AUDIT MONITORING REPORT 2022/23

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PROFESSIONAL STANDARDS DEPARTMENT

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INTRODUCTION

Rama Krishnan
Chair, Audit Registration Committee

As the Chair of the ICAEW Audit Registration Committee (ARC), I am very pleased to introduce ICAEW's *Audit Monitoring Report* for 2022/23.

This report reveals a mixed picture in relation to audit quality arising from the reviews that the Quality Assurance Department (QAD) conducted during 2022/23.

First, the good news. It was very pleasing to see that 95% of the non-public interest entity (PIE) audits reviewed at the largest seven audit firms were either rated 'good' or 'generally acceptable', which is the best set of results for that cohort. It was also pleasing to see that none of the audits reviewed for firms falling into the Financial Reporting Council's (FRC) Tiers 2 and 3 categories (commonly referred to as 'challenger firms') required 'significant improvement', and that the percentage of good and generally acceptable audits increased significantly from 56% to 72%.

On the other hand, it was disappointing to note a drop to 71% (compared to 76% last year) of these audits rated as either good or generally acceptable in the overall figure for audits across all firms reviewed. However, I do recognise that the list of the firms reviewed in 2022/23 would have been very different to the list of firms reviewed in the previous year (while QAD carries out reviews at larger firms more frequently, most firms are only reviewed once every 6 years). I believe it is, therefore, too early to draw any conclusions about possible trends in audit quality, particularly as firms have been telling QAD reviewers about challenges they have faced attracting and retaining staff post pandemic.

Where QAD identified areas of concern during visits necessitating a report to ARC, the committee reviewed their reports to determine whether those firms should be allowed to continue to audit or should have conditions and/or restrictions imposed on their licences. We considered 41 reports during the year where concerns were identified. The ARC imposed conditions and restrictions on the continuing audit registration of 33 firms and withdrew audit registration from a further five firms.

As in previous reports, Trevor Smith, QAD Director, has identified the key drivers behind audits requiring improvement or significant improvement, which are the more challenging aspects of audits, such as groups, stock, valuations and revenue. It is important that firms focus on these fundamental areas. It is also important that, when audits require improvement, robust root cause analysis takes place and action plans are drawn up to fix the issues and learn lessons for the future. It is good to hear that audit firms have found the implementation of the new International Standard on Quality Management 1 (ISQM1) both thought-provoking and valuable. For many firms, this has been a chance to formalise the risks to audit quality that they were generally aware of, and a prompt to revise and improve existing procedures. This will hopefully strengthen the foundations of audit quality for further development in the months and years to come.

Given the importance of ongoing education and development in improving audit quality, I very much welcome the significant changes which are being introduced in November 2023 to ICAEW's continuing professional development (CPD) requirements for members and the extension of the obligations to ICAEW firms. While there are already requirements and checks on CPD undertaken by responsible individuals, I am pleased to see that the new requirements will apply to all ICAEW members involved in audit work, and that there will be an obligation on members and other regulated individuals to provide evidence of their learning if selected for review by QAD. This will provide greater reassurance that all auditors retain, keep up to date and improve their knowledge and skills base.

I would like to sign off by thanking all the staff within QAD for their hard work and who carried out 496 audit monitoring visits during the year. I had the opportunity to see first-hand during the year just how much work is carried out and the quality and dedication of the QAD reviewers and managers, when I led the ARC's delegated powers' review. I was reassured that they continue to demonstrate a clear commitment to ensuring that reviews are undertaken fairly, and there is a robust quality review process in place.

Finally, I would like to express my thanks to all members of ARC who continue to give their valuable time and commitment to the work of ARC.

MONITORING REVIEWS IN 2022/23

AUDIT MONITORING

ICAEW plays a significant role monitoring the quality of non-PIE auditors and non-PIE audit work in the UK, as the largest UK recognised supervisory body, with responsibilities delegated by the Financial Reporting Council (FRC), the UK Competent Authority.

ICAEW registers about 2,250 firms to conduct audit work.

Our philosophy is to be a robust, proportionate, and transparent regulator. At the same time, we offer help and support to our firms where appropriate.

- Access further information about our audit monitoring visit process

AUDIT MONITORING VISITS IN 2022/23

In this part of the report, QAD Director, Trevor Smith, explains the range of audit monitoring activities undertaken by the QAD team in 2022/23. He highlights some of the key issues that drive poor audit quality and provides some early feedback on ISQM1 implementation. The overall picture of audit quality from audit visits completed during 2022/23 shows that there is still room for improvement in the group of firms reviewed this year, despite good results from the largest audit firms. He explores how proactive firms are using their system of quality management and root cause analysis to drive continuous improvement.

