dependence from one audit client. This short article has been prepared to clarify the requirements in this area and to help firms avoid potential pitfalls.

Considerations with regards potential fee dependency are governed by Ethical Standard 4 (ES4).

In summary, ES4 states that:

- If total fees, audit and non-audit, received from one non-listed audit client are regularly expected to exceed 15% of a firm's total annual fee income, then the audit firm should resign as auditor. In this circumstance Ethical Standard 4 states that there are no safeguards considered appropriate to reduce this threat to an acceptably low level.
- If the total fees from one audit client are regularly between 10% and 15% of the total fee income for the firm, then an external hot file review should be performed before the audit report is signed.

What if these fee levels do not occur on a regular basis?

ES4 is very prescriptive on the independence threat that exists when there is a fee dependency concern, however the key aspect to consider is whether the levels referred to above exist on a regular basis, or as a result of an individual event, the nature or size of which was unpredictable and where a reasonable and informed third party would regard ceasing to act as detrimental to the shareholders. Unfortunately the Standard does not define what a 'regular' basis is, however, in the spirit of the standard this could be interpreted to mean two consecutive years.

In these circumstances the auditor, though not required to resign, should disclose full details of the position to

those charged with governance of the audited entity, and discusses what, if any, safeguards may be appropriate in the circumstances.

Is there a further consideration if the Provisions Available for Small Entities (PASE) can be applied?

Many smaller clients fall into the audit regime and when this happens there are some areas of the Ethical Standards that, in practice, are difficult to apply. As a consequence, the APB has given certain dispensations so that a smaller audit can become cost effective, and these dispensations are covered in the PASE. Advantage of these exemptions can be taken if the client qualifies as small company, using the definitions in the Companies Act.

This is one such area where a PASE exemption for smaller entities exists where the income from a single audit client is between 10 and 15% of total fee income.

In this situation an independent hot file review is not required, although the matter is still required to be disclosed to those charged with governance, which can often not be a popular course of action as effectively the firm has to disclose to the client that their fee represents a significant level of income for the firm, and we often see firms adopting a hot file review process to avoid this.

What if the fee level is over 15%, but I am a new firm and my income is expected to grow?

Provisions are available for new firms whose fee base is growing, and ES4 states that, for a period not exceeding two years, the firm is required to obtain an external hot file review of those audits that represent more than 15% of the annual fee income. After this two year period, the firm is no longer classified as new, and therefore if the fee is still over 15% at that time, the firm should resign as auditor.

Should you wish to contact ICAS for advice on any independence or ethical matters, please do so using the following email address: accountingandauditing@icas.org.uk



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USE OF SUBCONTRACTORS TO CARRY OUT AUDIT WORK

In recent months the ICAS Audit Monitoring team has encountered a small number of issues in relation to the use of subcontractors, with audit firms not always ensuring that such members of the audit team are included in audit compliance considerations.

With that in mind, we thought it would be useful to remind firms of the common areas which should be considered, and to elaborate on the key requirements.

It will often be the case that an audit firm will utilise a subcontractor in the performance of audit work, most commonly to assist with a potential resource gap, or due to the location of an audit client.

The Audit Regulations refer to the use of a subcontractor, and the definition of an 'employee' of an audit registered firm includes a subcontractor or consultant that conducts audit work for the firm.

As such, consideration of the fit and proper status of individuals conducting audit work, as governed by Audit Regulation 3.06, should include any subcontractors.

In addition, Audit Regulation 4.03 confirms that a subcontractor cannot be designated as a Responsible Individual of the firm, and they are therefore prohibited from signing audit reports.

Independence, fit & proper and confidentiality

Audit firms are required to consider the fit and proper status of all individuals conducting audit work. An issue can arise where a firm retains up to date independence, confidentiality and fit and proper forms for all audit staff, however does not include subcontractors in this process.

It can often be the case that the subcontracted member of staff has been sourced from another audit registered firm and, consequently, reliance has been placed on the other firm's procedures in this area.

We would remind all audit firms that such declarations and forms are specific to a firm, and are, therefore, required to be

completed by all individuals conducting audit work, and that subcontractors from another firm are treated as an employee in this regard.

CPD

The Responsible Individual on an audit engagement is responsible for ensuring that all members of the team have sufficient and appropriate knowledge and experience to conduct their role.

A subcontractor should therefore be considered part of the engagement team, and the Responsible Individual should ask to see CPD records for this individual, in order to perform this assessment. This does not necessarily need to be performed on every engagement, and can be carried out as part of the firm's Annual Compliance Review, or another suitable time, however it is important that they are assessed in the same manner as other team members.

