

**The Auditing Practices Board**

# **Practice Note 27**

*Consultation Draft*

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**The audit of credit unions in the United Kingdom**

June 2008

## INVITATION TO COMMENT

This consultation draft is issued by the Auditing Practices Board (APB) for public comment.

The Board develops guidance in Practice Notes to assist auditors apply ISAs (UK and Ireland) and to indicate best practice in other areas; Practice Notes reflect existing auditing standards and regulatory requirements. They do not introduce new or additional standards or otherwise increase the regulatory burden on auditors.

Whilst the Board has not undertaken a formal regulatory impact assessment, the Board does not believe that the application of the guidance in this consultation draft will significantly increase audit costs but invites the views of commentators on this point. If commentators do believe there is a cost impact it would be appreciated if the specific aspect of the guidance could be identified and, as far as possible, the nature and quantum of the additional costs described. The Board will evaluate any comments on incremental costs before finalising the Practice Note.

You are invited to send written comments on any aspect of this consultation draft to the APB. The Board would like to receive comments from those who agree with the consultation draft as well as from those who do not. Your comments will be most helpful if they refer to the relevant paragraphs and are supported by reasoning.

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and should be despatched so as to be received no later than **25 September 2008**.  
All letters of comment will be regarded as being on the public record unless confidentiality is requested.

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditor's and reporting accountant's integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are not eligible for appointment as company auditors, as well as those who are so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

Neither the APB nor the FRC accepts any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

The purpose of Practice Notes issued by the APB is to assist auditors in applying auditing standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for auditing standards.

# PRACTICE NOTE 27

## The Audit of Credit Unions in the United Kingdom

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## **Preface**

This Practice Note contains guidance on the application of auditing standards issued by the Auditing Practices Board (APB) to the audit of credit unions in the United Kingdom (UK). In addition, it contains guidance intended to assist the auditors of credit unions in reporting on matters specified by the regulators, and guidance is also given on the auditors' right and duty to report to the regulators. For credit unions in Great Britain the regulator is the Financial Services Authority (FSA) and in Northern Ireland it is the Department of Enterprise, Trade and Investment (DETI).

The Practice Note is supplementary to, and should be read in conjunction with, International Standards on Auditing (ISAs) (UK and Ireland), which apply to all audits undertaken in the UK. This Practice Note sets out the special considerations relating to the audit of credit unions which arise from individual ISAs (UK and Ireland) listed in the contents. It is not the intention of the Practice Note to provide step-by-step guidance on the audit of credit unions, so where no special considerations arise from a particular ISA (UK and Ireland), no material is included.

This Practice Note has been prepared with advice and assistance from staff of the FSA (in so far as the obligations of credit unions and their auditors under the FSA Handbook are concerned) and with advice and assistance also from staff of DETI. It is based on the legislation and regulations which are in effect at 31 May 2008. The Practice Note does not constitute general guidance given by the FSA or Industry Guidance. It is not an exhaustive list of all the obligations that credit unions and their auditors may have under legislation and the FSA Handbook.

# Introduction

- 1 Credit unions are mutual savings and loan organisations which are not-for-profit and which operate solely for the benefit of their members. Any surpluses which are not distributed to members by way of dividend, or otherwise, are retained within the organisation for its future expansion. The members save by investing in the credit union's shares. Like any other similar financial organisation, the savings and deposits which the credit union take in, provide a fund from which loans are granted to members.
- 2 This Practice Note addresses the responsibilities and obligations of the auditor concerning:
  - the audit of financial statements in accordance with the requirements of legislation; and
  - the statutory duty to report directly to the regulators in certain circumstances.
- 3 Registered auditors are required to comply with ISAs (UK and Ireland) when conducting audits. This principle applies in the context of credit unions in the same way as to entities in any sector, but the way in which ISAs (UK and Ireland) are applied needs to be adapted to suit the particular characteristics of the entity audited.
- 4 Credit unions have as their basic aims:
  - the promotion of thrift among their members through the accumulation of savings;
  - the creation of sources of credit for the benefit of their members at fair and reasonable rate of interest;
  - the use and control of members' savings for their mutual benefit; and
  - the training and education of their members in the wise use of money and in the management of their financial affairs.
- 5 Members must be from the same locality, or be employed in the same industry or with the same employer or have some other "common bond". Each member must hold at least one fully paid up share in the credit union and must qualify under the common bond set out in the credit union's rules.
- 6 The "Common Bond" between members of the credit union must be one of the following: Members must:

- follow a particular occupation; or
- reside in a particular locality; or
- be employed in a particular locality; or
- reside or be employed in a particular locality; or
- be employed by a particular employer; or
- be a member of a bona fide organisation or society which has been formed for purposes of other than that of registration as a credit union; or
- have any other common bond approved by the regulators.

## **The Management and Operation of Credit Unions**

### **The responsibility of directors**

7 The primary responsibility for the conduct of the business of a credit union is vested in the board of directors, who have responsibility for the general control, direction, management of the affairs, funds and records of the credit union, and the management appointed by it. This responsibility includes:

- establishing adequate procedures and systems to ensure compliance with the law applicable to credit unions and guidance issued by the regulators;
- the preparation of financial statements that give a true and fair view of the credit union's affairs for the year and compliance with other aspects of credit union law; and
- providing information to the regulators.

### **The role of the supervisory committee**

8 Credit unions usually establish a committee, known either as a supervisory or audit committee, which normally consists of elected members who are all volunteers. This committee which is one of the most important from the internal governance perspective oversees the performance by the directors of their functions, and the observance of the credit union's own rules.

9 In both Great Britain and Northern Ireland there are a number of trade associations for credit unions. These issue rules and guidance for the benefit of their members, and credit unions normally take account of these when establishing their own rules. In Northern Ireland, the principal trade

associations have a role in the oversight of credit unions, and a brief summary of such activities is set out in Appendix 7 of this Practice Note.

### **Financial Statements**

- 10 FIPSA<sup>1</sup> and the NI Order<sup>2</sup> require the annual accounts of a credit union to give a true and fair view of its income and expenditure for the year, and of its state of affairs at the end of the year. The requirement for the accounts of credit unions to give a true and fair view is usually regarded as also requiring compliance with the requirements of the relevant accounting standards of the Accounting Standards Board (ASB) – in particular Statements of Standard Accounting Practice (SSAPs), Financial Reporting Standards (FRSs) and UITF Abstracts.
- 11 One FRS of particular relevance to credit unions is FRS 18 concerning estimation techniques. This FRS requires the selection of estimation techniques that enable the accounts to give a true and fair view, and that are judged to be the most appropriate in the particular circumstances for the purpose of a true and fair view (FRS 18, paragraph 51). An example of an estimation technique given in FRS 18 is the method of estimating the proportion of debts that will not be recovered (FRS 18, paragraph 4).
- 12 FRS 18 also requires disclosure of:
- each material accounting policy;
  - a description of its significant estimation techniques; and
  - the effects of changes in accounting policies or material effects of changes in estimation techniques (FRS 18, paragraph 55).

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<sup>1</sup> Section 3.

<sup>2</sup> Article 42.

## Legislative and regulatory framework

- 13 The legislative and regulatory framework within which credit unions operate in the UK is summarised in the following paragraphs.

### Great Britain

#### Relevant Legislation

- 14 Credit unions are registered under relevant sections of the Industrial and Provident Societies Acts 1965-2002 (IPSA 65/02)<sup>3</sup>, and comply with supplementary requirements set out in the Credit Unions Act 1979 (CU 79).
- 15 In Great Britain the principal legislation relevant to auditors of credit unions is the Friendly and Industrial and Provident Societies Act 1968 (FIPSA), and the Financial Services and Markets Act 2000 (FSMA 2000).

### FIPSA

- 16 Credit unions are bound by the provisions of FIPSA which require them to produce audited annual accounts which will be put on the public file. An explanation of the requirements of FIPSA is set out in the FSA's Credit Unions Sourcebook (CRED) Chapter 14 annex 1, a part of the FSA Handbook. Auditors are bound by the duties imposed by Section 9(4) of FIPSA. This requires them, in preparing their audit report to members, to carry out such investigations as will enable them to form an opinion on:
- (a) whether the credit union has kept proper books of account in accordance with the requirements of section 1(1)(a) of FIPSA;
  - (b) whether the credit union has maintained a satisfactory system of control over its transactions in accordance with the requirements of section 1(1)(b) of FIPSA; and
  - (c) whether the revenue account or the other accounts (if any) to which the report relates and the balance sheet are in agreement with the books of account of the credit union.

If the auditors are of the opinion that the credit union has failed to comply with any of the requirements of (a) to (c) above then they must state that fact in their report.

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<sup>3</sup> For more details see Appendix 2 of this Practice Note.

## FSMA 2000

- 17 FSMA 2000 sets out the high level regulatory framework for the financial sector more generally and not just credit unions. Appendix 2 sets out the main parts of FSMA 2000 relevant to authorised firms<sup>4</sup>.
- 18 The wide scope of FSMA 2000 reflects the FSA's extensive responsibilities. These are set out in FSMA 2000 as regulatory objectives covering:
- market confidence;
  - public awareness;
  - the protection of consumers; and
  - the reduction of financial crime
- 19 FSMA 2000 covers not only the regulation and supervision of financial sector entities but also other issues such as official listing rules, business transfers, market abuse, compensation and ombudsman schemes, investment exchanges and clearing houses.
- 20 FSMA 2000 is also supported by a large number of statutory instruments. Significant components of the definition and scope of the regulatory framework are contained in the main statutory instruments. A list of important provisions of FSMA 2000 and a list of statutory instruments relevant to the auditor is included in Appendix 3.
- 21 Under Part X FSMA 2000 the FSA has the power to make 'rules'. The legal effect of a rule varies depending on the power under which it is made and on the language used in the rule. Rules are mandatory unless a waiver has been agreed with the FSA. If an authorised firm contravenes a rule it may be subject to enforcement action and consequent disciplinary measures under Part XIV FSMA 2000. Furthermore, in certain circumstances an authorised firm may be subject to an action for damages under s150 FSMA 2000. In contrast, guidance is generally issued to throw light on a particular aspect of regulatory requirements, and is not binding. However if an authorised firm acts in accordance with it in the circumstances contemplated by that guidance, the FSA will proceed on the basis that the authorised firm has complied with the rule to which the guidance relates.

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<sup>4</sup> An entity which has been granted one of more Part IV permissions by the FSA and so is authorised under FSMA 2000 to undertake regulated activities.

- 22 Rules made by the FSA and associated guidance are set out in the FSA Handbook of Rules and Guidance ('the FSA Handbook') (guidance on this, and in particular on the FSA's Principles for Businesses and Threshold Conditions, is set out in Appendix 4 of this Practice Note). A summary of the high level requirements is set out in the 'Reader's Guide'. While the FSA's Handbook applies mainly to authorised firms, part of it also sets out Rules which impose duties on auditors. These can be found in the Supervision Manual and are referred to in CRED.
- 23 It is clearly unrealistic to expect all members of an audit engagement team to have detailed knowledge of the entire Handbook; rather ISA (UK and Ireland) 250 Section B requires the level of knowledge to be commensurate with an individual's role and responsibilities in the audit process. ISA (UK and Ireland) 220 requires the auditor to establish procedures to facilitate consultation and, thereby, to draw on the collective expertise and specialist technical knowledge of others within the audit firm.

### **Prudential requirements**

- 24 Credit unions are subject to certain prudential requirements which are detailed in CRED. These include the main measures set out below and additional related aspects of systems and controls not covered in the Senior management arrangements, Systems and Controls section of the FSA Handbook (SYSC). There are also certain specific prudential measures applied by the FSA which credit unions are required to report to the FSA via prudential returns. The main measures include:
- capital adequacy – ensuring sufficient capital resources in relation to risk requirements to absorb losses;
  - liquidity – ensuring sufficient liquid assets or maturing assets to meet liabilities as they fall due; and
  - large exposures – avoiding undue credit risk concentrations.

### **Annual Returns to Regulator**

- 25 The annual return (Form CY) that credit unions have to complete is a supervisory return and is not put on the public file and does not require to be audited. Instead it is required to contain a statement from the auditor as to whether the information contained in the balance sheet and revenue account of the annual return is consistent with the audited annual accounts of the credit union.

- 26 Credit unions are also required to submit unaudited quarterly returns to the FSA.