IN THE YEAR ENDED 31 MARCH 2023, WE COMPLETED...

496

audit monitoring review visits, incorporating the review of firms' work on

893

audits (year to 31 March 2022: 555 visits and 1,056 audits).

RETURN FROM PANDEMIC RESTRICTIONS

The overwhelming majority of audit monitoring visits in the period have been on site, with benefits to the effectiveness and efficiency of ICAEW's monitoring work, giving meaningful engagement, discussion and support to our audit registered firms, the great majority of which have three or fewer responsible individuals. However, we have taken some positive learnings from the years of lockdown, with a new hybrid approach to monitoring at the largest audit firms, combining high-quality, in-person interaction with the greater sustainability of remote working.

CONTINUING ISSUES WITH AUDIT QUALITY OVERALL

The nature of audit work and the skills required, including professional judgement, mean that very few audits are 'perfect'. Perfect should not be the enemy of good, and audits we conclude are good will, of course, have elements of audit testing and documentation that could, on reflection, have been done better. Furthermore, audits that are generally acceptable will include one or more elements that did not fully comply with the International Standards on Auditing (ISA), but ultimately these elements do not present a particular risk to the audit opinion in the circumstances, based on the professional judgement of our reviewers.

With 71% of audits judged good or generally acceptable, it is a less positive result for the firms and their audits reviewed in 2022/23, compared to the firms reviewed in previous years. If audits require improvement or significant improvement, this does not mean that the audit opinions were incorrect, but that the scope of audit work, or its documentation, were not adequate to underpin that opinion. We will need to look at audit quality over the next few years to ascertain whether these results represent a temporary issue, possibly an indication of the pressures caused by coronavirus lockdowns, or a longer-term trend.

POSITIVE SIGNS FOR AUDIT QUALITY AT THE LARGEST FIRMS

There are some positive messages coming out of our audit monitoring in 2022/23, not least the 95% of audits we reviewed at the seven largest firms in the FRC Tier 1, being either good or generally acceptable. It is likely this is due to the substantial investment and resources that these firms have been putting into all aspects of their audit practices in recent years.

The other cohort of firms that are singled out for public reporting are those in the FRC's Tiers 2 and 3. We have split out the ICAEW audit firms that audit PIEs but are outside the seven largest firms for the first time this year. These firms vary considerably in size, from relatively small firms to members of well-known international networks, with similarly wide variations in their non-PIE audit portfolios. In recent years, the proportion of good or generally acceptable audits from our visits to these firms has been below average, although they compare more favourably in 2022/23, with none of the audits reviewed at these firms requiring significant improvement, and the percentage of good and generally acceptable audits increased significantly from 56% to 72%.

ICAEW firms in Tiers 2 and 3 are important to the development of capacity and choice in the audit profession and are increasingly taking on more complex non-PIE audit clients. These may present very different challenges from the clients of a typical, smaller audit firm.

Tier 2/3 firms need to be particularly aware of the importance of their audit teams' skills in testing operating effectiveness of controls and applying substantive analytical review to obtain sufficient and appropriate audit evidence. In recent years, audits reviewed at these (and most other) firms have relied heavily on substantive tests of detail.

On a more general point, it is worth all audit firms reviewing their training and guidance to ensure that audit partners and staff have the appropriate skills to address evolving needs for the effective audit of more complex businesses.

QUALITY OF AUDITS

QUALITY MANAGEMENT

The largest audit firms in FRC Tier 1 require the most sophisticated systems of quality management, appropriate to their scale and the complexity of many of their audits. It is reassuring to see that their investment in various quality initiatives in recent years has resulted in 95% of these audits found to be good or generally acceptable in 2022/23. The audit market is changing, and it is important that challenger firms step up to operate alongside Tier 1 firms and ensure that there is enough capacity and choice of auditors for UK companies. Challenger firms have increasingly taken on larger and more complex audit clients, but not necessarily with equivalent, quality-control procedures, although this is changing with increasing investment in central resources at these firms.

