The Institute of Chartered Accountants in England and Wales

CORPORATE REPORTING

Edition 3

Study Manual

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Corporate Reporting
The Institute of Chartered Accountants in England and Wales

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I am delighted that you have chosen ICAEW to progress your journey towards joining the chartered accountancy profession. It is one of the best decisions I also made.

The role of the accountancy profession in the world's economies has never been more important. People making financial decisions need knowledge and guidance based on the highest technical and ethical standards. ICAEW Chartered Accountants provide this better than anyone. They challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity all over the world.

As a world leader of the accountancy and finance profession, we are proud to promote, develop and support over 144,000 chartered accountants worldwide. Our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. They are part of something special, and now, so are you. It's with our support and dedication that our members, and hopefully yourself, will realise career ambitions, maintain a professional edge and contribute to the profession.

You are now on your journey towards joining the accountancy profession, and a highly rewarding career with endless opportunities. By choosing to study for our world-leading chartered accountancy qualification, the ACA, you too have made the first of many great decisions in your career.

You are in good company, with a network of over 26,000 students around the world made up of like-minded people; you are all supported by ICAEW. We are here to support you as you progress through your studies and career; we will be with you every step of the way, visit page x to review the key resources available as you study.

I wish you the best of luck with your studies and look forward to welcoming you to the profession in the future.

Michael Izza
Chief Executive
ICAEW

Contents

Questions within the study manual should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the question bank.

1 Introduction

ACA qualification

The ICAEW chartered accountancy qualification, the ACA, is a world-leading professional qualification in accountancy, finance and business.

The ACA has integrated components that give you an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAEW Chartered Accountant.

Each component is designed to complement each other, which means that you can put theory into practice and you can understand and apply what you learn to your day-to-day work. Progression through all the elements of the ACA simultaneously will enable you to be more successful in the workplace and exams.

The components are:

- Professional development
- Ethics and professional scepticism
- 3-5 years practical work experience
- 15 accountancy, finance and business modules

To find out more on the components of the ACA and what is involved in training, visit your dashboard at icaew.com/dashboard.

2 Corporate Reporting

The full syllabus and technical knowledge grids can be found within the module study guide. Visit icaew.com/dashboard for this and more resources.

2.1 Module aim

To enable candidates to apply technical knowledge, analytical techniques and professional skills to resolve compliance and business issues that arise in the context of the preparation and evaluation of corporate reports and from providing audit services.

Candidates will be required to use technical knowledge and professional judgement to identify, explain and evaluate alternatives and to determine the appropriate solutions to compliance issues, giving due consideration to the needs of clients and other stakeholders. The commercial context and impact of recommendations and ethical issues will also need to be considered in making such judgements.

On completion of this module, candidates will be able to:

- Formulate, implement and evaluate corporate reporting policies for single entities and groups of varying sizes and in a variety of industries. They will be able to discern and formulate the appropriate financial reporting treatment for complex transactions and complex scenarios. Candidates will be able to evaluate and apply technical knowledge from individual accounting standards and apply professional skills to integrate knowledge where several accounting standards are simultaneously applicable and interact.
- Analyse, interpret, evaluate and compare financial statements of entities both over time and across a range of industries.
- Explain the processes involved in planning an audit, evaluating internal controls, appraising risk, gathering evidence and drawing conclusions in accordance with the terms of the engagement. In addition, they will be able to perform a range of assurance engagements and related tasks.
- Evaluate corporate reporting policies, estimates and disclosures in a scenario in order to be able to assess whether they are in compliance with accounting standards and are appropriate in the context of audit objectives.
- Identify and explain ethical issues. Where ethical dilemmas arise, candidates will be able to recommend, justify and determine appropriate actions and ethical safeguards to mitigate threats.

2.2 Method of assessment

The Corporate Reporting module will be examined using a paper-based assessment of 3.5 hours. Each exam will contain questions requiring integration of knowledge and skills, including ethics. Candidates will be allowed to take any written or printed materials into the exam hall subject to practical space restrictions.

The exam will consist of three questions. Ethical issues and problems could appear in any of the three questions.

2.3 Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will be within the ranges of weightings below, but slight variations may occur in individual papers to enable suitably rigorous questions to be set.

Syllabus area	*Weighting* %
Corporate Reporting – Compliance Corporate Reporting – Financial statement analysis	55–65
Audit and Assurance	30–40
Ethics	5–10
	100

Your exam will consist of three questions. Ethical issues and problems could appear in any of the three questions.

3 Permitted texts

At the Professional and Advanced Levels there are specific texts that you are permitted to take into your exams with you. All information for these texts, the editions that are recommended for your examinations and where to order them from, is available on www.icaew.com/permittedtexts.

Professional Level Examinations	Permitted Text
Audit and Assurance	✓
Financial Accounting and Reporting	✓
Tax Compliance	✓
Business Strategy	✗
Financial Management	✗
Business Planning: Banking/Insurance/Taxation	No restrictions

Advanced Level Examinations	
Corporate Reporting	No restrictions
Strategic Business Management	No restrictions
Case Study	No restrictions

Business Planning: Banking/Insurance/Taxation and the Advanced Level exams have no restrictions so you may take any hard copy materials in to these exams that you wish, subject to practical space restrictions.

Although the examiners use the specific editions listed to set the assessment, you **may** use a different edition of the text at your own risk. If you use a different edition within your exams, you should note this inside your answer booklet, at the beginning of the question.

This information, as well as what to expect and what is and is not permitted in your exams is available in the Instructions to Candidates. You will be sent this with your exam admission details and it is also available on our website; www.icaew.com/exams.

4 Key resources

Student support team

Our student support team is here to help you as much as possible, providing full support throughout your studies.

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F +44 (0)1908 248 069
E studentsupport@icaew.com

Student website

The student area of our website provides the latest information, guidance and exclusive resources to help you progress through the ACA. Find everything you need (from sample papers to errata sheets) at icaew.com/dashboard.

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Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are receiving structured tuition with an ICAEW Partner in Learning, make sure you know how and when you can contact your tutors for extra help. If you are not receiving structured tuition and are interested in classroom, online or residential learning, take a look at our recognised Partner in Learning tuition providers in your area, on our website icaew.com/dashboard.

Faculties and special interest groups

Faculties and special interest groups support and develop members and students in areas of work and industry sectors that are of particular interest.

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Our 12 special interest groups provide practical support, information and representation within a range of industry sectors. Register to receive free provisional membership of one group each year throughout your studies.

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Library & Information Service

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The library provides access to thousands of resources online and a document delivery service, you'll be sure to find a useful eBook, relevant article or industry guide to help you. Find out more at icaew.com/library.

CHAPTER 1

Introduction

Introduction

Learning objectives

	Tick off
• Appraise and explain the role and context of auditing	☐
• Explain the nature and purpose of quality assurance (at the level of both the firm and the individual audit) and assess how it can contribute to risk management	☐
• Comment on and critically appraise the nature and validity of items included in published financial statements	☐

Specific syllabus references for this chapter are: 2(a), 10(a), 10(b).

1 Using this Study Manual

Section overview

- This section gives a brief outline of how this Study Manual is structured and why.
- The key point is that the Corporate Reporting paper is integrated, so financial reporting and auditing must be studied together.

1.1 The importance of integration

The aim of the Corporate Reporting module is as follows:

'To enable candidates to apply technical knowledge, analytical techniques and professional skills to resolve compliance and business issues that arise in the context of the preparation and evaluation of corporate reports and from providing audit services.

Candidates will be required to use technical knowledge and professional judgement to identify, explain and evaluate alternatives and to determine the appropriate solutions to compliance issues, giving due consideration to the needs of clients and other stakeholders. The commercial context and impact of recommendations and ethical issues will also need to be considered in making such judgements.'

It is clear from this that the **application** of technical knowledge (financial reporting, audit, assurance and ethics) is **integrated**, so it is appropriate that these areas are **studied together** where possible.

At earlier levels you will have tended to study subjects in isolation, but this is no longer appropriate at Advanced Level, and indeed in the real world.

1.2 How this Study Manual is structured

1.2.1 Principles and regulations in financial reporting and auditing

This chapter and Chapter 2 cover the role and context of auditing and general principles of corporate reporting. This will largely be revision, but some of the regulations and standards will have changed since your earlier studies. The aim is to set the more specialised topics, and the integrated areas, in context.

1.2.2 Ethics and governance

Chapters 3 and 4 look at ethics and corporate governance. These topics underpin corporate reporting and auditing, and ethical matters come up in all kinds of contexts, both in the exam and in your working life as a professional. It is necessary to cover all relevant audit principles first because, in the later chapters on reporting performance and position, the principles are applied in audit focus sections.

1.2.3 The modern audit process

In Chapters 5 to 8 we revise and build on the auditing material covered at the Professional Level. This will put you in the position where you can consider the audit and assurance issues in relation to specific financial reporting topics, the aim being to study financial reporting and auditing together.

1.2.4 Financial reporting chapters

Chapters 9 to 22 deal with the financial reporting and auditing of specific areas:

- Reporting performance
- Assets and liabilities
- Financing
- Remuneration
- Business combinations
- Reporting foreign activities
- Taxation

The financial reporting aspects are covered first, followed by an 'audit focus' section for each topic, looking at the specific audit issues arising from the financial reporting of that area, generally with examples and/or questions. For example, the chapter on share-based payment has at the end a section on auditing share-based payment.

Audit focus sections may in turn be split into general and specific sections. For example, Chapter 9 Reporting Financial Performance covers general issues, including creative accounting, for which auditors need to be alert. However, a more specific section will refer back to standards and the auditing of, for example, related party disclosures, which has its own designated ISA (UK and Ireland) and particular risks. These sections allow scope for integrated examples or questions covering both corporate reporting and auditing elements.

Finally the self-test questions at the end of chapters will contain integrated questions where relevant.

1.2.5 Financial analysis chapters

Once you have a thorough understanding of the financial reporting and related auditing issues, including analytical procedures, you will be in a position to analyse and interpret the financial statements. You will not have studied financial analysis before, so Chapter 23 provides an introduction, and Chapter 24 deals with more advanced topics.

1.2.6 Assurance and other related services

The Study Manual concludes with coverage of assurance and related services, which can more easily be understood in the context of the knowledge you have gained in the earlier chapters.

2 The importance of corporate reporting

Section overview

- Corporate reporting embraces financial reporting, and both are different from management accounting.
- Financial statements are used to make economic decisions by a wide range of users.
- All users require information regarding:
  - Financial position
  - Financial performance
  - Changes in financial position

2.1 What is corporate reporting?

2.1.1 Financial reporting

Financial reporting is the process of identifying, measuring and communicating economic information to others so that they may make decisions on the basis of that information and assess the stewardship of the entity's management.

Financial reporting involves:

- Recording transactions undertaken by a business entity
- Grouping similar transactions together which are appropriate to the business
- Presenting periodic results

Financial reporting focuses on the preparation of published financial information. Typically, this information is made available annually or half-yearly (sometimes quarterly) and is presented in formats laid down or approved by governments in each national jurisdiction.

2.1.2 Corporate reporting

Corporate reporting is a broader term than financial reporting, although the two are often used interchangeably. As will be evident from this Study Manual and the exam it prepares you for, **corporate reporting covers reports other than financial statements,** in particular audit reports, but also assurance, internal audit and environmental reports.

PricewaterhouseCoopers states on its website:

> 'The exact definition of corporate reporting differs depending on who you speak to. However, throughout this web site we use the term "corporate reporting" to refer to the presentation and disclosure aspects – as distinct from accounting/measurement – of the following areas of reporting:
>
> - Integrated reporting
> - Financial reporting
> - Corporate governance
> - Executive remuneration
> - Corporate responsibility
> - Narrative reporting'

In the context of professional accountancy examinations, a Corporate Reporting paper is generally higher level than a Financial Reporting paper. In the context of your examination, Corporate Reporting is a more appropriate title because the paper is not just on financial reporting.