Undue influence

The risk of someone other than the Responsible Individual inappropriately influencing the audit is a serious issue, and can arise where someone outside of an audit team is involved to an unsuitable extent. We advise audit firms to consider whether such a risk exists, and to safeguard against this where possible

Some appropriate safeguards we have seen many audit firms implement include ensuring that:

- the subcontractor is appropriately supervised;
- the subcontractor does not make inappropriate decisions on behalf of the audit firm;
- the subcontractor is not allowed to sign audit reports for the firm; and
- that their work is appropriately reviewed.

The overriding consideration in the use of subcontractors should be that they are considered as an employee of the firm whenever conducting audit work, and that policies and procedures should be extended to cover these individuals.

THE AUDIT OF REGULATED AND SPECIALIST CLIENTS – ICAS HELPSHEETS

When we issued the Audit Monitoring Annual Report 2012 in the previous edition of Audit News, we noted that many of the audit files in 2012 that were identified as being of poorer quality were of a specialist or regulated nature.

These types of audit clients include charities, pension schemes, FSA regulated entities, Registered Social Landlords, Industrial & Provident societies, and credit unions.

Whilst there are many reasons for a variance in audit quality, we strongly advise firms to ensure that Responsible Individuals who have responsibility over such clients are undertaking regular training in the relevant area; that audit procedures reflect the specialist aspects of the assignment; and that sufficient time is devoted to these audits, which can often be perceived to be of a 'smaller' nature.

Particular areas of focus on these audits include compliance with laws and regulations; appropriately tailored engagement letters, audit reports and management representation letters; and specific balances depending on the nature of the client (eg investments held in a pension scheme; or authorisation of

expenditure and audit of fund allocations in a charity).

These audits are very important as, while they are often small or under the audit exemption threshold, there is often a public interest element to them.

Helpsheets for the audit of specialist and regulated entities

As a result, we have recently issued a helpsheet on the audit of charities registered with OSCR, and will shortly be issuing helpsheets in other specialist and regulated areas.

The release of these helpsheets will be communicated through future editions of Audit News, and will cover areas such as the audit of charities registered with The Charity Commission in England and Wales; pension schemes; FSA entities; Registered Social Landlords; and Credit Unions.

These helpsheets will be available on the ICAS website, at icas.org.uk/regulation/news/helpsheets/

KEEPING ICAS UP TO DATE WITH CHANGES TO YOUR FIRM

ICAS has a duty to keep the information on the public audit register up to date and, in order to achieve this, audit firms have an obligation to keep ICAS informed of any changes.

The public audit register can be accessed at: www.auditregister.org.uk

We would advise all firms to periodically review the information on this register to ensure that it reflects any recent changes, and contact ICAS Professional Services if any change is required.

In addition, there may be circumstances that could impact on a firm's ongoing registration, and clearly these matters are also required to be communicated to ICAS.

Audit Regulation 2.11 governs changes in circumstances, and confirms that a registered audit firm must inform ICAS in writing of any of the following changes within 10 business days:

- Any matter that could mean that the firm is no longer fit

and proper to be appointed as a Registered Auditor, or that might affect a firm's eligibility to be registered;

- If the firm is no longer complying with the PII regulations;
- Any change in the name or trading name of the firm; office addresses; and the name and address of principals or RIs;
- The details of any other audit registration that any RI has;
- The name and address of the audit compliance principal;
- If an RI leaves the firm or ceases to be an RI;
- In the case of a corporate practice, any change in the name or address of a shareholder; any change in the number of shares held by a shareholder; any change in the website address; and any change in the name or business address of any member of the management board.

In addition to the above, firms should notify ICAS if any significant changes are planned, so that registration is not interrupted.

Please note that this does not apply only to audit changes – the Audit Regulations require new partners to be notified to ICAS even if they are not going to apply for RI status.

REMINDER

Keeping Your Audit Firm and Files on the Right Track

Since the last edition of Audit News we have delivered our first courses of 2013. As we previously communicated, face-to-face courses were presented in a more condensed manner, and we have also delivered the material through a series of webinars, all of which has been very well received by participants.

The webinars will be a useful method of obtaining the material if you are struggling to get to any of the course locations, albeit we would still encourage Audit Compliance Principals to attend in person given that it provides you with more of an opportunity to speak to the monitoring team and ask any questions pertinent to your firm.

These courses, whether face to face or via webinar, are mandatory for Audit Compliance Partners, however to ensure

mandatory attendance is not too onerous, you are required to attend only once every five years, and the face-to-face courses are still heavily discounted for those requiring mandatory attendance.

Remaining 2013 courses

The next onsite course will be delivered in Glasgow, on the 30th October 2013, and the next series of webinars will be held on the 6th November 2013.

Further details, including an outline of each course and how to book, can be accessed at: www.icas.org.uk/Businesscourses/