Audit Monitoring 2018

WEIGHING UP THE RESULTS

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Topics covered so far are:

- Accounting estimates, valuations, impairment and the use of experts
- Audit compliance review
- Ethical standards
- Fraud
- FRS 102 implementation
- Group audits
- Internal controls
- Obtaining audit evidence from substantive analytical procedures
- Obtaining audit evidence from tests of detail

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UK GAAP

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FINANCIAL REPORTING FACULTY

With significant changes on the horizon as a result of several new IFRSs and continuing developments in UK GAAP, keeping up to date with the latest financial reporting changes is vital. The Financial Reporting Faculty (FRF) provides highly accessible and practical assistance on financial reporting issues to keep you informed. Members of the FRF have full access to practical online guidance, career advancing webinars and events, exclusive use of our online factsheets, monthly ebulletins, the benefit of our bespoke UK GAAP and IFRS standards tracker and bi annual journal By All Accounts. Faculty members also receive unlimited access to the IASB's eIFRS service (normally £295 pa).

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AUDIT AND ASSURANCE FACULTY

Operates as a centre of excellence in audit and assurance matters. It sponsors the Audit Quality Forum, runs the AuditFutures initiative and has shown the value of the profession with its Audit Insights initiative. Its assurance thought leadership programme explores new services and techniques to meet emerging market needs and share best practice. The faculty is proactive on audit quality matters, having hosted a series of webinars in this area. Subscribers also receive 10 editions of the faculty's magazine, *Audit & Beyond*, which provides valuable content on best practice and topical issues in the audit and assurance profession. The faculty produces a range of technical publications with recent topics including audit report wordings, materiality and root cause analysis.

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Got a question? Our technical advisory team is able to help with any accounting queries.

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Overview

In this issue of Audit Monitoring 2018, we present the results of our 2017 audit monitoring activities.

The results of our monitoring reviews have remained relatively consistent with previous years, with a significant majority of our visits again showing positive results. We closed 76% of our reviews without the need for any regulatory action, and the same percentage of audit files we reviewed were satisfactory or generally acceptable. However, there is room for improvement and both we and the Financial Reporting Council (FRC) are keen to see a reduction in the proportion of audits needing improvement. We are committed to helping firms, especially those that have struggled in the past, to improve and cope with the challenges that can result in poor quality work and non-compliance with other aspects of the Audit Regulations. This report provides case studies of some of the issues we find, guidance and hints and tips on how to avoid some of the common pitfalls we see.

Also included is a summary of the primary factors that lead to reports being sent to the ICAEW Audit Registration Committee (ARC). These factors include poor quality audit work, significant financial reporting issues, serious ethical/independence issues, and problems with eligibility.

In addition to this resource, further guidance is available from icaew.com/auditguidance including our series of *Insights from audit monitoring* webcasts and *Audit News*, your regulatory update containing the latest audit and assurance technical guidance and best practice advice. There is also a list of the wider range of audit-related resources available from ICAEW on the inside cover of this report.

FRS 102 ONE YEAR ON

In our 2017 monitoring visits, we reviewed many audits of financial statements completed for the first time under FRS 102 and have recently completed a second desktop review exercise. We have found a number of similar issues to those we reported last year and highlight the key themes in this report.

THE INTRODUCTION OF REVISED AUDITING AND ETHICAL STANDARDS

It is too early to report back on the implementation of the revised auditing and ethical standards as they generally did not yet apply to the audits we reviewed in 2017.

FAMILIARITY WITH IES8

International Education Standard 8 (IES8) came into effect in July 2016, creating more precise requirements for the competence of responsible individuals. While many firms may not need to make major changes to meet the requirements of IES8, we found that a significant number of firms were not familiar with IES8 and had not considered if they should enhance their existing procedures.

Any firms that have not yet looked at IES8 should do so without delay. More information can also be found in previous issues of *Audit News* icaew.com/auditnews

The Companies Act 2006 requires recognised supervisory bodies (RSBs) to license and monitor statutory audit. ICAEW is the largest RSB in the UK; we register about 3,000 audit firms.

Results of our audit file reviews

We completed 619 audit monitoring reviews in 2017, 611 as a UK recognised supervisory body (RSB) and 8 under the Crown Dependencies' recognised auditor oversight regime.

Although audit quality has remained relatively consistent overall, there is still room for improvement.