General principles relating to corporate reporting are set out in the IASB *Conceptual Framework for Financial Reporting (Conceptual Framework)*, which is covered in Chapter 2, together with regulatory matters and selected International Financial Reporting Standards (IFRS) that set out principles and frameworks.

2.1.3 Management accounting

By contrast, **management accounting** or reporting is **internal reporting** for the use of the management of a business itself. Internal management information can be tailored to management's own needs and provided in whatever detail and at whatever frequency (eg continuous real-time information) management decides is best suited to the needs of their business.

The distinction is not so clear-cut, in that management decisions may be affected by external reporting issues, for example, if a director's bonus depends on profit. These matters are covered in Chapter 24 on the more advanced aspects of financial analysis.

Interactive question 1: Management decisions

Can you think of another example of a way in which management decisions may be influenced by external reporting requirements?

See **Answer** at the end of this chapter.

2.2 Entity

Most accounting requirements are written with a view to use by any type of accounting entity, including companies and other forms of organisation, such as a partnership. In this Study Manual, the term 'company' is often used, because the main focus of the syllabus is on the accounts of companies and groups of companies, but International Financial Reporting Standards generally refer to entities.

2.3 Financial statements

The principal means of providing financial information to external users is the annual financial statements. Financial statements provide a summary of the performance of an entity over a particular period and of its position at the end of that period.

A complete set of financial statements prepared under IFRS comprises:

(a) The statement of financial position

(b) The statement of profit or loss and other comprehensive income or two separate statements being the statement of profit or loss and the statement of other comprehensive income (statements of financial performance)

(c) The statement of changes in equity (another statement of financial performance)

(d) The statement of cash flows

(e) Notes to the financial statements

The notes to the financial statements include:

(a) Accounting policies, ie the specific principles, conventions, rules and practices applied in order to reflect the effects of transactions and other events in the financial statements

(b) Detailed financial and narrative information supporting the information in the primary financial statements

(c) Other information not reflected in the financial statements, but which is important to users in making their assessments (an example of this would be the disclosures relating to contingent assets or liabilities)

The individual elements that are included in the financial statements are covered in detail later in this chapter.

2.4 Requirement to produce financial statements

Limited liability companies are **required by law** to prepare and publish financial statements annually. The form and content may be regulated primarily by national legislation, and in most cases must also comply with Financial Reporting Standards.

In the UK, **all companies** must comply with the provisions of the **Companies Act 2006 (CA 2006).** The key impact of this is as follows:

(a) Every UK registered company is required to prepare **financial statements** for each financial year which give a **true and fair view.**

(b) The individual (and some group) financial statements may be prepared:

  (i) In accordance with the **CA 2006** (as regards **format** and **additional information** provided by way of notes); **or**

  (ii) In accordance with international accounting standards.

2.5 Financial reporting standards

Company financial statements must also comply with relevant reporting standards. In the UK these are as follows.

(a) **Accounting Standards**

These include **Financial Reporting Standards** (FRSs) which are issued by the UK **Accounting Standards Board** (ASB) and **Statements of Standard Accounting Practice** (SSAPs) which have been adopted by the ASB. (SSAPs were originally issued by the Accounting Standards Committee (ASC), which was replaced by the ASB in 1990.) FRSs and SSAPs will apply to the majority of individual company financial statements in the UK, as most companies will choose to prepare their individual financial statements in accordance with the CA 2006 (see section 2.4 above).

(b) **Financial Reporting Standard for Smaller Entities** (FRSSE)

This brings together **all the accounting guidance** which UK **small companies** are required to follow in drawing up their financial statements.

- **International Financial Reporting Standards (IFRS)**

  These are issued by the **International Accounting Standards Board** (IASB). UK companies **whose securities are traded** in a regulated public market, eg the London Stock Exchange, must prepare **group accounts** in accordance with IFRS.

These learning materials assume the preparation of financial statements in accordance with IFRS.

Unincorporated entities are exempt from the above requirements but may need to follow other regulation, eg charities must comply with the Charities Act. Incorporated charities **must** prepare their financial statements **in accordance with the CA 2006** (ie the IFRS option is not open to them).

Point to note:

The term UK **Generally Accepted Accounting Practice (GAAP)** refers to all the rules, from whatever source, which govern UK accounting. In the UK this is seen primarily as a combination of:

- **Company law** (mainly CA 2006)
- **Accounting Standards**
- **Stock Exchange requirements**

In the UK, GAAP has **no statutory or regulatory authority or definition** (unlike some other countries such as the United States) although the use of the term is increasingly common in practice.

2.6 Fair presentation

IAS 1 *Presentation of Financial Statements* requires financial statements to 'present fairly' the financial position and performance of an entity.

'Present fairly' is explained as representing faithfully the effects of transactions. In general terms this will be the case if IFRS are adhered to. IAS 1 states that **departures** from international standards are only allowed:

- In extremely rare cases;
- Where compliance with IFRS would be so misleading as to conflict with the objectives of financial statements as set out in the *Conceptual Framework*, that is to provide information about financial position, performance and changes in financial position that is useful to a wide range of users.

2.7 Judgements and financial statements

Although IFRS narrow down the range of acceptable alternative accounting treatments, there are still many areas which are left to the discretion of the directors of the company. On the whole, the concept of faithful representation should result in transactions being 'presented fairly'. However, commercial and financial considerations may result in pressure being brought to bear to account for and report transactions in accordance with their strict legal form rather than their true substance. This can raise ethical questions for a professional accountant.

2.8 Users of financial statements

The form and content of financial statements must be influenced by the use to which they are put. The IASB *Conceptual Framework* emphasises that financial statements are used to make economic decisions, such as:

- To decide when to **buy, hold or sell an equity investment**
- To assess the **stewardship or accountability of management**
- To assess an entity's ability to pay and **provide other benefits to employees**
- To assess **security** for amounts lent to the entity
- To determine **taxation policies**
- To determine **distributable profits and dividends**
- To prepare and use **national income statistics**
- To **regulate** the activities of entities

Much of the information needed for these different decisions is in fact common to them all. Financial statements aimed at meeting these common needs of a wide range of users are known as '**general purpose**' financial statements.

We can identify the following **users** of financial statements:

- Present and potential investors
- Employees
- Lenders
- Suppliers and other trade payables
- Customers
- Governments and their agencies
- The public

Their specific information needs and how these needs may be addressed are covered in Chapter 23, the first of two chapters on financial analysis. In most cases the users will need to analyse the financial statements in order to obtain the information they need. This might include the calculation of accounting ratios.

2.9 Objective of financial statements

The objective of financial statements is to provide information about the reporting entity's **financial position and financial performance that is useful to a wide range of users in making economic decisions**.

This objective can usually be met by focusing exclusively on the information needs of present and potential investors. This is because much of the financial information that is relevant to investors will also be relevant to other users.

2.10 Accountability of management

Management also has a **stewardship role**, in that it is accountable for the safekeeping of the entity's resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role, but again this assessment is made only as the basis for economic decisions, such as those about investments and the reappointment/replacement of management.

It is also the case that in a smaller entity the owner and manager can be the same individual.

Financial reporting helps management to meet its need to be accountable to shareholders, and also to other stakeholders (eg employees or lenders), by providing information that is useful to the users in making **economic decisions**.

However, financial statements cannot provide the complete set of information required for assessing the stewardship of management.

2.11 Financial position, performance and changes in financial position

All economic decisions are based on an evaluation of an entity's ability to generate cash and of the timing and certainty of its generation. Information about the entity's financial position, performance and changes in financial position provides the foundation on which to base such decisions.

2.11.1 Financial position

An entity's financial position covers:

- The **economic resources** it controls;
- Its **financial structure** (ie debt and share finance);
- Its **liquidity and solvency**; and
- Its **capacity to adapt to changes** in the environment in which it operates.

Investors require information on financial position because it helps in assessing:

- The entity's ability to **generate cash in the future**
- How **future cash flows will be distributed** among those with an interest in, or claims on, the entity
- Requirements for **future finance** and ability to raise that finance
- The ability to meet **financial commitments** as they fall due

Information about financial position is primarily provided in a **statement of financial position**

2.11.2 Financial performance

The profit and the comprehensive income earned in a period are used as the key measures of an entity's financial performance. Information about performance and variability of performance is useful in:

- Assessing **potential changes in the entity's economic resources** in the future;
- **Predicting the entity's capacity to generate cash** from its existing resource base; and
- **Forming judgements** about the effectiveness with which additional resources might be employed.

Information on financial performance is provided by:

- The **statement of profit or loss and other comprehensive income**
- The **statement of changes in equity**

2.11.3 Changes in financial position

Changes in financial position can be analysed under the headings of **investing, financing** and **operating activities** and are presented in a **statement of cash flows**.

Cash flow information is largely free from the more **judgemental allocation and measurement issues** (ie in which period to include things and at what amount) that arise when items are included in the statement of financial position or performance statements. For example, depreciation of non-current assets involves judgement and estimation as to the period over which to charge depreciation. Cash flow information excludes non-cash items, such as depreciation.

Cash flow information is therefore seen as being **factual in nature**, and hence more reliable than other sources of information.

Information on the generation and use of cash is useful in evaluating the entity's ability to generate cash and its need to use what is generated.

3 The role and context of modern auditing

Section overview

- The audit provides assurance to shareholders.
- The audit enables the auditor to form an opinion as to whether the financial statements give a true and fair view.
- An expectation gap may exist between what shareholders expect the audit to achieve and what it is designed to achieve.
- You should be familiar with the audit process from your earlier studies.
- All companies, except those meeting exemption criteria, must have an annual external audit.
- The Companies Act sets down the responsibilities of the directors and auditors.

3.1 Purpose of the audit

Audits serve a fundamental purpose in helping to enforce **accountability** and **promote confidence** in financial reporting. Directors are delegated responsibility for managing the affairs of the company by the owners; in effect they act as trustees for the shareholders. The audit provides a mechanism for shareholders to help ensure that the directors are acting in the company's best interests and therefore plays a fundamental **stewardship role**.

ISA (UK and Ireland) 200 *Overall Objectives of The Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)* sets out the purpose of an audit as follows:

> 'The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.'

3.2 Part of the economic infrastructure

The audit is also a vital function of economic activity. For that economic activity to continue to flourish there has to be trust.

While the audit has a crucial role to play in providing assurance to shareholders, it cannot be seen in isolation. For example, the directors of the company have a role to play in the preparation of financial statements that show a true and fair view. The audit has to be seen in the context of a range of interwoven laws, regulations and guidance, all of which promote good corporate governance. (We will look at corporate governance in detail in Chapter 4.)

3.3 The expectation gap

The primary role of the auditor is to perform an independent examination of the financial statements and to form an opinion. You should be very familiar with this concept from your earlier studies. The audit opinion will provide **reasonable assurance** (a high but not absolute level of assurance) that the financial statements give a true and fair view; it does not provide a certificate that they are completely accurate and free from every error or fraud, no matter how small. ISA 200 explains that absolute assurance is not possible due to inherent limitations of the audit, including those resulting from the following factors:

- The nature of financial reporting; many items involve judgement and assessments of uncertainties
- The use of selective testing
- Inherent limitations of internal control
- The fact that most evidence is persuasive rather than conclusive
- The impracticability of examining all items within a class of transactions or account balance
- The possibility of collusion or misrepresentation for fraudulent purposes
- The fact that the work undertaken by the auditor is permeated by judgement

In some instances an '**expectation gap**' can lead to difficulties arising from the difference between what shareholders expect an audit to achieve and what it is designed to achieve. The public increasingly expect the following types of questions to be answered:

- Is the company a going concern?
- Is the company managed effectively?
- Is there an adequate system of controls?
- Is the company susceptible to fraud?

3.4 The audit opinion

The key judgement made by the auditor is whether the financial statements give a true and fair view. While there is no legal definition for these terms, 'true' and 'fair' are normally taken to mean the following:

Definition

True: The information in the financial statements is not false and conforms to reality.

