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The FRC's Melanie Hind discusses changes in audit and its regulation





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Time for change?



We must wait to see what can be learnt from the independent review of the Financial Reporting Council (FRC), the competent authority for audit regulation in the UK. The public consultation has closed, Sir John Kingman and his panel of experts are analysing feedback and the outcome is expected by the end of 2018 (see tinyurl.com/AB-GOV-FRC-rev). We'll continue to keep you informed (see page 17).

Meanwhile, we've had the opportunity to question one of the FRC's most influential figures in recent times. On page 6, you can read my interview with Melanie Hind, who shared some insights into developments around audit and its regulation during her six years as part of the FRC executive. We also discussed the evolution of FRC priorities, responsibilities, scope, powers, use of technology and the future post-Kingman and post-Brexit.

Change is inevitable and over the past year this has been reflected in the FRC's withdrawal of some practice notes (PNs). We touch on this in my interview with Melanie, in *Audit Clinic* in the September edition (see tinyurl.com/AB-Aud-Bey-2018) and in *On balance* (pages 12-14), which offers practical tips on taking a more risk-based approach to the audit of bank and cash, following the withdrawal of PN 16.

Audit & Beyond also considers regulatory developments in *Onwards and upwards* (page 9) and *On course for compliance* (page 10). The revised international education standard on competencies of engagement partners responsible for financial statement audits (IES 8) introduces more precise requirements and these articles outline what's required, consequent changes to ICAEW procedures, related resources, practical tips on how to comply and how to reflect this in firms' CPD, procedures and internal due diligence.

Some firms may still need to act. *Audit Monitoring 2018* (see tinyurl.com/AB-AudMon-18) noted that "a significant number of firms were not familiar with IES 8 and had not considered whether they should enhance their existing procedures". ICAEW is checking firms' progress during monitoring reviews and interactions such as applications to appoint a responsible individual and annual CPD declarations. We will wait and see what can be learned from this – and keep you informed.

Dr Nigel Sleigh-Johnson FCA
Head of Financial Reporting, Audit and Assurance

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NEWS & EVENTS



NEW BREXIT GUIDE

ICAEW and Chartered Accountants Ireland (CAI) have published a joint guide to help chartered accountants in practice and industry support businesses in the UK and Ireland as they navigate the challenges and opportunities of post-Brexit cross-border trading.

"We look forward to continuing our collaboration with our Irish colleagues," says ICAEW president Paul Aplin. "As chartered accountants, we stand united in helping to support the close trading relationship between our countries."

The joint ICAEW/CAI guide addresses: the trading landscape for goods after Brexit, EU customs and VAT frameworks, supply-chain challenges, trading in Ireland, barriers affecting trade, and the effect of Brexit from a business perspective.

The guide is available along with other resources at the Brexit hub (icaew.com/Brexit). Brexit insights from ICAEW are also available in *Preparing for 'No Deal'*, a recent blog by Michael Izza, ICAEW chief executive. Read this at tinyurl.com/AB-NoDealPrep

SUBSTANTIVE QAD WEBINARS

Substantive audit procedures are the subject of two webinars developed and presented by Emma Fountain, a reviewer in ICAEW's Quality Assurance Department (QAD), based on first-hand experiences of visiting firms of all sizes.

Substantive procedures 1 - Obtaining audit evidence from substantive analytical review (duration approximately 12 minutes) covers: options for substantive testing; its adequacy and suitability; the reliability and robustness of data sources; applying professional scepticism; the requirements of relevant auditing standards; justifying and documenting decisions; use of other audit evidence; and the importance of not confusing substantive procedures with analytical

reviews conducted at the planning and reporting stages of an audit.

Substantive procedures 2 - obtaining audit evidence from tests of detail (25 minutes) covers: planning and design of audit tests (including identification of the population to test and sample sizes); performance (including the quality of audit evidence); documentation; and conclusions (including how to deal with anomalies and deviations). The webinar also provides some helpful examples - of how not to effectively use and appropriately document tests of detail and the results - from audit files that QAD reviewers have seen.

These webinars are available at tinyurl.com/AB-QADWebs

RESPONSIBLE INDIVIDUALS: APPLICATIONS CHANGE

ICAEW has amended the application process for responsible individuals (RIs) and the form that firms must use when they wish to designate a principal or employee as an RI under Chapter 4 of the *Audit Regulations and Guidance* (which are at tinyurl.com/AB-RIC4).

These changes reflect the more precise requirements of International Education Standard (IES) 8 *Professional Competence for Engagement Partners Responsible for*

Audits of Financial Statements (Revised), which came into effect on 1 July 2016. You can learn more about what the standard requires, changes ICAEW has made, matters firms need to consider and get practical advice on how and why on page 9 and page 10.

ICAEW's updated application form must be used for all RI applications submitted from 1 July 2018. It is available at tinyurl.com/AB-UpApp

2018 CORPORATE GOVERNANCE CODE

The Financial Reporting Council (FRC) has published the UK Corporate Governance Code (July 2018), after consultation.

It's a shorter, sharper Code with a renewed focus on the application of its principles. The FRC wishes to see clear, meaningful reporting. Investors and proxy advisers must assess explanations carefully and not take a tick-box approach. *Guidance on Board Effectiveness* has also been published. The Code, board guidance and more are available at tinyurl.com/AB-CGCode

The FRC held a panel discussion on the new Code and whether corporate governance is fit for the future. A video recording of this is available at tinyurl.com/AB-CodePanel



BANK GUIDANCE ON AUDITORS' REQUESTS

The withdrawal of Practice Note (PN) 16 *Bank Reports for Audit Purposes in the UK* created an opportunity for auditors to take a more risk-based approach to making professional judgements on when it is necessary to obtain a bank confirmation (for practical tips, see page 12).