76% of the 1,019 audits were either satisfactory or generally acceptable

16% required improvement

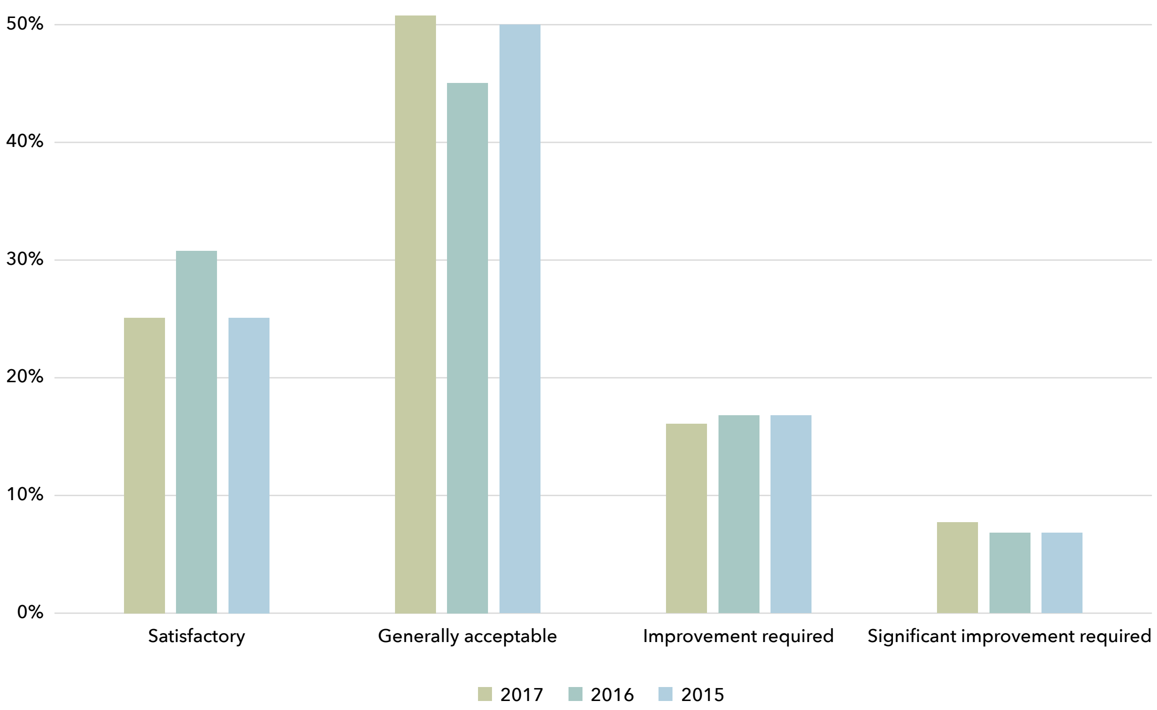
8% required significant improvement

2017 VISITS – THE NUMBERS

During these visits we reviewed 1,019 audits, including 26 AIM and Nex companies, 5 market-traded entities (under the Crown Dependencies regime), 199 charities and 44 pension schemes. 473 of the audits we reviewed were of entities that would have applied FRS 102 for the first time (barring early adoption).

These percentages are similar to 2016, although a lower proportion of audits were satisfactory; 25% in 2017 (closer to 2015) compared with 31% in 2016.

2017 VISITS – QUALITY OF AUDIT FILES



We reviewed limited aspects of a further 161 audits and 238 engagements completed under the Solicitors' Regulation Authority (SRA) Accounts Rules that require registered auditor status.

The picture varies a little across the different types of audit that we review. 92% of AIM and Nex companies and 82% of charities that we reviewed in 2017 were either satisfactory or generally acceptable. This is a better picture than for other non-specialist private companies – 74% of these audits were either satisfactory or generally acceptable. Market-traded entities are a small population but it is worth noting that three out of the five files we reviewed (60%) were either satisfactory or generally acceptable.

MARKET-TRADED ENTITIES

In 2017, the audit work we saw on market-traded entities under the Crown Dependency regime was generally of a good standard. However, we found two significant issues not relating to audit quality. In one case, the firm had failed to recognise that the entity was a market-traded entity, and had not therefore notified us it had taken on the audit, nor arranged an engagement quality control review (EQCR). In the other case, the roles of the engagement partner and individual responsible for the EQCR had become confused and the engagement partner was not eligible to be a responsible individual (RI) under the Crown Dependency Audit Rules.

What issues lead to a report to the Audit Registration Committee (ARC)?

We need to make a report to the ARC if we have significant concerns about a firm's compliance with the Audit Regulations. As you will see from the **Regulatory action** section below, in 2017 1 in 10 audit monitoring reviews resulted in a report to the ARC.

There could be one or more key reasons for a report. In 2017, 60% featured poor audit quality as one of the main reasons for the report, but other common factors were financial reporting errors, serious ethical issues and breaches of the eligibility requirements.

