Audit News

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The FRC consults on enhanced Ethical and Auditing Standards

The Financial Reporting Council (FRC) has issued a consultation proposing changes to the UK's Ethical and Auditing Standards, including more stringent ethical rules for auditors. The proposed changes are in response to findings from recent audit enforcement cases and from audit inspections. In response to feedback from investors, the FRC also proposes to enhance the quality and content of auditor's reports in order to improve transparency about what is found in the course of an audit.

The proposed changes include:

- In the Ethical Standard, a clearer and stronger 'objective, reasonable and informed third party test' which will require audit firms to consider whether a proposed action would affect their independence from the perspective of public interest rather than by another auditor.
- Enhancing the authority of the Ethics Partner function to ensure firm wide focus on ethical matters and the public interest, and to require reporting to those charged with governance where an audit firm does not follow the Ethics Partner's advice.
- The list of prohibited non-audit services that auditors of Public Interest Entities (PIEs) can provide to audited bodies has been replaced with a much shorter list of permitted services, all of which are 'closely related' to an audit or required by law and/or regulation. No other services can be provided.
- The requirement for the auditors of all UK listed entities to include in their published auditor's reports the performance materiality threshold used in the audit.

Further detailed amendments to individual standards clarify the auditor's responsibilities when considering whether the bodies they have audited are compliant with relevant laws and regulations, and when checking there are no material misstatements in the 'other information' companies include in their annual financial reports (other than the financial statements which are subject to audit).

The consultation closes on 27th September 2019, and relevant information including proposed revised standards can be found here.

The auditor's communication with the audit client at planning

A number of issues were raised on monitoring visits in 2018 relation to communication with the audit client at the planning stage of the audit, and how this was evidenced on the audit file.

International Standard on Auditing (UK) 260 (ISA (UK) 260) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although the ISA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities.

As a reminder, under the ISA, the objectives of the auditor are:

a. To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
b. To obtain from those charged with governance information relevant to the audit;
c. To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
d. To promote effective two-way communication between the auditor and those charged with governance.

What do we mean by those charged with governance?

In the UK, those charged with governance include the directors (executive and non-executive) of a company and the members of an audit committee where one exists. For other types of entity, it usually includes equivalent persons such as the partners, proprietors, committee of management or trustees.

In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by the ISA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role.

Importantly, the ISA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with governance - for example, the auditor might communicate with the finance manager of financial controller, or with a finance director who does not hold a governance role. This can present problems where the auditor is shielded from those charged with governance.

Example: charity audit clients

While trustees are the individuals charged with governance of the entity, very often the communication is with the finance manager, accountant or even bookkeeper at the charity rather than with the trustees and especially where the trustees are not involved in the day to day running of the charity.

While it may be appropriate in some instances to communicate solely with management (e.g. minor housekeeping matters), the responsibility of the auditor is to report to those trustees who are charged with governance, since any executive powers held by management are delegated from the trustee body.

Example: pension schemes

Some trustee bodies of occupational pension schemes operate their relationship with the auditor through individuals such as a professional trustee or the secretary to the trustees in these circumstances. There may be a tiered approach to communication, with the detailed matters being communicated to an audit committee (or similar group) and less detailed matters being communicated with the trustee body. It may therefore be difficult to ensure that oral communication is transmitted to all trustees and written communication may also be necessary.

As part of the planning process, the auditor must ensure that there has been adequate and appropriate communication with the client. In addition to communicating the scope of the audit and its limitations, agreeing the audit timetable and information to be provided by the client, communication is required to gather information from which to assess risk. This includes, but is not limited to:

- Updating the auditor's understanding of the business, including the impact of any current year developments on the audit approach.
- Discussing the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and the detection or possibility of fraud.
- Discussing matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
- Confirming significant communications between the entity and its regulators.
- Discussing significant risks assessed in the business and how the auditor plans to mitigate these.
- Considering the implications of any changes to financial systems and the financial reporting framework.
- Gathering of information sufficient to address risk assessment requirements of ISA(UK) 250A (laws and regulations); ISA(UK) 550 (related parties); and ISA(UK) 600 (group audits).
- Independence issues and the safeguards that the firm has put in place should be discussed with the client.

The nature and detail of the planning information communicated will reflect the size and nature of the entity and the manner in which those charged with governance operate.

Common issues identified on monitoring visits include:

- **The lack of a formal audit client planning meeting on the basis of regular client contact;**
- **The lack of a formal audit client planning meeting based on an assumption that nothing has changed and the approach to the audit will be the same as last year;**
- **Planning meeting held with management or an employee of the client, but no separate communication with those charged with governance;**
- **Insufficient identification of those charged with governance; and**
- **Communication solely with another firm of accountants who are responsible for the underlying accounting records (this often leads to a more serious issue around undue influence and third-party involvement in the audit process).**

It is a further requirement of ISA (UK) 240 that the make inquiries of management regarding fraud. Specifically, this should cover:

a. Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
b. Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
c. Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
d. Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

Unless all of those charged with governance are involved in managing the entity, the auditor should further enquire as to how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud; and determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

This is another area which is often not very well considered on files reviewed by the monitoring team. While the extent of these discussions will depend on the size and nature of the audited entity, discussions are often limited to whether there were any instances of fraud and do not extend to management's assessment of fraud.