When bank confirmations are required, auditors may find it helpful to refer to guidance on bank audit requests from the bank trade body, UK Finance. This was updated after the withdrawal of PN 16

(tinyurl.com/AB-UKF1) along with information on ISA (UK) 330 *The Auditor's Response to Assessed Risk* revisions that coincided with PN 16's withdrawal.

UK Finance notes that the underlying bank confirmation process remains the same and suggests auditors continue to use the forms first prepared for use under PN 16 or the BBA Confirmations Service, by the British Bankers Association (now part of UK Finance). See tinyurl.com/AB-InPN and tinyurl.com/AB-BBA-Conf

FRC ENFORCEMENT

Learn about the FRC's enforcement process without living through the experience. Claudia Mortimore, interim executive counsel and director of enforcement, explains how the team approaches these often large and complex investigations, including the process, timing, challenges and decision-making on enforcement action and sanctions, in a six-minute video at tinyurl.com/AB-FRC-Enf



ANNUAL CONFERENCE

The annual conference of the Financial Reporting Faculty will take place on 27 November 2018. Attendees will have an opportunity to get up to date with recent developments on financial reporting and its wider aspects: from developments in UK GAAP and IFRS, to the impact of technology on corporate reporting and the recently revised FRC *Guidance on the Strategic Report*. Learn more at icaew.com/aafevents

AUTUMN ROADSHOW

This year's roadshow is on the theme of case studies and examples in hot audit areas and it will be at many venues across England and Wales during October/November.

Speakers will be Peter Herbert, Andrew Mead and John Selwood. They will use practical examples plus ICAEW expertise to cover a range of topical issues, including: audit exemptions; changes in non-audit assurance engagements; Companies Act 2006 and other legislation; feedback on hot topics from the ICAEW technical helpline and the monitoring unit; revisions to standards for audit and financial reporting; the FRC Ethical Standard; the latest developments in technology and current thinking on efficient auditing; and upcoming changes and how they may affect auditors.

To learn more and to reserve your place, visit tinyurl.com/AB-Events2018

FACULTY WEBINARS

Learn from the experiences of mid-sized firms implementing audit data analytics by joining Alex Peal and Lisa Leighton for their webinar on 15 October. They will discuss how extensively they are using data analytics; how they rolled out this initiative; case study examples; and their future plans. They will also consider progress that has been made over the past year, since their earlier faculty webinar on this.

You can register to attend at tinyurl.com/AB-DataAn1

Shortly after the live webinar, it will become available in our webinar library as a recording, along with earlier webinars on this – and many other subjects.

To access the webinar library, visit icaew.com/aafwebinars

Melanie Hind stepped down this summer as an executive director of the Financial Reporting Council (FRC) after more than six years. Before she departed to explore a family opportunity in the US, the ex-auditor took time to reflect on how audit and the FRC has changed, and what the future holds.

Hind says she's proud of what the FRC has achieved and her contributions. In her initial role as executive director, codes and standards, Hind successfully concluded the FRC's decade-long programme to reform UK accounting standards, as well as implementing extended auditor reporting and introducing the requirement for the viability statement in the UK Corporate Governance Code. She moved into her role in audit and actuarial regulation, just in time for 17 June 2016.

"It was a big day," she says, referring to the European Union (EU) Audit Regulation Directive (ARD) becoming applicable across the EU and the FRC becoming the competent authority for audit regulation. "The UK participated strongly in development of the EU regime and it has been very positive," she recalls, citing mandatory firm rotation and retendering as stand out examples.

RESPONDING TO RISKS

The audit business model has been transformed by the UK implementation of the ARD, she suggests:

The reformer

Nigel Sleight-Johnson speaks to the FRC's Melanie Hind about changes in audit and its regulation



"The risk-reward ratio in audit has changed. Let's be clear, audit used to be an annuity in perpetuity and now it isn't. This has combined with increased regulatory scrutiny to drive up the quality of audit and that is a good thing."

Getting audit back on policymakers' agendas – as something in the public interest that needs close attention – is the most significant audit development of the past five years, says Hind. Nonetheless, she has concerns about the public interest entity (PIE) definition in the ARD: "It may not be in the right place, because it is a post-financial crisis response."

Some small listed UK PIEs have less potential to affect the public interest than a large (but non-PIE) company. Some private utility companies could significantly impact on the public interest if they were to fail – and the same can be said of the big four audit firms where PIE and other FTSE 350 audits are concentrated. "These firms are systemically important. Our capital markets depend on them," says Hind. This does not mean that there are too few for one to fail, she clarifies: "But if something were to go wrong in one of these firms and the cause was an audit failure or some ethical or criminal failure, it would damage trust in our capital markets."

The FRC has broadened what it does with these firms, to better see what the risks are and can be. Less concentration and more distribution of audits would mitigate risk, but the FRC has no power to force this; whereas the Competition and Markets Authority (CMA) does. "That's why we've highlighted to the CMA that we feel it would be timely for them to reconsider the FTSE 350 audit market," she says.

SMALL ENTITY AUDIT

The FRC's focus on the quality of audits of PIEs is perhaps understandable; its position on smaller entity audit can seem more difficult to fathom. Witness its June 2018 withdrawal of Practice Note (PN) 26 - *Guidance on Smaller Entity Documentation*, because it "no longer supports the documentation requirements of a high quality audit".

This alarmed some auditors and training providers, because their audit methodologies make reference to it. "PN 26 is outdated, it's been superseded in all sorts of ways," says Hind. After outreach with technical groups and its advisory council, the FRC decided that PN 26 was not needed and could be withdrawn without any consequence.