### **Reporting direct to the FSA**

- 27 Under FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587) the auditor of an authorised firm or the auditor of an entity closely linked to an authorised firm who is also the auditor of that authorised firm has a statutory duty to communicate matters of material significance to the FSA. Under s340 FSMA 2000 ‘the auditor’ is defined as one required to be appointed under FSA ‘rules’ or appointed as a result of another enactment. In addition s342 FSMA 2000 provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the FSA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.
- 28 Guidance on the identification of matters to be reported to the regulators is set out in the section of this Practice Note dealing with ISA (UK and Ireland) 250 Section B. In particular, auditors consider reporting to the FSA concerns they may have over apparent significant failures by the credit union to comply with the requirements of FIPSA set out above – for example the failure to maintain a satisfactory system of control over its transactions.

### **Communication between the FSA and the auditor**

- 29 Within the legal constraints that apply, the FSA may pass on to the auditor any information which it considers relevant to his function. An auditor is bound by the confidentiality provisions set out in Part XXIII of FSMA 2000 (Public record, disclosure of information and co-operation) in respect of confidential information the auditor receives from the FSA. The auditor may not pass on such confidential information without lawful authority, for example if an exception applies under the FSMA 2000 (Disclosure of confidential information) Regulations 2001 or with the consent of the person from whom that information was received and, if different, to whom the information relates.
- 30 Before communicating to an authorised firm any information received from the FSA, the auditor considers carefully whether:
- the auditor has received the FSA’s express permission to communicate a particular item of information;

- the information relates to any other party whose permission may need to be obtained before disclosure can be made;
- the information was received by FSA in a capacity other than discharging its functions under FSMA 2000 or from another regulator (in which case the auditor may either be prohibited from disclosure or may need permission of the party which provided the information to that regulator).

31 The auditor may however disclose to an authorised firm information they have communicated to the FSA except where to do so would have the effect of disclosing information communicated to them by the FSA.

32 Matters communicated by the FSA during any bilateral meeting may be conveyed by those representatives of the auditor who were present at the meeting (or otherwise received the communication directly) to other partners, directors and employees of the audit firm who need to know the information in connection with the auditor's performance of its duties relating to that authorised firm without FSA's express permission. However in the interests of prudence and transparency the auditor should inform the FSA that they will be discussing the issues covered with colleagues.

33 Where the FSA passes to the auditors information which it considers is relevant to their function, the auditors consider its implications in the context of their work and may need to amend their approach accordingly. However the fact that they may have been informed of such a matter by the regulator does not, of itself, require auditors to change the scope of the work, nor does it necessarily require them actively to search for evidence in support of the situation communicated by the regulator.

34 The auditor is required to cooperate with the FSA (SUP3.8.2R). This may involve attending meetings and providing the FSA with information about the authorised firm that the FSA may reasonably request in discharging its functions.

35 The auditor must notify the FSA without delay if the auditor is removed from office, resigns before the term of office expires or is not re-appointed by the authorised firm. Notification to the FSA includes communicating any matters connected with this event that the auditor considers ought to be drawn to the FSA's attention or a statement that there are no such matters (s344 FSMA 2000 and SUP3.8.11R and 12R).

## **Northern Ireland**

### **Relevant Legislation**

36 In Northern Ireland the principal legislation relevant to credit unions is the Credit Unions (Northern Ireland) Order 1985 (the NI Order).

#### The NI Order

37 Requirements relevant to auditors are set out in Articles 47 and 49 of the NI Order, relevant extracts from which are as follows:

- The auditors of a credit union shall make a report to the credit union on the accounts examined by them, and on the revenue account and the balance sheet of the credit union for the year of account in respect of which they are appointed.
- The report shall state whether the revenue account and the balance sheet for that year comply with the requirements of this Order and whether, in the opinion of the auditors –
  - (a) the revenue account gives a true and fair view in accordance with Article 42 of the income and expenditure of the credit union for that year of account, and
  - (b) the balance sheet gives a true and fair view in accordance with that Article of the state of the affairs of the credit union as at the end of that year of account.
- Without prejudice to the previous paragraph, where the report of the auditor relates to any accounts other than the revenue account for the year of account in respect of which they are appointed that report shall state whether those accounts give a true and fair view of any matter to which they relate.
- The auditors of a credit union, in preparing their report under this Article, shall carry out such investigations as will enable them to form an opinion as to the following matters, that is to say -
  - (a) whether the credit union has kept proper books of account in accordance with the requirements of Article 40(1)(a);
  - (b) whether the credit union has maintained a satisfactory system of control over its transactions in accordance with the requirements of Article 40(1)(b); and

(c) whether the revenue account, the other accounts, if any, to which the report relates, and the balance sheet are in agreement with the books of account of the credit union,

and if the auditors are of opinion that the credit union has failed to comply with Article 40(1)(a) or (b), or if the revenue account, the other accounts, if any, and the balance sheet are not in agreement with the books of account of the credit union, the auditors shall state that fact in their report.

- If the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they shall state that fact in their report.

### **Annual Returns to Regulator**

38 Every credit union shall, not later than 31 March in each year, send to the Registry of credit unions (part of DETI) a return (Form AR 25) relating to its affairs for the period ended on the previous 30 September together with –

- (a) a copy of the report of the auditor or auditors on the credit union's accounts for the period included in the return; and
- (b) a copy of each balance sheet made during that period and of any report of the auditor or auditors on that balance sheet.

Annual Returns submitted to DETI do not therefore require to be audited, but a signed copy of the auditor's report on the accounts is to be appended.

### **Reporting direct to DETI**

39 There is no statutory duty on auditors in Northern Ireland for whistleblowing to DETI. Auditors consider the guidance set out in the section on ISA (UK and Ireland) 250 B when deciding whether a report should be made to DETI in the public interest.

# The Audit of Financial Statements

*ISAs (UK and Ireland) apply to the conduct of all audits. This includes audits of financial statements of credit unions. The purpose of the following paragraphs is to identify the special considerations arising from the application of certain “bold letter” requirements (which are indicated by grey shaded boxes below) to the audit of credit unions and to suggest ways in which these can be addressed. This Practice Note does not contain commentary on all the bold letter requirements included in the ISAs (UK and Ireland) and reading it should not be seen as an alternative to reading the relevant ISAs (UK and Ireland) in their entirety. In addition, where no special considerations arise from a particular ISA (UK and Ireland) no material is included.*

## ISA (UK and Ireland) 200: Objective and General Principles Governing an Audit of Financial Statements

### Background Note

The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (paragraph 2)

In the UK and Ireland the relevant ethical pronouncements with which the auditor should comply are the APB’s Ethical Standards and the ethical pronouncements relating to the work of auditors issued by the auditor’s relevant professional body. (paragraph 4-1).

The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated (paragraph 6)

The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. The audit procedures required to conduct an audit in accordance with ISAs(UK and Ireland) should be determined by the auditor having regard to the requirements of ISAs (UK and Ireland), relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements. (paragraph 7)

40 Auditing standards include a requirement for auditors to comply with relevant ethical requirements relating to audit engagements. In the UK, the auditor should comply with the APB Ethical Standards and relevant ethical guidance relating to the work of auditors issued by the auditor’s professional body. A fundamental principle is that practitioners should not accept or perform work which they are not competent to undertake. The importance of technical

competence is also underlined in the Auditors' Code<sup>5</sup>, issued by the APB, which states that the necessary degree of professional skill demands an understanding of financial reporting and business. Practitioners should not undertake the audit of credit unions unless they are satisfied that they have, or can obtain, the necessary level of competence.

- 41 Independence issues can be complex for the auditor of a credit union. In the case of a credit union, auditors review any financial relationships that the firm or its partners and staff (and, separately, partners and staff assigned to that engagement) may have with that credit union to consider whether such relationships may affect independence.

### **ISA (UK and Ireland) 210: Terms of Audit Engagements**

#### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on:

- (a) agreeing the terms of the engagement with the client; and
- (b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

The auditor and the client should agree on the terms of the engagement (paragraph 2).

The terms of the engagement should be recorded in writing (paragraph 2-1)

In the UK and Ireland, the auditor should ensure that the engagement letter documents and confirms the auditor's acceptance of the appointment, and includes a summary of the responsibilities of those charged with governance and of the auditor, the scope of the engagement and the form of any reports. (paragraph 5-1)

- 42 The same basic principles used in drafting engagement letters apply in relation to the audit of credit unions as to the audit of any entity. Practical considerations arising from the particular characteristics of credit unions are considered below.

- 43 Matters which the auditor may decide to refer to in the engagement letter are as follows:

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<sup>5</sup>This is appended to the APB's Scope and Authority of Pronouncements.

- the responsibility of the directors/senior management to comply with applicable legislation (principally IPSA 65/02, CU 79 and FSMA 2000) and FSA Handbook rules and guidance, or relevant NI legislation, including the need to keep the regulators informed about the affairs of the entity;
- the statutory right and duty of the auditor to report direct to the FSA, or the right to report to DETI, in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B);
- the auditor's responsibility in respect of other information published with the financial statements in the annual report – see the section of this Practice Note on ISA (UK and Ireland) 720 (Revised);
- in Great Britain, the requirement to cooperate with the auditor (SUP3.6.1R). This includes taking steps to ensure that, where applicable, each of its appointed representatives and material outsourcers gives the auditor the same right of access to records, information and explanations as the authorised firm itself is required to provide the auditor (s341 FSMA 2000 and SUP 3.6.2G to 3.6.8G). It is a criminal offence for a credit union or its officers to provide false or misleading information to the auditor (s346 FSMA 2000);
- the need for the credit union to make the auditor aware when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt (see also paragraph 79 below).

44 The directors and supervisory committee are volunteers and are unlikely to be experts in financial and accounting matters. It may be appropriate for the engagement letter to specify the role and responsibilities of the directors regarding accounts preparation, selection of accounting policies and the role of the auditor.

## **ISA (UK and Ireland) 220: Quality Control for Audits of Historical Financial Information (revised)**

### **Background Note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on specific responsibilities of firm personnel regarding quality control procedures for audits of historical financial information, including audits of financial statements.

Reference should also be made to ISQC (UK and Ireland) 1 – Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and other Assurance and Related Services Engagements.

The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued. (paragraph 19)

- 45 The nature of financial services business is one of rapidly changing and evolving markets. Often credit unions and other financial services entities develop new products and practices which require specialised auditing and accounting responses. It is therefore important that the auditor is familiar with current practice.
- 46 As well as ensuring that the engagement team has an appropriate level of knowledge of the industry and its corresponding products, the engagement partner also satisfies himself that the members of the engagement team have sufficient knowledge of the regulatory framework within which credit unions operate commensurate with their roles on the engagement.
- 47 Given the public interest nature of a credit union, firms may establish policies to require an independent review in relation to credit union audits to be undertaken by a partner with sufficient experience and authority to fulfil that role. In the case of sole practitioners and small firms a suitably qualified external consultant may perform the role of independent partner and carry out the independent review. In such circumstances, appropriate arrangements are made to safeguard client confidentiality.

## **ISA (UK and Ireland) 240 (Revised): The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements**

### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements<sup>6</sup> and expand on how the standards and guidance in ISA (UK and Ireland) 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" and ISA (UK and Ireland) 330, "The Auditor's Procedures in Response to Assessed Risks" are to be applied in relation to the risks of material misstatement due to fraud.