AUDIT QUALITY

Poor audit quality was a key issue in 36 out of 60 reports to the ARC in 2017. In some but not all cases, this featured alongside significant financial reporting issues.

Poor audit quality invariably results from a lack of sufficient, appropriate audit evidence in one or more key areas. It is more serious than simply minor gaps in the audit documentation and means that we have concluded that there is a risk of material misstatement that the firm has not addressed – or at least not documented.

When we record audit quality weaknesses, we identify which International Standards on Auditing (ISAs) they primarily relate to.

We have identified the top three ISAs that cause audit quality weaknesses as:

1. **ISA 500 Audit Evidence;**
2. **ISA 230 Audit Documentation; and**
3. **ISA 315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment.**

This is perhaps unsurprising as these three ISAs are probably the most fundamental to any audit engagement. We should also remember that many issues may also have subsidiary aspects relating to other ISAs. The next three most common ISAs where we record non-compliance are ISA 530 on audit sampling, ISA 580 on written representations and ISA 570 on going concern.

1 ISA 500 AUDIT EVIDENCE

Insufficient audit evidence is the most common significant weakness on audit files that we review. The areas where we record most issues are revenue testing, fixed assets, stock and work in progress, and other areas of professional judgement such as goodwill and intangibles. In over half of cases where we have concerns with audit evidence these concerns relate to a single aspect of the audit (such as fixed asset valuation). However, in other cases we identify several aspects that are weak.

We regularly identify problems with the sufficiency of audit evidence for:

- completeness of revenue;
- ownership;
- rights and obligations relating to fixed assets; and
- valuation of stock and work in progress.

2 ISA 230 AUDIT DOCUMENTATION

Significant issues with audit documentation occur when firms have not recorded material aspects of their audit work, or the link between the audit evidence and final conclusion of the audit can be understood if explained, but is unclear from the audit file alone.

We also find a handful of cases each year where significant parts of audit files go missing or the file has not been completed and archived within 60 days of signing the audit report.

3 ISA 315 RISK OF MATERIAL MISSTATEMENT

ISA 315 was one of the more fundamental changes introduced by the original International Standards on Auditing in 2005. It sets an expectation that the audit work will be based on individual risk assessment of the audited entity, its activities, governance and internal controls.

Cases where the auditor does not adequately assess risk through lack of understanding of the business' activities and internal controls can lead to an inappropriate audit plan and, consequently, audit evidence that does not address the risks of material misstatement in the statutory accounts.

We find a number of cases where we can't see from the audit file how well the auditor understands the business and the risks, or sometimes, that there are apparently significant risks that the auditor does not appear to have addressed.

The extent of work required to comply with ISA 315 is scalable, and will depend on the complexity of the audited entity. A well run locally-based property investment company will generally need much less sophisticated processes, procedures and controls to maintain the business than a larger entity in retail or construction, or one with a wide geographical spread of operation. Therefore, the effectiveness of audit work on the latter type of client will be particularly reliant on detailed planning and understanding of audit risks from the outset.

OTHER COMMON ISSUES

- Audit sampling should reflect the materiality and audit risk of the relevant balance or class of transactions. Identifying the correct population for sampling is critical. We sometimes find that a sample has been taken from a restricted population; for example overdue trade debtors, with no testing of the – possibly lower risk, but very material – trade debtors within credit terms at the year end.
- ISA 570 requires certain management representations on all audits and in many cases these may not go beyond standard clauses. We sometimes find, in significant areas of judgement, that an auditor has not requested specific management representations to supplement detailed audit work where appropriate, or has over-relied on representations without doing supporting detailed audit work.
- Going concern must also be assessed on all audits, and the auditor is required to assess the work done and conclusions reached by those charged with governance. For many profitable and financially sound businesses, this assessment can be very straightforward. However, when businesses operate on small margins and with little headroom over loan covenants, the judgements can be difficult. It is important that the auditor can demonstrate how it has challenged management's forecasts when the assumptions contradict recent trading results or other available evidence.

Where we find poor quality audit work, we will take into account the strength of the firm's response on how it will address the matters raised and, where relevant, the findings from our previous monitoring visit. We also consider whether our findings appear to be isolated to a particular audit, or whether they may be more widespread.

CASE STUDY – POOR AUDIT QUALITY INCLUDING ONE AUDIT REPORT SIGNED WHEN THE AUDIT WORK WAS INCOMPLETE

We visited this firm in 2011 and did not identify any significant concerns, concluding our review based on the firm's responses with no follow up action. However, when we visited in 2017 we found that the firm had not completed regular audit cold file reviews as part of annual audit compliance reviews, and the quality of their audit work had deteriorated.