The FRC has split its work at PIE audit firms between teams that review the quality of audit engagements and those who perform detailed assessment and testing of the firm's audit procedures and quality control. Over the coming year, we will explore a similar separation of audit monitoring at our mid-sized and larger non-PIE firms. We believe this will maximise the opportunities offered by ISQM1 to enable these firms to safeguard, and in some cases improve, audit quality.

Audit firms' engagement with external training organisations and other audit technical resources, including some from ICAEW, remain critical to success. QAD has seen how firms have benefited from the range of guidance and materials available to support implementation of ISQM1, and more recently revised auditing standards such as ISA 315. Firm's feedback to QAD reviewers on visits has been very positive about the wide range of support available to help them navigate the new standards.

KEY AREAS OF CONCERN OVER AUDIT QUALITY

While all audits are unique, the key drivers for many of the audits we reviewed that required improvement or significant improvement in 2022/23 related to four broad areas:

- group accounts and related audit work
- stock and long-term contracts
- valuation
- revenue.

Group accounts and related audit work

All audits of consolidated group accounts require appropriate audit work on the consolidation, and in many cases, some of the more complex aspects of financial reporting related to business combinations. Consolidation adjustments need to be properly audited according to their underlying purpose, sometimes restricted to agreement with those adjustments made in prior years' audited accounts, but often requiring additional audit evidence to conclude.

Goodwill and intangibles arising on consolidation must be assessed for indications of impairment, and by audit work done on a full impairment review conducted by the audited entity where necessary.

Investments in parent company balance sheets must also be carefully compared to the consolidated position of the group that those investments represent. In a loss-making phase of the group's operations, these investments often appear more valuable than the balance sheet value of the consolidated group. This is a risk of impairment that must be addressed, with work on valuations of the consolidated group that explains why these are higher than the net asset value, supported by robust and justifiable forecasts and assumptions relating to future performance.

It is common for auditors of smaller groups to provide non-audit services related to the preparation of the consolidated group financial statements. For most non-PIE audits, this is allowed by the FRC Ethical Standard, but it is essential that the firm applies robust safeguards to address the self-review threat and ensures that the audit team applies the same level of scrutiny as would be expected on the same financial statements prepared by the staff of the audited entity.

The audit of group accounts presents additional challenges where the group audit team is also directing and supervising the work of component auditors to support the group audit opinion. ISA 600 requires close involvement by the group auditor with the work of the component audit team, from planning and risk assessment through to completion, including assessment of the adequacy of work and conclusions of component auditors in key areas of their audit.

Issues arise in cases where audited entities appoint a relatively small audit firm as group auditor of a worldwide group, possibly with component auditors that are members of one of the large international networks. There are financial benefits to the audited entity, with the group audit fees likely to be lower than fees that would be charged by the UK member firm of the international network. However, it is essential that these smaller audit firms are just as robust in their involvement, including direction and supervision of the component auditor as when dealing with another, lower profile firm.

On the other end of the scale, UK audit firms sometimes deal with component auditors who cannot communicate in English. In this case, the UK audit firm will have to obtain its own relevant language skills and translation and ultimately may need to insist to its client that it goes out to the subsidiary to do audit work directly, or another, more appropriate audit firm, is appointed to the component to enable the necessary effective direction, communication and review to take place.

Stock

Stock will be a material balance sheet item in many trading companies, including retail and wholesale businesses. It presents a wide range of potential risks that need to be considered by the auditor: existence, valuation, cut-off. It may be on a container ship somewhere in the world, or held by a third-party warehouse, or even on consignment/sale or return to its potential customer.

In the simplest audit, existence will be audited through attendance at a full stocktake at the year end, with auditor test counts of stock quantities, assessment of condition and an opportunity to collect copies of final stock sheets and despatch documentation for use later in the audit process. coronavirus added further complexity to stocktake attendance, but even without this, we find weaknesses in how this evidence from the stocktake is dealt with during the main period of the audit. Stock quantities must be checked through to final stock listing and variances properly investigated in order to conclude.

Larger businesses have multiple stock locations and may operate a perpetual inventory counting system. Multiple locations do not need to be all visited annually, but the auditor should plan and justify a suitable cycle, ideally with an element of unpredictability, so that the audited entity does not have a significant period of notice that a certain site will be subject to audit stock counts, but not others. Audit of a perpetual inventory system is never a purely substantive test. The auditor needs a thorough understanding of the system and its operation, including coverage of stock lines and controls around counting, recounting and approval of variances booked into the stock system throughout the year.

