

Audit Committee Terms of Reference (Code provision C3.3)**Auditors' procedures**

Auditors should review whether:

- the terms of reference for the audit committee are posted on the company's website or otherwise made readily available; and
- a description of the work performed by the audit committee is included in a separate section of the annual report, and is not materially inconsistent with the information that the auditor has obtained in the course of their audit work.

Advice on Annual Report (Code provision C3.4)**Auditors' procedures**

Auditors should assess whether the audit committee has responded to requests for advice and assess the processes they go through to provide the information necessary for the shareholders to identify the company's business model and strategy.

Raising Staff Concerns (Code provision C3.5)**Auditors' procedures**

Auditors should review:

- supporting documentation to determine whether there is evidence that the audit committee has reviewed the arrangements and discuss the review with staff as necessary; and
- documentation supporting the company's arrangements for 'proportionate and independent' investigations.

Auditors are not responsible for considering whether the arrangements do allow 'proportionate and independent' investigations or whether follow-up action is appropriate, but rather should review the process undertaken to assure the audit committee that this is the case.

Internal Audit (Code provision C3.6)**Auditors' procedures**

The Bulletin states that auditors should perform the following procedures:

- hold discussions with the audit committee chairman and review supporting documentation to establish that the effectiveness of any internal audit function has been monitored and reviewed;
- where no internal audit function exists, review whether:
 - the audit committee has considered the need for an internal audit function;

- there is documentation that this recommendation has been made to the Board; and
- the reasons for not having an internal audit function are included in the relevant section of the annual report.

The auditor is not responsible for considering whether the internal audit function is effective or whether the reasons disclosed in the annual report for not having an internal audit function are reasonable.

Appointment, Reappointment and Removal of the External Auditor (Code provision C3.7)**Auditors' procedures**

Auditors should:

- review the terms of reference of the audit committee, or other documentation, to ensure that the audit committee has primary responsibility for making a recommendation on the appointment, reappointment and removal of auditors;
- review documentation of the audit committee's recommendation to the Board;
- where the Board has not accepted the audit committee's recommendation, review the annual report and any papers recommending appointment or reappointment of the auditors, to ensure inclusion of:
 - a statement from the audit committee explaining its recommendation; and
 - a statement from the Board setting out reasons why they have taken a different position from that recommended by the audit committee.

Non-audit activities (Code provision C3.8)**Auditors' procedures**

The Bulletin recommends that auditors should review whether the annual report includes a statement explaining how the objectivity and independence of the auditor is safeguarded if they provide non-audit services. Auditors should consider this statement and:

- notify the audit committee and Board if the audit committee has not fulfilled its responsibilities to review and monitor the independence and objectivity of the external auditor and to develop and implement policy on the engagement of the external auditors to supply non-audit services; and
- consider the requirements of ISA (UK and Ireland) 720 in relation to other information issued with audited financial statements if they believe the explanation is misleading. This will involve attempting to resolve differences with the Board, and considering the implications for their report if they are not able to do so.

15.6.4 Going concern

The requirement for directors to report that the business is a going concern is set out in the Listing Rules and detailed in *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* issued by the Financial Reporting Council in 2009 ('the FRC guidance'). The Listing Rules require the directors of all companies which have a premium listing (see 15.7.3 below) of equity shares, preference shares or securities convertible into equity shares to include in the annual report and accounts a statement that:

the business is a going concern, together with supporting assumptions or qualification as necessary, as has been prepared in accordance with *Going Concern and Liquidity Risk: Guidance for directors of UK Companies 2009*, published by the Financial Reporting Council in October 2009.

The FRC guidance sets out three principles that directors should apply to determine whether it is appropriate to adopt the going concern assumption, see **Table 5**.

TABLE 5: Principles in the FRC Guidance

Principle 1: Assessing Going Concern

Directors should make and document a rigorous assessment of whether the company is a going concern when preparing annual and half-yearly financial statements. The process carried out by the directors should be proportionate in nature and depth depending upon the size, level of financial risk and complexity of the company and its operations.

Principle 2: The Review Period

Directors should consider all available information about the future when concluding whether the company is a going concern at the date they approve the financial statements. Their review should usually cover a period of at least 12 months from the date of approval of annual and half-yearly financial statements.

Principle 3: Disclosures

Directors should make balanced, proportionate and clear disclosures about going concern for the financial statements to give a true and fair view. Directors should disclose if the period that they have reviewed is less than 12 months from the date of approval of annual and half-yearly financial statements and explain their justification for limiting their review period.