On one audit file, the firm signed the audit report when the audit work was substantially incomplete. On other files there were weaknesses including audit work on revenue and the existence and valuation of plant and machinery. The firm was quick to acknowledge the issues and took the findings of our review very seriously. It planned to arrange external hot file reviews on all audits for at least the next two years. We agreed with this course of action and recommended to the ARC that they impose these external hot file reviews on the firm as a condition of registration until they have seen clear progress.

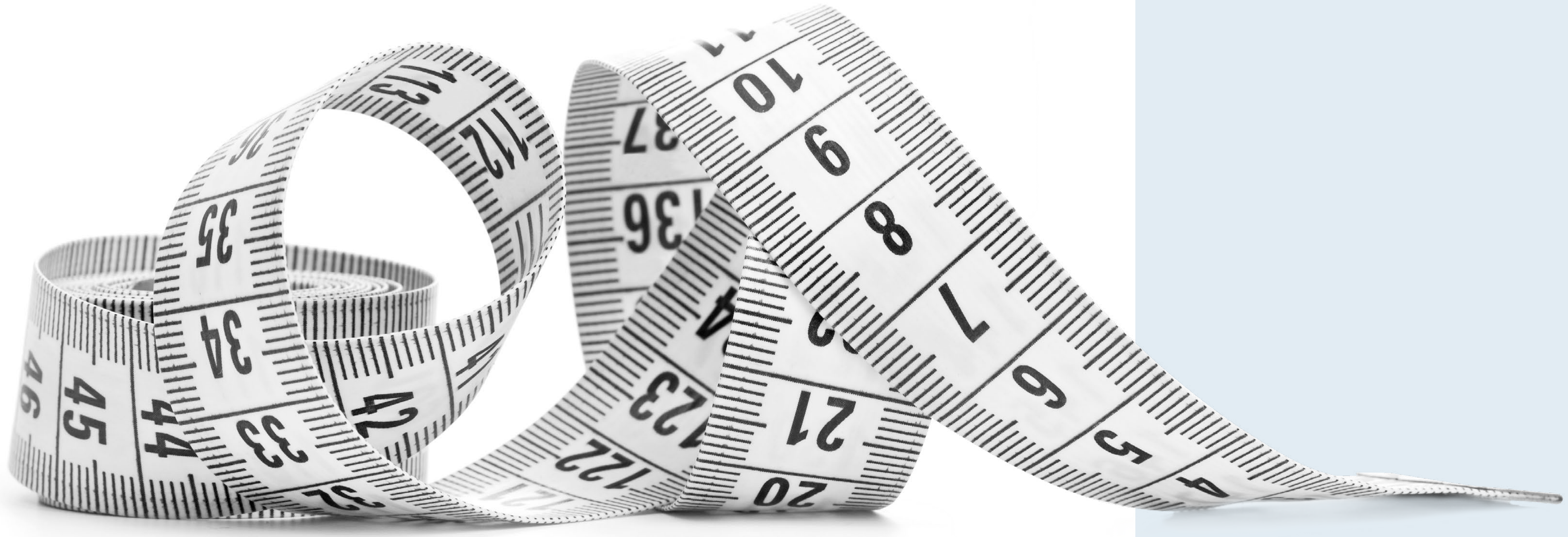
For the incomplete audit work, we recommended that the ARC consider either a regulatory penalty or a referral to the Professional Conduct Department of ICAEW for further investigation.

FINANCIAL REPORTING

The directors are responsible for the financial statements, but they rely on their auditor to highlight problems. Auditors should qualify their audit opinion if there is an unadjusted material misstatement that impacts the true and fair view shown by the financial statements.

Poor accounting combined with weak audit work can result in significant financial reporting issues that we report to the ARC.

Financial reporting issues featured in 21 of our 60 reports in 2017. Some of the issues arose from the implementation of FRS 102, and some related to medium-sized entities wrongly taking advantage of small company exemptions. These statutory requirements are important, but most of the issues resulting in reports to the ARC were more fundamental accounting and financial reporting issues.



CASE STUDY – CLASSIFICATION OF LIABILITIES AND IRRECOVERABLE ASSETS

We highlighted financial reporting issues on two audit files that we reviewed at this small firm with five audits.

On one file, our questions about a material liability on the balance sheet revealed that it was quite likely to be a contingent liability requiring disclosure rather than recognition in the accounts. On the other file we queried a large intercompany debtor balance that the firm itself had identified as doubtful, and further investigation suggested that this was a very legitimate concern, but the firm had not proposed any adjustments to its client and had given an unqualified audit opinion.

