

AUDIT NEWS

ISSUE No 53B June 2014

INTRODUCTION

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

We have prepared a short announcement of the Financial Reporting Council's (FRC's) revised

Practice Note 14 on the audit of Housing Associations; and the recent EU agreement on audit reforms.

In addition, further articles have been presented on the justification of audit sampling; FRC Bulletin and the FRC's work to enhance audit confidence; the

required wording for incorporated firms Articles of Association; recent changes to the Responsible Individual application process; a reminder of the 'Statutory Auditor' designation on audit reports; and a reminder on the ICAS mandatory Audit Compliance Partner course.

THE AUDIT OF HOUSING ASSOCIATIONS IN THE UNITED KINGDOM – PRACTICE NOTE 14

In January of this year the Financial Reporting Council (FRC) issued a revision to Practice Note 14, The Audit of Housing Associations in the United Kingdom. The previous guidance was issued in 2006, and was subsequently withdrawn in 2012, pending the revision now issued.

The revision has been made by the FRC in the light of the landscape in which the social housing sector now operates, where there has been welfare reform and a reduction in grant funding. As a consequence, some associations augment their traditional housing activities with more commercial activities, such as student accommodation or the operation of care homes. Some others have moved away from long term bank financing to bond financing and an increased use of interest rate swaps.

In addition, over recent years, the devolved regulatory regimes have been subject to a great deal of change so it is important that auditors are not only familiar with the sector and risks which could affect a housing association, but also how the individual regimes across the UK operate and, in particular, the extent of communication required between the regulator and auditor. In this regard the revised Practice Note may be particularly useful to auditors who are new to the sector.

The Practice Note provides a foundation for the auditor to consider risk, and is presented across four principal sections:

- (a) Background information about the sector;
- (b) A description of the four devolved regulatory regimes in Scotland, England, Wales and Northern Ireland, and appendices which summarise the regulatory background;

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- (c) A description of generic business risks that could adversely affect a Housing Association and which may give rise to a risk of material misstatement in its financial statements; and
- (d) A discussion of audit risks, primarily arising from the generic business risks, which the auditor is likely to need to pay particular attention to.

ICAS Audit Monitoring has now issued a more detailed helpsheet in relation to the audit of Housing Associations, and this can be accessed at icas.org.uk/regulation/news/helpsheets/

In addition, the Practice Note can be accessed on the FRC's website at frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Practice-Note-14.pdf

We would highlight that the accounting by Housing Associations is only briefly covered in Practice Note 14. Auditors of such entities need to be aware that the introduction of Financial Reporting Standard (FRS 102) has led to a revised SORP being developed which will be published in the coming months. This is likely to have a significant impact on accounting by housing associations in certain areas and auditors will need to cognisant of these changes and the impact they will have on their clients.

EU AGREEMENT ON AUDIT REFORMS FOR PUBLIC INTEREST ENTITIES

Agreement on the long-awaited audit reforms for public interest entities was reached by the European Parliament on 3 April and subsequently ratified by the Council of Ministers.

The changes will apply from two years after coming into force (expected to be 15 June 2016) for all articles except article 16(6), which will apply after three years.

Although the revised proposals are much less radical than the originals, there are still some significant implications for auditors and the audit market.

The regulation is only applicable to public interest entities (PIEs). These are actually defined in the directive but cross referenced to the regulation as follows:

- (a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;
- (b) credit institutions as defined in point 1 of Article 4 3(1) of Directive 2006/48/EC 2013/36/EU of the European Parliament and of the Council , other than those referred to in, unless they fall under Article 2 of that Directive;
- (c) insurance undertakings within the meaning of Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings, or;
- (d) entities designated by Member States as Member States may also designate public-interest entities, for instance entities undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

Some of the key features of the new legislation are:

- the creation of a 'blacklist' of prohibited non-audit services that includes all tax services, albeit there is an option of a materiality test by Member States;
- when the audit firm provides non-audit services, other than those referred to in Article 5(1), for a period of three or more consecutive years, the total fees for such services shall be limited to no more than 70% of the average of the fees paid in the last three consecutive years;
- mandatory auditor rotation after a maximum period of 10 years, which may be extended to 20 years where a public tendering process has been conducted, or 24 years where joint auditors are appointed;
- audit reports should include the date of the auditor appointment and the length of the engagement, and should provide details of the most significant audit risks; and
- a new EU framework in the form of a Committee of European Auditing Oversight Bodies (CEAOB) is to be established to ensure co-operation between Member States.