The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance. (paragraph 24)

The auditor should make inquiries of management, internal audit and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (paragraph 38)

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present. (paragraph 48)

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained indicates risks of material misstatement due to fraud.(paragraph 55)

The auditor should consider whether analytical procedures that are performed at or near the end of the audit when forming an overall conclusion as to whether the financial statement as a whole are consistent with the auditor's knowledge of the business indicate a previously unrecognised risk of material misstatement due to fraud (paragraph 85)

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management (paragraph 93)

The auditor should document communications about fraud made to management, those charged with governance, regulators and others. (paragraph 109)

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<sup>6</sup> The auditor’s responsibility to consider laws and regulations in an audit of financial statements is established in ISA (UK and Ireland) 250 “Consideration of Laws and Regulations”

- 48 As outlined in paragraphs 13 to 16 of ISA (UK and Ireland) 240, it is the responsibility of those charged with governance of the entity and management, to take such steps as are reasonably open to them to prevent and detect fraud. It is the auditors' responsibility to plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud.
- 49 Credit unions have custody of valuable and fungible assets including money. As a result fraud is an inherent risk of undertaking credit union business. Frauds relating to most types of transactions can be facilitated by identity theft and so 'know your customer' procedures are an important component of the procedures taken by credit unions to mitigate the risk of fraud.
- 50 Every credit union is required by FIPSA<sup>7</sup> or the NI Order<sup>8</sup> to establish and maintain a system of control of its business and records. This would include the appropriate control procedure to minimise the risk of losses to the credit union from irregularities or fraud. The FSA's Principle 3 also requires a firm to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. SYSC requires a firm to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system. Whilst the inherent risk of fraud may continue to exist, the establishment of accounting and internal control systems sufficient to meet these requirements frequently reduces the likelihood of fraud giving rise to material misstatements in the financial statements. Guidance on the auditors' consideration of accounting systems and internal controls is provided in ISA (UK and Ireland) 315. Examples of weaknesses in control that could give rise to fraud risk factors are also set out in that section.
- 51 Examples of conditions or events particularly relevant to credit unions which may increase the risk of fraud include:
- the non-participation in the running of the credit union on the part of some of the director or officers leading to a small number of their colleagues dominating the credit union's management;
  - excessive influence of one or a few officers or employees;
  - inadequate segregation of duties between credit union staff;
  - failure to document or follow the credit union's standard operating procedures;

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<sup>7</sup> Section 1.1(b).

<sup>8</sup> Article 40.1(b).

- failure by the members of the supervisory committee to monitor the credit union's affairs on an ongoing basis during the year;
- loans granted in circumstances which do not appear to comply with the stated procedures of the credit union;
- failure to regularly reconcile funds received through payroll deductions particularly where the credit union's membership has an employment common bond;
- failure to prepare on a timely basis bank reconciliations and other control accounts in order to present periodic management accounts to the board of directors;
- funds disbursed, even if with board approval, in circumstances which do not appear to fall within the authorised activities of the credit union; or
- issuance of loans to, or failure to make appropriate bad debts provision in respect of members already failing to meet the repayment schedule of existing loans.

52 The auditor considers reports or information obtained from the credit union's money laundering reporting officer together with any reviews undertaken by third parties.

53 Reduction of financial crime is one of the FSA's statutory objectives. The FSA's rules require authorised firms to report 'significant' fraud to the FSA (SUP15.3.17R). The auditor of a credit union in Great Britain is aware of the auditor's duty to report direct to FSA in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B).

## **ISA (UK and Ireland) 250: Section A - Consideration of Law and Regulations in an Audit of Financial Statements**

### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in the audit of financial statements.

When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non-compliance by the entity with laws and regulations may materially affect the financial statements.(paragraph 2)

In accordance with ISA (UK and Ireland) 200, “Objective and General Principles Governing an Audit of Financial Statements the auditor should plan and perform the audit with an attitude of professional scepticism recognising that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. (paragraph 13)

In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework. (paragraph 15)

- 54 The directors of a credit union are responsible for ensuring that the necessary controls are in place to ensure compliance with applicable law and regulations, and to detect and correct any breaches that have occurred, even if they have delegated some of their executive functions to staff or professional advisors.
- 55 FSMA 2000 and related statutory instruments and, and in Northern Ireland the NI Order, contain sections that will normally be central to the ability of credit unions to conduct business. Detailed rules and guidance applicable to credit unions in Great Britain is set out in the FSA Handbook. In addition to accepting deposits, a credit union in Great Britain may also have one or more Part IV permissions from the FSA to undertake one or more types of other regulated activity. If this is the case, the auditor also considers the laws and regulations (which includes FSMA 2000 and the FSA Handbook) central to the credit union’s ability to conduct these additional regulated activities.
- 56 The auditor is alert to any indication that a credit union is conducting business outside its objects or the scope of its permission or is failing to meet Threshold Conditions<sup>9</sup>. Such action may be a serious regulatory breach, which may result in fines, public censure, suspension or loss of authorisation. The auditor compares the current activities of the credit union with the permission granted by the regulators and considers as necessary the requirements of ISA (UK and Ireland) 250 Section A and where appropriate ISA (UK and Ireland) 250 Section B.

After obtaining the general understanding, auditor should perform further audit procedures to help identify possible or actual instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements, specifically:

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<sup>9</sup> The minimum standards that a credit union in Great Britain needs to meet to become and remain authorised by the FSA – see Appendix 4.

- (a) Inquiring of management as to whether the entity is in compliance with such laws and regulations;
- (b) Inspecting correspondence with the relevant licensing or regulatory authorities;
- (c) Enquiring of those charged with governance as to whether they are on notice of any such possible instances of non-compliance with laws or regulations. (paragraph 18)

In the UK and Ireland, the auditor's procedures should be designed to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence to its financial statements. (paragraph 18-1)

57 Specific areas that auditors' procedures may address include the following:

- the adequacy of procedures to inform staff of the requirements of relevant legislation and the requirements of the regulator;
- the adequacy of procedures for authorisation of transactions;
- review of procedures for internal review of the entity's compliance with regulatory or other requirements;
- review of procedures to ensure that possible breaches of requirements are investigated by an appropriate person and are brought to the attention of senior management; and
- review of any compliance reports prepared for the directors or supervisory committee.

### **Money laundering**

In the UK and Ireland, when carrying out procedures for the purpose of forming an opinion on the financial statements, the auditor should be alert for those instances of possible or actual non compliance with laws and regulations that might incur obligations for partners and staff in audit firms to report money laundering offences. (paragraph 22-1)

58 Authorised firms including credit unions are subject to the requirements of the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002 as well, in Great Britain, to FSA rules. These laws and regulations require institutions to establish and maintain procedures to identify their customers, establish appropriate reporting and investigation procedures for suspicious transactions and maintain appropriate records.

- 59 Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which credit unions conduct their business. By the nature of their business, credit unions are ready targets of those engaged in money laundering activities. The effect of this legislation is to make it an offence to provide assistance to those involved in money laundering and makes it an offence not to report suspicions of money laundering to the appropriate authorities, usually the Serious Organised Crime Agency ('SOCA')<sup>10</sup>. FSA requirements for credit unions in Great Britain are set out in SYSC3.2.6AR.– 6.3.5G. In this context, FSA has due regard to compliance with the relevant provisions of guidance issued by the Joint Money Laundering Steering Group ('JMLSG')(SYSC3.2.6EG).
- 60 In addition to considering whether a credit union has complied with the money laundering laws and regulations, the auditor has reporting obligations under the Proceeds of Crime Act, 2002 and the Money Laundering Regulations, 2007 to report knowledge or suspicion of money laundering offences, including those arising from fraud and theft, to SOCA. The auditor is aware of the prohibition on 'tipping off' when discussing money laundering matters with the credit union. Further guidance for auditors is provided in Practice Note 12 Money Laundering - Interim Guidance for Auditors in the United Kingdom (Revised).

### **ISA (UK and Ireland) 250: Section B – The Auditors' Right and Duty to Report to Regulators in the Financial Sector**

The auditor of a regulated entity should bring information of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor's audit responsibilities to the attention of the appropriate regulator without delay when:

- (a) The auditor concludes that it is relevant to the regulator's functions having regard to such matters as may be specified in statute or any related regulations; and
- (b) In the auditor's opinion there is reasonable cause to believe it is or may be of material significance to the regulator. (paragraph 2)

Where an apparent breach of statutory or regulatory requirements comes to the auditor's attention, the auditor should:

- (a) Obtain such evidence as is available to assess its implications for the auditor's reporting responsibilities;

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<sup>10</sup> Previously National Criminal Intelligence Service ('NCIS').

(b) Determine whether, in the auditor's opinion, there is reasonable cause to believe that the breach is of material significance to the regulator; and

(c) Consider whether the apparent breach is criminal conduct that gives rise to criminal property and, as such, should be reported to the specified authorities. (paragraph 39)

61 This section sets out the reporting requirements for auditors of credit unions in Great Britain. The guidance is however likely to be useful for auditors of credit unions in Northern Ireland when deciding whether to make a report to the regulator in the public interest. Auditors may need to take legal advice before making a decision on whether a matter should be reported in the public interest.

### **Auditor's duty to report to the FSA**

62 Under FSMA 2000 (Communication by Auditors) Regulations 2001 ('the 2001 Regulations'), the auditor has duties in certain circumstances to make reports to the FSA. The 2001 Regulations do not require the auditor to perform any additional audit work as a result of the statutory duty nor is the auditor required specifically to seek out breaches of the requirements applicable to a particular authorised firm. Information and opinions to be communicated are those meeting the criteria set out below which relate to matters of which the auditor<sup>11</sup> of the authorised firm (also referred to below as a 'regulated entity') has become aware:

(i) in his capacity as auditor of the authorised firm, and

(ii) if he is also the auditor of an entity who has close links with the authorised firm, in his capacity as auditor of that authorised firm.

63 The criteria for determining the matters to be reported are as follows:

(i) the auditor reasonably believes that there is, or has been, or may be, or may have been a contravention of any 'relevant requirement' that applies to the authorised firm concerned and that contravention may be of material significance to the FSA in determining whether to exercise, in relation to that authorised firm, any of its functions under FSMA 2000, or

(ii) the auditor reasonably believes that the information on, or his opinion on, those matters may be of material significance to the FSA in determining whether the authorised firm concerned satisfies and will continue to satisfy the Threshold Conditions, or

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<sup>11</sup> An 'auditor' is defined for this purpose in the Regulations as a person who is, or has been, an auditor of an authorised firm appointed under, or as a result of, a statutory provision including Section 340 of FSMA.

(iii) the auditor reasonably believes that the authorised firm concerned is not, may not be, or may cease to be, a going concern, or

(iv) the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with FIPSA or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation<sup>12</sup>.

64 In relation to paragraph 63 (i) above, 'relevant requirement' is a requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FSA's rules (other than the Listing rules) including the Principles for Businesses. The duty to report also covers any requirement imposed by or under any other Act<sup>13</sup> the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000.

65 In relation to paragraph 63 (ii) above the duty to report relates to either information or opinions held by the auditor which may be of significance to the FSA in determining whether the regulated entity satisfies and will continue to satisfy the Threshold Conditions. The duty to report opinions, as well as information, allows for circumstances where adequate information on a matter may not readily be forthcoming from the regulated entity, and where judgments need to be made.

### **Material significance**

66 Determining whether a contravention of a relevant requirement or a Threshold Condition is reportable under the 2001 Regulations involves consideration both of whether the auditor 'reasonably believes' and that the matter in question 'is, or is likely to be, of material significance' to the regulator.

67 The 2001 Regulations do not require the auditor to perform any additional audit work as a result of the statutory duty nor is the auditor required specifically to seek out breaches of the requirements applicable to a particular regulated entity. However, in circumstances where the auditor identifies that a reportable matter may exist, the auditor carries out such extra work, as he considers necessary, to determine whether the facts and circumstances cause them 'reasonably to believe' that the matter does in fact exist. It should be noted that the auditors' work does not need to prove that the reportable matter exists.

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<sup>12</sup> Relevant rules and legislation comprise rules made by the FSA under Section 340 of FSMA 2000.

<sup>13</sup> Examples include The Proceeds of Crime Act 2002 and CU 79.

- 68 ISA (UK and Ireland) 250 Section B requires that, where an apparent breach of statutory or regulatory requirements comes to the auditors' attention, they should obtain such evidence as is available to assess its implications for their reporting responsibilities and determine whether, in their opinion, there is reasonable cause to believe that the breach has occurred and that it relates to a matter that is of material significance to the regulator.
- 69 'Material significance' is defined by ISA (UK and Ireland) 250 Section B as follows:  
*"A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."*
- 70 'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of an entity, it may be of a nature or type that is likely to change the perception of the regulator. For example, a failure to reconcile bank accounts may not be significant in financial terms but would have a significant effect on the FSA's consideration of whether the regulated entity was satisfactorily controlled and was behaving properly towards its members.
- 71 The determination of whether a matter is, or is likely to be, of material significance to the FSA inevitably requires the auditor to exercise their judgment. In forming such judgments, the auditor needs to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered.
- 72 The auditor of a regulated entity bases his judgment of 'material significance' to the FSA solely on their understanding of the facts of which they are aware without making any assumptions about the information available to the FSA in connection with any particular regulated entity.
- 73 Minor breaches of the FSA's rules that, for example, are unlikely to jeopardise the entity's assets or amount to misconduct or mismanagement would not normally be of 'material significance'. ISA (UK and Ireland) 250 Section B however requires the auditor of the authorised firm when reporting on their financial statements, to review information obtained in the course of the audit and to assess whether the cumulative effect is of 'material significance' such as to give rise to a duty to report to the regulator. In circumstances where the auditor is uncertain whether he may be required to make a report or not, he may wish to consider whether to take legal advice.
- 74 On completion of their investigations, the auditor ensures that the facts and circumstances, and the basis for his conclusion as to whether these are, or are likely to be, of 'material significance' to the FSA, are adequately documented

such that the reasons for his decision to report or not, as the case may be, may be clearly demonstrated should the need to do so arise in future.