These issues indicated ineffective review of audit work and financial statements on both files. The firm agreed to discuss these points with its clients to resolve them at the next audit and we were satisfied that this was an appropriate response in the circumstances.

However, the occurrence of these significant errors in two sets of audited financial statements was a significant concern and we made a report to the ARC to recommend imposing external hot file reviews of all audits (to include review of the draft financial statements) until we are satisfied that the quality of financial statements is of an appropriate standard.

CASE STUDY – USE OF SUBCONTRACT STAFF LED TO INDEPENDENCE THREAT

In this case, the previous auditor resigned due to a threat to independence, caused by the firm's sole equity partner joining the client as a director. When the new firm took on this audit, it agreed to use two of the former auditor's staff as subcontractors on the audit.

This arrangement probably made practical sense to help the new auditor, but we concluded that these subcontractors could not be independent as they were employed by a director of the audit client.

When we reviewed the audit we concluded that the work done appeared to be of a good standard, but the firm understood our concerns about the independence of the audit team and confirmed it would not use these subcontractors in the future. We recommended the ARC require an external hot file review of the next audit of this client in order to provide evidence that all threats to independence had been resolved.

ETHICAL STANDARDS

All auditors must comply with the FRC Ethical Standard (previously APB Ethical Standards). With 9 of the 60 reports to the ARC in 2017 including ethical issues, these are not as prevalent as issues with audit quality and financial statements. However, objectivity and independence are critical attributes for registered auditors and the ARC take breaches very seriously.

We continue to come across cases where a partner in the audit firm is trustee of a trust that owns a material interest in an audit client. Firms do not always assess these situations in sufficient detail with reference to the precise requirements. Firms should look closely at the definition of 'covered person' within the new ethical standard when assessing trustee shareholdings. While similar to the definition of 'person in a position to influence the audit' within the previous standard, the definition of 'covered person' is more specific, meaning that some situations where there was previously some room for judgement are no longer acceptable. See our *Covered person* helpsheet which sets out who is included in the definition of 'covered person'.

The ARC expects firms to look carefully at the requirements and available guidance. We have seen some clear breaches, for instance where the audit compliance principal or another senior partner within the firm is the trustee in question. Firms should also take care to apply the new 'covered person' definition to any other independence threats involving relationships with clients.

ELIGIBILITY

Eligibility is the fourth and last area that accounts for a significant number of our reports to the ARC. To be a registered auditor, all firms must continue to meet the criteria for eligibility set out in the Audit Regulations.

Compliance with the eligibility criteria is essential to ensure that appropriately qualified individuals can exercise legal control over the activities of a registered audit firm. This enables those individuals to influence and, where necessary, safeguard the quality of audit work where the other activities of the firm, or of its principals who are not audit qualified, could be a risk to the firm's objectivity and independence.

Structural changes within a firm may result in short periods when a registered auditor cannot fulfil the eligibility requirements. If a firm consults with ICAEW swiftly we can help it to resolve the issue and arrange a dispensation to allow it to continue signing audit reports for an interim period of three months while it resolves the matter. If firms do not tell us about changes, this risks their objectivity and independence and, in some cases means that they underpay audit registration fees.

When firms have been ineligible for audit registration for a significant period and have saved registration fees as a result, we report this to the ARC. An example is when a firm appoints a new principal who isn't an ICAEW, ICAS, CAI, ACCA member or a registered auditor, but does not apply for audit affiliate status for the new principal. To continue audit registration, the ARC will ensure the firm makes the appropriate changes to become eligible for audit registration and may impose a regulatory penalty. The starting point for such a penalty is likely to be the amount of underpaid registration fees so that all firms pay their appropriate share of the costs of ICAEW regulation. In 2017, eight of our reports to the ARC included eligibility as a key issue.

Helping firms to improve

Many of the 60 firms we reported to ARC in 2017 will now be subject to additional monitoring and the involvement of external reviewers – often training organisations – to help them to improve their audit work and resolve other issues from our visit. We keep in regular contact with these firms, reviewing reports from the external reviewers and checking that the firms are complying with any conditions and restrictions set by the ARC.

These external reviews can mean a significant cost for the audit firms, but they are a constructive measure that provides important training and technical support when firms are struggling.

Our policy is to revisit firms subject to this kind of follow-up action within three to four years of the previous visit. This means that it is not long before we see, first hand, how they are progressing, and can help to ensure they stay on track.