Auditors' procedures

The Listing Rules require a listed company to ensure that the auditor reviews the going concern statement prior to publication of the annual financial report. Auditors have a responsibility to:

- review the documentation prepared by or for the directors which supports the use of the going concern assumption;
- evaluate the consistency of the documentation with their knowledge of the client obtained during their audit of the financial statements; and
- consider whether the directors' statement meets the disclosure requirements set out in the FRC guidance.

15.7 Other Disclosures

15.7.1 Disclosures under the FRC guidance

ISA (UK and Ireland) 720 sets out the auditors' responsibilities in relation to other information in documents containing audited financial statements. This other information will include the FRC guidance disclosures.

These Auditing Standards require that where there is an inconsistency between the audited financial statements and the FRC guidance disclosures, the auditors determine which needs to be amended and seek to resolve the matter with those charged with governance.

If an amendment is needed to the audited financial statements and the entity refuses to make the amendment, auditors express a qualified or adverse opinion on the financial statements.

If the directors' disclosures are not balanced, proportionate or clear, auditors should consider including an 'other matter' paragraph describing the material inconsistency in their report.

If there is a material uncertainty about the ability of the company to continue as a going concern, but the going concern basis remains appropriate, the directors should disclose this fact. If the directors make this disclosure, the audit report will not be qualified but should contain an emphasis of matter paragraph. If the directors' disclosure is not balanced, proportionate or clear, an 'other matter' paragraph should be added to the auditor's report.

15.7.2 Disclosures under the 'Disclosure Rules and Transparency Rules'

European Directive 2006/46 requires that publicly traded companies include a Corporate Governance Statement in the annual report. In the UK this has been implemented through:

- s. 7.2 of the *Disclosure Rules and Transparency Rules* (DTR) of the FCA;
- s. 496 of the *Companies Act 2006*; and
- the *Companies Act 2006 (Accounts, Reports and Audit) Regulations 2009* (SI 2009/1581) ('the Regulations').

The FSA requirements are effective for financial years beginning on or after 29 June 2008 and include a new requirement for disclosure to include a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process. Details of all the requirements relating to the Corporate Governance Statement are set out in **Table 6** below.

The *Companies Act 2006* amendments are effective for financial years beginning on or after 29 June 2008 which had not ended by 27 June 2009.

TABLE 6: Disclosure Rules and Transparency Rules requirements relating to the Corporate Governance Statement

DTR 7.2.2R and 7.2.3R

Requirements relating to the Corporate Governance Code to which the issuer is subject which are satisfied by compliance with LR 9.8.6R (3) (the 'comply or explain' rule, see 15.5 above).

DTR 7.2.5R

New requirement requiring a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process, see below.

DTR 7.2.6R

Takeover Directive disclosures regarding share capital which were first introduced in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and effective for financial years beginning on or after 20 May 2006.

DTR 7.2.7R

Description of the composition and operation of the issuer's administrative, management and supervisory bodies and their committees, which is also covered by adherence to provisions A.1.1, A.1.2, A.4.6, B.2.1 and C.3.3 of the UK Corporate Governance Code.

The disclosure requirements set out in the DTR may be fulfilled by including the Corporate Governance Statement:

- as a separate section of the directors' report; or
- in a separate report, which is either:
 - published together with the annual report; or
 - available on the company's website with its location cross-referenced in the director's report.

Wherever the disclosure is made, auditors are responsible for forming an opinion on whether the information in the Statement is consistent with the financial statements.

Where the disclosure is made in the directors' report auditors are not required to make specific reference to it in their report.

If the disclosure is made in a separate report, auditors are required to consider whether the information required by DTR Rules 7.2.5 and 7.2.6 is consistent with the financial statements and report in the opinion section of their report (see **Table 7**).

When there is no Corporate Governance Statement in the directors' report s. 498A of the CA 2006 requires auditors to ascertain whether or not such a statement has been prepared. If no statement has been prepared, this must be stated in the auditor's report.

If the Corporate Governance Statement is included in a document containing audited financial statements, the requirements of Section A of ISA (UK and Ireland) 720 apply.

15 December 2004, the guidance within them remains relevant under the new regime. Where the guidance refers to the old SASs, this commentary also includes references to the relevant ISA (UK and Ireland).