- 75 Whilst confidentiality is an implied term of auditors' contracts with a regulated entity, s342 of FSMA 2000 states that an auditor does not contravene that duty if he reports to the FSA information or his opinion, if he is acting in good faith and he reasonably believes that the information or opinion is relevant to any function of the FSA. The protection afforded is given in respect of information obtained in his capacity as auditor.

### **Conduct of the audit**

- 76 ISA (UK and Ireland) 250 Section B requires the auditor to ensure that all staff involved in the audit of a regulated entity 'have an understanding of (a) the provisions of applicable legislation, (b) the regulator's rules and any guidance issued by the regulator, and (c) any specific requirements which apply to the particular regulated entity, appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations they encounter in the course of the audit which may give reasonable cause to believe that a matter should be reported to the regulator.'
- 77 Understanding, commensurate with the individual's role and responsibilities in the audit process, is required of :
- the provisions of the Regulations concerning the auditors' duty to report to the regulator;
  - the Standards and guidance in ISA (UK and Ireland) 250 Section B, and in this section of this Practice Note; and
  - relevant sections of the FSA's Handbook including the Principles for Businesses and the Threshold Conditions.
- 78 The auditor includes procedures within his planning process to ensure that members of the audit team have such understanding (in the context of their role) as to enable them to recognise potentially reportable matters, and that such matters are reported to the audit engagement partner without delay so that a decision may be made as to whether a duty to report arises.
- 79 An audit firm appointed as auditor of an authorised firm needs to have in place appropriate procedures to ensure that the audit engagement partner is made aware of any other relationship which exists between any department of the audit firm and the regulated entity when that relationship could affect the audit firm's work as the auditor. (This matter is covered in more detail in Appendix 2 of ISA (UK and Ireland) 250 Section B). The auditor also requests

the regulated entity to advise him when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt. This matter may usefully be referred to in the engagement letter.

### **Information received in a capacity other than as auditor**

- 80 There may be circumstances where it is not clear whether information about an authorised firm coming to the attention of the auditor is received in the capacity of the auditor or in some other capacity, for example as a general adviser to the entity. Appendix 2 to ISA (UK and Ireland) 250 Section B provides guidance as to how information obtained in non-audit work may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit.

### **Discussing matters of material significance with the directors**

- 81 The directors are the persons principally responsible for the management of the authorised firm. The auditor will therefore normally bring a matter of material significance to the attention of the directors and seek agreement on the facts and circumstances. However, ISA (UK and Ireland) 250 Section B emphasises that where the auditor concludes that a duty to report arises, he should bring the matter to the attention of the regulator without undue delay. The directors may wish to report the matters identified to the FSA themselves and detail the actions taken or to be taken. Whilst such a report from the directors may provide valuable information, it does not relieve the auditor of the statutory duty to report directly to the FSA.

### **Timing of a report**

- 82 The duty to report arises once the auditor has concluded that they reasonably believe that the matter is or is likely to be of material significance to the FSA's regulatory function. In reaching their conclusion the auditor may wish to take appropriate legal or other advice and consult with colleagues.
- 83 The report should be made without undue delay once a conclusion has been reached. Unless the matter casts doubt on the integrity of the directors this should not preclude discussion of the matter with the directors and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are however

undertaken on a timely basis to enable the auditor to conclude on the matter without undue delay.

### **Auditors' right to report to the FSA**

- 84 Section 342 of FSMA 2000 provides that no duty to which an auditor of an authorised firm is subject shall be contravened by communicating in good faith to the FSA information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.
- 85 The scope of the duty to report is wide particularly since, under the FSA's Principle for Businesses 11 (and corresponding application rules and guidance in SUP15.3), an authorised firm must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice. However in circumstances where the auditor concludes that a matter does not give rise to a statutory duty to report but nevertheless should be brought to the attention of the regulator, in the first instance he advises the directors of his opinion. Where the auditors are unable to obtain, within a reasonable period, adequate evidence that the directors have properly informed the FSA of the matter, then the auditor makes a report themselves to the regulator without undue delay.
- 86 The auditor may wish to take legal advice before deciding whether, and in what form, to exercise their right to make a report direct to the regulator in order to ensure, for example, that only relevant information is disclosed and that the form and content of their report is such as to secure the protection of FSMA 2000. Appendix 6 provides additional guidance on disclosure in the public interest. This is relevant to both the auditor's consideration of the right to report and also where neither the right nor the duty to report exists. However, the auditor recognises that legal advice will take time and that speed of reporting is likely to be important in order to protect the interests of customers and/or to enable the FSA to meet its statutory objectives.

### **ISA (UK and Ireland) 260: Communication of Audit Matters to those Charged with Governance**

#### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity.

The auditor should communicate audit matters of governance interest arising from the audit of financial statements to those charged with governance of an entity. (paragraph 2)

The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated. (paragraph 5)

The auditor should communicate audit matters of governance interest on a timely basis. This enables those charged with governance to take appropriate action. (paragraph 13)

The auditor should plan with those charged with governance the form and timing of communications to them. (paragraph 13-1)

- 87 As noted in the Introduction, a supervisory or audit committee usually plays an important role in the governance of credit unions. The auditors of the credit union meet with and report to the directors and the members of the supervisory committee on the annual accounts and any matters relating to the accounts that the auditor feels should be drawn to their attention.
- 88 The auditors' consideration of the system of internal control is undertaken both for the purpose of forming an opinion on the financial statements and so as to meet their statutory reporting requirements. Therefore, in the first instance their assessment is focused on controls designed to prevent or detect material misstatements in the financial statements arising from fraud, or other irregularity or error.
- 89 In addition, auditors obtain sufficient appropriate evidence that material weaknesses in control have not existed during the year. ISA (UK and Ireland) 260 defines a material weakness as "...a condition which may result in a material misstatement in the financial statement".
- 90 ISA (UK and Ireland) 260 requires auditors to report any material weaknesses in the accounting and internal control system identified, during the audit procedures in paragraphs 88 and 89 above, to directors on a timely basis.
- 91 Where significant matters raised in previous reports to directors or management have not been dealt with effectively, the auditors enquire why appropriate action has not been taken. If the point is still significant, consideration is given to repeating the point in the current report, otherwise there is a risk that they may give the impression that they are satisfied that the weakness has been corrected or is no longer significant.

## ISA (UK and Ireland) 300: Planning an Audit of Financial Statements

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the considerations and activities applicable to planning an audit of financial statements. This ISA (UK and Ireland) is framed in the context of recurring audits. In addition, matters the auditor considers in initial engagements are included in paragraphs 28 and 29.

The auditor should plan the audit so that the engagement will be performed in an effective manner. (paragraph 2)

The auditor should establish the overall audit strategy for the audit. (paragraph 8)

The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit. (paragraph 16)

The auditor should plan the nature, timing and extent of direction and supervision of engagement team members and review of their work. (paragraph 18)

92 Matters the auditors of a credit union may consider as part of the planning process for the audit of the financial statements include:

- the nature and scope of the credit union's activities;
- the complexity of the credit union's information systems;
- the credit union's relationship with the regulator;
- changes in applicable laws, regulations and accounting requirements;
- the need to involve specialists in the audit;
- the extent to which controls and procedures are outsourced to a third party provider;
- in Great Britain, issues relating to the auditor's statutory duty to report; and
- the appropriateness of the accounting policies adopted by the credit union.

93 Guidance on the first four of these matters is set out in the Section on ISA (UK and Ireland) 315 'Obtaining an Understanding of the Entity and its

Environment and Assessing the Risk of Material Misstatement' below. Considerations in relation to other matters in planning the audit are:

- the auditor considers the need to involve specialists in the audit, for example in the valuation of complex investments and loans;
- the auditor considers the implications of the outsourcing of functions by the credit union and the sources of evidence available to the auditors for transactions undertaken by service organisations in planning their work. This may include the outsourcing of certain functions such as the management of investment funds.
- issues relating to the auditor's statutory duty to report include the adequacy of the audit team's understanding of the law; and
- the auditor considers the appropriateness and consistency of the application of the credit union's accounting policies particularly those applied to valuation of investments and loans.

94 When planning the work to be undertaken in respect of a credit union audit, it is important to identify those areas which are key to its operations as reflected in its financial statements. The key areas of credit unions' financial statements would include:

- shares held by members;
- loans to members;
- cash;
- funds invested ; and
- fixed assets.

95 When considering the key areas it is also important to identify other possible sources of information available to the credit union auditors that may assist in the planning process, including:

- correspondence between the credit union and the regulators;
- reports of the supervisory committees;
- minutes of board, and other relevant committee, meetings;
- the register of directors' interests;

- correspondence between the credit union and its solicitors;
- correspondence between the credit union and its investment advisors; and
- reports commissioned by the credit union or by the regulators from reporting accountants or other professional advisors.

## **ISA (UK and Ireland) 315: Obtaining an Understanding of the Entity and its Environment and Assessing the Risks of Material Misstatement**

### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and to provide guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit.

- 96 The auditor seeks to understand the business activities and the regulatory regime in which credit unions operate. Generally, there is a close relationship between planning and obtaining an understanding of the business and the control environment, which is covered more fully below.

The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework (paragraph 22)

The auditor should obtain an understanding of the nature of the entity (paragraph 25)

- 97 When performing procedures to obtain an understanding of the credit union's business activities, the auditor considers:
- the relevant aspects of the credit union's risk management procedures;
  - the complexity of the credit unions information systems;
  - any changes in the market environment;
  - the consistency of products, methods and operations in different departments or locations;
  - the legal and operational structure of the credit union;
  - the number and location of branches;
  - the respective roles and responsibilities attributed to the finance, risk control, compliance and internal audit functions; and
  - the recruitment, competence, and experience of management.

98 In obtaining an understanding of the regulatory factors the auditor considers:

- any formal communications between the regulators and trade associations and the credit union, including the results of any supervisory visits<sup>14</sup>; and
- the contents of any publications from the regulators and trade associations.

The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (paragraph 28)

99 Accounting policies of particular relevance may include allowances for impairment, classification of assets and liabilities (and thereby their measurement), and revenue and expense recognition. The auditor undertakes procedures to consider whether the policies adopted are in compliance with applicable accounting standards, and gains an understanding of the procedures, systems and controls applied to maintain compliance with them.

The auditor should obtain an understanding of the entities objectives and strategies, and the related business risks that may result in material misstatement of the financial statements (paragraph 30)

100 It is important for the auditor to understand the nature and extent of the financial and business risks which are integral to the environment, and how the credit union's systems record and address these risks. Although they may apply to varying degrees, the risks include (but are not limited to):

- credit risk at its simplest, this is the risk that members will be unable to meet their obligations. Particular attention may be given to review of the application by the credit union of mechanistic approaches to assessing doubtful loan provisions. Management and auditors may exercise critical judgement in concluding on the adequacy of such provisions;
- liquidity risk: the risk that arises from the possibility that a credit union has insufficient liquid funds to meet demands of members. Particular attention may be given to the nature of investments acquired by the credit union, in particular the maturity profile of investment bonds, and the appropriateness of acquisition control

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<sup>14</sup> See Appendix 7 of this Practice Note for more details of trade associations in Northern Ireland.

procedures and accounting policies in relation to such instruments;

- interest rate risk: the risk that arises where there is a mismatch between the interest rate contractual repricing dates or bases for assets and liabilities;
- operational risk is the risk of loss, arising from inadequate or failed internal processes, people and systems or from external events;
- investment risk: the risk of failure to comply with the regulator's rules regarding investments; and
- regulatory risk is the risk of public censure, fines (together with related compensation payments) and restriction or withdrawal of authorisation to conduct some or all of the credit union's activities. This could arise from enforcement activity by the regulators.