Straightforward valuation tests for stock will include checking to purchase invoices (cost) and recent sales invoices (as confirmation of net realisable value). If there are no recent sales invoices, maybe the last being 2–3 years previously, we sometimes see firms ignoring the evident risk of the need for full or partial provision over the value of that stock.

More complex cases, particularly manufacturing, will involve standard costing and bills of materials that themselves must be audited in order to rely on them for the purposes of audit work. Agreeing standard costs of products to those applied at the previous audit has never been appropriate, but it is clearly inadequate with the return of significant inflationary pressures worldwide.

Long-term contracts

Long-term contracts typically occur in the construction and engineering sectors, but also feature elsewhere. The nature of long-term contract accounting makes these challenging for any firm to audit. There are potentially complex judgements required and the need to rely on experts, normally experts employed by the audited entity, but occasionally the auditor’s experts.

It is hard to envisage circumstances where it can be effective to audit individual financial statement line items, rather than taking a holistic approach to audit a sample of the contracts in the accounts with their respective contributions to revenue, expenditure, assets and liabilities.

A firm may test a larger sample of contracts in cases where it does not obtain audit assurance from tests of the operating effectiveness of the audited entity’s controls, or a smaller sample where it does plan to obtain controls assurance. Reliance on controls must be based on evidence that these controls are effective, not simply an understanding that controls are in operation (which would be a base-line requirement for audit risk assessment at the planning stage). Typical controls in a long-term contract business will include a process for contract management and regular contract review meetings between members of the audited entity's finance and operational staff. Auditors will need to attend at least one of these meetings as part of their tests of operational effectiveness, understanding the key elements of the meeting: standing agenda items, financial information prepared as a basis for discussion and process to resolve and feedback on any questions, requests for further information or uncertainties raised, and minutes to record the key points. Needless to say, the auditor will also want to see evidence of the same processes in operation through the selection of a sample of other contract review meetings that have not been attended. If the auditor cannot see documentary evidence of the meetings happening routinely across all contracts through agendas, minutes and email correspondence, then this is not a control that can be relied on to reduce the sample of substantive contract testing.

The most common weakness we see in auditing of long-term contracts is the assessment of provisions and costs to complete, which will normally result in uncertainty over the level of revenue, expenditure and profit reflected in the financial statements.

Property valuation

Assessing the appropriateness of property valuations can be challenging. Firms need to assess the evidence objectively and test assumptions against whatever reliable data is available. In some cases, they may need to rely on specialists.

QAD reviewers sometimes find very little evidence to support valuations and, where there is a formal valuation by a specialist valuer (usually a management expert), little or no evidence of evaluating their competence and objectivity, the relevance and reasonableness of assumptions, or completeness and accuracy of source data. These steps are required by ISA 500.

In other cases, property valuations may be provided by management, and there may be little direct evidence to support such estimates. Sometimes, QAD reviewers see no attempt has been made by the auditor to assess such valuations objectively. Management may provide a written representation, but this does not provide any evidence by itself. We have come across cases where professional valuers have valued the bulk of an investment property portfolio, leaving one or two exceptions which the firm has done nothing to consider.

QAD reviewers also come across firms that say they do not have the expertise to assess assumptions, in which case they should be considering whether to engage their own expert. These issues should, of course, be identified before the audit is accepted. However, with some further thought and discussion for non-specialist properties (for instance, residential, office, retail or light industrial), experienced auditors should be able to test these estimates using suitably reliable, publicly available information, without necessarily having very specialist knowledge.

Business valuations

Similar challenges arise in business valuations, with estimates and judgements a key component of frequently complex valuation models, with assumptions driving forecasts of revenue and profit into the future. The first step is to verify the integrity of the model. Then the need for experts is a matter of judgement for the auditor and will depend on experience within the audit team. We identify a relatively small number of audits with problems in this area. That is likely to be a consequence of fewer audits requiring assessment of business valuations and impairment testing in the non-PIE audit population.

Revenue

Weaknesses in the audit of revenue are common across audits requiring improvement or significant improvement. Issues are varied and, in some cases, will be linked to the approach to long-term contract accounting, with the interaction of estimates and judgements in determination of revenue to be recognised in any given accounting period.

More generally, although most firms will identify the rebuttable fraud risk in relation to revenue recognition, it can be difficult to see how this risk has been addressed in subsequent audit work.