Some saw this as a sign that the FRC is disengaged from the small end of the audit market. "That is an entirely inappropriate reaction," asserts Hind. "It has nothing to do with the FRC saying 'not interested' and everything to do with the FRC maintaining a fit-for-purpose set of requirements and guidance, and not having material out there that is superfluous or could even confuse." On the challenges of applying increasingly complex auditing standards to small and non-complex entities, Hind says: "The mantra 'an

"It's important the UK has regard to high-quality global standards, so it should play its part in looking at what would be appropriate for small and non-complex entities"

audit is an audit is an audit' has survived a long time, but I am open-minded on whether it remains appropriate." What of projects exploring simplification? Accountancy Europe recently outlined some solutions (tinyurl.com/AB-Simp-Aud-Stand).

With her FRC hat firmly in place Hind adds: "It's important the UK has regard to high-quality global standards, so it should play its part in looking at what would be appropriate for small and non-complex entities. It's something we might try and influence. From time-to-time we play an international pathfinder role, but there are issues around resources and priorities."

RESOURCES AND PRIORITIES

Brexit and the Kingman review may create more issues around resources and priorities: one or both could mean more or less regulatory responsibility and activity for the FRC. Kingman is a root and branch review of all the FRC does and post-Brexit changes around audit registration and recognition of audit qualifications are inevitable.

Work by the Monitoring Group (tinyurl.com/AB-Reshape-Aud) to strengthen governance and oversight of international audit-related standard setting also promises change. Hind praises the profession for its role in developing and funding standards, but says: "In today's world there's a perception of self-interest, so the FRC supports the Monitoring Group taking this forward."

Perceptions of self-interest may also reshape regulation. There is already a statutory regime for audit and the FRC and professional bodies are debating the future of voluntary regulation in other areas. Hind explains: "A decade ago, self-regulation and the contribution of the profession was the norm. But the pendulum has swung away from self-regulation."

SCOPING CHANGE

Hind thinks the time has come to also reconsider the scope of audit. "Since the 2008 financial crisis we have learnt more about what is systemically important to us as a society. We know that a lot more matters than just the financial performance and position of a company, and society seems to want more information and more assurance of it," says Hind. A discussion is needed, she suggests, about what matters and what



information people want on this. Do they want to go beyond the financial, to matters such as the treatment of customers or slavery in the supply chain? Conjecture on the future?

"After deciding what matters, we need to think about ways of reporting on this and how to assure or audit it in some way."

Despite all of this looming change, Hind expects technology to shape the most significant developments over the next five years. "We don't see the use of data analytics or artificial intelligence (AI) on every audit, but they are becoming more commonplace." Over the next year she expects to see more use in smaller listed audits and niche areas such as investment trusts and pension schemes.

EXPLOITING TECHNOLOGY

"The power of technology is such an opportunity," Hind says. So far, the FRC is seeing better analysis and presentation of data without the use of AI or machine learning. It's not fully automated audit yet, but the need to select a random sample is being replaced by the ability to go through an entire data population, such as a portfolio of assets, movements or valuation oddities.

"Audit inspection depends on reviewing evidence that is on an audit file, but some new technologies mean that the evidence is the whole of the general ledger," says Hind. The FRC has to balance innovation and regulation: "We wouldn't want to stymie progress towards better quality audit using technology, just because we couldn't find a way of inspecting it."

Auditors are already using analytics to focus on where issues might be in a more laser-like fashion. "This is improving the quality of audit and it is becoming more forensic. That must be good," she says. In future, AI and machine learning developments will bring fresh challenges, but she

thinks auditors and regulators will be able to manage the sort of 'black box' issues that may arise.

Entrants to audit will need a better appreciation of technology, but Hind expects this to be combined with key auditor skills, such as critical thinking and professional scepticism.

TIME TO ADAPT

Keeping audit and its regulation fit for purpose in this new world is no small undertaking. "Since I arrived at the FRC in 2012, I've tried to be responsive to public needs, work in the public interest and genuinely do the right thing," says Hind. Nonetheless, the FRC is currently under a lot of scrutiny and there's quite a lot of external criticism.

"I don't think we've been in the least bit complacent," she says, but the FRC has learnt the hard way that public mood and sentiment can change quickly. "If we are going to serve the public interest, we probably need to be a bit swifter at taking the input, listening, and perhaps be a bit readier to change – not in terms of just acquiescing, but in thinking carefully."

Audit is highly technical, so it is difficult for the FRC to monitor and promote continuous improvements in audit quality without expertise; even public consultations attract the usual suspects. "When we go out and engage with stakeholders, they tend to be people who are close to what we do and close stakeholders," says Hind. An exercise of judgement is necessary.

Over time, the FRC has taken on tricky responsibilities, often without powers and relying on influence, and Hind acknowledges some errors: "An objective review would be welcome at this point in time." Kingman may deliver that. "We need to find a way to make what we do more accessible and of greater value to the public." The audit profession and Hind's successor may want to take note. ●

ONWARDS AND UPWARDS

ICAEW has amended its procedures to reflect the requirements of IES 8. Has your firm?

When International Education Standard (IES) 8 *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)* came into effect on 1 July 2016 (see box, right) it set new professional competence requirements for audit engagement partners in all audit firms. In addition, the requirements for the competence of responsible individuals (RIs) became more precise. However, some firms may have overlooked the changes and the need to take appropriate steps.

ICAEW drew firms' attention to IES 8 before and after it came into force, with information in multiple editions of *Audit News* (at tinyurl.com/AB-AuditNews) and *Audit & Beyond*. Some of you may (or may not) recall a John Selwood Q&A on IES 8 in June 2016 (tinyurl.com/AB-JSQA-0616). There is also a faculty webinar from 2015 on auditor competencies (at tinyurl.com/AB-AudComp). Topics covered include technical competencies and professional skills, values, ethics and attitudes for auditors (as covered in IES 8).