In practical terms this means that the information is presented in accordance with **accounting standards and law**. The financial statements have been correctly **extracted from the underlying records** and those records reflect the **actual transactions** which took place.

Definition

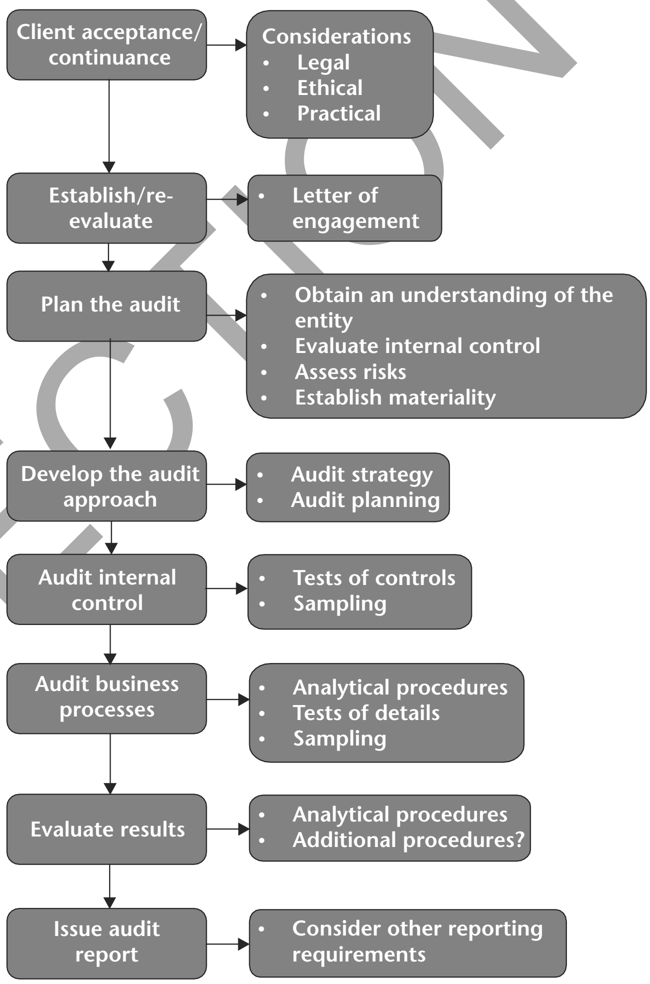
Fair: The financial statements reflect the commercial substance of the company's underlying transactions and the information is free from bias.

You will have come across examples of the application of **substance over form** in your financial reporting studies eg the treatment of a finance lease.

The problem with making judgements such as these is that they can be called into question, particularly where others have the benefit of hindsight. The major defence that the auditor has in this situation is to show that the work was performed with **due skill and care** and that the judgements made about truth and fairness were reasonable based on the evidence available at the time. We will look at quality control in section 6 of this chapter.

3.5 The audit process

You will have covered the audit process in your earlier studies. The following diagram summarises the key points you should be familiar with. Chapters 5 to 8 of this Study Manual cover the audit in more detail.



Point to note:

ISA 260 requires the auditor to promote and engage in two-way communication with those charged with governance throughout the audit process. In particular, auditors must:

(a) 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) Obtain from those charged with governance information relevant to the audit; and

(c) 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.

(ISA 260 paragraph 9)

ISA 200 requires that the audit should be planned and performed with an attitude of **professional scepticism**. Professional scepticism is covered in detail in Chapter 5.

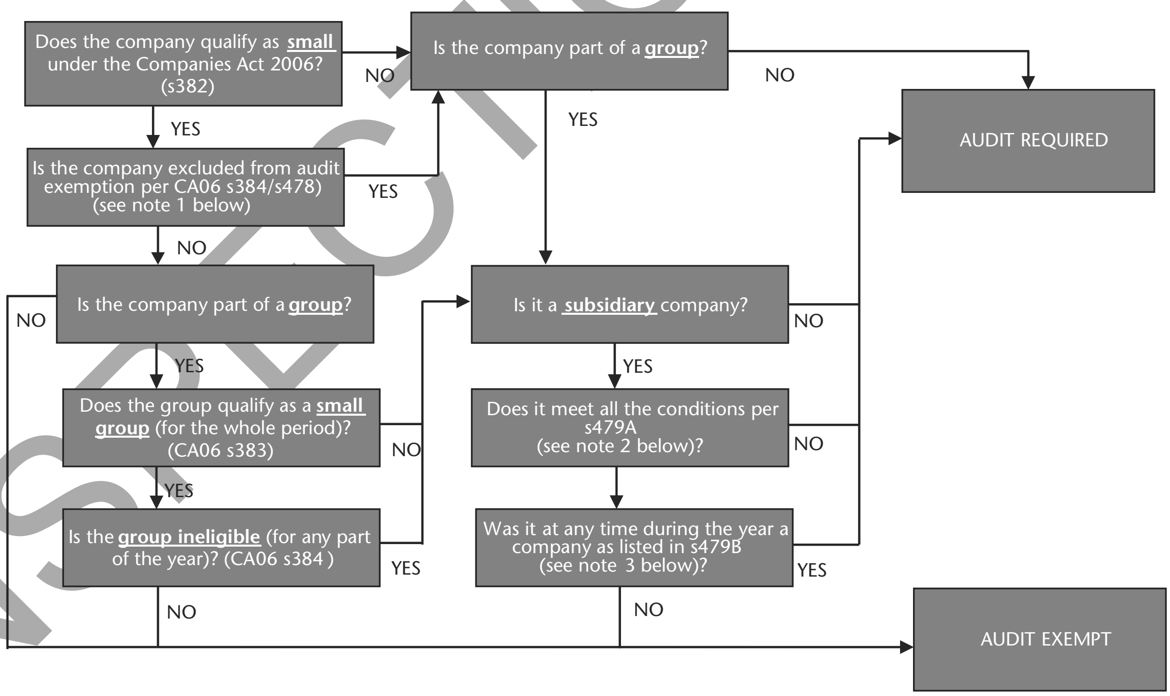
3.6 Statutory audit requirement

All companies except those meeting exemption criteria must have an audit.

The basic principle is that all companies registered in the UK should be audited. However, in the early 1990s certain very small companies were granted an **exemption**. In September 2012 the UK Government announced that, for accounting periods ending on or after 1 October 2012, the audit exemption criteria would be aligned with the small company criteria stated under the Companies Act 2006 satisfying at least two of the following:

- Annual turnover must be £6.5 million or less.
- The balance sheet total must be £3.26 million or less.
- The average number of employees must be 50 or fewer.

Once an entity qualifies as a small entity, it must satisfy a set of other criteria to be exempted from audit. An ICAEW Helpsheet summarises the situation in the following diagram:



Note 1: s478:

A company is not entitled to take audit exemption per section 477 if it was at any time within the financial year:

(1) A public company (listed or unlisted)

(2) A company that

(a) Is an authorised insurance company, a banking company, an e-money issuer, a Markets in Financial Instruments Directive (MiFID) investment firm or a UCITS management company or

(b) Carries on insurance market activity

(3) A special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c52)(a) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (SI 1992/807) (NI5)

Note 2: s479A:

(1) A company is exempt from the requirements of this Act relating to the audit of individual accounts for the financial year if:

(a) It is itself a subsidiary company
(b) Its parent undertaking is established under the law of an EEA state

(2) Exemption is conditional upon compliance with all of the following conditions:

(a) All members of the company must agree to the exemption in respect of the financial year in question

(b) The parent undertaking must give a guarantee under section 479C in respect of that year

(c) The company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with

(i) The provisions of the Seventh Directive (83/349/EEC)(d) or
(ii) International accounting standards

(d) The parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section; and

(e) The directors of the company must deliver to the registrar on or before the date they file the accounts for that year:

(i) The written notice of the agreement referred to in subsection 2(a)
(ii) The guarantee referred to in section 479C (1)
(iii) A copy of the consolidated accounts referred to in subsection 2(c)
(iv) A copy of the auditors report on those accounts, and
(v) A copy of the consolidated annual report drawn up by the parent undertaking

(3) This section has effect subject to section 475(2) and (3) (requirements as to statements contained in balance sheet) and section 476 (rights of members to require an audit).

Note 3: s479B:

A company is not entitled to the exemption conferred by section 479A (subsidiary companies) if it was at any time within the financial year in question:

(1) A quoted company as defined in section 385(2) of this Act,

(2) A company that:

(a) Is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company or;

(b) Carries on insurance market activity

(3) A special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c52)(a) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (SI 1992/807) (NI5)

Notice, however, even if a small company met these criteria, it must still have its accounts audited if this is demanded by a member, or members, holding at least 10% of the nominal value of the issued share capital or holding 10% of any class of shares; or – in the case of a company limited by guarantee – 10% of its members in number. The demand for the financial statements to be audited should be in the form of a notice to the company, deposited at the registered office at least one month before the end of the financial year in question. The notice may not be given before the financial year to which it relates.

In addition, a company should have an audit, irrespective of size, if it is:

- A regulated company, such as Financial Conduct Authority regulated businesses and insurance providers (S 478); or
- A public company.

Points to note:

1 The criteria use UK accounting terminology rather than IFRS terminology as they are required by UK law.

2 Any company which meets the small company criteria can choose to be exempt from audit (ie if the company meets two out of the three following criteria: no more than 50 employees, balance sheet total of no more than £3.26m, less than £6.5m in turnover).

4 Legal responsibilities of directors and auditors

4.1 Companies Act 2006

The legal responsibilities regarding directors and auditors are currently contained in the Companies Act 2006 (CA 2006). The majority of the auditing requirements of the Act came into force for periods on or after 6 April 2008.

4.2 Directors' responsibilities

These duties are as follows:

(a) **'Enlightened shareholder value' duty**

The CA 2006 requires directors to act in a way that they consider, in good faith, would be most likely to **promote the success of the company for the benefit of its members as a whole**. In doing so they should consider such factors as:

- The likely long-term consequences
- The interests of employees
- Relationships with customers and suppliers
- The impact of the company's operations on the community and the environment
- The desirability of maintaining a reputation for high standards of business conduct
- The need to act fairly as between members of the company

(b) **Duty of skill and care**

Directors have the responsibility to take **reasonable steps** to ensure the safeguard, insurance, etc of the company's assets.

A director is required to:

- Exhibit a degree of skill that can reasonably be expected
- Take such care as an ordinary man might be expected to take on his behalf

(c) **Conflicts of interest**

Directors should not place themselves where their personal interest conflicts with their duty to the company. Directors will be **personally liable** to the company for any loss suffered by the company. (*Regal (Hastings) Ltd v Gulliver 1942*)

If a director has an interest in a contract to which his company is party, the company may in certain circumstances void the contract.

(d) **Fraudulent trading**

Directors will be responsible should the company trade with the intent to **defraud creditors** if they are knowingly party to such conduct. Responsibility will arise whether or not the company is in the course of winding up.

(e) **Wrongful trading**

Where a company is in the course of winding up, **the provisions of wrongful trading may apply**. An action may be brought against the director if at some time before the commencement of the winding up the person knew or ought to have concluded there was no reasonable prospect of avoiding liquidation.

(f) **Theft**

If a company obtains property or pecuniary advantage by deception and the director has consented, then **the director will be liable as well as the company**.

(g) **Accounting records**

A company is required to keep **adequate accounting records**, which are sufficient to show and explain the company's transactions. Failure to do so may render every officer of the company liable to a fine or imprisonment.

In addition to the statutory requirement, the directors have an overriding responsibility to ensure they have **adequate information** to enable them to fulfil their duty of managing the company's business.

(h) **Annual accounts**

Directors have a number of responsibilities with regard to the annual accounts. The directors are required to:

(i) Select **suitable accounting policies** and apply them consistently.

(ii) Make **judgements and estimates** that are prudent.