For more information on the common findings from our audit monitoring reviews, together with tips for avoiding pitfalls, watch our *Insights from audit monitoring* webcasts, available at icaew.com/auditguidance

Topics covered so far are:

- Ethical standards
- Group audits
- Audit compliance review
- Accounting estimates, valuations, impairment and the use of experts
- Audit work on internal controls
- Fraud
- Substantive testing – substantive analytical review and tests of detail.

These short webcasts are developed and presented by our reviewers who have first-hand experience of visiting firms of all sizes.

WITHOUT QUESTION

The latest training film from ICAEW is a valuable resource that audit firms can use to develop the skills of entire audit teams. The script for *Without Question* was produced in consultation with representatives from organisations that have used our first film, *False Assurance*. They helped capture the most important issues they ask their teams and clients to be aware of.

Set in a family business that seeks expansion, the audit scenario is accessible to firms of all sizes. The film highlights the importance of professional scepticism, a key skill for everyone from juniors through to audit partners and board members to have and to continually develop. As well as this, a tax storyline highlights risks to independence and objectivity, and the importance of appropriate safeguards and risk management policies.

To find out more about ICAEW films visit icaew.com/films

FRS 102 one year on

In Audit Essentials 2017, we reported the results of our reviews of the first round of audited financial statements prepared under FRS 102. Our findings came from a desktop review of a substantial sample of accounts filed at Companies House, together with a relatively small number of reviews of financial statements as part of our 2016 onsite visits. In a clear majority of cases we raised no significant issues, but we did identify a number of problem areas.

One year on from our previous desktop review, we carried out another similar exercise, but based on a smaller sample of accounts. We also reviewed a significant number of audits of FRS 102 based accounts in the course of our 2017 visits. These monitoring activities have highlighted some very similar issues to those reported last year. Here are the most significant themes.

1. Group accounts, business combinations and goodwill

Group accounts had not always been prepared when required.

Presentation within primary statements in group accounts can be a challenging area. Non-controlling interest was sometimes missing or incorrect, and totals for profit and other comprehensive income didn't always tie in with the Statement of Changes in Equity (SOCIE).

Disclosures relating to business combinations are sometimes very weak due to a lack of clarity and the necessary detail.

We sometimes have doubts as to whether the treatment of post-transition combinations fully complies with FRS 102.

Some improvements are needed in goodwill accounting and disclosure. Useful life should be disclosed along with the reason for choosing that period. Disclosure of the reason was sometimes missing when particularly important, because the useful life exceeded 10 years.

Some entities continued to assume that goodwill has an indefinite useful life (despite this no longer being permitted), disclosing this as a departure from FRS 102. It is difficult to see that departure from the requirement to amortise goodwill is justified, particularly when no reason is disclosed.

2. Investment property, property, plant and equipment (PPE) and deferred tax

We raised a number of questions about the accounting for investment properties and PPE. Gains and losses on investment property and PPE were sometimes incorrectly presented and disclosures confusing.

Deferred tax was not always recognised on unrealised gains in investment property or PPE when it should have been.

3. Transition disclosures

Some transition disclosures were weak or had been omitted.

Some entities have no transition adjustments, with no clear disclosure about the impact of FRS 102 which would be good practice.

4. Financial statements prepared under old UK GAAP in error

We again found a small number of cases where FRS 102 had not been adopted when it should have been, and where the audit firm had not picked this up. We have seen this happen where all of a firm's audit clients were small entities except for one medium-sized entity, and the firm had mistakenly assumed FRS 102 did not yet apply to any of its clients. We do not expect this to recur now that new UK GAAP applies to all companies.

HOW TO AVOID THESE PITFALLS

We talked about some of the underlying causes of these errors in Audit Essentials 2017, and these remain relevant. Key factors are likely to be:

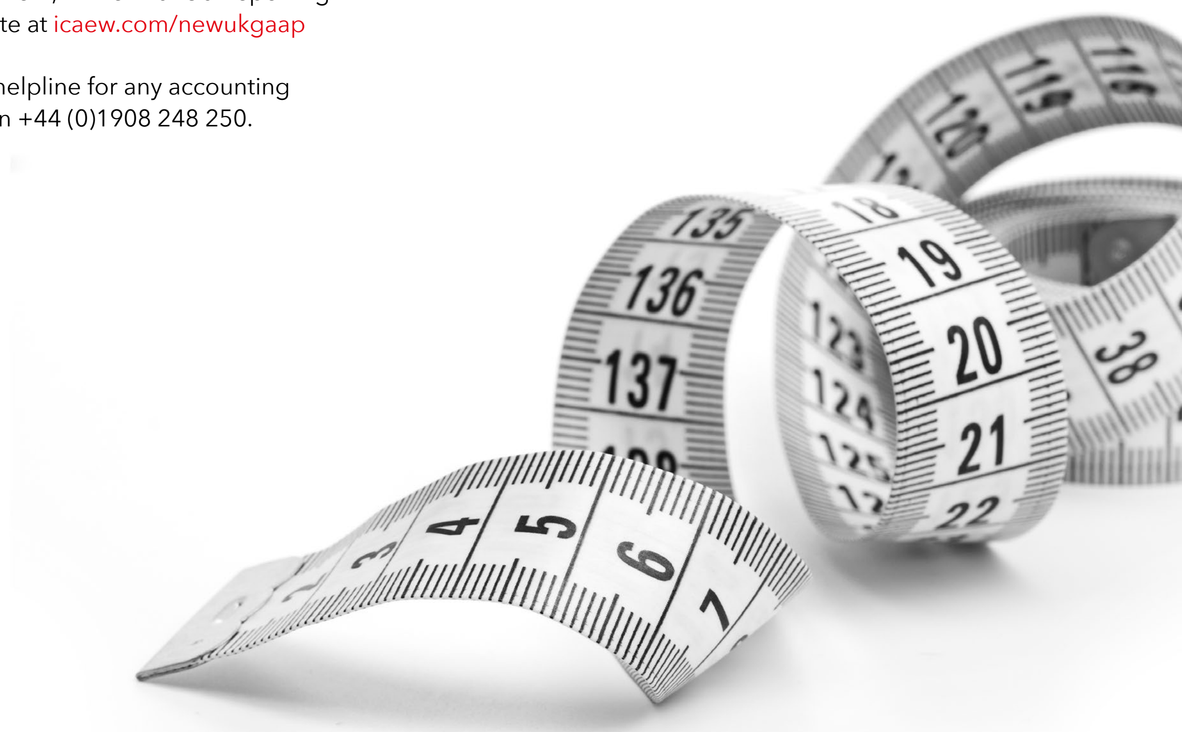
- insufficient CPD;
- over-reliance on accounting software; and
- insufficient quality control.

Firms may have had some good FRS 102 training to start with, but more is needed to pick up on the more recent developments in guidance and understanding of FRS 102 throughout the profession.

Accounting software is an invaluable tool, but care is needed to apply it properly. Some firms place too much reliance on their software, and blame it for not picking up errors and omissions. The software has improved, but firms should always make sure they robustly review the output. **Firms that make good use of disclosure checklists are more likely to identify errors and omissions.**

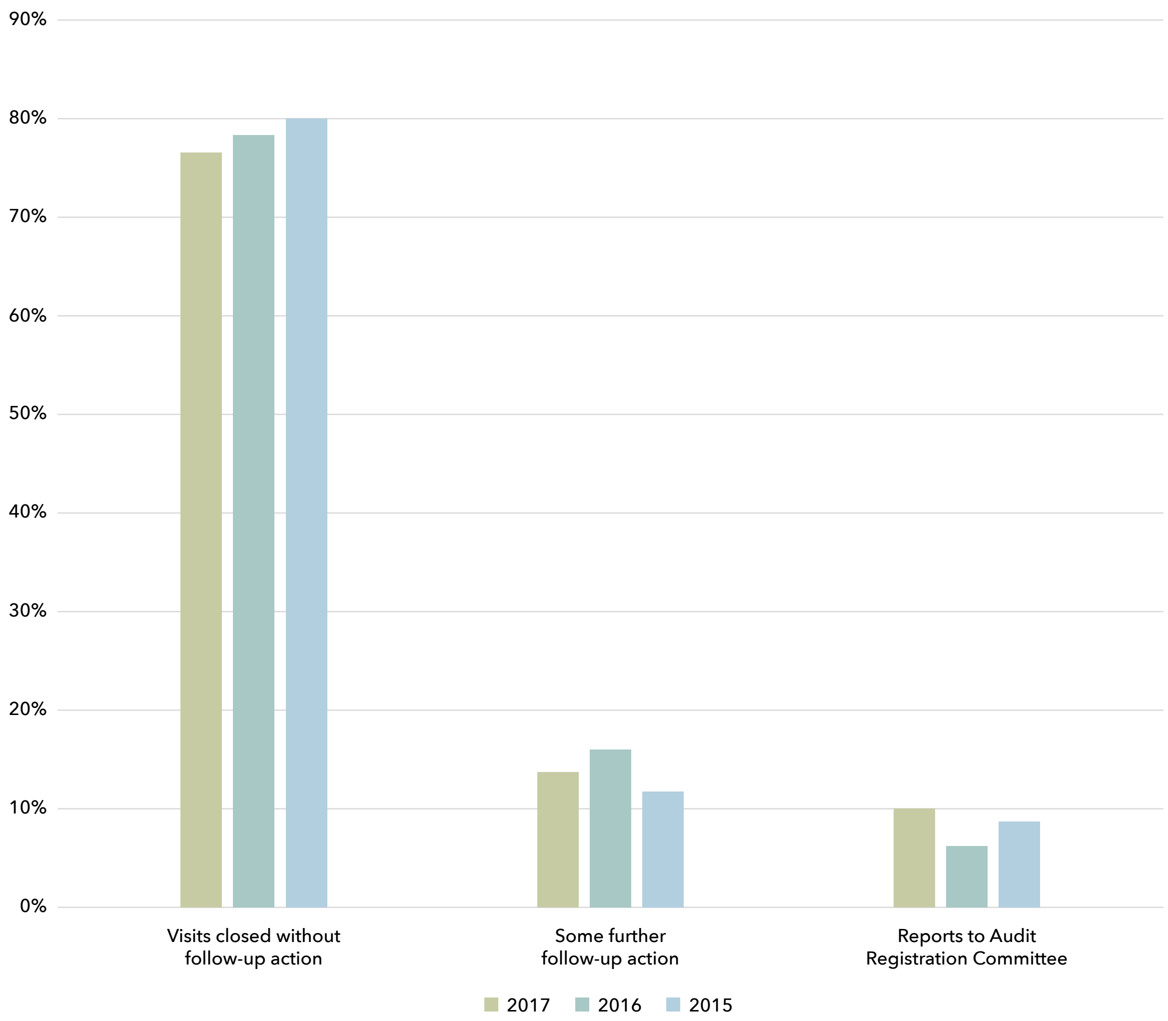
Watch our webcast *FRS 102 implementation* at icaew.com/auditguidance. You can also access a wealth of information about new UK GAAP, including free content, in the financial reporting area of our website at icaew.com/newukgaap