Completeness of income is often a potential risk identified at the audit assertion level for a private company. The audit testing of a sample taken from the general ledger will only provide audit evidence over income that has been recorded, not about the completeness of that income. However, a private company looking for a buyout or buy-in by external investors may present very different risks, with the incentive to overstate revenue and profits far more relevant to the audit risk assessment.

The first step in the audit of revenue is understanding the accounting policy and sales terms to determine whether the point of revenue recognition is appropriate. Whilst many companies are straightforward, sales of services (such as software and maintenance contracts, or goods involving bill and hold arrangements, export sales and use of intermediaries), need more care.

Different sources of audit evidence all present their own challenges in the audit of revenue. Tests of detail are most common, arguably the simplest approach, but on 'stand back' it can be hard to conclude that there is enough weight of audit evidence gathered without very large sample sizes. Methodologies that apply a judgemental 'cap' on sample sizes can give a false sense of security, and it is not an approach that was ever intended to be simply taken by default without further thought. In a business with huge numbers of very small transactions, the selection of 60 or 100 in a sample may represent a very small proportion of the activity.

Substantive analytical review and tests of operating effectiveness of controls can provide high-quality audit evidence for businesses, especially those with high sales volumes and automation (including online businesses). However, these are far more complex techniques. All of the inputs to a substantive analytical review must be fully audited and verified, controls must be seen in operation consistently throughout the period, through observation, examination of documentation or tests of IT controls.

Complexity of the audit technique should not be seen as a barrier for use by firms but does require additional expertise and training. Having gained this expertise, substantive analytical review and tests of operating effectiveness of controls could be used more routinely by firms where the audited entity's own processes and procedures are robust enough to support their use.

Despite a wide range of weaknesses that may result in a QAD conclusion that the audit of revenue needs improvement or significant improvement, in some cases, it is a simple lack of audit work, either in relation to material revenue streams, or even revenue as a whole.

ROOT CAUSES AND HOW THESE ARE ADDRESSED

In our 2021 Audit Monitoring Report, we shared insights into the root causes of poorer quality audit files identified by firms in response to our visits. Commonly identified root causes remain the same: a lack of knowledge (either of what was required by the ISAs or by accounting standards), flaws in the design of audit tests, and inadequate review by the manager and/or audit partner. Another factor that has compounded these issues, particularly since the pandemic, is resource pressures with firms either unable to recruit enough staff to service existing audit clients, or staff lost mid-way through an audit, including those deciding to move to other equally resource-constrained audit firms.

Additional technical training is often one of the steps taken to address these root causes of poor audit quality. This may be training that focuses on particular audit issues, such as long-term contract auditing, or more general training, such as on audit planning and risk assessment, that can then help audit teams to design appropriate audit tests from the start and identify particular issues that may need more specialist expertise or support during the course of the audit.

As many auditors will realise, the topic areas we've identified as key drivers of audits that need improvement or significant improvement are neither new/emerging issues, nor particularly complex areas for a competent auditor. There is a common theme linking all of the areas around auditors making, analysing and challenging judgements, both of themselves and their audit clients.

Coaching and training within audit teams is important, and this should not be restricted to technical matters but also skills such as application of judgement, interviewing techniques, guiding and providing feedback to staff, as well as dealing with difficult conversations. Much of the investment in audit by the largest firms in recent years has been in culture and skills, developing audit teams that work effectively at all levels, challenging audit clients and each other, and with the resilience and courage to speak up and ask difficult questions.

Reflecting on training needs and acting upon them are required of all audit firms by the Audit Regulations in line with ICAEW's long-standing approach to CPD. All responsible individuals must also consider the requirements of International Education Standard 8 (IES 8) in their own CPD and related development.

Most IES 8 components are equally important for the whole audit engagement team, including knowledge of the business environment, interpersonal skills, information technologies and professional scepticism.

CASE STUDY

Root cause analysis

A mid-sized firm, with seven responsible individuals, more than 200 audits and about 30 staff engaged in audit work, had a good history of audit quality over several decades but when visited in 2022/23, two of the five audit engagements reviewed required improvement or significant improvement.

The firm was naturally disappointed in the results of our reviews. It acknowledged that it had significant challenges at the time the audits had been completed, with implementation of a new audit system and resource constraints requiring the use of temporary staff over the busiest audit period.