(iii) State whether **applicable accounting standards** have been followed, subject to any material departures disclosed and explained in the financial statements.

(iv) Prepare the financial statements on a **going concern basis** unless it is an inappropriate assumption.

(v) Ensure the financial statements are delivered to **Companies House** within the specified time.

A **statement of directors' responsibilities** should be included in the financial statements.

(i) **Directors' and officers' insurance**

Generally a company **cannot** indemnify a director against a liability arising from an act of negligence, default or breach of duty. However, this statutory provision does not prevent a company from buying and maintaining insurance against such a liability.

(j) **Safeguarding the assets**

Responsibility to safeguard the assets of the company includes the **prevention and detection of fraud**. One of the main ways in which this duty can be carried out is to implement an **effective system of controls**.

4.3 Directors' loans and other transactions

4.3.1 Background

The CA 2006 imposes restrictions on dealings between a company and its directors in order to prevent directors taking advantage of their position. These restrictions are probably the main legal safeguard available against directors abusing their position in a company. The disclosures ensure that shareholders and other stakeholders will be informed about all the significant transactions entered into by a company with its management that might benefit those individuals.

This is an important area for the auditor because he has a specific duty to disclose details of directors' transactions in the audit report if not disclosed elsewhere. The information is very sensitive, and it is difficult to audit due to materiality, complexity and the potential lack of any formal documents.

4.3.2 Definitions

The following definitions are relevant to your understanding of this issue.

Definitions

Persons connected with a director. These include:

- Directors' spouses, minor (including step) children
- A company with which a director is associated (ie controls > 20% voting power)
- Trustee of a trust whose beneficiaries include the director or connected person
- Partner of the director or connected person

Loan: A sum of money lent for a time to be returned in money or money's worth.

Quasi-loan: The company agrees to pay a third party on behalf of the director, who later reimburses the company (eg personal goods bought with company credit card).

Credit transaction: A transaction where payment is deferred (eg goods bought from company on credit terms).

4.3.3 Members' approval

The following rules apply to **all companies**:

(a) Loans > £10,000 must be approved by the members of the company. In order for the resolution to be passed members must be provided with details of the nature of the transaction, the amount of the loan and the purpose for which it is required and the extent of the company's liability.

(b) Advances for legitimate business expenditure do not require approval. However, the value of any transaction is not allowed to exceed £50,000.

The following rules apply to **public companies** (or companies associated with public companies).

- Loans > £10,000 made to persons connected with a director must be approved by the members of the company.
- Quasi-loans > £10,000 made to directors or connected persons must be approved by the members of the company.
- Credit transactions > £15,000 for the benefit of a director or a connected person must be approved by the members of the company.
- Where transactions are entered into without the required approval the transaction is voidable at the instance of the company.

4.3.4 Disclosure

For all loans etc to directors, disclose:

- Its amount
- An indication of the interest rate
- Principal terms
- Any amounts repaid

4.3.5 Other transactions and contracts

Directors' interests in contracts

Directors may have a personal interest in contracts planned or made by the company, eg because they are also directors of another company.

Directors must declare interests in contracts to the board of directors at the earliest opportunity.

Substantial property transactions between company and directors also require approval by members. A transaction is substantial if:

- Value > £100,000; or
- Value > 10% of company's net assets (per latest accounts).

Exception: the transaction is not substantial if < £5,000 (*de minimis* limit).

If not approved, the transaction is voidable by the company.

Service contracts

Members must approve long service contracts for directors (> 2 years).

Service contracts must be open to inspection by members.

In examining directors' service contracts, auditors should check particularly that:

- Company and each director are complying wholly with terms of contract.
- Terms themselves comply with Companies Act requirements and are consistent with company's articles

4.4 Auditors' responsibilities

Under the CA 2006, it is the external auditor's responsibility to:

(a) Form an **independent opinion** on the **truth and fairness** of the financial statements

(b) Confirm that the financial statements have been **properly prepared** in accordance with the relevant financial reporting framework and the CA 2006

(c) State in their audit report whether in their opinion the information given in the **directors' report is consistent** with the financial statements

The auditor will also report by exception on the following.

- Whether proper returns, adequate for audit purposes, have been received from branches
- Whether the accounts agree with the underlying records
- Whether adequate accounting records have been kept
- Whether all necessary information and explanations have been obtained
- In the case of a quoted company whether the auditable part of the directors' remuneration report has been properly prepared

If the accounts (or directors' remuneration report) omit or incorrectly disclose information on directors' emoluments, loans and other transactions, the correct disclosure must be included in the auditor's report (due to the particularly sensitive nature of this information and its importance to users of the accounts).

The auditor also has a duty towards other information in documents containing audited financial statements in accordance with ISA (UK and Ireland) 720A *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* (see Chapter 8).

Point to note:

The scope of an audit under UK law and ISAs is now set out in formal guidance that can be cross-referred to from auditor's reports (see Chapter 8).

5 International standards on auditing

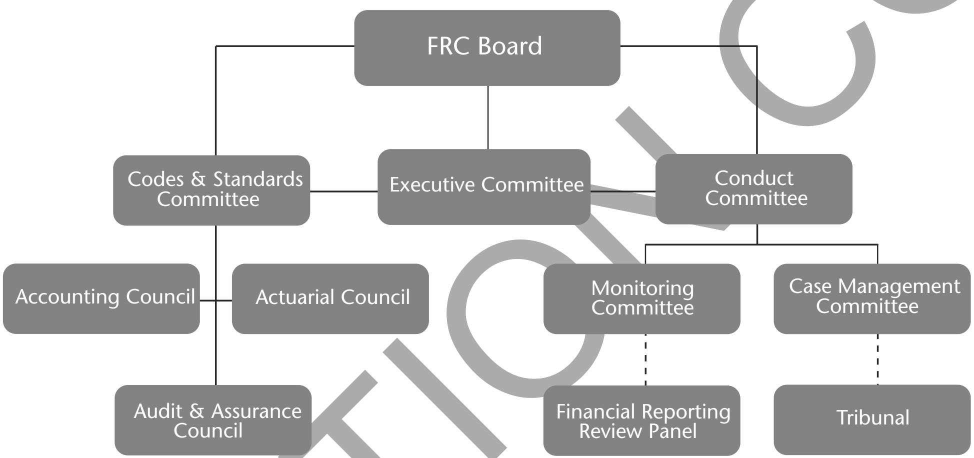
Section overview

- The structure of the FRC has been revised.
- The International Auditing and Assurance Standards Board (IAASB) issues International Standards on Auditing (ISAs).
- The IAASB has reissued its ISAs as a result of its Clarity Project.
- These have been adopted by the FRC (previously APB) in the UK.

5.1 FRC Update

In June 2012 the UK Parliament approved a proposal to revise the structure of the FRC. This became effective in 2012. The FRC structure is summarised in the diagram below:

FRC Structure



5.1.1 FRC Board

The revised role of the FRC Board is as follows:

- To set high standards of corporate governance through the UK Corporate Governance Code
- To set standards for corporate reporting and actuarial practice
- To monitor and enforce accounting and auditing standards
- To oversee regulatory activities of the actuarial profession and professional accountancy bodies
- To operate independent disciplinary arrangements for public interest cases

The FRC Board is supported by three committees, the Codes and Standards Committee, the Executive Committee and the Conduct Committee.

Point to note:

The FRC is now responsible for Auditing Standards. Previously these were issued by the APB.

5.1.2 Codes and Standards Committee

The Codes and Standards Committee is responsible for advising the FRC Board on the maintenance of an effective framework of UK Codes and standards for Corporate Governance, Stewardship, Accounting, Auditing and Assurance and Actuarial technical standards. The Codes and Standards Committee also advises on influencing the wider regulatory framework and on the FRC's research programme. It advises the FRC Board on the Annual Plan for Codes and Standards work and for making appointments to, and overseeing the work of, the Councils.

It comprises FRC Board members together with others with particular technical expertise, including practising professionals. The FRC Board and the Codes and Standards Committee are advised by three Councils covering Accounting, Audit and Assurance, and Actuarial work (see sections 5.1.5 and 5.1.6 below).

5.1.3 Executive Committee

The basic purpose of the Executive Committee is to provide day to day oversight of the work of the FRC. In particular it:

- Recommends the strategic direction to the FRC Board
- Oversees the implementation of the FRC business plan
- Advises the FRC Board on the budget, business plan, Board agenda and management of the organisation
- Advises the FRC Board and its Committees on requirements to establish new advisory groups to deal with specific issues
- Debates and resolves issues affecting the Codes and Standards, and Conducts divisions
- Ensures consistency and connectivity between the various divisions and decides which part of the FRC should lead in cross-cutting issues

5.1.4 Conduct Committee

The Conduct Committee is responsible for overseeing the FRC's Conduct Division. Its responsibilities include overseeing:

- Monitoring of recognised supervisory and recognised qualifying bodies
- Audit Quality Reviews
- Corporate reporting reviews
- Professional discipline
- Oversight of the regulation of accountants and actuaries

The Conduct Committee is supported by two subcommittees: the Monitoring Committee and the Case Management Committee (see sections 5.1.7 and 5.1.8).

FRC's Conduct division

The Conduct division encompasses the FRC's monitoring, oversight and disciplinary functions through a number of teams. For example, the Audit Quality Review team monitors the quality of the audits of listed and other major public interest entities and the policies and procedures supporting audit quality at the major audit firms.

5.1.5 Audit and Assurance Council

The Audit and Assurance Council is responsible for:

- Providing strategic input and thought leadership on audit and assurance matters
- Considering and advising the FRC Board on draft Codes and Standards (or amendments thereto)
- Considering and commenting on proposed developments in relation to international Codes and Standards and regulations
- Considering and advising on research proposals and other initiatives

No more than half the members can be practising members of the auditing profession

5.1.6 Accounting Council and Actuarial Council

The role of the Accounting Council and the Actuarial Council is essentially the same as that of the Audit and Assurance Council but in relation to accounting and financial reporting and actuarial matters respectively.

5.1.7 Monitoring Committee

The Monitoring Committee helps ensure the consistency and quality of the FRC's monitoring work. Its functions include:

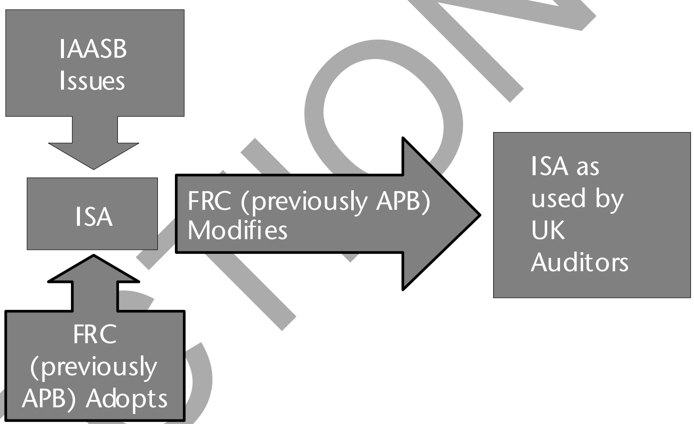
- Agreeing the assessment of the standard of audit work for individual audits reviewed
- Approving letters summarising the key findings from reviews of individual audit engagements
- Agreeing the contents of public reports on individual firms in relation to audit quality
- Determining conditions or sanctions for acceptance by auditors or audit firms (and referring matters to an independent tribunal if not accepted)
- Requiring Recognised Supervisory Bodies to implement conditions or sanctions accepted by an auditor or audit firm, or determined by a sanctions tribunal
- Appointing a Financial Reporting Review Group
- Referring matters to the Conduct Committee with a view to an investigation leading to a possible disciplinary action

5.1.8 Case Management Committee

The Case Management Committee advises on the handling of disciplinary cases.