IES 8 built on professional competencies that were already a requirement of legislation, ICAEW requirements and audit firms internal due diligence, so some firms may not have needed to make major changes to meet the more precise requirements of IES 8.

MONITORING COMPLIANCE

However, ICAEW monitoring activities during 2017 (see *Audit Monitoring 2018* at tinyurl.com/AB-AudMon-18) found that "a significant number of firms were not familiar with IES 8 and had not considered whether they should enhance their existing procedures".

ICAEW monitoring reviews check:

- whether firms have appropriate procedures in place to meet the requirements of IES 8; and
- that selected engagement partners and other RIs are using a planned programme of continuing professional development (CPD) to ensure that they are developing and maintaining the competencies required by IES 8.

As you will need to make your annual CPD declaration between 1 November 2018 and 31 January 2019, you may want to revisit ICAEW's guidance on CPD (at

IES 8 – A BRIEF HISTORY

The International Accounting Education Standards Board (IAESB) published IES 8 (Revised) in 2014 and it took effect on 1 July 2016.

IAESB is an independent standard-setter and part of the global professional organisation the International Federation of Accountants (IFAC), of which ICAEW is a member.

IES 8 implementation support from IAESB is in a helpful staff questions and answers publication and webcast at tinyurl.com/AB-StaffQA and additional information is available from the IAESB at tinyurl.com/AB-IAESB-IES8

tinyurl.com/AB-ICAEW-CPD), which outlines ICAEW's suggested approach to CPD. This approach is also noted in the article on pages 10 and 11 along with some practical tips on how IES 8 can be integrated into CPD planning.

NEW FORM FOR RI APPLICATIONS

ICAEW has amended the application process for RIs and the form that firms must use when they wish to designate a principal or employee as an RI under chapter four of the *Audit Regulations and Guidance* (which is at tinyurl.com/AB-ARG-0417). This updated form was made available in June 2018 at tinyurl.com/AB-RegAuditor and must be used for all RI applications from 1 July 2018.

All applicants and their firms must confirm that those proposed as RIs have achieved the competencies listed in IES 8 through their work experience and CPD – and new information is requested.

For example, firms will need to outline the internal process undergone by the applicant in order for the audit compliance principal to support the application for RI status. First-time applicants will also need to provide details of any induction, mentoring and training undertaken in anticipation of their role as RI.

More information on the new information required can be found, along with clarifications on some questions the form asks, in *Audit News* 62 (tinyurl.com/AB-AuditNews). Firms that have not yet thoroughly considered IES 8 should do so without delay. ●



ON COURSE FOR COMPLIANCE

Professional development for responsible individuals is about more than technical updating, says **Julia Penny**



We all know that it is vital to consider what continuing professional development (CPD) we undertake to ensure that we can properly do our jobs. Hopefully you will also remember that the ICAEW guide to CPD is based on an approach which can be summarised using the acronym RAID (see box, opposite). However, some of you may be less familiar with the International Accounting Education Standards Board and the standards it issues that provide us with more information on what sort of CPD we may need.

International Education Standard (IES) 8 *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)* (see tinyurl.com/AB-IAESB-IES8) sets out the competencies that you are expected to have if you are a responsible individual (RI), which the standard refers to as an engagement partner. Newer RIs will have needed to demonstrate these competencies when first being approved (see page 9). Subsequently, the competencies provide a useful checklist of topics and skills, so should be

considered as part of your RAID approach to CPD.

IES 8

The current version of IES 8 took effect from July 2016 but has had a relatively low profile except for those seeking approval as an RI. As you might expect, the standard requires that RIs must develop and maintain their professional competence. The learning outcomes that competence must be demonstrated against are set out in detail in Table A of IES 8 (at tinyurl.com/AB-IAESB-IES8), which includes a wide range of areas for competence.

Briefly, the technical competency areas include: audit; financial reporting; governance and risk management; business environment; taxation; information technology; business laws and regulations; and finance and financial management. Professional skills areas include: intellectual; interpersonal and communication; personal; and organisational. Professional values, ethics and attitudes include: commitment to the public interest; professional scepticism and professional judgement;

As you might expect, IES 8 requires that responsible individuals must develop and maintain their professional competence



and ethical principles.

Most of the descriptions of the learning outcomes in each of these competency areas are very much what you might expect. For instance, under audit, the RI must be able to: lead the identification and assessment of the risk of material misstatement, evaluate responses to those risks and the audit work performed and develop an appropriate opinion.

Less intuitive perhaps is what is meant by personal skills as part of professional skills. This includes promoting and undertaking lifelong learning, acting as a role model to the engagement team and in a mentoring or coaching capacity to that team. How often do you consider these softer skill requirements when planning your CPD?

FOCUS ON SKILLS

Although we may be tempted to think of audit and financial reporting knowledge as the main element of any CPD programme - and it is clearly essential that we have that knowledge - we will not be effective RIs if we cannot ensure the whole team does their job properly. We

won't be effective RIs if we cannot exercise an ethical strength in standing up to others who may seek to sway our views. We won't be effective RIs if we cannot properly plan and organise an audit. These softer skills are therefore not just nice to have but essential to our role as an RI.

The standard recognises that many skills of an RI are developed through experience and that this can be evidenced through annual self-declarations, records of chargeable time and the results of quality monitoring. However, there is clearly going to be a requirement for a certain amount of specific CPD activity, such as:

- attendance at courses, webinars and other relevant events;
- reading technical briefings; and
- researching and/or presenting on a new or complex technical area.

When reflecting on the CPD activity necessary, we need to be careful not to neglect the skills element - both professional and personal.