In respect of a lack of work on defined benefit pensions obligations on one audit, the firm noted that it had appropriately identified risks at the planning stage and prompted its client to obtain updated actuarial input for the financial statements. However, other issues arose relating to the financial position of the entity, delaying the audit work and taking the attention of the responsible individual and manager. As a result, the pensions liabilities were not revisited until much later in the audit than planned. The client had not obtained the actuarial input as requested, and the firm was left trying to do some limited work to gain audit assurance on the balances. This was clearly not what the firm planned and agreed with its client at the outset. In the end, this work was time-pressured with an under-resourced team and, as a consequence, the results were poorly documented.

IMPORTANCE OF QUALITY MANAGEMENT

All audit firms should have implemented ISQM1 with the first cycle of monitoring and remediation underway. Firms, that have received an ICAEW audit monitoring visit since February 2020, will have become more familiar with the concept of root cause analysis of more significant weaknesses identified in audit quality. Audit firms now need to adopt this technique as part of their routine monitoring.

Effective root cause analysis followed by remediation to address the root causes will help ensure that firms' audit quality management procedures evolve with their practices. The largest audit firms have invested in dedicated root cause analysis toolkits and dedicated teams. Processes for smaller firms do not need to be as complicated or involved. The important aspect is that, if problems recur, firms then take time to reassess. Was the root cause too rudimentary and stopped short of the real cause? Was the remediation plan appropriate but then not followed through? Or was the plan itself ineffective? After a few iterations, all firms should be able to settle on a process that works for them.

Our survey in the first quarter of 2023 told us that many firms have invested considerable efforts in the implementation of ISQM1, and most had either fully implemented it, or were making good progress. ISQM1 does not introduce significant new elements to a firm's underlying audit quality control procedures. Rather it has formalised the need for risk assessment and ongoing monitoring and remediation to identify and address changing circumstances to protect audit quality over the long term. It was clearly a sprint for many firms to be ready for 15 December 2022, but the more important, long-term changes only started at that date, and it is critical that every firm maintains focus on operating and maintaining its system of quality management in the months and years to come.

CASE STUDY

ISQM1 implementation

A mid-sized firm, with several offices, eight responsible individuals and about 40 staff involved in audit work, put together an ISQM1 implementation team of three and used guidance and materials from two training organisations to provide both a structure for the risk assessment process and skeleton manual on which to base the firm's documentation of its quality management procedures.

The implementation team consulted staff to provide input into the risk assessment process.

Identified risks included structural matters such as inconsistency in approach to audits between offices, a responsible individual, with very few audits outside the core audit team, and whether all staff with operational responsibility for quality management had the appropriate level of seniority and authority to be fully effective. The firm also identified potential risks from the influence of client engagement principals over the audit responsible individual of that client where those roles were separate, common at many firms of this size.

Many risks related to resourcing and the economics of the audit, with low audit fees meaning that non-audit work may be prioritised as more profitable, use of financial key performance indicators having a negative impact on audit quality, and inappropriate/insufficient allocation of audit staff due to challenges in recruitment.

In many cases the firm was able to conclude that risks were already addressed by existing policies and procedures, subject to some minor changes and improvements, and where this was not the case, the firm developed a clear action plan to address them. Changes to procedures included enhancing the new client acceptance process for new audits, to assess staff resources in more depth, and governance changes to ensure that the managing partner and board had full oversight and responsibility for quality management in the firm.

The firm acknowledged that the system of audit quality management will be an ongoing process of development, monitoring and feedback.

Action required by all audit firms

All firms' ISQM1 risk assessment needs to include consideration of information from external sources, and this should include key findings from ICAEW audit monitoring. As set out above, common areas of weakness leading to audits that either need improvement or significant improvement are group audits, including consolidation, stock and long-term contracts, valuation and revenue. One or more of these areas will be relevant to all active audit firms and each should know to consider how these risks may present themselves in the firm's audit portfolio. Firms should be asking themselves some of the following questions.

- What are the group audit clients? Does audit planning and risk assessment start at the consolidated group level? How do those working on the group audit supervise and control work done on components (either within the audit firm or by another audit firm)? What audit programmes, training and other guidance are available to audit teams?
- What types of stock do audit clients have? Are there significant audit risks to be addressed? Manufacturing clients with stocks at standard cost, clients with long-term contracts and those where stock management relies on perpetual inventory counting systems may all be considered 'specialist' in their own right. Members of the audit team will need particular knowledge and experience to conduct these audits to a good standard.
- Where are there significant valuation judgements in the audit portfolio? What is the asset (or liability) being valued? Do engagement teams have the necessary skills to challenge the client and/or its experts appropriately? Or is there a need for the firm to obtain its own expert assistance?
- Does the audit of revenue start with a clear understanding and critical assessment of the revenue recognition accounting policy? This should be a starting point for audit risk assessment and then the design of appropriate audit procedures. Typically, audit teams will accept the significant risk relating to fraud, but what exactly is this risk, and how is it addressed through the audit work performed? For some types of business, it may be difficult to conclude on sufficiency of audit evidence over revenue, whether you have a sample of 20 or 2,000 items, so audit plans may need to consider other audit techniques to gather evidence.