5.2 Interaction between FRC and IAASB Standards

The system in the UK currently works as follows:



5.3 International Auditing and Assurance Standards Board

5.3.1 Pronouncements

The IAASB was set up by the International Federation of Accountants (IFAC), which nominates a majority of its members – others are nominated by the Forum of Firms – to issue professional standards. It issues the following standards:

- **International Standards on Auditing** (ISAs)
- **International Standards on Assurance Engagements** (ISAEs) (applicable to assurance engagements which are not audits)
- **International Standards on Related Services** (ISRSs) (applicable to other, non-assurance engagements)
- **International Standards on Quality Control** (ISQCs) (applicable to all engagements carried out under any of the IAASB's standards)
- **International Standards on Review Engagements** (ISREs) (to be applied in the review of historical financial information)

It also issues the following practice statements:

(a) **International Auditing Practice Notes** (IAPNs). This is a new category of pronouncement for use in issuing non-authoritative material. They provide practical assistance to the auditor and may help the auditor in:

(i) Obtaining an understanding of the circumstances of the entity, and in making judgements about the identification and assessment of risks of material misstatement;

(ii) Making judgements about how to respond to assessed risks, including judgements about procedures that may be appropriate in the circumstances; or

(iii) Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

To date, one IAPN has been issued, IAPN 1000 *Special Considerations in Auditing Financial Instruments*. This is covered in Chapter 16.

(b) **International Review Engagement Practice Statements**, **International Assurance Engagement Practice Statements** and **International Related Services Practice Statements** are issued to serve the same purpose for implementation of ISREs, ISAEs and ISRSs respectively.

Point to note:

All International Auditing Practice Statements have now been withdrawn.

5.3.2 Authority of ISAs

ISAs are to be applied in the audit of **historical financial information**.

In **exceptional circumstances**, an auditor may judge it necessary to **depart from an ISA** in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

5.3.3 Working procedures

The working procedures of the IAASB can be summarised as follows.

(a) The Public Interest Activity Committee identifies potential new projects based on a review of national and international developments.

(b) A project task force is established to develop a new standard based on research and consultation.

(c) There is transparent debate as the proposed standard is presented at an IAASB meeting which is open to the public.

(d) Exposure drafts are posted on the IAASB's website for public comment.

(e) Comments and suggestions are discussed at a further IAASB meeting, which is open to the public and if substantive changes are made a revised exposure draft is issued.

(f) The final ISA is issued after approval by IFAC's Public Interest Oversight Board, which reviews whether due process has been followed and clears the ISA for publication.

5.4 Clarity Project

In March 2009 the IAASB completed its Clarity Project, during which it reissued existing ISAs, with the aim of making the requirements within them clearer.

Under this project, each ISA has:

- A stated overall objective
- Clarified obligations, by use of the word 'shall' where a requirement of the ISA is set out
- Less ambiguity
- Improved readability

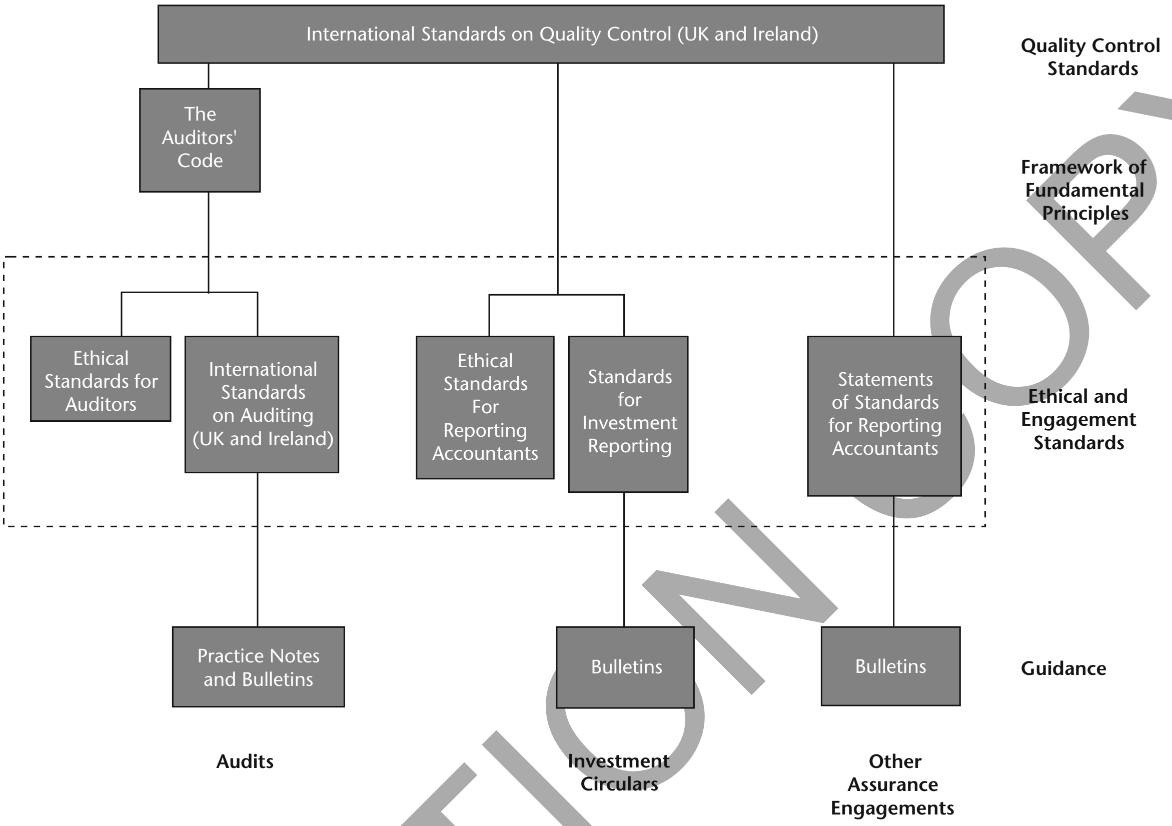
These standards are effective for audits of financial statements for periods beginning on or after 15 December 2009.

5.5 FRC

5.5.1 FRC pronouncements

The following summary diagram is provided in the FRC *Scope and Authority of FRC Audit and Assurance Pronouncements*.

Scope and Authority of FRC Audit and Assurance Pronouncements



The FRC (previously APB) makes three categories of pronouncements in relation to audit:

- Auditing standards (quality control, engagement and ethical)
- Practice notes
- Bulletins

5.5.2 Relationship between ISAs and UK standards

International Accounting Standards (IASs) have been adopted by **all EU listed companies** for accounting periods commencing on or after 1 January 2005.

Since that time the EU has been working towards the adoption of ISAs for the audit of all EU financial statements. In the UK, the APB (now FRC) decided to replace all its own standards – Statements of Auditing Standards (SASs) – with the equivalent ISAs for audits of financial statements covering accounting periods beginning on or after 15 December 2004.

The adoption of the ISAs at that time did not mean that the substance of UK auditing standards was abandoned. In areas where SASs were more advanced than ISAs, or where there were additional UK legal requirements, **additions to the ISA text were made** to add enhanced requirements, considerations or procedures. This was indicated in their title – 'International Standards on Auditing (UK and Ireland)'. This additional material was clearly differentiated from the international standards, and over time, the APB (now FRC) hoped to be able to withdraw such supplementary material as relevant ISAs were revised by IAASB.

5.5.3 Harmonisation – Clarity standards for UK and Ireland

When the APB (now FRC) first issued the ISAs (UK and Ireland) in December 2004, these standards were based on the IAASB ISAs in issue at that time. The APB Work Programme highlighted the need for the

APB to be at the forefront of international developments by contributing to IAASB work projects and, in particular, the development of Europe-wide auditing standards following recent amendments to the Eighth EC Directive, resulting in EU statutory auditors being required to carry out audits in accordance with ISAs.

It is expected that the EU will adopt the clarified standards as a requirement for all audits throughout the EU. During 2008, an APB consultation produced support for the APB view that the clarified standards were more rigorous and clearer than the existing ISAs and that they should be implemented in the UK and Ireland as soon as possible, rather than waiting for the EU decision.

The APB contributed to the Clarity Project and many of its recommendations were accepted and, as a result, the number of supplementary requirements needed for the ISAs (UK and Ireland) has been significantly reduced.

The Clarified ISAs (UK and Ireland) were issued as exposure drafts in April 2009 and the final versions were issued in October 2009. These standards apply to audits of accounting periods ending on or after 15 December 2010.

Point to note:

Unless indicated otherwise, this Manual refers to the clarified ISAs (UK and Ireland).

6 Audit quality control

Section overview

- Quality control procedures should be adopted:
  - At the firm level; and
  - On an individual audit.
- Professional bodies also have a responsibility to develop quality control standards and monitor compliance.
- Audit documentation is an important part of quality control.
- It provides evidence of work done to support the audit opinion.
- Significant matters must be documented.
- Audit working papers should be reviewed.

6.1 Principles and purpose

Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition.

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgements.

Many principles contribute to audit quality including good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices and effective quality control and monitoring review processes.

The standards on audit quality provide guidance for firms on how to achieve these principles.

6.2 Quality control at a firm level

The fact that auditors follow ISAs provides a general quality control framework within which audits should be conducted. There are also specific quality control standards. ISQC (UK and Ireland) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements* deals with quality control at a firm level. You have studied ISQC 1 in Audit and Assurance at the Professional Level. A summary of the key points is provided below.

6.2.1 Objective of ISQC 1

The objective set by ISQC 1 is for the firm to establish **a system of quality control** designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.

6.2.2 Elements of a system of quality control

ISQC 1 identifies the following six elements of the firm's system of quality control.

(1) **Leadership responsibilities for quality within the firm**

The standard requires that the firm implements policies such that the internal culture of the firm is one where quality is considered essential. Such a culture must be inspired by the leaders of the firm, who must sell this culture in their actions and messages. In other words, the entire business strategy of the audit firm should be driven by the need for quality in its operations.

The firm's managing partners are required to assume ultimate responsibility for the firm's system of quality control. They may appoint an individual or group of individuals to oversee quality in the firm. Such individuals must have:

- Sufficient and appropriate experience and ability to carry out the job
- The necessary authority to carry out the job

(2) **Ethical requirements**

Policies and procedures should be designed to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements and in particular independence requirements.

The policies and procedures should be in line with the fundamental principles, which should be reinforced by:

- The leadership of the firm
- Education and training
- Monitoring
- A process to deal with non-compliance

At least annually, the firm should obtain **written confirmation** of compliance with its policies and procedures on independence from all firm personnel required to be independent by ethical requirements.

(3) **Acceptance and continuance of client relationships and specific engagements**

A firm should only accept, or continue with, a client where:

- It has considered the **integrity** of the client and does not have information that the client lacks integrity
- It is **competent** to perform the engagement and has the capabilities, including time and resources, to do so
- It can **comply with ethical requirements**, including appropriate independence from the client

(4) **Human resources**

The firm's overriding desire for quality will necessitate policies and procedures on ensuring **excellence in its staff**, to provide the firm with 'reasonable assurance that it has sufficient personnel with the competence, capabilities and commitment to ethical principles necessary to perform engagements in accordance with professional standards and applicable and regulatory requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances'.

These will cover the following issues:

- Recruitment
- Capabilities
- Career development
- Compensation
- Performance evaluation
- Competence
- Promotion
- The estimation of personnel needs

The firm is responsible for the ongoing excellence of its staff, through continuing professional development, education, work experience and coaching by more experienced staff.

The **assignment of engagement teams** is an important matter in ensuring the quality of an individual assignment.

This responsibility is given to the audit engagement partner. The firm should have policies and procedures in place to ensure that:

- Key members of client staff and those charged with governance are **aware of the identity of the audit engagement partner**.
- The engagement partner has appropriate **capabilities**, **competence and authority** to perform the role.
- The responsibilities of the engagement partner are clearly defined and communicated to that partner.

The engagement partner should ensure that he assigns staff of sufficient capabilities, competence and time to individual assignments so that he will be able to issue an appropriate report.