101 Failure to manage the risks outlined above can also cause serious damage to a credit union's reputation, potentially leading to a loss of confidence in the credit union, withdrawal of shares and deposits or problems maintaining liquidity.

The auditor should obtain an understanding of the measurement and review of the entity's financial performance. (paragraph 35)

102 The auditor obtains an understanding of the measures used by management to review the credit union's performance. Guidance on key performance indicators is included in the Section on ISA (UK and Ireland) 520 in this Practice Note.

The auditor should obtain an understanding of internal control relevant to the audit. (paragraph 41)

The auditor should obtain an understanding of the control environment. (paragraph 67)

103 The quality of the overall control environment is dependent upon management's attitude towards the operation of controls. A positive attitude may be evidenced by an organisational framework which enables proper segregation of duties and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the

operation of a control is treated as a matter of concern, the control environment will be stronger and will contribute to effective control systems; whereas a weak control environment will undermine detailed controls, however well designed.

104 No internal control system can by itself guarantee effective administration and completeness and accuracy of the credit union's records. However, the attitude, role and actions of the directors are fundamental in shaping the control environment of a credit union . Factors to consider include:

- the amount of time committed by individual directors;
- the skills, experience and qualifications of individual directors;
- the frequency and regularity of Board/Committee meetings; and
- the degree of supervision of the credit union's transactions by individual directors.

105 The FSA requires authorised firms, including credit unions in Great Britain, to maintain systems and controls appropriate for its business. These include (but are not limited to):

- clear and appropriate reporting lines which are communicated within the credit union;
- appropriate controls to ensure compliance with laws and regulations;
- appropriate risk assessment process;
- appropriate management information;
- controls to ensure the suitability of staff;
- documented and tested business continuity plans;
- documented business plans and strategies;
- an internal audit function (where appropriate); and
- appropriate record keeping arrangements

## Requirements of auditors in relation to control systems

- 106 Legislation requires auditors of credit unions to state in their report on the financial statements if the credit union has failed to maintain a satisfactory system of internal control. In forming a view as to whether a system of internal control is satisfactory, the auditor obtains sufficient appropriate evidence that material weaknesses in control have not existed during the year. A material weakness is defined as 'a condition which may result in a material misstatement in the financial statements'.
- 107 The legislation does not establish the criteria by which auditors assess whether a system of control is satisfactory; this is a matter for the auditors' judgement. In forming a judgement, auditors consider, for example:
- (a) evidence obtained in relation to compliance with ISAs (UK and Ireland); and
  - (b) their knowledge of the control procedures adopted by the entity, obtained in complying with paragraph 90 of ISA (UK and Ireland) 315.

The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks. (paragraph 90)

- 108 There is a wide variation between different credit unions in terms of size, activity and organisation, so that there can be no standard approach to internal controls and risk. In assessing whether there is a risk of material misstatement, the auditor may consider the factors outlined below:

### *(i) Control Environment*

- inadequate segregation of duties;
- weaknesses in “know your customer” procedures;
- lack of an effective supervisory committee;
- inadequate definition of management responsibilities and supervision of staff and contractors;
- ineffective personnel practices;

- inadequate communication of information to management;
- voluntary nature of those charged with governance;
- controls over outsourced activities (see the section on ISA (UK and Ireland) 402 of this Practice Note);
- in Northern Ireland, reports issued by the main trade associations relating to internal controls;
- products or processes inadequately understood by management; this includes undue concentration of expertise concerning matters requiring the exercise of significant judgment or capable of manipulation such as valuations of financial instruments or allowances for impairments; and
- weaknesses in back office procedures contributing to completeness and accuracy of accounting records.

*(ii) Loans:*

- inadequate procedures relating to loan approvals;
- lack of proper documentation;
- failure to systematically validate security or guarantees given in respect of loans;
- failure to regularly review loan policies and related procedures;
- failure to consistently take into account the borrower's ability to repay the loan in accordance with the agreed terms and conditions;
- rescheduling loans to a member as a means of addressing repayment difficulties encountered in respect of original loan; and
- failure to monitor loan book on a regular basis to ensure that the specific statutory requirements governing loans in excess of stated amounts, or for longer than stated periods, are not breached.

*(iii) Shares of members*

- inadequate monitoring procedures relating to dormant accounts;

- failure to monitor deposit levels on a regular basis and develop appropriate cash flow forecasts to ensure that the credit union's lending activities will not give rise to significant bank borrowing;
- an individual member holding more than one share account;
- payment of appropriate dividend and where the credit union has allocated its depositors to differing categories, based on amounts deposited, confirmation that the appropriate rate has been paid to each category and the same rate to all members of a particular category; and
- where passbooks are not issued, failure to issue statements to members on a regular basis.

*(iv) Distributions*

- failure to distinguish correctly between realised and unrealised gains for the purpose of declaring a dividend; and
- desire to declare a dividend in line with members' expectations regardless of income and reserve levels.

*(v) Investments*

- non compliance with any rules<sup>15</sup> issued by the regulators regarding investments.

The auditor should obtain an understanding of how the entity has responded to risks arising from IT. (paragraph 93)

109 The auditor assesses the extent, nature and impact of automation within the credit union and plans and performs work accordingly. In particular the auditor considers:

- the required level of IT knowledge and skills may be extensive and may require the auditor to obtain advice and assistance from staff with specialist skills;

<sup>15</sup> For credit unions in Great Britain see CRED chapter 7.

- the extent of the application of audit software and related audit techniques;
- general controls relating to the environment within which IT based systems are developed, maintained and operated; and
- external interfaces susceptible to breaches of security.

The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. (paragraph 100)

As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditors judgement, risks that require special audit consideration (such risks are defined as “significant risks”). (paragraph 108)

For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity’s related controls, including relevant control activities, and determine whether they have been implemented. (paragraph 113)

110 Significant risks are likely to arise in those areas that are subject to significant judgment by management or are complex and are properly understood by comparatively few people in the credit union.

111 Examples of significant risks for credit unions requiring special audit consideration may include:

- allowances for loan impairment;
- (for the larger credit unions) valuation of investments; and
- assessment of going concern.

112 Weaknesses in the control environment and in controls such as those described above could increase the risk of fraud.

### **ISA (UK and Ireland) 330: The Auditors Procedures in Response to Assessed Risks**

#### **Background note**

The purpose of ISA (UK and Ireland) is to establish standards and provide guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit.

When, in accordance with paragraph 115 of ISA (UK and Ireland) 315, the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness. (paragraph 25)

113 As in the audit of other entities, the auditor obtains and documents an understanding of the accounting system and control environment to assess whether they are adequate as a basis for drawing up the financial statements and to determine their audit approach. If, having carried out this task, the auditor expects to be able to rely on the assessment of risk to reduce the extent of the substantive procedures, the auditor makes a preliminary assessment of risk for material financial statement assertions and plans and performs tests of control to support that assessment.

114 Control procedures designed to address specified control objectives are subject to inherent limitations and accordingly, errors or irregularities may occur and not be detected. Such control procedures cannot guarantee protection against fraud or collusion especially on the part of those holding positions of authority or trust.

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk (paragraph 51).

115 Examples of significant risks for credit unions requiring special audit consideration include allowances for loan impairment, and the valuation of investments and other financial instruments for which valuation techniques are required – see the Section on ISA (UK and Ireland) 540, and going concern – see the section on ISA (UK and Ireland) 570.

The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework. (paragraph 65)

116 Specific financial reporting standards can require extensive narrative disclosures in the financial statements of some credit unions; for example, in relation to the nature and extent of risks arising from financial instruments. In designing and performing procedures to evaluate these disclosures the auditor obtains audit evidence regarding the assertions about presentation and

disclosure described in paragraph 17 of ISA (UK and Ireland) 500: Audit Evidence.

## ISA (UK and Ireland) 402: Audit Considerations Relating to Entities using Service Organisations

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance to an auditor where the entity uses a service organisation.

In obtaining an understanding of the entity and its environment, the auditor should determine the significance of service organisation activities to the entity and the relevance to the audit. (paragraph 5)

- 117 The auditor gains an understanding of the extent of outsourced functions and their relevance to the financial statements. The credit union is obliged to ensure that the auditor has appropriate access to records, information and explanations from material outsourced operations.
- 118 In common with other industries the outsourcing of functions to third parties is becoming increasingly prevalent with credit unions albeit to a more limited degree for the smaller credit unions. Some of the more common areas may have a direct relevance to the audit such as IT services, investment management, payroll processing services and internal audit.
- 119 Whilst a credit union may outsource functions to third parties the responsibility for these functions remains that of the credit union. The credit union should have appropriate controls in place over these arrangements including:
- risk assessment prior to contracting with the service provider, which includes a proper due diligence and periodic review of the appropriateness of the arrangement;
  - appropriate contractual agreements or service level agreements;
  - contingency plans should the service provider fail in delivery of services;
  - appropriate management information and reporting from the outsourced vendor;
  - protection over member information; and
  - right of access of the credit union's internal audit and external auditors to test the internal controls of the service provider.

120 If the auditor is unable to obtain sufficient appropriate audit evidence concerning outsourced operations the auditor considers whether it is necessary to report the matter direct to the regulator – see Section of this Practice Note relating to ISA (UK and Ireland ) 250 Section B, and whether this represents a material weakness in internal control.

## **ISA (UK and Ireland) 501: Audit Evidence – Additional Considerations for Specific Items**

### **Background Note**

The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance additional to that contained in ISA (UK and Ireland) 500, “Audit Evidence” with respect to certain specific financial statement account balances and other disclosures.

When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure. (paragraph 38)

- 121 When investments, normally held only by the larger credit unions, are classified as long term, audit procedures ordinarily include obtaining audit evidence as to whether the entity has the authority to hold the investments on a long term basis and obtaining written representations from directors.
- 122 The auditor ordinarily considers information, such as market quotations and related financial statements, which provide an indication of value and compares such values to the carrying amount of the investments up to the date of the auditor’s report. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

## ISA (UK and Ireland) 505: External Confirmations

### Background note

The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining evidence.

The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level (paragraph 2)

- 123 The following types of balances and transactions are worthy of particular consideration:
- members loans and shares; and
  - investments held with investment managers and custodians.
- 124 The supervisory committee may decide to carry out a circularisation of a certain number of members' loans, in accordance with the credit union's own rules. In such circumstances the auditor is aware of the timing of that circularisation and any potential evidence available from it.
- 125 Members' loans and shares typically comprise high volumes of comparatively low value amounts. Members do not usually maintain independent records of their balances but rather usually depend on information provided to them by the credit union. Accordingly the auditor may consider the inherent reliability of such responses is comparatively low and will seek sufficient evidence from other audit procedures.
- 126 The credit union may obtain "certified" lists of investments held by custodians on a regular basis. Because these are sent directly to the credit union, they are not as conclusive as direct audit evidence. In the event that the auditor determines that a confirmation letter should be obtained from the investment custodians, arrangements should be made for such custodians to mail directly to the auditor a copy of such lists and confirmation of other matters the auditor deems appropriate.

## ISA (UK and Ireland) 520: Analytical Procedures

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the application of analytical procedures during an audit.

The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit. (paragraph 2).

When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence. (paragraph 17)

- 127 Credit unions are required to submit annual returns to the regulators which contain a comprehensive range of information and data which may assist auditors by providing an indication of trends and current ratios. In addition, detailed internal financial information produced for directors and management may provide a valuable source of evidence.
- 128 Examples of key ratios which auditors may wish to consider in carrying out analytical procedures on a credit union's results and balance sheet are as follows:
- bad debt provisions to average total loans;
  - total arrears to total net liabilities;
  - non-performing loans to total loans;
  - earnings cover of loan losses;
  - liquid assets to total assets;
  - liquid assets to total relevant liabilities;
  - cost to income ratio;
  - loans to shares ratio;
  - investment income received/dividend paid ratio;
  - capital (general reserves) to total assets;
  - total borrowing (by the credit union) to total shares;

- unattached shares/funds ratio;
- staff costs/gross income ratio;
- average loan duration (months);
- value and number of re-scheduled loans;
- “weeks in arrears” value; and
- non-qualifying members to total members.