We have already observed some changes within the listed environment In the UK, following the introduction of the UK Corporate Governance Code provision to tender the audit appointment after 10 years on a 'comply or explain' basis. Additionally, the UK has already introduced more informative auditor reporting for certain PIEs which has been well received by stakeholders.

Attention has now focussed to the implementation stage of the EU legislation and the UK Government is already making preparations in this regard. The UK Government intends to issue a consultation paper towards the end of 2014 setting out its proposals as to how these reforms will be implemented.

JUSTIFICATION OF AUDIT SAMPLING

As auditors, we are all aware that we are normally unable to test every item in a client's accounting records, and we therefore need to select representative samples to allow appropriate conclusions to be drawn. ISA (UK and Ireland) 530 governs the application of audit procedures to less than 100% of items within a population.

Audit sampling provides an efficient and practical audit approach, however there are inherent risks, where the sampling method used is not sufficiently robust; the sample is not representative of the entire population; or that sample sizes have been reduced to an inappropriate level based on perceived comfort obtained elsewhere.

ICAS Audit Monitoring regularly encounters issues with regards the documented justification of audit samples. Common minor matters identified include:

- insufficient documentation of the sample size basis;
- using 'judgmental sampling', with no justification of the judgments taken;
- a lack of support of the risk assessment as a contributing factor; and
- selecting items within a population due to accessibility.

In a number of instances these matters can be easily addressed by effectively using sampling plans within a firm's audit programmes; ensuring that the samples are based on appropriate criteria; and recording this in sufficient detail on the audit file.

However, in this article we would like to focus on a more serious matter which can impact on the level of audit evidence obtained, as we have seen a number of instances recently of firms reducing sample sizes due to reliance on controls, where tests of control have not been sufficiently carried out; or substantive analytical review, where the extent of the analytical review is not sufficient to justify such an approach.

When can it be appropriate to reduce sample sizes based on controls reliance or analytical review?

Reliance on internal controls

ISA (UK and Ireland) 530 states that sampling risk can lead to an erroneous conclusion in the case of a test of controls, where it is perceived that the control is more effective than it actually is.

Substantive testing may be reduced in some areas by placing reliance on internal controls, however in order to achieve this the auditor should perform an appropriate test to assess the operating effectiveness of the relevant control and determine whether the control has been properly designed to prevent or detect a material misstatement in the financial statements.

The more common types of controls selected for testing include authorisation of transactions; reconciliation procedures; and assessment of segregation of duties. ISA (UK and Ireland) 530 provides a significant level of guidance regarding the determination of sample sizes, and the consideration of the impact of reliance from other areas of the audit engagement, including determination of tolerable misstatement; and the consideration of risk in determining whether a smaller or greater sample size is required.

Substantive analytical review

Analytical review can be a valuable substantive audit procedure; however it can often be the case that the reviews performed by firms are not sufficient to meet the definition of substantive procedures and, as such, should not be relied upon for the purpose of reducing sample sizes.

As a brief reminder, in order for this review to be robust, there are considerations to be addressed by the audit team and a well performed analytical review will address the following key steps:

- Build an expectation – this should be based on reliable data, and therefore if the firm uses last year's figure then they should justify why they consider this to be reasonable and not to have fluctuated in any way.
- Compare with actual values – this will enable levels of variance to be determined and, if material, whether these should be investigated.
- Corroboration of explanations – once the difference has been quantified, these should be independently verified, including corroboration of management's explanations.

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

FRC'S BULLETIN HIGHLIGHTS THE AUDITOR'S RESPONSIBILITIES WITH RESPECT TO THE STRATEGIC REPORT AND THE DIRECTORS' REMUNERATION REPORT

There have been a number of recent developments in UK Company Law, the UK Listing Rules and ISAs (UK and Ireland) that affect both the auditor's duties and the wording of auditor's reports on the financial statements of companies.

These developments are:

- (a) The introduction of the Strategic Report;
- (b) The option for companies to provide its members with a stand-alone "Strategic Report with Supplementary Material" in place of the company's full accounts and reports.
- (c) Amendment of the Regulations that specify the information to be included in a quoted company's Directors' Remuneration Report;
- (d) Changes in the requirements of the Listing Rules with respect to directors' remuneration disclosures; and
- (e) Changes to ISA (UK and Ireland) 700 "The Independent Auditor's Report on Financial Statements" and the issuance of a Clarification Statement in respect thereof.