(5) **Engagement performance**

The firm should take steps to ensure that engagements are performed correctly; that is, in accordance with standards and guidance. Firms often produce a manual of standard engagement procedures to give to all staff so that they know the standards they are working towards. These may be electronic.

Ensuring good engagement performance involves a number of issues:

- Direction
- Supervision
- Review
- Consultation
- Resolution of disputes

Many of these issues will be discussed in the context of an individual audit assignment (see below).

The firm should have policies and procedures to determine when a quality control reviewer will be necessary for an engagement. This will include all audits of financial statements for listed companies. When required, such a review must be completed **before the report is signed**.

The firm must also have standards as to what constitutes a suitable quality control review.

In particular, the following issues must be addressed:

(a) Discussion of significant matters with the engagement partner;

(b) Review of the financial statements or other subject matter information of the proposed report;

(c) Review of selected engagement documentation relating to significant judgements the engagement team made and the conclusions it reached; and

(d) Evaluation of the conclusions reached in formulating the report and considering whether the proposed report is appropriate.

For listed companies in particular the review should include:

(a) The engagement team's evaluation of the firm's independence in relation to the specific engagement

(b) Significant risks identified during the engagement and the responses to those risks

(c) Judgements made, particularly with respect to materiality and significant risks

(d) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations

(e) The significance and disposition of corrected and uncorrected misstatements identified during the engagement

(f) The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies

(g) Whether documentation selected for review reflects the work performed in relation to the significant judgements and supports the conclusions reached

(6) **Monitoring**

The standard states that firms must have policies in place to ensure that their quality control procedures are:

- Relevant
- Adequate
- Operating effectively

In other words, they must **monitor their system of quality control**. Monitoring activity should be reported on to the management of the firm on an annual basis.

There are two types of monitoring activity, an **ongoing evaluation** of the system of quality control and **cyclical inspection** of a selection of completed engagements. An ongoing evaluation might include such questions as 'has it kept up to date with regulatory requirements?'.

An inspection cycle would usually fall over a period such as three years, in which time at least one engagement per engagement partner would be reviewed.

The people monitoring the system are required to evaluate the effect of any deficiencies found. These deficiencies might be one-offs. Monitors will be more concerned with systematic or repetitive deficiencies that require corrective action. When evidence is gathered that an inappropriate report might have been issued, the audit firm may want to take **legal advice**.

Corrective action:

- Remedial action with an individual
- Communication of findings with the training department
- Changes in the quality control policies and procedures
- Disciplinary action, if necessary

Point to note:

All quality control policies and procedures should be **documented** and **communicated** to the firm's personnel.

6.2.3 Practical application

The ICAEW Audit and Assurance Faculty publication *Quality Control in the Audit Environment: A Practical Guide for Firms on Implementing ISQC (UK and Ireland) 1* recommends that firms take the following key steps to give them confidence that they are compliant with ISQC 1:

(a) Document the operation of the quality control system.

(b) Lead from the top giving a consistent message on the importance of quality control.

(c) Always act ethically in accordance with relevant standards and pronouncements.

(d) Accept only those engagements where the firm is confident it can provide a service in compliance with requirements with particular emphasis on integrity and competencies.

(e) Recruit, develop and support capable and competent staff giving due attention to the firm's human resources policies and procedures.

(f) Deliver quality audits consulting when needed and meeting requirements for engagement quality control review.

(g) Monitor and seek continuous improvement of the firm's system of quality control and carry out a periodic objective inspection of a selection of completed audit engagements.

6.3 Quality control on an individual audit

You will have studied ISA (UK and Ireland) 220 *Quality Control for an Audit of Financial Statements* in the previous Audit and Assurance paper. A summary of the key points is provided below.

6.3.1 Policies and procedures

ISA 220 states that the objective of the auditor is to implement quality control procedures at the individual engagement level. The **engagement partner** is ultimately responsible for quality control on an individual engagement.

The policies and procedures for quality control on individual audits parallel those for the firm outlined above. For example, ethical requirements must be considered. In addition, however, of particular significance for individual audits are the procedures of **direction, supervision and review**.

(a) **Direction**

At the planning stage, but also during the audit, the engagement partner ensures that the members of the engagement team are informed of:

- Their responsibilities
- The objectives of the work to be performed
- The nature of the entity's business
- Risk issues
- Problems that may arise
- Detailed approach to the audit engagement

(b) **Supervision**

Supervision includes:

- Tracking the progress of the audit engagement
- Considering the capabilities of individual members of the engagement team and that they understand their instructions
- Addressing issues that arise and modifying the audit approach if appropriate
- Identifying matters for consultation or consideration by more experienced members of the audit engagement

(c) **Review**

Reviewing concerns the inspection of work by engagement members by more senior members of the same engagement. This includes ensuring that:

- The work has been carried out in accordance with professional and regulatory requirements
- Significant matters have been raised for further consideration
- Appropriate consultations have taken place and have been documented
- Where appropriate the planned audit work is revised
- The work performed supports the conclusions
- The evidence obtained is sufficient and appropriate to support the audit opinion
- The objectives of the engagement have been achieved

6.4 Assuring the quality of professional services

IFAC Statement of Membership Obligations 1 (SMO 1) (revised) *Quality Assurance* sets out the requirements of an IFAC member body with respect to quality assurance review systems for its members who perform audits, review and other assurance and related services engagements of financial statements. It covers many of the issues dealt with by ISQC 1 and ISA 220 but addresses them largely **from the perspective of the role of the professional bodies** eg ICAEW. SMO 1 was revised in November 2012 and has an effective date of 1 January 2014. The revised SMO includes an applicability framework that provides guidance on how to address obligations where organisations have varying degrees of responsibility for meeting the requirements of the SMO:

(a) Where IFAC members have direct responsibility they must implement all the requirements of the SMO.

(b) Where IFAC members have no responsibility for this area they must use their best endeavours to encourage those responsible to follow the requirements of the SMO and assist in their implementation if appropriate.

(c) Where responsibility is shared they must implement those that they are responsible for and use their best endeavours to encourage those responsible for the remainder to follow the requirements of the SMO.

In particular, SMO 1 (revised) makes the following points.

IFAC believes that the following objectives have worldwide applicability and that member bodies should strive to achieve them.

(a) Member bodies must identify and undertake actions to have ISQC 1 and other relevant standards adopted and implemented and requirements established for firms to implement a system of quality control in their jurisdiction. Firms are responsible for implementing policies and procedures that comply with ISQC 1.

(b) Member bodies must assist their members to understand the objectives of quality control, and implement and maintain appropriate systems of quality control. This assistance can take various forms, such as continuing professional development guidelines and implementing programmes that enable firms to obtain an independent confidential assessment of their quality control policies and procedures.

(c) Member bodies must develop quality review programmes designed to evaluate whether firms (or an individual partner) have established appropriate quality control policies and procedures and are complying with those. A cycle-based, risk-based or mixed approach for selecting firms for quality assurance review must be used. All firms or partners performing audits must be considered in the selection process.

(d) Member bodies must require quality assurance review teams to follow procedures that are based on published guidelines. The procedures should include reviews of audit working papers and discussions with appropriate personnel.

(e) The quality assurance team leader must issue a written report on completion of the review assignment, including a conclusion on whether the firm's system of quality control has been designed to meet the relevant standards and whether the firm has complied with its system of quality control during the review period. Reasons for negative conclusions should be given, with recommendations for areas of improvement.

(f) Member bodies must require firms to make improvements in their quality control policies and procedures where improvement is required. Corrective action should be taken where the firm fails to comply with relevant professional standards. Educational or disciplinary measures may be necessary.

Interactive question 2: Addystone Fish

You are an audit senior working for the firm Addystone Fish. You are currently carrying out the audit of Wicker Ltd, a manufacturer of waste paper bins. You are unhappy with Wicker's inventory valuation policy and have raised the issue several times with the audit manager. He has dealt with the client for a number of years and does not see what you are making a fuss about. He has refused to meet you on site to discuss these issues.

The former engagement partner to Wicker retired two months ago. As the audit manager had dealt with Wicker for so many years, the other partners have decided to leave the audit of Wicker largely in his hands.

Requirement

Comment on the situation outlined above.

See **Answer** at the end of this chapter.

6.5 Audit documentation

Audit documentation is a key part of the overall quality control framework during the course of an audit. All audit work must be documented: the working papers are the **tangible evidence of all work done in support of the audit opinion**. ISA (UK and Ireland) 230 *Audit Documentation* provides guidance on this issue.

In your previous studies, you have learnt the practical issues surrounding how audit papers should be completed. The key general rule to remember concerning what to include in a working paper is:

> 'What would be sufficient to enable an experienced auditor, having no previous connection with the audit to understand the nature, timing, and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements and the results of the audit procedures and the audit evidence obtained, and significant matters arising during the audit and the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.'

The key reason for having audit papers therefore is that they provide evidence of work done. They may be required in the event of litigation arising over the audit work and opinion given.

The ISA sets out certain requirements about what should be recorded, such as the identifying characteristics of the specific items being tested.

It also sets out points an auditor should record in relation to significant matters. These include:

- Discussions undertaken with directors
- How the auditor addressed information that appeared to be inconsistent with his conclusions in relation to significant matters

If an auditor felt it necessary to depart from customary audit procedures required by audit standards, he should document why, and how the different test achieved audit objectives.

The ISA also contains details about how the audit file should be put together and actions in the event of audit work being added after the date of the audit report (for example, if subsequent events result in additional procedures being carried out). You should be familiar with these points from your earlier studies.

6.6 Review of working papers

We shall briefly revise here the review of working papers. **Review** of working papers is important, as it allows a more senior auditor to **evaluate the evidence obtained** during the course of the audit for sufficiency and reliability, so that more evidence can be obtained to support the audit opinion, if required. It is an important quality control procedure.

Work performed by each assistant should be reviewed by personnel of appropriate experience to consider whether:

- The work has been **performed** in **accordance with the audit programme**.
- The work performed and the results obtained have been **adequately documented**.
- Any **significant matters** have been **resolved** or are reflected in audit conclusions.
- The **objectives** of the audit procedures have been achieved.
- The **conclusions** expressed are **consistent** with the results of the procedures performed and support the audit opinion.

The following should be reviewed on a timely basis.

- The **overall audit strategy** and the **audit plan**
- The **assessments of inherent and control risks**
- The **results** of **control** and **substantive procedures** and the conclusions drawn including the results of consultations
- The **financial statements**, proposed audit adjustments and the proposed auditors' report

In some cases, particularly in large complex audits, personnel not involved in the audit may be asked to review some or all of the audit work, the auditors' report etc. This is sometimes called a **peer review** or **hot review**.

Interactive question 3: Documentation (revision)

Viewco is a manufacturer of TVs and DVD players. It carries out a full physical inventory count at its central warehouse every year on 31 December, its financial year end. Finished goods are normally of the order of £3m, with components and work in progress normally approximately £1m.

You are the audit senior responsible for the audit of Viewco for the year ending 31 December 20X1. Together with a junior member of staff, you will be attending Viewco's physical inventory count.

Requirements

(a) Explain why it is necessary for an auditor to prepare working papers.

(b) State, giving reasons, what information the working papers relating to this inventory count attendance should contain.

See **Answer** at the end of this chapter.

Interactive question 4: TrucksToGo Ltd

You are the audit senior on the audit of TrucksToGo Ltd. You are supervising the work of a relatively inexperienced audit junior. The junior has been carrying out audit procedures on the assertions of completeness and existence of non-current assets. According to the junior, audit procedures have been completed and the memo below has been produced outlining some of the issues found during the audit.

Memo: Issues identified during audit

The directors have confirmed that there are no further non-current assets to include in the financial statements. This representation was received in a meeting with the Finance Director and recorded on the audit file at this time.