129 Key analytical procedures auditors may wish to perform include:

- reviewing total loan interest earned from members’ borrowings and comparing with the average monthly outstanding balance for the year taken at the prevailing interest rate;
- comparing the total dividends paid on members’ shares with the credit union and testing against the dividend rate based on the average monthly share balance;
- comparing total payroll costs with previous years and obtaining explanations of variations;
- comparing the financial statements with budgets, forecasts, or management expectations;
- considering whether the financial statements adequately reflect any changes in the scope and nature of the credit union’s activities of which the auditors are aware;
- enquiring into unexplained or unexpected features of the financial statements; and
- where industry information is available, this may be used to benchmark income, resources and expenditure against other credit unions.

Key performance indicators could also include measures relating to regulatory compliance and operational risk measures.

130 When performing their review of the financial statements as a whole for consistency with their knowledge of the entity's activities and the results of

other audit procedures, the auditor considers transactions occurring either side of the year end, including:

- loan repayments which are received shortly before the year end then re-advanced shortly afterwards; material sale and repurchase transactions or other financing or linked transactions. Experience and judgment are required to identify and assess the implications, if any, of these transactions; they may, for example, be indicative of 'window dressing' of the balance sheet over the year end date;
- other transactions around the year end, apparently at rates which are significantly off market including those that appear or give rise to significant profits or losses;
- the reclassification of balances and transactions to achieve advantageous income recognition and balance sheet treatment/presentation.

131 Where non financial information or reports produced from systems or processes outside the financial statements accounting system are used in analytical procedures, the auditor considers the reliability of that information or those reports.

## ISA (UK and Ireland) 540: Audit of Accounting Estimates

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the audit of accounting estimates contained the financial statements.

The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates (paragraph 2)

The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:

- (a) Review and test the process used by management to develop the estimate;
- (b) Use an independent estimate for comparison with that prepared by management;  
or
- (c) Review of subsequent events which provide audit evidence of the reasonableness of the estimate made. (paragraph 10).

The auditor should make a final assessment of the reasonableness of the entity's accounting estimates based on the auditor's understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit. (paragraph 24).

- 132 Accounting estimates are used for valuation purposes in a number of areas; the most common examples are for loan losses and valuation of investments not traded on an active market. Such estimates may represent significant risks.
- 133 The credit union will either calculate a bad debt provision or perform an impairment review of the loan book depending on whether fair value accounting is used. Auditors' review of a credit union's methods for making provisions and writing off bad loans includes consideration of their reasonableness, consistency with prior years and conformity with generally accepted practices.
- 134 In reviewing the reasonableness of loan loss provisions, both specific and general, credit union auditors ascertain that management have properly exercised their judgment, followed a consistently applied policy in determining the level of provisions and not merely followed a standard formula/matrix calculation. Auditors need to be mindful of practices such as re-scheduling, non-cash transfers or top-up lending that can have the effect of understating provisions. In ascertaining the appropriateness of general

provisions credit union auditors should take into consideration the level of risk inherent in the loan book and changes in the economic environment.

- 135 In reviewing the adequacy of loan impairment provisions the auditor assesses whether the assumptions made by management in arriving at their estimate of likely cash flows to be received from impaired loans have been made after due consideration and whether they are supported by relevant evidence, including evidence derived from backtesting and the issue of enforceability of contracts in relation to collateral. In the case of individual loan impairment calculations such evidence will be specific to the borrower but where impairment is estimated for a portfolio of similar loans the auditor considers observable data across a group of assets as a whole such as arrears statistics or economic conditions.
- 136 Management bias whether intentional or unintentional, can be difficult to detect in a particular estimate. It may only be identified when there has been a change in the method for calculating estimates from the prior period based on a subjective assessment without evidence that there has been a change in circumstances, when considered in the aggregate of groups of estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, management may have no intention of misleading the users of financial statements. If however, there is intention to mislead through, for example, the intentional use of unreasonable estimates, management bias is fraudulent in nature. ISA (UK & Ireland) 240 provides standards and guidance on the auditor's responsibility to consider fraud in an audit of financial statements.

## **ISA (UK and Ireland) 545: Auditing fair value measurements and disclosures**

### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements.

The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. (paragraph 3)

As part of the understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures. (paragraph 10)

The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework. (paragraph 17)

- 137 The valuation of derivative and other financial instruments which are not traded in an active market and so for which valuation techniques are required is an activity that can give rise to significant audit risk. Auditors of larger credit unions which may hold such instruments consider the guidance on audit procedures set out in the ISA (UK and Ireland) 545 section in PN 19: The audit of Banks and Building Societies in the United Kingdom (Revised).

### **ISA (UK and Ireland) 550: Related Parties**

#### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties regardless of whether International Accounting Standard (IAS) 24, "Related Party Disclosures," or similar requirement, is part of the applicable financial reporting framework.

When planning the audit the auditor should assess the risk that material undisclosed related party transactions or undisclosed outstanding balances between an entity and its related parties may exist. (paragraph 106-3)

- 138 The principles and procedures set out in ISA (UK and Ireland) 550 apply to the audit of credit unions as for other undertakings. However, the organisation of credit unions is such that the issue of a controlling shareholding of a credit union by any party will not arise. Related party transactions which are likely to arise include shares held by and/or loans to directors or members of the supervisory committee of the credit union.
- 139 Related party transactions are defined in FRS 8<sup>16</sup> 'Related party disclosures'. Paragraph 16 of FRS 8 states that the 'disclosure provisions do not apply where to comply with them conflicts with the reporting entity's duties of confidentiality arising by operation of law'. This is particularly relevant in a credit union context: credit unions are usually under a strict duty of confidentiality (by operation of statute, contract or common law) regarding the affairs of their members.

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<sup>16</sup> As at the date of issue of this Practice Note, the ASB has consulted on replacing FRS 8 with a standard that is convergent with IAS 24.

140 Auditors will enquire as to the procedures, required under the rules of the individual credit union, governing the authorisation, recording and monitoring of any related party transactions. They will assess the operation of those procedures during the financial year and consider whether appropriate disclosure has been made in the financial statements.

## ISA (UK and Ireland) 560: Subsequent Events

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility regarding subsequent events.

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. (paragraph 4).

- 141 Matters specific to credit unions which auditors may consider in their review of subsequent events include:
- an evaluation of material loans and other receivables identified as being in default or potential default at the period end to provide additional evidence concerning period end loan impairment provisions;
  - a check to ensure that dividends declared after the year end have not been included as a liability at the balance sheet date<sup>17</sup>;
  - an assessment of material loans and other receivables identified as (potential) defaults since the period end to consider whether any adjustment to the period end carrying value is required; and
  - a review of correspondence with the regulators and enquiries of directors and management to determine whether any significant breaches of laws and regulations or other significant regulatory concerns have come to light since the period end.

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<sup>17</sup> FRS 21 'Events after the Balance Sheet Date' (paragraph 12)

## ISA (UK and Ireland) 570: Going Concern

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility on the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements, including considering management's<sup>18</sup> assessments of the entity's ability to continue as a going concern. (paragraph 1)

When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's<sup>18</sup> use of the going concern assumption in the preparation of the financial statements. (paragraph 2)

The auditor should consider any relevant disclosures in the financial statements. (paragraph 2-1).

In obtaining an understanding of the entity, the auditor should consider whether there are any events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.(paragraph 11)

The auditor should remain alert for audit evidence of events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern in performing audit procedures throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures set out in paragraph 26, consider whether they affect the auditor's assessment of the risks of material misstatement. (paragraph 12)

- 142 When events or conditions have been identified which may cast significant doubt on a credit union's ability to continue as a going concern, the auditor should in accordance with ISA (UK and Ireland) 570, paragraph 26;
- (a) review the directors' plans for future actions based on its going concern assessment;
  - (b) gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of directors and other mitigating factors; and
  - (c) seek written representations from directors regarding its plans for the future.

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<sup>18</sup> In the UK and Ireland, those charged with governance are responsible for the preparation of the financial statements and the assessment of the entity's ability to continue as a going concern.

143 In reviewing going concern, the auditor may consider the following areas in addition to those set out in ISA (UK and Ireland) 570:

- capital adequacy ratios – review of management’s analysis and rationale for ensuring that the credit union is capable of maintaining adequate financial resources in excess of the minimum;
- liquidity indicators – eg review of the credit union’s liquidity management process for signs of undue deterioration; and
- reputational and other indicators – eg review of the financial press and other sources of market intelligence for evidence of deteriorating reputation; review of correspondence with regulators.

Further details of possible factors that may indicate going concern issues in these areas are set out in Appendix 5 to this Practice Note.

144 If the auditor has any doubts as to the ability of a credit union to continue as a going concern, the auditor considers whether he ought to make a report direct to the regulators on which guidance is set out in the section of this Practice Note relating to ISA (UK and Ireland ) 250 Section B.

## ISA (UK and Ireland) 580: Management Representations

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

Written confirmation of appropriate representations from management, as required by paragraph 4 below, should be obtained before the audit report is issued. (paragraph 2-1)

The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. (paragraph 4)

145 ISA (UK and Ireland) 250 Section A and ISA (UK and Ireland) 550 require auditors to obtain written confirmation in respect of completeness of disclosure to the auditors of:

- all known actual or possible non-compliance with laws and regulations (including, for credit unions in Great Britain, breaches of FSMA 2000, FSA rules, the Money Laundering Regulations, other regulatory requirements or any other circumstance that could jeopardise the authorisation of the credit union) whose effects should be considered when preparing financial statements together with the actual or contingent consequences which may arise therefrom; and
- the completeness of information provided regarding the identification of related parties and the adequacy of related party disclosures in the financial statements.

146 In addition to the examples of other representations given in ISA (UK and Ireland) 580, the auditor also considers obtaining confirmation:

- as to the adequacy of provisions for loan impairment (including provisions relating to individual loans if material) and the appropriateness of other accounting estimates (such as investment valuations or adequate provisions for liabilities);
- that all contingent transactions or commitments have been adequately disclosed and/or included in the balance sheet as appropriate; and

- that all correspondence with regulators has been made available to the auditor.

## ISA (UK and Ireland) 700: The Auditor's Report on Financial Statements

### Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. (paragraph 2)

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. (paragraph 4)

In the UK and Ireland, the auditor should not date the report earlier than the date on which all other information contained in a report of which the audited financial statements form a part have been approved by those charged with governance and the auditor has considered all necessary available evidence. (paragraph 24-1)

- 147 The form and content of auditors' reports on the financial statements of credit unions follow the basic principles and procedures established by ISA (UK and Ireland) 700. Illustrative auditor's reports for a credit union are included in Appendix 1 of this Practice Note.
- 148 ISA (UK and Ireland) 700 requires that Independent Auditors' reports on financial statements identify the financial reporting framework used to prepare the financial statements. The expression UK Generally Accepted Accounting Practice can be used to describe compliance with applicable law and accounting standards issued by the ASB.
- 149 As noted in the Introduction, auditors are bound by the duties imposed by FIPSA and the NI Order. These require them, in preparing their audit report, to carry out such investigations as will enable them to form an opinion on:
- (a) whether the credit union has kept proper books of account in accordance with the requirements of the legislation;
  - (a) whether the credit union has maintained a satisfactory system of control over its transactions in accordance with the requirements of the legislation; and

- (b) whether the revenue account or the other accounts (if any) to which the report relates and the balance sheet are in agreement with the books of account of the credit union.

If the auditors are of the opinion that the credit union has failed to comply with any of the requirements of (a) to (c) above then they must state that fact in their report.

- 150 If references to inadequate records or systems of internal control under the relevant legislation are included in the auditors' report, consideration is given by the auditors to a qualification on the grounds of limitation of the scope of the work the auditors were able to perform.
- 151 If any significant matters of concern have arisen during the audit of a credit union, the auditors consider whether they need to report the matter to the regulators (see the section on ISA (UK and Ireland) 250 B of this Practice Note).