Ultimately, ISA (UK) 260 says that there must be **effective two-way communication** between the audit team and those charged with governance, and the key issue raised on files reviewed by ICAS AM is where this cannot be evidenced on the file at planning. Firm's are advised to review the requirements of the revised ISA, a copy of which can be obtained from the FRC website.

International Standard on Auditing (ISA) (UK) 600 (Revised) Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)

ICAS AM would like to remind firms of additional guidance in FRC Staff Guidance Note 02/2018 in determining whether components are significant and/or material.

Under ISA (UK) 600, there is a requirement for the group auditor to evaluate and review the work performed by component auditors where that work is used for the purpose of the group audit. While the wording of the revised ISA does not specify the nature and extent of this work, the Staff Guidance Note (SGN) provides further guidance which should be considered. Specifically:

- Where a component is financially significant – the group auditor will be required to review more of the component auditor's working papers.
- Where a component is significant due to certain account balances / classes of transactions – the group auditor will focus their review on working papers of the component auditor for these specific areas.
- Where a component is material (a lower threshold than significant) the review will likely be limited to documentation relevant to a risk of material misstatement of the group accounts.

Note that the term "material subsidiary" was brought in by the Audit Directive, which is not used in ISA (UK) 600 (which focuses on "significant components"). The FRC view is that determination of "material subsidiaries" uses the same measure of materiality as the group audit.

Determination of 'financial significance'

Judgement will have to be applied in determining 'financial significance' in relation to a component and group auditors will be required to consider:

- the extent to which the group auditor has been able to evaluate and review the work performed by the component auditor and the results obtained;
- the group auditor experience of review of the component auditor in prior periods;
- the relative significance of the component; and
- the nature of risks relevant to that component.

The group auditor should use the planning process to develop and document their understanding of the component and the component auditor to help assess these matters. It is important that this forms part of the planning process to prevent delays in signing the audit report.

A key issue raised in ICAS AM visits relates to how the auditor has considered ISA(UK)600, and specifically the determination of 'financial significance', significance of certain balances and transactions; and 'material subsidiary'. This has a consequential impact on the audit approach. Common issues include:

- **components assessed incorrectly as 'immaterial' leading to a lack of audit evidence over balances and transactions consolidated into the group accounts;**
- **components which contain one, or a small number of, balances or transactions which are significant but ignored because the auditor considers the component immaterial; and**
- **components assessed as 'financially significant' however the review of the work of the component auditor was not sufficient to meet the requirements of the standard.**

Other matters to consider

The group auditor should also consider:

- ensuring time to review the component auditor's work is built into the planned approach and budget;
- whether work will have to be completed remotely or will require a visit to the component auditor;
- ensuring audit team members with appropriate skill and experience performs the review of working papers; and
- if the work is documented in the component auditor's local language, the group auditor should have sufficient understanding of that language or identify someone independent who can translate the working papers.

A common root cause of ISA(UK)600 issues on monitoring visits, is a lack of appropriate planning and overreliance on the work of a component auditor without appropriate consideration of the extent, nature and timing of work performed.

It is often the case that this consideration is limited to the issue of a generic questionnaire which has not been tailored and does not actually address the requirements of the standard. Firms are advised to review the standard and SGN to ensure they are aware of the requirements to ensure appropriate evidence is obtained prior to signing a group audit report.

Amendments to FRS 102

The FRC has issued ***Amendments to FRS 102 – Multi-employer defined benefit plans***.

These narrow-scope amendments respond to a current financial reporting issue regarding where to present the impact of an employer's transition from defined contribution accounting to defined benefit accounting; specifically, that it should be presented in other comprehensive income.

The transition is required by FRS 102 when sufficient information about the multi-employer defined benefit plan becomes available for the employer to apply defined benefit accounting for the first time. The amendments do not affect the requirement to recognise the relevant liability (or asset) in relation to the plan.

The amendments are effective for accounting periods beginning on or after 1 January 2020, with early application permitted.

Audits of Less Complex Entities: Discussion paper *on Applying the ISAs in Audits of Less Complex Entities*

The International Auditing and Assurance Standards Board (IAASB) has published a Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the International Standards on Auditing (ISAs)*. The IAASB seeks to further understand the challenges of using ISAs in audits of less complex entities—and views about possible actions to address these challenges.