Don't forget our helpline for any accounting queries. Call us on +44 (0)1908 248 250.



Regulatory action

Consistent with previous years, we concluded the vast majority of our 2017 visits without any further regulatory action. As the chart shows, the results indicate a broadly similar position to previous years but with more visits resulting in a report to the ARC in 2017 (10% of visits). We review a different population of audit firms each year so year-on-year comparisons are difficult, however this shift reverses the downward trend in these reports that we saw previously.



Where some follow-up action is needed, we may ask firms to provide further information such as the results of external cold file reviews, details of training courses or improved audit programmes. In more serious cases we write a detailed report for the ARC so it can decide what actions to take.

You can read about the type of issues we report to the ARC in the **What issues lead to a report to the Audit Registration Committee?** section of this report.

ARC ACTIONS IN 2017

In 2017, in the vast majority of cases it considered, the ARC allowed the firms to continue with conditions, or with conditions and restrictions. In most cases, these conditions include the submission of the results of external hot or cold file reviews to enable us to keep a close eye on firms' audit work.

The ARC has a range of options at its disposal. It can:

- impose conditions and restrictions;
- offer a regulatory penalty or refer the firm to the ICAEW Professional Conduct team for further investigation; or
- withdraw audit registration (in the most serious cases). The ARC rarely withdraws registration from a firm without giving it a chance to make the necessary improvements.

	2017
Registration withdrawn	3
Firms where conditions and restrictions imposed	25
Firms where conditions imposed	19
Voluntary withdrawal accepted after an adverse monitoring visit	2

*These numbers include some visits carried out in 2016.

The ARC also imposed 19 regulatory penalties on firms in 2017 for the following reasons:

Eligibility	6
Breach of undertaking or conditions/restrictions	5
Inaccurate annual returns (mainly relating to incorrect statements about cold file reviews)	4
Failure to conduct an audit compliance review	2
Independence	1
Not retaining audit working papers for six years	1

The ARC highlights changes relevant to audit firms and any emerging concerns in *Audit News*.

The current and previous issues of *Audit News* are available at icaew.com/auditnews

There are over 1.7m chartered accountants and students around the world – talented, ethical and committed professionals who use their expertise to ensure we have a successful and sustainable future.

Over 150,000 of these are ICAEW Chartered Accountants. We train, develop and support each one of them so that they have the knowledge and values to help build local and global economies that are sustainable, accountable and fair.

We've been at the heart of the accountancy profession since we were founded in 1880 to ensure trust in business. We share our knowledge and insight with governments, regulators and business leaders worldwide as we believe accountancy is a force for positive economic change across the world.

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