Quality control reviews of audit files may indicate areas in which our skills as an RI may need to be improved or refreshed. Our own experience of an audit may also point to areas where we could enhance our abilities and a root cause analysis may further highlight areas for improvement. But sometimes it can still be difficult to realise what it is that needs improving.

The trick then is to use the prompts in IES 8 to remind ourselves of all the competencies expected of an RI and to consider which areas might need a refresher. Let's have a look at an example of the process you might use.

LEAD BY EXAMPLE

An RI might identify that they need regular updating on changes to accounting, auditing and legal issues and that they plan to achieve this through attendance at quarterly updates.

With respect to keeping up to date with tax or issues such as IT, they might attend updates suitable for auditors or perhaps attend periodic meetings with the relevant internal department to understand the issues and changes.

On the professional skills side, they may maintain these competencies merely by continued experience at work but decide that this year an update on project planning with respect to audit (for example, an audit efficiency course) would help improve organisational skills.

Additionally, an appraisal, root cause analysis or 360-degree review might have

ICAEW ON CPD

The ICAEW guide to CPD ([at tinyurl.com/AB-ICAEW-CPD](http://tinyurl.com/AB-ICAEW-CPD)) uses an approach that can be summarised by the acronym RAID:

- Reflect - consider what your CPD needs are and plan how you will achieve this.
- Act - undertake the CPD you have planned.
- Impact - evaluate whether what you have done has met your needs and adjust your plan if necessary.
- Declare - annually you must declare to ICAEW that you have completed the required CPD.

identified that better leadership or management skills are needed and so the RI may plan to attend a course on mentoring skills.

Professional values and ethics might be dealt with by facilitated group discussions of areas that threaten ethical behaviour and by using video resources such as ICAEW's new training film *Without Question* and its predecessor *False Assurance* (see the ICAEW website at tinyurl.com/ICAEW-Films and the article in the September 2018 edition of *Audit & Beyond* (see tinyurl.com/AB-Aud-Bey-2018).

Documentation of the planned and completed CPD, together with the reasons why these were chosen will help ensure a clear picture of what was done. It will also help planning CPD in later years, as an RI may decide to revisit areas on a periodic basis.

DEMONSTRATE COMPETENCY

The ICAEW Quality Assurance Department expect firms to be able to demonstrate how RIs have ensured that they have maintained the competencies in Table A of IES 8. So it's important to ensure that the RAID analysis for RIs includes consideration of all the elements listed in Table A and that you can show how you have ensured that the required competencies are maintained. ●



Julia Penny FCA, technical director, SWAT (part of Mercia) and ICAEW Council member for the London region

The withdrawal of Practice Note (PN) 16 *Bank Reports for Audit Purposes in the UK* (PN 16) has created an opportunity for auditors to exercise more professional judgement in determining whether it is necessary to obtain a bank confirmation in all circumstances.

PN 16 stated that without obtaining a bank confirmation "it will not normally be practical to obtain sufficient appropriate audit evidence from other sources". This led many audit firms to conclude that they had to obtain bank confirmations as a matter of course, regardless of the level of risk or other audit evidence that had been obtained.

When PN 16 was withdrawn in 2017, the accompanying feedback statement (see box, *From PN 16 to UK ISAs*) noted that the Financial Reporting Council (FRC) proposals were "intended to encourage the auditor to apply their professional judgement as to when a confirmation report is required". The feedback statement further stated that "deciding whether a confirmation report is required continues to be a matter of professional judgement for the auditor". This appears to permit auditors to adopt a more risk-based approach, taking into account the auditor's risk assessment of bank and cash.

UNDERSTANDING THE ENTITY

As part of performing that risk assessment, a key factor to consider is the understanding of the entity. This could include the number of bank accounts the entity has, with which banks, in what country and the reasons for those accounts. If the entity has numerous bank accounts with a number of different banks in multiple countries, this may indicate higher audit risk. This would especially be the case if this number or spread of bank accounts was particularly unusual for the type of entity.

In such circumstances, the auditor may choose to obtain bank confirmations as more

ON BALANCE

Phil Lenton offers practical tips on taking a more risk-based approach to the audit of bank and cash

persuasive evidence. A determining factor should not be the perceived difficulty in obtaining those confirmations. The use of an electronic audit confirmation system, such as Confirmation.com, may be particularly useful for overseas banks where auditors have had difficulties obtaining confirmations in the past.

However, there may be situations where the auditor assesses the risk as low and thinks a bank confirmation unnecessary. One example of this is where the entity has only one bank account with a major high street bank and the bank details can easily be viewed online in the presence of the auditor. While the auditor might be able to obtain a confirmation relatively easily, the auditor may consider reviewing bank details online as providing sufficient appropriate evidence.



The use of many bank accounts in multiple countries is an example of where the auditor needs to consider the risk of fraud, which is often a principal reason to obtain bank confirmations. The more the auditor is concerned about the possibility of fraud – for example, if the auditor does not understand (and entity personnel cannot articulate sufficiently) the reason for particular bank accounts – the more the need for a bank confirmation increases.

The auditor also needs to consider whether the confirmation is being used for other purposes, for example a client money engagement, where it is often critical to obtain a bank confirmation. In these situations, as a bank confirmation is required for the additional assurance engagement, it can also be used for the audit.

The other information being requested is also an important factor to consider. Often the least interesting part of the confirmation is the summary of the bank balances, but other information in the confirmation, such as details of derivative transactions or trade finance, may be more important and a key reason to obtain a bank confirmation.

FIRST YEAR AUDITS

An additional factor to consider is whether it is a first year audit. For such audits, the auditor may not have the same level of understanding of the entity and its banking arrangements. As a result, the auditor may consider it necessary to obtain bank confirmations for at least the first year of the audit. However, the fact that it is a first year audit does not necessarily mean that sufficient understanding could not be obtained without a bank confirmation. For example, the auditor could obtain sufficient understanding by reviewing the predecessor auditor's working papers, including seeing bank confirmations obtained in the past, and observing that there was nothing unusual or unexpected.