## **ISA (UK and Ireland) 720 (Revised): Other Information in Documents containing Audited Financial Statements**

### **Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

The auditor should read the other information to identify material inconsistencies with the audited financial statements. (paragraph 2)

If, as a result of reading the other information, the auditor becomes aware of any apparent misstatements therein, or identifies any material inconsistencies with the audited financial statements, the auditor should seek to resolve them. (paragraph 2-1)

- 152 Auditors are required to report on whether the information given in the report of the board of directors of a credit union is consistent with the financial statements. In addition, one of the fundamental principles set out in the Auditors' Code is that auditors do not allow their reports to be included in documents containing other information if they consider that the additional information is in conflict with the matters covered by the report or they have cause to believe it to be misleading.
- 153 The auditors are not responsible for auditing the additional information. ISA (UK and Ireland) 720 does not require auditors to undertake additional procedures to corroborate other information in documents containing audited financial statements but rather to read the other information in the context of the knowledge they have obtained during the audit.
- 154 It is important to ensure that the directors are made aware of the auditors' responsibilities in respect of the other information, as set out in ISA (UK and Ireland) 720, and the extent of those responsibilities is specifically dealt with in the engagement letter.
- 155 The information which may accompany the financial statements of a credit union include :
- directors' report;
  - supervisory committee report;
  - treasurer's report;

- credit committee report;
- credit control report;
- membership committee report; and
- financial highlights for previous years.

156 The directors may also distribute other documents with the financial statements such as newsletters, new rules booklets, statement of member's balances of loans and/or shares in the credit union. The auditors have no responsibility to consider these documents.

## **Reporting on regulatory returns**

### **Great Britain**

- 157 All credit unions in Great Britain are required<sup>19</sup> to submit an annual return (Form CY) to the FSA within seven months of each year-end. A copy of the audited annual financial statements of the credit union, together with the auditor's report, should also be submitted.
- 158 Auditors are required to complete a Statement included in Form CY on whether the information contained in the balance sheet and revenue account of the annual return is, or is not, consistent with the audited financial statements (with an attached statement detailing inconsistencies if there are any). Standard wording for the auditor's Statement is as follows:
- “In my opinion, the information contained in the balance sheet and revenue account of the Annual Return is /is not consistent with the audited accounts published in accordance with section 3A of the Friendly and Industrial and Provident Societies Act 1968”.
- 159 The auditor is not required to form an opinion on whether the annual return gives a true and fair view. It is in any event unlikely that the annual return could give a true and fair view, as some of the detailed information in the financial statements is not included.
- 160 Matters which may give rise to an inconsistency include:
- (a) information which has been inaccurately extracted from the annual financial statements (for example, incorrect extraction of amounts appearing in the balance sheet or revenue account);
  - (b) information which, in the auditor's opinion has been presented in a manner which is not consistent with the annual financial statements and reports; and
  - (c) omission from the annual return of information which is necessary to ensure consistency with the annual financial statements and reports.
- 161 When the auditor identifies what he believes may be an inconsistency he discusses the matter with those charged with governance, so that they may eliminate the inconsistency, for example by including additional information in the annual return.

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<sup>19</sup> In accordance with SUP 16.3.6R – 16.3.13R.

- 162 If discussion with those charged with governance does not result in the elimination of the inconsistency, the auditor attaches a description of the inconsistency to his Statement.
- 163 Credit unions in Great Britain are also required to submit quarterly returns (Form CQ) to the FSA within one month of each quarter end, but there is normally no involvement by auditors with this return.

### **Northern Ireland**

- 164 As noted in the Introduction to this Practice Note, auditors of credit unions in Northern Ireland have no direct reporting responsibilities in respect of annual returns submitted to DETI, although a signed copy of their report on the annual financial statements is required to be included.

## **Appendix 1**

### **1.1- Illustrative Auditors' Report for a Credit Union in Great Britain**

#### **Independent Auditors' Report to the Members of XYZ Credit Union**

We have audited the financial statements of XYZ credit union for the year ended ...which comprise [specify the primary financial statements such as the revenue account, appropriation account, the statement of general reserve, the balance sheet] and the related notes. These financial statements have been prepared under the accounting policies set out therein.

#### **Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (UK Generally Accepted Accounting Practice), are set out in the Statement of Directors' Responsibilities. Our responsibility, as independent auditor, is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Industrial and Provident Societies Act 1965 to 2002 and the Credit Unions Act 1979. We also report to you if, in our opinion, a satisfactory system of control over transactions has not been maintained, or if proper books of account have not been kept by the credit union. In addition we state if we have not obtained all the information and explanations necessary for the purposes of our audit or if the credit union's balance sheet and its revenue account are not in agreement with the books of account.

We read other information contained in the Annual Report [e.g. Treasurer's Report, the Supervisory Committee Report and the Credit Committee Report] and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

#### **Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the credit union's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### **Opinion**

In our opinion the financial statements give a true and fair view of the state of the credit union's affairs as at .... and of its income and expenditure for the year then ended, and have been properly prepared in accordance with UK Generally Accepted Accounting Practice, and with the Industrial and Provident Societies Acts 1965 to 2002 and the Credit Unions Act 1979.

Registered Auditors

Address

Date

## **1.2- Illustrative Auditors' Report for a Credit Union in Northern Ireland**

### **Independent auditors' report to the members of XYZ Credit Union Limited**

We have audited the financial statements of XYZ Credit Union Limited for the year ended 30 September 200x, which comprise [specify the primary financial statements such as the revenue account, appropriation account, the statement of general reserve, the balance sheet] and the related notes. These financial statements have been prepared under the accounting policies set out therein.

#### **Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (UK Generally Accepted Accounting Practice), are set out in the Statement of Directors' Responsibilities. Our responsibility, as independent auditor, is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view, and are properly prepared in accordance with the Credit Unions (Northern Ireland) Order 1985. We also report to you if, in our opinion, a satisfactory system of control over transactions has not been maintained, or if proper books of account have not been kept by the credit union. In addition we state if we have not obtained all the information and explanations necessary for the purposes of our audit or if the credit union's balance sheet and its revenue account are not in agreement with the books of account.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

#### **Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the credit union's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement,

whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### **Opinion**

In our opinion the financial statements give a true and fair view of the state of the credit union's affairs as at 30 September 200x and of its income and expenditure for the year then ended, and have been properly prepared in accordance with UK Generally Accepted Accounting Practice, and with the Credit Unions (Northern Ireland) Order 1985.

Registered Auditors

Address

Date

## **Appendix 2 The main parts of legislation relevant to credit unions in Great Britain**

### **FSMA 2000**

Part I (and Sch 1) sets out matters concerning structure and governance of the FSA including its regulatory objectives and the principles to be followed in meeting those objectives.

Part II (and Sch 2) sets out the general prohibition on conducting regulated business unless an entity is either authorised or exempt, including restrictions on financial promotions. Regulated activities are defined in SI 2001/544.

Part III (and Schs 3-5) sets out the requirements to become authorised either by receiving a specific permission from the FSA or through the exercise of EEA passport rights. Exempt persons are listed in SI 2001/1201.

Part IV (and Sch 6) sets out the arrangements for application for a permission to undertake authorised business and the criteria (Threshold Conditions) that must be met. An applicant who is refused can apply to the Financial Services and Markets Tribunal (established under Part IX).

Part V sets out the provisions applying to individuals performing designated functions (controlled functions) in an authorised firm. The FSA can specify controlled functions and authorised firms must take reasonable care to ensure that only persons approved by the FSA can undertake these functions. The FSA can specify qualification, training and competence requirements and approved persons must comply with the FSA's statement of principles and code of conduct for approved persons. Appeals can be made to the Tribunal.

Part VIII gives the FSA powers to impose penalties for market abuse - using information not generally available; creating a false or misleading impression; or, failure to observe normal standards - abuse being judged from the point of view of a regular market user. The FSA's powers extend to all persons - not only authorised firms. The FSA is required to publish a code to provide guidance on behaviours that do and do not constitute market abuse. This forms part of the Market Conduct Sourcebook and is called the Code of Market Conduct.

Part X provides the FSA with general powers to make rules which apply to authorised firms, including rules on specific matters - e.g. client money, money laundering. Rules must be published in draft for consultation. Guidance may be provided individually or generally and may be published. The FSA may modify rules or waive particular rules for particular authorised firms in certain situations.

Part XI allows the FSA to gather information from authorised firms, including use of skilled persons' reports under s166, or to commission investigations into authorised firms.

Part XIV sets out the disciplinary measures available to the FSA which can include public censure, unlimited fines, withdrawal of authorisation.

Part XXII includes provisions relating to auditors and their appointment.

Part XXVI brings together in one place the arrangements applying to warning notices and decision notices concerning possible breaches of various requirements imposed by FSMA 2000 or by FSA rules. A warning notice has to state the reasons for proposed actions and allow reasonable time for representations to be made. This will be followed by a decision notice with a right to appeal to the Tribunal.

## **Industrial and Provident Societies Acts 1965-2002 and the Friendly and Industrial and Provident Societies Act 1968**

- 1 The Industrial and Provident Societies Act 1965 (the 1965 Act) sets out important matters related to Industrial and Provident Societies. The 1965 Act sets out some basic requirements in relation to the audit of the accounts of an Industrial and Provident Society. In particular it requires that auditors should satisfy themselves that proper records have been kept of all transactions, assets and liabilities.
- 2 The Friendly and Industrial and Provident Societies Act 1968, which sets out the main accounting and audit requirements, requires proper financial records to be kept and that all financial statements agree with those records, that there is satisfactory internal control over transactions and that the financial statements show a true and fair view of the credit union's financial position. In particular, section 9(2) of FIPSA states that "The (auditor's) report shall state whether the revenue account or accounts and the balance sheet for that year comply with the requirements of this Act and the appropriate registration Act...."
- 3 The Industrial and Provident Societies Act 1978 altered Section 7(3) of the 1965 Act. More importantly, the 1978 Act sets out that the 1978 Act and the 1965 Act should be construed as one. The Industrial and Provident Societies Act 2002 gave power to the Treasury to modify the relevant statutory provisions in the 1965 Act for the purpose of assimilating the law relating to companies and the law relating to Industrial & Provident Societies. Because of this power it is necessary when referring to the 1965 Act also to refer to the 2002 Act. As a consequence, the accounts of an Industrial and Provident Society comply with the Industrial & Provident Societies Acts 1965 to 2002 and the audit report should cover those Acts.

## Appendix 3 FSMA 2000 and related statutory instruments: Important provisions for auditors in Great Britain

*FSMA 2000 provisions and related statutory instruments relevant for the auditors of a credit union are set out below. Further details of the legislation can be found on The Stationery Office website- [www.hmso.gov.uk](http://www.hmso.gov.uk).*

*FSMA 2000 and statutory instruments as amended*

Section/Sch	
19	General prohibition from undertaking regulated activity unless authorised
20	Authorised firms acting without permission
21	Restrictions on financial promotion
41	Threshold conditions
59	Approval by FSA of persons undertaking controlled functions
165	FSA's power to require information
166	Reports by skilled persons
167	Appointment of persons to carry out general investigations
168	Appointment of persons to carry out investigations in particular cases
178	Obligation to notify FSA concerning controllers of an authorised firm
340	Appointment of auditor or actuary by FSA
341	Access to books etc (by auditor or actuary)
342	Information given by auditor or actuary to the FSA
343	Information given by auditor or actuary to the FSA : entities with close links
344	Duty of auditor or actuary resigning etc to give notice
345	Disqualification (of auditor or actuary from acting by FSA)
346	Provision of false or misleading information to auditor or actuary
348	Restrictions on disclosure of confidential information by FSA etc
349	Exceptions from s348
351	Competition information (offence relating to the disclosure of competition information)
352	Offences (contravention of s348 to 350(5))
398	Misleading the FSA
Sch 6	Threshold Conditions
SI 2001	
544	Regulated Activities Order
1177	Carrying on Regulated Activities by Way of Business Order
1201	Exemption Order

Section/Section	
1857	Disclosure of Information by Prescribed Persons
2188	Disclosure of Confidential Information
2587	Communications by Auditors

## Appendix 4      The FSA Handbook

- 1      Not all authorised firms are required to comply with all rules contained within the FSA Handbook. This varies with the type of permission - the regulated activity an authorised firm is permitted to undertake is set out in the authorised firm's Scope of Permission. The following can be viewed on the FSA website:
  - contents of the FSA Handbook – [www.fsa.gov.uk/Pages/handbook](http://www.fsa.gov.uk/Pages/handbook)
  - FSA register which lists the regulated activities that each authorised firm has permission to undertake – [www.fsa.gov.uk/Pages/register](http://www.fsa.gov.uk/Pages/register)
- 2      In gaining an understanding of the Handbook the auditor bears in mind the four statutory objectives of the FSA, set out in the Introduction above, which underpin the content of the FSA Handbook. To facilitate usage the FSA Handbook has been structured into a number of blocks and within each block the material has been sub-divided into Sourcebooks, Manuals or Guides. There are Rules, evidential provisions<sup>20</sup> and guidance which are contained within all of the blocks<sup>21</sup>. Contravention of Rules (which includes Principles for businesses) or evidential provisions can give rise to an obligation on the auditor to report the matter direct to the FSA – see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B.