GOOD PRACTICE

Every year we identify examples of good practice to share with most of the firms we review. Good practice does not mean going substantially over and above ISA requirements, doing additional work in areas of relatively low risk or generally 'over-auditing'. Any of those traits is likely to endanger audit quality because they distract from a focus on audit risk. Good practice is clear demonstration of audit risk assessment based on understanding of the audit client, tailoring the work to address those risks, with execution and documentation of that work showing how the firm has reached its conclusions on that audit.

ICAEW'S MONITORING RESPONSIBILITIES

MONITORING RISKS AND ACTIVITY

To support firms to develop their audit practices and maintain high standards, we have increased audit monitoring activities and broadened the nature and scope of monitoring. An Audit Risk Officer has been recruited to proactively identify and monitor audit risks as they occur within ICAEW registered audit firms. Articles from the Risk Officer are being included in Audit News and Regulatory & Conduct News. Where appropriate, we engage with firms early in the audit process, providing them with support to better manage any potential risks and prevent problems from occurring.

MONITORING RISKS IN THE NON-PIE AUDIT SECTOR

The number of UK companies seeking new auditors has risen sharply over the past couple of years, and the market has been turbulent in 2022/23. All auditors have responsibilities in relation to resignations and need to make informed decisions when choosing whether to accept new audits into an existing portfolio.

Our work in 2022/23 has highlighted concerns in some cases with the audits that firms have taken on. The ARC has taken follow-up action to ensure firms take the necessary steps to resolve the issues for future audits. We have also seen good practice by firms at all stages of the process, from informative cessation statements to careful consideration of risk management and resources in making the decision whether or not to tender for a new audit opportunity.

CASE STUDY

A company seeks a new auditor

A small audit firm submitted a cessation statement under Companies Act s519 for the audit of a company in a relatively complex, niche market. As well as recognising that it could no longer continue to service the audit requirements of this growing company based on the firm's available expertise, it also listed concerns in the cessation statement concerning ethical practices and negative media. The cessation statement was filed appropriately on Companies House within the required timeframe.

Through ongoing risk monitoring activity, our work identified one firm who had been subsequently approached by the company and declined to tender for the audit. From our discussions with that firm, it had determined that the audit did not fit well with its risk strategy and client acceptance criteria, and specifically identified that it lacked sufficient expertise in the sector. The firm cited the cessation statement as being useful additional intelligence to inform its decision.

The company has since found an auditor, and as part of a standard QAD audit monitoring visit, we were able to explore the new auditor's acceptance decision in this case. Thanks to wider links within its own network, the new auditor had access to significant expertise relevant to the niche sector. As part of the decision process, it critically assessed the other concerns listed in the previous auditor's cessation statement, including exploring these issues through discussions with the potential new client in order to form a judgement on whether it would be able to perform a high-quality audit.

The firm compiled all relevant information and took the case to its audit committee for approval. This committee was itself part of recently enhanced audit acceptance procedures, having been formed as part of the firm's implementation of ISQM1. After this careful consideration, the audit firm decided that it was able to accept the client.

This one example highlights how clarity of cessation statements by outgoing auditors, combined with clear and robust client acceptance criteria, processes and procedures, support the wider audit quality agenda. Each firm involved was able to make clear and informed decisions and ultimately, the audit was undertaken by a firm that appeared well-equipped to deliver a high-quality audit for this client and its stakeholders.

OTHER AUDIT MONITORING WORK

Other audit monitoring work undertaken by QAD includes:

- local public audit
- Crown Dependency visits
- monitoring for other regulators.

Local public audit

We continue to review local public audit engagements at firms registered with ICAEW to carry out local public audit work. There have been well-publicised delays in completion of local public audits in recent years, with consequential impact on the timing of our monitoring work.