The FRC's latest Audit and Assurance Bulletin deals with each of these, and notes that auditors have the same statutory reporting responsibility for the new Strategic Report as they have for the existing Directors' Report. The Bulletin also sets out their responsibilities in relation to the directors' remuneration report.

The effects of the various developments on the auditor's report of a company preparing accounts under the FRSSSE, and of a premium listed group, are illustrated in two Appendices. The Bulletin can be viewed at: frc.org.uk/News-and-Events/FRC-Press/Press/2014/April/Audit-and-Assurance-Bulletin-highlights-the.aspx

FRC'S WORK TO ENHANCE JUSTIFIABLE CONFIDENCE IN AUDIT

The FRC has set out its work programme to give justifiable confidence in the quality of audit. This expands on the outline of projects and activity announced in the FRC's current three year strategic programme.

Audit is a key pillar of public confidence in the UK's corporate governance and reporting. Since the financial crisis the FRC has introduced a number of measures designed to enhance audit quality and increase the value of auditor reporting to investors to underpin UK corporate activity. These measures include retendering, enhanced and extended auditor reporting, and directly informing audit committees of the results of the FRC's audit quality inspections.

In the near to medium term, the FRC will focus on the expansion of its audit inspection work in line with recommendations from the Competition Commission, the implementation of the new EU Directive on statutory audit and enhancing the quality of bank audits, including through its thematic review of audits in this sector.

Over the longer term, the FRC will assess whether any change to the scope of audit is necessary to meet investor expectations. In this respect, ICAS has been actively promoting the need for auditors of larger listed entities to be providing a positive opinion on the front half of a company's annual report. ICAS recently published its report summarising the feedback and comments received on its Balanced and Reasonable discussion paper, issued in April last year. The new paper, entitled 'Assurance on Management Commentary - Where Next?' and previous work, focuses on the provision of positive assurance on the narrative content provided in annual reports. The report summarises the key messages from the respondents and participants in the various events and meetings hosted by ICAS.

In conducting the research, ICAS received feedback from nine of the current top 10 UK accounting firms. Meetings were held with senior staff from the Financial Reporting Council (FRC) and International Auditing and Assurance Standards Board (IAASB). Debates were also hosted in London and Brussels and senior ICAS staff engaged with investor groups and bodies to discuss the proposals.

Key messages from the consultation process were:

- There was broad support for the proposals;
- 44% of responses stated that there was a need to demonstrate user demand for this type of assurance;
- The responses demonstrated some confusion over the extent of assurance currently provided by auditors on information contained in the front-half of annual reports;
- 25% of respondents favoured monitoring the impact of the fair balanced and understandable requirement before proposing any more change;
- An exercise to demonstrate the benefits compared with the cost of the additional work was mentioned by 41% of respondents; and

- There was a need to revisit the auditor liability regime which could be an obstacle to this type of work.

Next steps

ICAS is keen to promote a reporting and assurance framework which meets the needs of a wide range of users and primarily investors. A number of initiatives and next steps have been proposed in the report which will be overseen by a High Level Steering Group.

A first step is to commission research into the changes observed in the current reporting and assurance environment. The findings from this research will form the basis of a discussion and interaction between auditors, preparers and investors to understand how far the new regime has gone in meeting their needs and if they would like any further assurance to be provided.

REQUIRED WORDING FOR AN INCORPORATED FIRM'S ARTICLES OF ASSOCIATION

ICAS Audit Monitoring would like to bring the requirements of Audit Regulation 2.03(d) to every corporate firm's attention. This is of particular reference to firms who may have been incorporated a number of years ago, and whose Articles of Association may not be fully compliant. As such, we would recommend that each incorporated firm reviews its Articles and considers updating these to reflect the current requirements.

Audit Regulation 2.03(d) states that where a firm is a corporate practice, the Articles of Association:

- 1) require its shareholders to notify it of any changes in the number of shares held in the corporate practice, whether the shares are held directly or indirectly;
- 2) enable the board of directors to require shareholders to supply information about their shareholdings in the corporate practice over the previous three years;
- 3) enable the board of directors to require any non-shareholder whom the directors know or have reasonable cause to believe has or had an interest in the shares of

the corporate practice to supply information about their interests in the previous three years;

- 4) enable the board of directors to deprive any shareholder of the right to vote if the information asked for in regulation 2.03 is not given in the time specified in the request;
- 5) enable the board of directors to deprive any shareholder of the right to vote if the corporate practice's application for registration is rejected under regulation 2.05, or registration has been withdrawn under regulation 7.03, and the corporate practice has been told that the refusal or withdrawal relates to the ownership of any shareholding; and
- 6) require the board of directors to approve any transfer of shares which would result in a shareholder having an interest representing more than 3% of the aggregate nominal value of the issued share capital.