If bank confirmations have been obtained in the past with no issues,

The use of many bank accounts in multiple countries is an example of where the auditor needs to consider the risk of fraud

this may mean that the auditor could consider it unnecessary to obtain confirmations for all bank accounts every year. Instead, the auditor may choose to rotate the confirmations between the various banks over a number of years.

EXPECTATIONS

Expectations can also be key – both of a group auditor and of the client. If the auditor is a component auditor, then where the group auditor insists that bank confirmations be obtained, the component auditor should follow those instructions.

In terms of client expectations, the auditor needs to be aware of the concern that the client is inappropriately driving auditor behaviour. Where the auditor thinks a bank confirmation necessary, irrespective of the views of the client, the auditor should always obtain a confirmation. Only in situations where the auditor does not believe a bank confirmation is necessary,

KEY FACTORS TO CONSIDER

A risk-based approach to the audit of bank balances needs to consider factors including:

- understanding the entity;
- fraud risk;
- non-audit confirmations;
- past bank confirmations;
- expectations of group auditors;
- expectations of clients;
- type of client;
- nature of entity and size of bank balances;
- factors of particular relevance to the entity;
- documenting the rationale for the approach taken; and
- appropriate evidence to support the risk assessment.

FROM PN 16 TO UK ISAS

PN 16 *Bank Reports for Audit Purposes in the UK* was withdrawn in July 2017 by the FRC after consultation.

Its withdrawal coincided with the FRC issuing a revised International Standard on Auditing (ISA) (UK) 330 *The Auditor's Response to Assessed Risk*, with conforming amendments to ISA (UK) 505 *External Confirmations*. The revisions were effective for audits of financial statements for periods commencing on or after 15 December 2017 and had the effect of streamlining and integrating the ISAs (UK) the guidance on obtaining bank reports for audit purposes.

The FRC feedback statement and impact assessment on the withdrawal of PN 16 and minor revisions to ISAs (UK) 330 and 505 is at tinyurl.com/AB-FeedbackSt

ARTICLES AND WEBINARS

Audit & Beyond has featured a number of articles on approaches to audits of bank and cash since the withdrawal of PN 16.

They include:

Taking a view (see tinyurl.com/AB-TakeView) appears in the November 2017 edition and covers post-PN 16 strategy, review of methodologies, the value of confirmations, and evidence from internet banking.

Sharing insights (see tinyurl.com/AB-Shar-Ins) appears in the December 2017/January 2018 edition and covers post-PN 16 approaches to risk, fraud, use of data analytics and internal control issues.

Both of these articles are based on – and include insights from – a series of interviews the authors conducted with practitioners, training providers, FRC staff and ICAEW's QAD.

Audit of bank and cash in light of recent developments was the subject of a faculty webinar in May 2018. It considers the transition from the specific guidance in PN 16 to a more risk-based approach to bank confirmations and is followed by a brief but interesting Q&A session.

A recording is available in our webinar library at icaew.com/aafwebinars

Worthwhile or Wasteful: Understanding the Value of External Confirmations was the subject of a faculty webinar in July 2018. In it, speakers from Confirmation.com assert the value of third party confirmations and discuss best practices for an independent confirmation process.

A recording of the webinar is available at tinyurl.com/ABwebinarworthwaste

Depending on the nature and type of the entity, there could be a number of other relevant factors

might the auditor consider the client's views. If the client expects, or indeed insists, on a bank confirmation, the auditor may still choose to obtain a confirmation. If, however, the auditor was already of the view that a confirmation was unnecessary and the client has no issue with this approach, then the auditor might choose not to obtain a bank confirmation.

The type of client is also relevant: the more high profile or public interest in the client, the more the auditor may face increased challenge if they do not obtain a bank confirmation. This would especially be the case if anything were subsequently to come to light that would have been identified through obtaining a bank confirmation.

A related factor is the nature of the entity and size of the bank balances relative to other items in the financial statements. If the bank balance is the single largest

item in the financial statements and dwarfs all of the other account balances, the auditor may not think the audit credible unless bank confirmations are obtained.

DOCUMENTATION AND EVIDENCE

The previously listed factors are only examples for an auditor to consider. Depending on the nature and type of the entity, there could be a number of other relevant factors. This decision on whether to obtain a bank confirmation needs to be based on the risk assessment performed for that particular entity and it is important for the auditor to document the rationale for the approach taken.

In particular, there needs to be evidence to support the risk assessment and this needs to be persuasive and not give the impression that the auditor has taken the quickest and easiest route. The documentation also needs to justify clearly how any alternative procedures performed provide sufficient appropriate evidence such that a bank confirmation is not necessary. ●



Phil Lenton,
director, Deloitte



JOHN SELWOOD'S AUDIT CLINIC

John revisits some issues around audit work relating to investments, and to pension scheme obligations and disclosures

QUESTION

Following a recent file review, my firm has been criticised for over-reliance on fund managers' reports when auditing investments held by charities. Why is this sort of third party confirmation not sufficient audit evidence?

ANSWER

It is not sufficient audit evidence because it is probably not a third party confirmation at all.

It is not uncommon for some auditors to place too much reliance on the investment manager's year end portfolio valuation. The problem is that very often this has been produced by a 'service organisation' and the audited entity does not maintain its own investment records, which means that the year end valuation is not an external confirmation. It is merely an extension of the entity's accounting records, which are being maintained by a third party.

Indeed, the International Standard on Auditing (UK) 402 *Audit considerations relating to an entity using a service organisation* specifically says that if the user entity does not maintain independent records, information

obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence.