26.3 Respective Responsibilities

The Practice Note makes clear that it is the directors' responsibility to develop procedures to enable the entity to comply with FRS 17 requirements. As directors may not have immediate access to the records of scheme assets, and are unlikely to possess the expertise to value the scheme liabilities, they may need to involve others in the process:

- the scheme trustees to value the scheme assets; and
- a qualified actuary to value the scheme liabilities.

Auditors' objectives are to consider the appropriateness of the steps taken by directors to satisfy themselves that the amounts and disclosures made in the financial statements are sufficiently reliable. Auditors are especially concerned whether directors have devoted sufficient resources to this process.

The Practice Note emphasises that it is not the auditors' role to 'second guess' actuaries' work in valuing scheme liabilities. Auditors should, however, assess whether the procedures taken by directors are appropriate and whether the FRS 17 accounting entries and disclosures are consistent with their knowledge of the reporting entity. See **Chapter 38** for further guidance on relying on the work of actuaries.

The Practice Note stresses the need for auditors to satisfy themselves that they are independent and objective when the audit firm provides other services to a client. This is especially important when such services directly affect the client's financial statements. Where an audit firm provides actuarial services to a client for FRS 17 purposes, this could constitute a threat to auditors' objectivity and independence. Where the audit firm concludes that it cannot adopt safeguards to address this problem, the firm would be unable to accept both engagements.

26.4 Planning

When planning, auditors should assess the process by which directors intend to comply with FRS 17 in preparing their financial statements. Auditors' discussions with directors are likely to cover:

- who is responsible for the process;
- the arrangements to identify the schemes where FRS 17 is significant;
- who is valuing the scheme assets;

- the arrangements to identify significant matters affecting the actuarial valuation;
- who is valuing the scheme liabilities;
- how the actuarial assumptions are to be developed and approved;
- whether there is a realistic coordinated timetable (allowing time for auditors to complete their work on retirement benefits); and
- whether procedures exist to enable effective communication between all parties.

The Technical Release highlights the potential problem where auditors discover at the planning stage that directors have taken no steps to comply with FRS 17 requirements. In these circumstances auditors should consider whether the necessary information can be obtained at short notice (for example, by employing actuaries other than those of the pension scheme).

26.4.1 Risks of material misstatement

Auditors and directors should also discuss the risk of material misstatement in the financial statements arising from FRS 17 requirements.

TABLE 1: Examples of risks of material misstatement in relation to FRS 17

The risks below may not necessarily exist in every case, nor is this table intended to be an exhaustive list of all possible risks.

General

- directors may not have allocated sufficient resources to the FRS 17 compliance process.

Completeness of retirement benefit arrangements

- directors may not be aware of all schemes (for example, information about overseas schemes may not be well documented).

Subsidiaries

- directors of subsidiary entities may not fully understand the FRS 17 requirements.

Scheme changes

- scheme actuaries may not have been advised of important changes to schemes (for example, changes in benefit structures).

Consistency

- the treatment of scheme assets and liabilities related to bulk transfers may be inconsistent (leading to cut-off errors).

Actuarial assumptions

- key assumptions may be inconsistent (for example, the discount rate and the expected return on assets) or may be inappropriate (for example, benefit improvements).

Timetable

- the timetable for valuing scheme assets and liabilities may not be compatible with the entity's reporting timetable.

Surpluses

- directors may not have considered the recoverability of a surplus or may argue that it will be used for future benefit improvements (and therefore should not be accounted for in full).

Deficits

- the entity may be in breach of loan covenants when the deficit is taken into account and this may bring the entity's going concern into question.

Distributable profits

- the impact of any deficits in the group on distributable profits may not have been considered.

Actuarial updates

- changes since the most recent full actuarial valuation may give rise to imprecise liability calculations.

Source data

- actuaries may use incomplete or inaccurate source data (for example, in respect of membership records).

Asset values

- a timely, appropriate report on scheme assets may not be provided by trustees (for example, investments may be incomplete).

Multi-employer schemes

- it may be possible to allocate assets and liabilities to an individual reporting entity within the scheme and this may not have been identified.

Measurement and disclosure

- there may be a misallocation between the profit and loss account and the STRGL.

Deferred taxation

- directors may have failed to consider the allocation of deferred tax between the profit and loss account and the STRGL.

26.4.2 Communication

Effective communication between all the parties involved in FRS 17 compliance is essential to ensure a common understanding of what has to be done by each party and the timetable for its completion.