The IAASB recognizes the global call for action to address issues of complexity, length, understandability, scalability, and proportionality related to using the ISAs. Continuing the debate on these strategic issues, the Discussion Paper explores how the IAASB, and others, could further support auditors working in increasingly evolving environments.

The consultation will remain open until the 12th September 2019.

Exposure Draft: International Standard on Quality Management 1

To ensure that firms' systems continue to be robust and effectively support high-quality audits and other engagements, the IAASB has proposed various enhancements to address firms' systems of quality management, previously known as the International Standard on Quality Control 1 (ISQC1)

The Exposure Draft follows a proactive risk-based approach to an effective system of quality management, establishing the foundation for consistent engagement quality.

Other enhancements include:

- Increasing firm leadership responsibilities and accountability, and improving firm governance;
- Modernizing the standard for an evolving environment. This includes addressing the impact of technology, networks, and use of external service providers; and
- More rigorous monitoring of quality management systems and how deficiencies are remedied.

An overall explanatory memorandum, is available, together with proposed standards on engagement quality reviews and revisions to ISA 220 as follows:

- Overall Explanatory Memorandum, *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*
- Proposed International Standard on Quality Management 2, *Engagement Quality Reviews*
- Proposed International Standard on Auditing 220 (Revised), *Quality Management for an Audit of Financial Statements*

Triennial Review 2017 — Reminder

The first triennial review of FRS 102 was conducted over a two-year period concluding with the publication final amendments in December 2017, and a revised edition of FRS 102 was published in March 2018, alongside revised editions of the other UK accounting standards.

The Triennial Review 2017 Amendments are generally effective for accounting periods beginning on or after 1 January 2019 and two transitional exceptions to retrospective application have been introduced. The date of transition is the beginning of the earliest period for which an entity presents full comparative information.

The majority of the amendments made by the Triennial Review 2017 Amendments are editorial in nature and/or are intended to merely clarify rather than change accounting treatment. The principal amendments that might have an impact on financial statements are:

- The removal of undue cost or effort exemptions which, in some cases, are replaced by accounting policy options. In particular, an accounting policy choice is introduced for entities that rent investment property to another group entity, whereby they can choose to measure the investment property either at cost or at fair value.
- The introduction of a description of a basic financial instrument to support the detailed conditions for classification as basic. This should result in a relatively small number of financial instruments, which breach the detailed conditions for classification as basic, now being considered to be basic and measured at amortised cost.
- For small entities, a more proportionate accounting solution for a loan from a person within a director's group of close family members that includes at least one shareholder in the entity, which will permit the loan to be initially measured at transaction price rather than present value.
- Entities will be required to recognise fewer intangible assets acquired in a business combination separately from goodwill. Entities may choose to separately recognise additional intangible assets acquired in a business combination if this provides useful information to the entity and the users of its financial statements.
- The principle included in the financial institution definition has been amended to remove references to 'generate wealth' and 'manage risk', and stockbrokers and retirement benefit plans have been removed.

Entities require to update their accounting policies note as required to reflect the new requirements of FRS 102 and any accounting policy choices that have been made.

The FRC has released staff factsheets covering the triennial review and adjustments, which can be found here.

Mandatory course: Keeping Audit on the Right Track

This course aims to educate Audit Compliance Principals (ACPs) and Responsible Individuals (RIs) in developing a strong compliance function and preventing some of the recurring issues identified on audit monitoring visits. It lasts three hours and is presented across various locations each year. The ICAS Authorisation Committee has imposed, since the inception of the course in 2010/11, a mandatory aspect for ACPs and RIs, where each ACP is required to attend once within a three-year cycle; and RIs are required to attend once within a five-year cycle.

For clarification, the current requirements are:

- The current cycle for ACPs commenced on 1 January 2019. As such, each ACP will be required to attend at least once in the three-year period from 1 January 2019 to 31 December 2021.
- The current cycle for RIs commenced on 1 January 2016. As such, each RI will be required to attend at least once in the five-year period from 1 January 2016 to 31 December 2020.
- Newly approved RIs will be required to attend the course within 12 months of approval; and
- Previously inactive RIs (i.e. approved RIs who are not signing audit reports), who have recommenced the role, will be required to attend the course within 12 months of becoming active.

The course is presented by the ICAS Audit Monitoring team and has been created to educate and support ACPs and RIs and covers all areas of audit compliance responsibilities, key regulatory issues, common compliance failings, and key findings from ICAS audit monitoring visits. The course is open to all audit professionals and many attend yearly to maintain audit CPD, however there is a mandatory requirement, as noted above. Detailed materials are provided during the course, and this is useful reference material for all firms.

Full details of dates and times for this course can be found on the ICAS website by searching ‘Keeping Audit on the Right Track’, however remaining courses for 2019 are scheduled as follows:

- Perth – 17th September;
- Edinburgh – 23rd October; and
- London – 26th November.