### Principles for businesses

3.      The eleven Principles for businesses, which are general statements that set out the fundamental obligations of firms under the regulatory system, are set out in the FSA Handbook (PRIN 2.1). They derive their authority from the FSA's rule-making powers as set out in the Act and reflect the regulatory objectives. These Principles are as follows:
  - an authorised firm must conduct its business with integrity;
  - an authorised firm must conduct its business with due skill, care and diligence;
  - an authorised firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management;
  - an authorised firm must maintain adequate financial resources;

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<sup>20</sup> An evidential provision is not binding in its own right, but establishes a presumption of compliance or non-compliance with another rule. Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, or to recommend a particular course of action or arrangement.

<sup>21</sup> Rules are set out in emboldened type and are marked with the icon 'R', evidential provisions are marked 'E' and guidance 'G'. Further guidance on the status of the Handbook text is set out in the General Provisions (GEN) Sourcebook Chapter 2.2 and Chapter 6 of the Reader' Guide.

- an authorised firm must observe proper standards of market conduct;
- an authorised firm must pay due regard to the interests of its customers and treat them fairly;
- an authorised firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading;
- an authorised firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client;
- an authorised firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement;
- an authorised firm must arrange adequate protection for clients' assets when it is responsible for them; and
- an authorised firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice (see SUP15 – Notifications to the FSA).

*Senior management arrangements, systems and controls*

- 4 SYSC amplifies Principle 3, the requirement for a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The relevant chapters are as follows;
- 2 – senior management arrangements
  - 3 – systems and controls
  - 4 – general organisational requirements
  - 5 – employees, agents and other relevant persons
  - 6 – compliance, internal audit and financial crime
  - 7 – risk control
  - 8 – outsourcing
  - 9 – record keeping
  - 10 – conflicts of interest
  - 11 – liquidity risk systems and controls

- 12 – group risk systems and control requirements
- 18 – guidance on Public Disclosure Act - whistle blowing

### *Threshold Conditions*

- 5 Under s41 and Schedule 6 of FSMA 2000 Threshold conditions are the minimum requirements that must be met at authorisation and must continue to be met. The relevant statutory Threshold conditions include:
- legal status: deposit taking business must be conducted through a body corporate or partnership - that is, individuals cannot undertake deposit taking business;
  - location of offices: the head office of a body corporate must be in the same territory/member state as the registered office;
  - adequate resources: the authorised firm must have adequate resources (financial and non financial) for the type of business conducted taking into account the impact of other group entities and having regard to provisions made against liabilities (including contingent and future liabilities) and the approach to risk management; and
  - suitability: the FSA will consider the fitness and propriety of authorised firms, including whether business is conducted with integrity and in compliance with high standards, and whether there is competent and prudent management and exercise of due skill, care and diligence. This will include consideration of whether those subject to the approved persons regime (i.e. those undertaking controlled functions) are, or will be, approved by the FSA.

## **Appendix 5 Possible factors that may indicate going concern issues**

### **Capital adequacy ratios**

- the credit union operating at or near the limit of its individual capital guidance or limit otherwise set by management under the FSA's capital requirements, either on a group or solo basis;
- unjustified attempts to reduce the size of the buffer over and above the threshold solvency ratio that management has agreed to operate at;

### **Operations/profitability indicators**

- marked decline in new lending/dealing volumes during the year or subsequently;
- marked decline in new business margins;
- severe overcapacity in markets leading to low pricing as well as low volumes;
- significant increase in loan defaults or seizure of collateral (e.g. house repossessions);
- excessive exposures to troubled industry sectors;
- unusually aggressive dealing positions and/or regular breaches of dealing or lending limits;
- redundancies, layoffs or failure to replace natural wastage of personnel;

### **Liquidity indicators**

- low ratio of liquid assets to total relevant liabilities;
- mismatch between loans being issued and shares in the credit union;
- anticipated defaults on loan repayments;
- expected cash flows;

### **Reputational and other indicators**

- adverse publicity which could lead to loss of confidence or reputation, including fines or public censure by the regulator;

- urgent attempts to remove assets from the balance sheet, apparently involving material loss of profits or at significant expense;
- deferral of investment plans or capitalisation of expenditure.

## **Appendix 6 Reporting direct to the regulators – statutory right and protection for disclosure under general law**

- 1 When the auditor concludes that a matter does not give rise to a statutory duty to report direct to the regulators, the auditor considers the right to report to the regulators.
- 2 In cases of doubt, general law provides protection for disclosing certain matters to a proper authority in the public interest.
- 3 Audit firms are protected from the risk of liability from breach of confidence or defamation under general law even when carrying out work which is not clearly undertaken in the capacity of auditor provided that:
  - in the case of breach of confidence:
    - (i) disclosure is made in the public interest; and
    - (ii) such disclosure is made to an appropriate body or person; and
    - (iii) there is no malice motivating the disclosure; and
  - in the case of defamation:
    - (i) the information disclosed was obtained in a proper capacity; and
    - (ii) there is no malice motivating the disclosure.
- 4 The same protection is given even if there is only a reasonable suspicion that non-compliance with law or regulations has occurred. Provided that it can be demonstrated that an audit firm, in disclosing a matter in the public interest, has acted reasonably and in good faith, it would not be held by the court to be in breach of duty to the institution even if, an investigation or prosecution having occurred, it were found that there had been no breach of law or regulation.
- 5 When reporting to proper authorities in the public interest, it is important that, in order to retain the protection of qualified privilege, auditors report only to one who has a proper interest to receive the information.
- 6 'Public interest' is a concept which is not capable of general definition. Each situation must be considered individually. In general circumstances, matters to be taken into account when considering whether disclosure is justified in the public interest may include:
  - the extent to which the suspected non-compliance with law or regulations is likely to affect members of the public;
  - whether the directors (or equivalent) have rectified the matter or are taking, or are likely to take, effective corrective action;

- the extent to which non-disclosure is likely to enable the suspected non-compliance with law or regulations to recur with impunity;
- the gravity of the matter;
- whether there is a general management ethos within the entity of disregarding law or regulations;
- the weight of evidence and the degree of the auditors' suspicion that there has been an instance of non-compliance with law or regulations.

7 Determination of where the balance of public interest lies requires careful consideration. The auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest of disclosure to a proper authority and to use their professional judgement to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.

## Appendix 7 Trade Associations in Northern Ireland

1. The majority of credit unions in Northern Ireland are members of a trade association. The main trade associations are the Irish League of Credit Unions (ILCU) and the Ulster Federation of Credit Unions (UFCU). As at the date of issue of this Practice Note, of the 170 credit unions in Northern Ireland the approximate membership was:

- ILCU – 104,
- UFCU – 49.

2. The function of ILCU and UFCU is, broadly:

- to promote the credit union idea and ethos;
- to represent affiliated credit unions with Government, the EU and other agencies;
- to provide central services to credit unions.

3. The typical contact between a credit union and the trade associations is:

- submission of quarterly prudential returns;
- periodic visits from a field officer (by ILCU every 18 months). A report is issued after this visit to comment on aspects of internal control against the trade association's rulebook and requirements of the NI order. If there are any issues the field officer would report directly to DETI. The visit from the field officer is taken no less seriously than a monitoring officer visit (DETI) or auditor visit;
- payment of affiliation fees (deducted from member accounts);
- chapter meetings are held once a month between local credit unions and these meetings are attended by a liaison officer from the trade association;
- amendments to the trade association's rules are adopted at the annual AGM;
- credit unions are sent a copy of 'Credit Union year end requirements' each year; and
- credit unions contact the trade association on day to day enquiries on legal/secretarial/insurance matters.

4. Typical contact between the trade associations and auditors:

- ILCU also sends direct to auditors a copy of 'Credit Union year end requirements' each year. This includes specific guidance over accounting areas, for example bad debt provision, accounting for dividends, level of general reserves. It also includes guidance on AGM

and election of officer procedures, pro-forma audit report, requirement to submit to them a copy of the annual return (AR25), audited accounts and management letter etc.;

- auditors review any report made by the trade association's field officers (treated the same as a monitoring officer report);
- auditors have a copy of the credit union rule book and have traditionally tested internal control procedures against the rule book in key areas such as work performed by the supervisory committee.

5. Auditors do not have an obligation to report to the trade associations, nor to report in line with their year end requirements. However the information available from the Standard Rules for credit unions is a useful tool in the assessment of the internal control framework, while the year end requirements sent directly to auditors provides focus for the year end audit and a consistent approach to accounting policies across credit unions.

## Appendix 8 Definitions

Abbreviations and frequently used terms in this Practice Note are set out below

ARROW II	‘Advanced Risk Responsive Operating frameWork’. The term used for FSA’s risk assessment process – the application of risk based supervision. It is the mechanism through which the FSA evaluates the risk an authorised firm poses to its statutory objectives enabling it to allocate its resources appropriately and respond to the risks identified.
authorised firm	An entity which has been granted one of more Part IV permissions by the FSA and so is authorised under FSMA 2000 to undertake regulated activities – an authorised person. Authorised firms include deposit takers.
authorised person	Term used throughout FSMA 2000 and related statutory instruments to refer to an authorised firm – see above.
authorised by FSA	Same as authorised firm or authorised firm – see above.
COND	Threshold conditions element of the high level standards block of the FSA Handbook.
CRD	Capital Requirements Directive
CRED	Credit Unions sourcebook
credit institution	An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account and to which the Banking Consolidation Directive applies.
Credit Union	A “credit union” in the context of this Practice Note is a society registered as a credit union under IPSA or the NI Order. A credit union is a body corporate with perpetual succession which is known by its registered name.
CU 79	Credit Unions Act 1979
deposit taker	Authorised firms which under FSMA 2000 have a Part IV permission to accept deposits.
DETI	Department of Enterprise, Trade and Investment in Northern Ireland
FIPSA	Friendly and Industrial and Provident Societies Act 1968
FRS	Financial Reporting Statements
FSA	The Financial Services Authority
FSMA 2000	Financial Services and Markets Act 2000
FRSSE	Financial Reporting Standard for Smaller Entities
IPSA 65/02	Industrial and Provident Societies Acts 1965-2002
JMLSG	Joint Money Laundering Steering Group
MiFID	Markets in Financial Instruments Directive
material significance	A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator
NI Order	Credit Unions (Northern Ireland) Order 1985
Part IV permission	A permission granted by FSA under Part IV FSMA 2000 permitting an authorised firm to carry on regulated activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended.
permission	Part IV permission under FSMA 2000 to undertake one or more regulated activities.
Principles for Businesses	FSA Handbook defined principles with which an authorised firm must comply. The 11 principles are included in a stand alone element of the

	high level Standards block of the FSA Handbook – PRIN.
regulated activities	Activities as defined in the Regulated Activities Order SI 2001/544 as amended
relevant requirement	In relation to the auditors’ duty to report direct to the FSA - requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FSA's rules (other than the Listing rules) including the Principles for businesses. The duty to report also covers any requirement imposed by or under any other Act the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000.
SOCA	Serious Organised Crime Agency
SUP	Supervision manual of the FSA Handbook.
SYSC	Senior management arrangements, systems and controls element of the High Level Standards block of the FSA handbook.
The 2001 Regulations	SI 2001/2587 – FSMA 2000 (Communications by Auditors) Regulations 2001
Those charged with governance	ISAs (UK and Ireland) use the term “those charged with governance” to describe the persons entrusted with the supervision, control and direction of an entity, who will normally be responsible for the quality of financial reporting, and the term “management” to describe those persons who perform senior managerial functions. The FSA Handbook of Rules and Guidance (FSA Handbook) uses the term “governing body” to describe collectively those charged with governance. In the context of this Practice Note, references to those charged with governance include directors of credit unions.
Threshold Conditions	The minimum standards that an authorised firm needs to meet to become and remain authorised by the FSA. The 5 conditions are included in a stand alone element of the high level Standards block of the FSA Handbook – COND.