With the permission of directors, auditors communicate with actuaries at the audit planning stage to:

- inform actuaries of their intention to use their work as audit evidence;
- discuss the scope of their work, for example:
 - steps to produce the valuation within the reporting timescale,
 - procedures to establish the validity and completeness of the source data used in the valuation,
 - the possible variation in the liability and costs estimated by actuaries,
 - the impact of any significant events on the valuation,
 - the extent to which a fuller or more recent valuation may be required;
- ascertain the form and content of any reports to be issued in respect of FRS 17;
- confirm that actuaries:
 - will follow the FRS 17 requirements and their own professional guidance,
 - will include all the retirement benefits payable under schemes they have been engaged to advise upon,
 - understand the timetable for the preparation and audit of the financial statements,
 - will advise auditors of any matters occurring between the reporting entity's balance sheet date and the completion date of the valuation which would have a material effect on the valuation of scheme liabilities,
 - are content for directors to supply auditors with copies of the actuaries' draft or final FRS 17 reports.

Although actuaries are not professionally obliged to agree an engagement letter with directors, any terms of reference for their work may assist auditors in understanding the scope of their work.

For most FRS 17 purposes, actuaries can often update the most recent scheme valuation to reflect current conditions. Where significant changes have taken place, however, they may lead to material changes in the value of liabilities

(for example, the impact of large bulk transfers or major new early retirement programmes). In such cases, auditors have to discuss the issues with directors and actuaries to determine whether actuaries need to carry out any additional work.

The entity auditors may also contact scheme auditors, fund managers or investment custodians who may be valuing the scheme assets.

Where the reporting entity prepares consolidated financial statements, there may be a large number of schemes. This may therefore involve a number of different trustees and actuaries with whom auditors may have to communicate. In practice, some responsibility passes to the subsidiary auditors, although it is important to establish that they are familiar with FRS 17 requirements (especially in the case of overseas subsidiaries). The reporting entity may appoint a lead actuary to communicate with the actuaries of the various schemes and collate FRS 17 information.

The Technical Release identifies a number of steps which auditors may take in respect of overseas schemes.

TABLE 2: Steps in respect of overseas schemes

- consider how, if at all, the principles of FRS 17 apply to the overseas schemes (for example, pension schemes being state run);
- review the year end reporting timetable;
- determine whether overseas accounts staff are familiar with FRS 17 requirements;
- enquire if it is possible to communicate with overseas actuaries; and
- assess whether there are material schemes within overseas joint ventures or associates.

26.4.3 Materiality

ISA (UK and Ireland) 320 *Materiality in planning and performing an audit* accepts that there may be different materiality considerations depending on the aspect of the financial statements being considered. Auditors may judge, for example, that the expected degree of accuracy for note disclosures is lower than for the figures included in the primary financial statements. The level at which an omission or misstatement is material would therefore be higher.

This may be the case in the transitional period to full FRS 17 compliance. In the first two years, auditors' judgments of materiality relating to note disclosures may be based primarily on the relative significance of amounts in the context of the reporting entity's balance sheet. Auditors should recognise, however, that note disclosures in the first two years will be the basis for the comparative figures in the financial statements in the third year.

26.5 Audit Evidence

26.5.1 Understanding the schemes involved

Given the potential material impact which FRS 17 could have on an entity's financial statements, it is important for auditors to understand which schemes are involved and the general nature of their provisions.

Auditors should therefore obtain from directors an understanding of the scheme rules which could have a significant influence on the entity's FRS 17 compliance (for example, the details of obligations to pay retirement benefits).

There could, however, be other benefits payable not covered in the scheme rules, for example:

- legal obligations to pay retirement benefits arising from informal agreements rather than formal contracts; and
- statutory requirements overriding the original scheme provisions.

Auditors should also take care to ensure that they receive the most up-to-date copy of the scheme rules.

Auditors may perform other procedures during their work which may help identify obligations to pay retirement benefits (for example, the review of board minutes or communications with employees).

26.5.2 Scheme assets

Scheme assets normally comprise one or more of the following:

- quoted securities;
- unquoted securities;
- unitised securities;
- insurance policies;
- loans and debt instruments; and
- freehold and leasehold properties.

Auditors may be able to obtain satisfactory evidence in respect of scheme assets without carrying out procedures on scheme asset records. Where there is a short period between the most recent scheme year end and the reporting entity's year end, and audited scheme financial statements are available, auditors may be able to obtain sufficient audit evidence by:

- asking directors to reconcile the scheme assets valuation at the scheme year end date with the assets valuation at the reporting entity's date being used for FRS 17 purposes;
- obtaining direct confirmation of the scheme assets from the investment custodian; and