A copy of the model article can be obtained from ICAS by contacting lbyrne@icas.org.uk or ereid@icas.org.uk

RESPONSIBLE INDIVIDUAL (RI) APPLICATIONS: KEY CHANGES

Firms changing legal status or reorganising

First the good news! The majority of audit registration applications we receive relate to firms who are already registered and are merely changing legal status or re-organising with no changes in RIs. Up until now we have required firms to complete application forms for each RI in the new firm as well as the registered auditor firm application.

Key change:

Going forward, where the firm is changing legal status or re-organising, we have dropped the requirement for RI applications for those who are already existing RIs. This should reduce the administration involved. Any new RI applicants will still require to apply as normal.

More information required on audit experience and CPD

Following a thematic review of RI applications across all the Recognised Supervisory Bodies (RSBs), it is clear that the Financial Reporting Council is expecting firms to supply more detailed audit experience and CPD information in support of RI applications going forward.

Key Changes

- All RI applicants will be required to submit two years' CPD records to show how audit CPD has been maintained. For ICAS members these records should be in ICAS CPD format.
- An Audit Experience Form will be required to supplement the RI application form where the applicant:
 - has not been an RI before; or
 - has been an RI, but not in the last three months, or
 - is an RI but has not had any audit clients in the last 12 months.

The Audit Experience Form is also now more prescriptive as to the information required.

Audit Experience Form: this now requests the following information:

- Current Position Held: including seniority and reporting lines;
- Audit hours in the past 24 months;
- Nature of audit work to be provided (details of the number, nature, specialist or regulatory clients);
- Nature of any induction to be provided; and
- Audit, financial reporting & other relevant experience (full details of years and nature of experience, scope of clients, size of clients, reporting lines on audits, responsibility on audits and details of professional judgement exercised on audits (eg significant audit issues, potential modifications to audit report, complex accounting issues, ethical situations and judgements).

A large number of firms may face challenges, given audit exemption thresholds and their small audit client base, in trying to ensure that their incoming RIs have enough audit experience. In such cases, the Audit Registration Committee may only grant RI status subject to conditions (such as hot file reviews of all audits for the first twelve months and/or attendance at the mandatory audit course) or, in the worst case scenario, may reject the application on the grounds of lack of experience.

The Audit Registration Committee would therefore like to stress to firms the importance of succession planning well ahead of time, where possible, in order to ensure that incoming RIs have enough audit experience well in advance of applying for RI status.

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/

STATUTORY AUDITOR DESIGNATION – SIGNING OF AUDIT REPORTS

It has come to our attention during recent ICAS Audit Monitoring visits that some financial statement software packages do not automatically include the required 'Statutory Auditor' designation on audit reports. Consequently, there have been instances where signed audit reports have not correctly identified the firm as the 'Statutory Auditor'.

Firms are reminded that the requirements are built into Audit Regulation 3.16, and it is recommended that any software packages that do not incorporate the correct references should be updated as soon as possible.

As a brief reminder, for companies; banks; insurers; certain partnerships; building societies; LLPs; and Lloyds syndicates, the audit report is required to be signed by the 'Senior Statutory Auditor', being the RI, and on behalf of the 'Statutory Auditor', being the firm.

REMINDER – MANDATORY COURSE FOR AUDIT COMPLIANCE PARTNERS

Keeping Your Audit Firm and Files on the Right Track

As we confirm in each of our Audit News editions, these courses 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 courses are still heavily discounted for those requiring mandatory attendance. Courses are developed and delivered by the ICAS Audit Monitoring team and there is one further course date for 2014, being 6 November in Glasgow,

and you can book a place on this course at: icas.org.uk/Businesscourses/

The first course was run in 2010, and therefore we are nearing the end of the first five year cycle for attendance, therefore if you have not yet attended we would strongly recommend attending the Glasgow date.

If you would like to see any particular articles in future editions of Audit News or any particular auditing areas covered in future monitoring helpsheets please send your ideas to: auditandpracticemonitoring@icas.org.uk