Part of the existence work on non-current assets included obtaining a sample of assets from the asset register and then physically verifying those assets. Unfortunately, a significant number of assets were not available for verification – the vehicles were in use by the company and therefore not on the premises. As an alternative, vehicles on the premises were agreed back to the asset register.

A number of vehicles were noted on the company premises in a poor state of repair; for example, engines missing. On inquiry, the vehicle manager confirmed that the vehicles were under repair. I am therefore happy that the vehicles belonged to the company and no further action is necessary.

I have reached the conclusion that all non-current assets are correctly stated and valued in the financial statements.

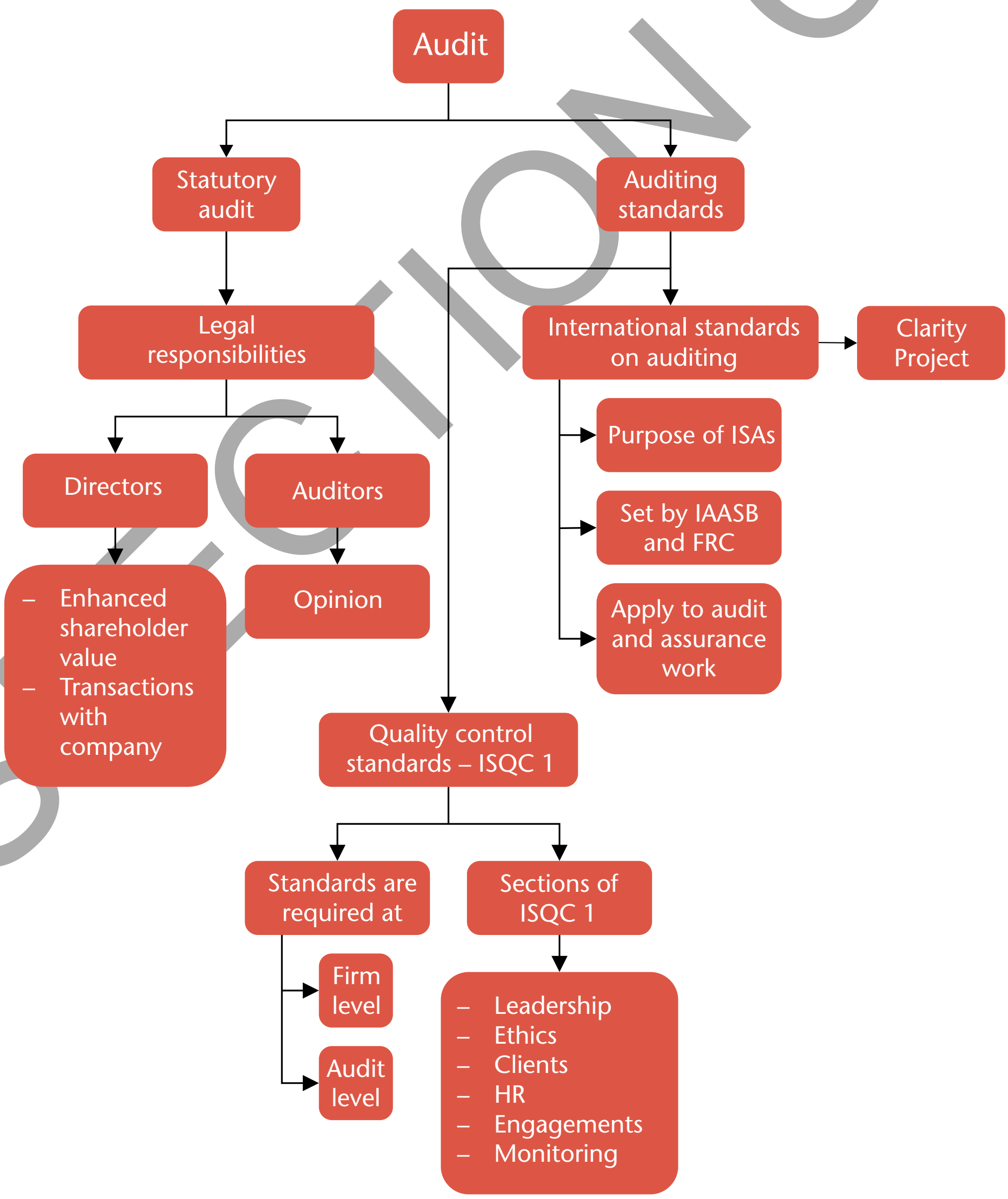
Requirement

Explain to the junior why the evidence collected is insufficient, and detail the action necessary to complete the audit procedures. Refer to your objectives in reviewing audit documentation as a format for your answer.

See **Answer** at the end of this chapter.

Summary and Self-test

Summary



Self-test

1 **Performance and position**

Explain the terms 'performance' and 'position' and identify which of the financial statements will assist the user in evaluating performance and position.

2 **LaFa plc**

The WTR audit firm has 15 partners and 61 audit staff. The firm has offices in 3 cities in one country and provides a range of audit, assurance, tax and advisory services. Clients range from sole traders requiring assistance with financial statement production to a number of small plcs – although none is a quoted company.

LaFa plc is one of WTR's largest clients. Due to the retirement of the engagement partner from ill health last year, LaFa has been appointed a new engagement partner. WTR provides audit services as well as preparation of taxation computations and some advisory work on the maintenance of complicated costing and inventory management systems. The audit and other services engagement this year was agreed on the same fee as the previous year, although additional work is required on the audit of some development expenditure which had not been included in LaFa's financial statements before. Information on the development expenditure will be made available a few days prior to audit completion 'due to difficulties with cost identification' as stated by the Finance Director of LaFa. LaFa's management were insistent that WTR could continue to provide a similar level of service for the same fee.

Part way through the audit of WTR, Mr W, WTR's quality control partner, resigned to take up a position as Finance Director in SoTee plc, LaFa's parent company. SoTee is audited by a different firm of auditors. Mr W has not yet been replaced, as the managing board of WTR has yet to identify a suitable candidate. Part of the outstanding work left by Mr W was the implementation of a system of ethical compliance for all assurance staff whereby they would confirm in writing adherence to the ICAEW Code of Ethics and confirm lack of any ethical conflict arising from the code.

Requirement

Identify and explain the risks which will affect the quality control of the audit of LaFa. Suggest how the risks identified can be reduced.

3 **Bee5**

You are the audit manager in charge of the audit of Bee5, a construction company. The client is considered to be low risk; control systems are generally good and your assurance firm, Sheridan & Co, has normally assisted in the production of the financial statements providing some additional assurance of the accuracy and completeness of the statements.

During the initial planning meeting with the client you learn that a new Finance Director has been appointed and that Bee5 will produce the financial statements this year; the services of your firm's accounts department will therefore not be required. However, Bee5 has requested significant assurance work relating to a revision of its internal control systems. The current accounting software has become less reliable (increased processing time per transaction and some minor data loss due to inadequate field sizes). The client will replace this software with the new Leve system in the next financial year but requires advice on amending its control systems ready for this upgrade.

Requirement

Discuss the impact on the audit approach for Bee5 from the above information. Make specific reference to any quality control issues that will affect the audit.

Technical reference

1 What is financial reporting?

- Financial reporting is the provision of financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. — Concept Frame (OB2)

  Corporate reporting is a broader concept, which covers other reports, such as audit or environmental reports.

- Financial statements comprise statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes. — IAS 1 (10)

2 Purpose and use of financial statements

- Users' core need is for information for making economic decisions. — Concept Frame (OB2)
- Objective is to provide information on financial position (the entity's economic resources and the claims against it) and about transactions and other events that change those resources and claims. — Concept Frame (OB12)
- Financial position: — Concept Frame (OB13)
  - Resources and claims
  - Help identify entity's strengths and weaknesses
  - Liquidity and solvency
- Changes in economic resources and claims: — Concept Frame (OB15–16)
  - Help assess prospects for future cash flows
  - How well have management made efficient and effective use of the resources
- Financial performance reflected by accrual accounting. — Concept Frame (OB17)
- Financial performance reflected by past cash flows. — Concept Frame (OB20)

3 ISA 200

- Purpose of an audit — ISA 200.3
- General principles of an audit — ISA 200.14–.24

4 ISQC 1

- Objective — ISQC 1.11
- Elements of a system of quality control — ISQC 1.16
- Importance of documenting procedures — ISQC 1.17
- Leadership — ISQC 1.18–.19
- Ethical requirements — ISQC 1.20
- Independence — ISQC 1.21
- Acceptance and continuance — ISQC 1.26
- Human resources — ISQC 1.29
- Engagement performance — ISQC 1.32
- Monitoring — ISQC 1.48

5 ISA 220

- Leadership responsibilities — ISA 220.8
- Ethical requirements — ISA 220.9
- Acceptance and continuance — ISA 220.12
- Assignment of engagement teams — ISA 220.14
- Engagement performance — ISA 220.15

6 ISA 230

- Purposes of audit documentation. — ISA 230.2–.3
- Should enable an experienced auditor to understand the procedures performed, the results and evidence obtained and significant matters identified. — ISA 230.8
- Auditors must document discussions of significant matters with management. — ISA 230.10
- Inconsistencies regarding significant matters must be documented. — ISA 230.11
- Departures from relevant requirements in ISAs must be documented. — ISA 230.12
- The identity of the preparer and reviewer must be documented. — ISA 230.9

Answers to Self-test

1 **Performance and position**

Performance

The financial performance of a company comprises the return it obtains on the resources it controls. Performance can be measured in terms of the profits and comprehensive income of the company and its ability to generate cash flows.

Management will be assessed on their skill in achieving the highest level of performance, given the resources available to them.

Information on performance can be found in:

- The statement of profit or loss and other comprehensive income
- The statement of changes in equity
- The statement of cash flows

Position

The financial position of the company is evaluated by reference to:

- Its economic resources and claims
- Its capital structure, ie its level of debt finance and shareholders' funds
- Its liquidity and solvency

The user of the financial statements can then make assessments on the level of risk, ability to generate cash, the likely distribution of this cash and the ability of the company to adapt to changing circumstances.

The statement of financial position is the prime source of information on a company's position but the statement of cash flows will also indicate a company's cash position over a period of time.

2 **LaFa plc**

Culture of WTR

The quality control auditing standard, ISQC 1, requires that the firm implements policies such that the internal culture of the firm is one where quality is considered essential. Such a culture must be inspired by the leaders of the firm, who must sell this culture in their actions and messages. In other words, the entire business strategy of the audit firm should be driven by the need for quality in its operations.

In the WTR audit firm, there appears to be a lack of leadership on quality control. Two issues give rise for concern:

(a) First, the partner in quality control resigned during the audit of LaFa plc and has not been replaced. This means that there is no one person in charge of maintaining quality control standards in the audit firm. There is the risk that deficiencies of quality control will go undetected.

(b) Second, WTR is under fee pressure from LaFa plc to complete the audit and provide other services for the same fee as last year, even though the scope of the audit has increased. There is the risk that audit procedures will not be fully carried out to ensure that the tight budget is met. Lack of a comprehensive quality control review (the quality control partner resigning as noted above) increases the risk of poor quality work.

The quality control partner should be replaced as soon as possible, while the fee situation with LaFa should be monitored – any potential cost overrun must be discussed with the client and where necessary additional fees agreed.

Ethical requirements

Policies and procedures should be designed to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

In WTR, it is not clear that staff will comply with the code. While professional staff will be members of ICAEW or a similar body, and therefore subject to the ethical requirements of their professional body, precise implementation has not been confirmed within WTR. While it is unlikely that staff will knowingly break the ethical code, there is still room for inadvertent breach. For example, partners may not be aware of the full client list of WTR and hold shares in an audit client. Similarly, audit staff may not be aware of WTR's policy on entertainment and therefore accept meals, for example, over these guidelines.

The guidelines should be circulated and confirmed by all staff as soon as possible.