This, of course, leads to another question. What should the auditor do in such circumstances?

In general, the auditor is required to understand the entity's internal controls, which means understanding the internal controls in the service organisation.

A good place to start would be to request what is commonly known as an AAF 01/06 report, which are produced based on guidance in faculty technical release AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*. This is at tinyurl.com/AB-AAF-0106 along with other useful resources, such as an article explaining who should be able to view such reports – and how to overcome difficulties in arranging access.

Even when they exist these reports can be difficult to track down. Assurance reports on controls at service organisations can be produced under various standards including the



Those who audit many academies should gain good experience of how these pension schemes work

international ISAE 3402 and US standards SSAE 16 and SSAE 18. Users, providers and auditors of such reports may also refer to them as SOC 1 and SAS 70 reports, even when these terms of reference are not strictly correct, so there is potential for confusion – and a list of alternatives for you to ask about if your quest for an AAF 01/06 report is not successful.

In the scenario you are asking about, the auditor of the investment management company would typically produce these reports, which would provide the auditor's conclusions on the operating effectiveness of internal controls covering client asset management.

This means that the 'user auditor', which could be you, can easily obtain an understanding of the controls and could possibly choose to rely on the operating effectiveness of those controls, thus reducing the amount of substantive testing required on the investments.

Assurance reports on controls at service organisations are not available for all investment management companies and it can sometimes be difficult to find the right person to provide this information; but one of these reports should be available for most major investment management companies.

Another problem is that sometimes there is a gap between the audited entity's accounting period and the period covered by the AAF 01/06 (or similar) report, which could make an update letter

necessary. However, regardless of whether one of these reports is obtained, further evidence is always needed. In the absence of such a report then substantive testing will be more extensive.

Valuation testing should be fairly straightforward, particularly if all investments are listed. Sampling the investments and testing to external valuation data or, if necessary, valuation model inputs, should suffice.

Testing for ownership is often more challenging. There is no point in trying to test a sample of investments to share certificates. Most investments don't have such things nowadays and even if they did it would probably be in the name of a nominee. A good real life solution, that many auditors adopt, is requesting a confirmation directly from the custodian, who is usually independent from the investment managers. This sort of external confirmation of beneficial ownership is good audit evidence.

QUESTION

As it is the actuary who is responsible for the calculations, how much work does an auditor need to do on pension scheme obligations?

ANSWER

This area can be very simply summed up with the following.

- The auditor must obtain sufficient appropriate audit evidence to support pension scheme obligations (and disclosures).
- The auditor must not blindly rely on the actuary, just because "after all, they are the expert".

Actuarial valuations are part of a skill set that most auditors do not possess. However, it is often possible for auditors to obtain evidence to support an actuarial valuation without actually re-performing it.

Equally, there are instances where the auditor will not be able to perform the work without an auditor's expert, who is effectively their actuary. This is common on very large audits.

When auditing pension scheme obligations, auditors should:

- Perform a risk assessment. This will help establish what audit evidence is needed. Audit risk will be influenced by the nature of the scheme, its members, the general economic environment and how the obligations are being calculated. It is most important to recognise that certain assumptions will

be more sensitive than others.

- Consider the source of the data used in the valuation. Review the assumptions and form a view as to the reasonableness of the assumptions.
- Remember to properly document their work if an auditor's expert is used.
- Communicate with those charged with governance as necessary.

Obviously, these issues only arise with defined benefit pension schemes – and these are not as common as they used to be. Nowadays, when I come across pension scheme obligations it is often on academy school audits. Those who audit many academies should gain good experience of how these pension schemes work and be in a position to spot a rogue valuation.

As with all things in auditing, do not forget to document the work in this area.

You may also want to dip into a recent pension-themed report from the Financial Reporting Council (FRC). *The Audit of Defined Benefit Pension Scheme Obligations* includes examples of good practices relating to the audit of pension balances and related disclosures. It also suggests areas where auditors can improve the audit of pension fund balances by:

- assessing the sensitivity of the valuation to changes in assumptions;
- clearly evidencing the work done by actuarial experts and the rationale for conclusions reached;
- considering whether the source data used to calculate the valuation of the defined benefit obligation is materially accurate and complete;
- identifying different categories of investment assets and obtaining sufficient audit evidence to support the valuation of each;
- paying attention to evidence to support the allocation of the defined benefit obligation and pension scheme assets in multi-employer schemes;
- focusing on the completeness and accuracy of the pensions related disclosures, not just the valuation; and
- considering whether, given the material nature and risks, the audit work on pensions should be explained in the auditor's report.

This FRC report is at tinyurl.com/AB-AudDefBenPen ●

John Selwood is a member of the faculty's Practitioner Services Panel and freelance lecturer and writer

TECHNICAL UPDATES

The Audit & Assurance Faculty roundup of new and updated legal and regulatory changes and guidance

information to improve its clarity and conciseness.

Guidance on the Strategic Report outlines the content of strategic reports required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013; Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016; and The Companies (Miscellaneous Reporting) Regulations 2018. It strengthens the link between the strategic report's purpose and the director's duty under section 172 of the Companies Act to promote the success of the company.

The updated guidance is available along with related information including links to clarification on some legal matters, regulations, FAQs, a non-financial reporting factsheet and the original 2014 strategic report guidance at tinyurl.com/AB-StratRep

AUDIT AND ASSURANCE
US



PCAOB STRATEGIC PLAN
August 2018

The Public Company Accounting Oversight Board (PCAOB) is considering comments on its draft five-year strategic plan after inviting public comment for the first time on its areas of strategic focus in fulfilling its mission to protect investors and the public interest through high quality audit reports.

The board intends to use the strategic plan to:

- broaden its approach to driving quality improvement in audit services and better communicate how it is driving that improvement;
- ensure that its inspections and standard-setting activities are responsive to and do not impede technological innovations; and
- engage proactively more often and directly with investors, audit committees, and other stakeholders to encourage relevant and timely conversations about the quality of audit services.

The 2018-2022 draft strategic plan is at tinyurl.com/AB-DraftCom

AUDIT AND ASSURANCE
UK & IRELAND



INDEPENDENT REVIEW OF FRC
August 2018

The independent review of the Financial Reporting Council (FRC) is considering responses to its call for evidence, which closed on 6 August.

Led by Sir John Kingman with the support of an advisory group, the root and branch review will help government to assess whether the FRC is fit for the future by considering its:

- purpose and function;
- impact and effectiveness;
- powers;
- legal status and relationship with government;
- governance and leadership;
- funding, resources and staffing; and
- role in reducing the risk of major corporate failure.

The review aims to make the FRC the best in class for corporate governance and transparency, while helping it fulfil its role safeguarding the UK's leading business environment. It is due for completion by the end of 2018.

Details of the consultation are at tinyurl.com/AB-InRev; the ICAEW representation is at tinyurl.com/AB-Reps18

Minutes of meetings between Kingman and the FRC review advisory group are at tinyurl.com/AB-Minutes

NARRATIVE REPORTING
UK & IRELAND



STRATEGIC REPORT GUIDANCE
July 2018

Following consultation, the FRC has updated its *Guidance on the Strategic Report* encouraging companies to consider broader matters that affect performance over the longer term.

The updated guidance is set in the context of the annual report as a whole, to recognise that the strategic report does not exist in isolation from other aspects of corporate reporting. It includes communication principles that emphasise qualities of good corporate reporting. Companies are encouraged to focus on the application of materiality to disclosures and to be innovative in the structuring of

INTERNATIONAL ACCOUNTING EDUCATION STANDARDS BOARD



PROFESSIONAL SCEPTICISM

August 2018

The International Accounting Education Standards Board has published two Accounting Education Insights articles on professional scepticism.

Unconscious Bias and Professional Skepticism examines the underlying theory of how unconscious bias arises; the relevance of implicit or unconscious bias on professional scepticism; the various components of, and mitigations for, professional scepticism; and practical tips on reducing professional accountants' unconscious bias.

How Can We Become Better Skeptics? examines what it takes to become a "good" sceptic and how the accountancy profession can develop or enhance the areas that underpin scepticism.

These and other Accounting Education Insights articles are at tinyurl.com/AB-AccEd

INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS



KEY AREAS FOR SMES AND SMPS

September 2018

The International Ethics Standards Board for Accountants (IESBA) has published an article highlighting aspects of its revised and restructured Code of Ethics for professional accountants which are of most note for small and mid-sized practices. These include:

- a more robust definition of safeguards;
- the distinction between safeguards and "conditions, policies and procedures";
- clearer descriptions of other key terms; and
- revisions to the independence provisions relating to the provision of non-assurance services to audit and assurance clients.

The article can be read at tinyurl.com/AB-IFKey

It also includes helpful links to related information, such as the IESBA's guidance on inducement (revised July 2018), which is at tinyurl.com/AB-IESBA-Rev

In April 2018, IESBA issued a rewritten and revamped Code of Ethics for professional accountants and renamed it the *International Code of Ethics for Professional Accountants (including International Independence Standards)*. It is available at tinyurl.com/AB-RestrCode

INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD



PROPOSED AMENDMENTS TO IPSAS 36 AND IPSAS 41

August 2018

The International Public Sector Accounting Standards Board (IPSASB) has published for consultation Exposure Draft (ED) 66 *Long-term Interests in Associates and Joint Ventures* (Amendments to IPSAS 36) and *Prepayment Features with Negative Compensation* (Amendments to IPSAS 41).

ED 66 proposes amendments to converge with the narrow-scope revisions to IAS 28 *Investments in Associates and Joint Ventures* and International Financial Reporting Standard (IFRS) 9 *Financial Instruments* made by the International Accounting Standards Board (IASB) and issued in October 2017.

The deadline for comments is 22 October 2018.

ED 66 is at tinyurl.com/AB-Ex66

IPSAS 41 FINANCIAL INSTRUMENTS

August 2018

IPSASB has published IPSAS 41 *Financial Instruments* to improve the relevance of information for financial assets and financial liabilities.

IPSAS 41 will replace IPSAS 29 *Financial Instruments: Recognition and Measurement* and strengthens that standard's requirements by introducing:

- simplified classification and measurement requirements for financial assets;
- a forward looking impairment model; and
- a flexible hedge accounting model.

IPSAS 41 is based on IFRS 9 *Financial Instruments*, developed by the IASB. However, IPSAS 41 also includes public sector-specific guidance and

illustrative examples on:

- financial guarantees issued through non-exchange transactions;
- concessionary loans;
- equity instruments arising from non-exchange transactions; and
- fair value measurement.

IPSAS 41 is available along with related resources including a brief summary and a webinar at tinyurl.com/AB-IPSAS41

ACCOUNTANCY EUROPE



IMPLEMENTATION OF EU AUDIT RULES

August 2018

Accountancy Europe has published its latest state of play on implementation of the new audit rules that were introduced when the European Union (EU) Audit Directive and Regulation took effect in June 2016.

The update from Accountancy Europe covers 30 European countries, including 28 EU member states. It also offers analysis of member states' decisions and visualised the outcomes for the key options regarding: providing non-audit services, mandatory audit firm rotation and public oversight.

This latest update and other related information are at tinyurl.com/AB-MemStat



Peter Mandich produces Technical Updates. He is a manager in the Audit & Assurance Faculty

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