Client acceptance

A firm should only accept, or continue with, a client where it:

- Has considered the integrity of the client and does not have information that the client lacks integrity
- Is competent to perform the engagement and has the necessary time and resources
- Can comply with ethical requirements including appropriate independence from the client

While there is little indication that LaFa lacks integrity, the client is placing fee pressure on WTR. The client has also indicated that information regarding development expenditure may not be available during the audit and will be subject to a separate audit check just prior to the signing of the financial statements and audit report. There could be an attempt to 'force' an unmodified audit report when WTR should take more time (and money) auditing development expenditure. There is therefore a risk that LaFa management is losing some integrity and WTR need to view other management evidence with increased scepticism.

The audit of LaFa plc this year includes development expenditure. As this is a new audit area, the audit partner of LaFa should have ensured that the audit team, and WTR as a whole, had staff with the necessary experience to audit this item. Lack of competence increases audit risk, as the area may not be audited correctly or completely.

Mr W accepting the position of Finance Director at SoTee appears to place the independence of WTR with LaFa in jeopardy. As Finance Director of the parent company, Mr W will be in a position to influence the management of LaFa, and potentially the financial information being provided by that company. While SoTee is not an audit client, the audit partner in WTR must ensure that no undue influence is being placed on LaFa. If, however, this is the case, then WTR must consider resignation from the audit of LaFa.

Monitoring of audit

The audit firm must have policies in place to ensure that quality control procedures are implemented and maintained.

Regarding the audit of LaFa, there is some risk that control quality regarding audit monitoring will be compromised because:

- The audit partner is new, and may therefore not have extensive knowledge of the audit client; and
- There appears to be a tight audit deadline for auditing development expenditure.

To decrease audit risk, it will be appropriate to maintain similar audit staff from last year (eg retain the audit senior and manager) and WTR could consider a second partner review to ensure WTR quality control standards have been followed.

3 **Bee5**

Client acceptance

In previous years Bee5 has required a standard audit from your assurance firm. However, this year there is a request for additional assurance regarding the internal control systems. This work will not only raise the amount of income generated from the client but will also require the use of specialist staff to perform the work.

Before accepting the engagement for this year Sheridan & Co must ensure that:

(a) Income from Bee5 is not approaching 15% of the firm's total income. If income is approaching this level then additional independence checks may be required, such as a second partner review.

(b) Ensure that staff familiar with the Bee5 internal control system are available to provide the assurance work. If these skills are not available then Sheridan & Co must either hire staff with those skills or decline the work on internal control systems.

Plan the audit – evaluate internal control

The current internal control system is due to be upgraded in the next financial year. There is therefore no impact on the current year's audit as a result of this change. However, the reason given by the client for the upgrade relates to reliability issues with the current control systems.

The control system used by Bee5 must still be evaluated to determine the extent to which the system is still reliable. Where deficiencies are identified then control risk will increase. There will be consequent impact on the audit approach as noted below.

Develop the audit approach

An increase in control risk will cause detection risk to increase. The impact on the audit will be an increased level of substantive testing to obtain sufficient confidence on assertions such as completeness and accuracy.

There will be a further impact on the quality control of the audit. Commencing the audit with the expectation of finding control deficiencies means that audit staff must be selected carefully. It may not be appropriate to send junior trainees with restricted experience to the client unless their work is closely monitored and carefully reviewed.

Audit internal control – tests of controls

As noted above, detailed tests of control on the accounting system will be limited. However, reliance will still be obtained from the overall control environment.

Evaluate results

The higher risk associated with the audit this year means that a quality control review will be appropriate for this client. Sheridan & Co needs to maintain the integrity of work performed as well as ensuring that the audit opinion is correct. Part of the planning process will be to book the time of the quality control partner.

Answers to Interactive questions

Answer to Interactive question 1

Where IFRS allows a choice of accounting policy, directors may wish to select the policy that gives the most favourable picture, rather than the one which is most useful to users of financial statements. For example, they may wish to adopt the direct, rather than the indirect, method of preparing a statement of cash flows if they believe that gives a more favourable view of the company's liquidity and solvency in the eyes of a lender, such as a bank. Auditors need to be on the lookout for this kind of manipulation.

Answer to Interactive question 2

Several quality control issues are raised in the scenario.

Engagement partner

An engagement partner is usually appointed to each audit engagement undertaken by the firm, to take responsibility for the engagement on behalf of the firm. Assigning the audit to the experienced audit manager is not sufficient.

The lack of audit engagement partner also means that several of the requirements of ISA 220 about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit are not in place.

Conflicting views

In this scenario the audit manager and senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the manager refusing to discuss the issue with the senior.

ISA 220 requires that the audit engagement partner takes responsibility for settling disputes in accordance with the firm's policy in respect of resolution of disputes required by ISQC 1. In this case, the lack of engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the firm's policy under ISQC 1. At worst, it indicates that the firm does not have a suitable policy concerning such disputes as required by ISQC.

Answer to Interactive question 3

(a) Working papers are necessary for the following reasons:

- To assist the engagement team to plan and perform the audit
- To assist members of the engagement team responsible for supervision to direct and supervise the audit procedures, and to discharge their review responsibilities in accordance with ISA 220
- To enable the engagement team to be accountable for its work
- As a record of matters of continuing significance to future audits
- To enable the conduct of quality control reviews and inspections in accordance with ISQC 1
- To enable the conduct of external inspections in accordance with applicable legal, regulatory or other requirements

(b)

Information	Reasons
(1) Administration	
Client name	• Enables an organised file to be produced
Year end	
Title	
Date prepared	• Enables papers to be traced if lost
Initials of preparer	• Any questions can be addressed to the appropriate person • Seniority of preparer is indicated
Initials of senior to indicate review of junior's work	• Evidence that guidance on planning, controlling and recording is being followed • Evidence of adherence to auditing standards
(2) Planning	
(i) Summary of different models of TVs and DVD players held and the approximate value of each Summary of different types of raw material held and method of counting small components Summary of different stages of WIP identified by client	• Enables auditor to familiarise himself with different types of inventory lines
(ii) Time and place of count	• Audit team will not miss the count
(iii) Personnel involved	• Auditor aware who to address questions/ problems to
(iv) Copy of client's inventory count instructions and an assessment of them	• Enables an initial assessment of the likely reliability of Viewco's count • Assists in determining the amount of procedures audit team need to do • Enables compliance work to be carried out; that is, checking Viewco staff follow the instructions
(v) Plan of warehouse	• To ensure all areas covered at count • Clear where to find different models/components • Location of any third party/moving inventory clear
(vi) Details of any known old or slow moving lines	• Special attention can be given to these at count; for example, include in test counts
(vii) Scope of test counts to be performed that is, number/value of items to be counted and method of selection. For Viewco probably more counting of higher value finished goods	• Ensures appropriate amount of procedures performed based on initial assessment • Clear plan for audit team

Information	Reasons
(3) Objectives of attendance; that is, to ensure that the quantity and quality of inventory to be reflected in the financial statements is materially accurate	• Reporting partner can confirm if appropriate/adequate procedures performed
(4) Details of procedures performed	• Provides evidence for future reference and documents adherence to auditing standards • Enables reporting partner to review the adequacy of the procedures and establish whether it meets the stated objective
A. Details of controls testing procedures performed – observing Viewco's counters and ensuring they are following the instructions and conducting the count effectively, for example:	• Enable reassessment of likely reliability of Viewco's count • Enables assessment of chances of items being double-counted or omitted
(i) Note of whether the area was systematically tidied	
(ii) Note of whether or how counted goods are marked	
(iii) Note of how Viewco records and segregates any goods still moving on count day	
(iv) Note of adequacy of supervision and general impression of counters	• Enables assessment of overall standard of count and hence likely accuracy
(v) Note whether counters are in teams of two and whether any check counts are performed	• Evidence of independent checks may enhance reliability
B. Details of substantive procedures performed	
(i) Details of items of raw materials or finished goods test counted:	
• From physical inventory to client's count sheet	• Evidence to support the accuracy and completeness of Viewco's count sheets
• From Viewco's count sheets to physical inventory	• Evidence to support the existence of inventory recorded by Viewco
For both of the above note inventory code, description, number of units and quality. Use a symbol to indicate agreement with Viewco's records	
(ii) Details of review for any old/obsolete inventory, for example dusty/damaged boxes. Note code, description, number of units and problem	• Details can be followed up at final audit and the net realisable value investigated
(iii) Details of review of WIP	
• Assessment of volume of part complete items of each stage	• Evidence in support of accuracy of quantity of WIP
• Assessment of appropriateness of degree of completion assigned to each stage by Viewco (could describe items at various stages)	• Details can be followed through at final audit to final inventory sheets • Basis for discussion of any description

Information	Reasons
(iv) Copies of: • Last few despatch notes • Last few goods received notes • Last few material requisitions • Last few receipts to finished goods	• Enables follow up at final audit to ensure cut-off is correct; that is, goods despatched are reflected as sales, goods received as purchases and items in WIP are not also in raw materials and finished goods
(v) Copies of client's inventory count sheets (where number makes this practical)	• Enables follow up at final audit to ensure that Viewco's final sheets are intact and no alterations have occurred
(5) Summary of results In particular: (i) Details of any problems encountered (ii) Details of any test count discrepancies and notes of investigation into their causes (iii) Details of any representations by the management of Viewco	• Senior/manager can assess any consequences for audit risk and strategy and decide any further procedures needed • Provides full documentation of issues that could require a judgemental decision and could ultimately be the basis for a qualified opinion
(6) Conclusion	• Indicates whether or not the initial objective has been met and whether there are any implications for the audit opinion

Answer to Interactive question 4

- Has the work been **performed** in **accordance with the audit programme**?

  The non-current asset procedure of agreeing non-current asset details from the asset register to the actual asset is to confirm the existence of the asset – in other words, that the asset should be included in the register. Agreeing physical asset details back to the register tests for the assertion of completeness, not existence; that is, all assets that should be recorded in the register are recorded – not that assets in the register do exist. The audit procedure has therefore not been completed in accordance with the audit programme.

  I recommend that the existence test is completed as specified. However, where physical existence of the asset cannot be determined by seeing the asset, then alternative evidence such as the log book is obtained.

- Have the work performed and the results obtained been **adequately documented**?

  Adequate documentation normally means that written representations by management are recorded in writing, either in a paper document or through use of email or other electronic communication system that can be traced back to the client. Regarding the completeness of non-current assets, it is unclear how the representation from the director was received – although it appears that this was only verbal. The difficulty with verbal evidence is that it can be disputed at a later date.

  I recommend that the director's representation is obtained in writing.

- Have any **significant matters** been **resolved** or are reflected in audit conclusions?

  The fact that some vehicles were found obviously not in working order is cause for concern. While your primary task was satisfying the assertions of existence and completeness, where assets are obviously unusable, this fact needs to be recorded. The issue is that assets may well be overvalued in the financial statements; in practice the asset values need to be compared to the carrying amounts in the asset register and, where the asset will no longer be used, complete write-off or disposal considered.

While no further action may be necessary on completeness and existence, I recommend that you prepare a list of the assets which are in a poor state of repair so additional valuation procedures can be performed on them.

- Have the **objectives** of the audit procedures been achieved?

  As already noted, the objectives of audit procedures have not been achieved. There is still insufficient evidence to confirm the existence and completeness of non-current assets.

  I recommend that the procedures you were carrying out are completed as detailed in the audit programme.

- Are the **conclusions** expressed **consistent** with the results of the work performed and do they support the audit opinion?

  The conclusion on the assertions of completeness and existence is incorrect. Your memo states that assets were correctly stated and valued.

  The point is not valid for two reasons.

  First, audit procedures have not been completed correctly (see the point on completeness testing for example) which means that the assertion of completeness cannot be confirmed.

  Second, the audit procedures carried out do not relate to the valuation of those assets. Valuation procedures include the auditing of depreciation and not simply ascertaining the condition of those assets at the end of the reporting period.

  I recommend that when audit procedures are complete that the conclusion is amended to match the assertions being audited.