The results of our latest monitoring, reported to the ARC in October 2022, were that 88% of the local public audit files reviewed were either good or generally acceptable. This is a consistent standard to the previous period of reviews included in our 2020/21 audit monitoring report.

Crown Dependency visits

We completed four visits in 2022/23 (five visits in 2021/22). One firm had no audits (three firms in 2021/22), and all files reviewed were either good or generally acceptable in 2021/22, as they were in 2021/22.

Monitoring for other regulators

We undertake audit monitoring under contract for a range of organisations, including Monitor on NHS Foundation Trusts, Audit Wales, Northern Ireland Audit Office, Audit Scotland and a number of overseas bodies. This work helps to further support overall trust in the profession, both in the UK and overseas. It also provides our reviewers with a broader experience, and this variety of work helps ensure we continue to attract high-quality candidates for positions available within the QAD review team.

FUTURE AREAS OF FOCUS

LOOKING AHEAD TO 2023/24

Looking ahead to 2023/24, the areas to monitor will include:

- new ISAs and sustained attention to quality management
- CPD for ICAEW auditors.

NEW ISAs AND SUSTAINED ATTENTION TO QUALITY MANAGEMENT

Audits in 2023/24 will be the first done using the new fraud and risk assessment ISAs (ISAs 240 and 315) that are applicable for periods commencing on or after 15 December 2021. As with all such changes, these are intended to enhance the quality of audits but will be a challenge for audit teams working with revised procedures for the first time. Firms should consider hot or cold reviews of early engagements conducted under these new standards as a timely check that changes have been understood and are effective, with feedback on aspects requiring improvement.

Quality management, both ISQM1 and ISQM2, should continue to be an area of focus for firms, with the need to operationalise the system of quality control designed in 2022 and start the ongoing process of monitoring and development to ensure that it is fully effective.

CPD FOR ICAEW AUDITORS

From 1 November 2023, all individuals affected by CPD Regulations will be required to identify which CPD category is most applicable to them, based on the type of work they do.

Each CPD category has a corresponding minimum number of hours of CPD that must be undertaken, a proportion of which must be verifiable. The minimum hours requirements apply regardless of whether the individual in parti-time or full-time work. Audit firms and their staff should assess the implications for them using ICAEW's CPD self-assessment tool. Some responsible individuals and audit staff will be in the lowest category (3) but many, who are either responsible individuals or audit staff spending a good proportion of their time on audits of large companies/public sector bodies or of PIEs/Major Local Audits, will find that they are subject to the additional hours requirements in categories 2 and 1, respectively.

Under the new requirements, audit firms registered with ICAEW have a direct responsibility to ensure that all individuals within the firm affected by the regulations are in compliance with the requirements and maintain records of relevant and verifiable CPD hours. Firms will need to review their processes to ensure they can demonstrate how, as a firm, they review and monitor CPD. Firms need to ensure individuals have correctly assessed which CPD category they sit in and check they have carried out the minimum required hours, including verifiable hours and mandatory ethics training.

From 1 November 2023, for those affected by the revised CPD Regulations, at least one hour of verifiable CPD each year must be on ethics. ICAEW has created a free ethics CPD course to help individuals comply with the new regulations, equipping them with the knowledge and confidence to demonstrate high standards of ethical conduct in their professional roles. Given the importance of ethics to auditors, we do not expect this should present any significant change for our audit firms.

CPD RESOURCES

There is a wealth of resources available to help members and firms with these changes.

- Access our CPD hub for members
- Firm responsibilities for revised CPD Regulations
- ICAEW Ethics CPD Course
- Continuing Professional Development (CPD) Regulations 2023
- Audit Regulations and Guidance

RESOURCES

RESOURCES AND GUIDANCE

CPD LEARNING RESOURCES

ON-DEMAND WEBINARS

AUDIT NEWS

REGULATORY AND CONDUCT NEWS

TECHNICAL AND ETHICS ADVISORY SERVICES

HELPSHEETS

GROUP AUDITS HELPSHEET

ISQM1 RESOURCES

AUDIT AND ASSURANCE FACULTY

CORPORATE REPORTING FACULTY

OVERSIGHT OF ICAEW IN THE REGULATED AREA OF AUDIT

GENERAL INFORMATION AND OVERSIGHT

All work carried out by the ICAEW Professional Standards Department (PSD) is overseen by the ICAEW Regulatory Board (IRB). In turn, our work in areas regulated by law (audit, anti-money laundering, local audit, investment business, insolvency and probate) is monitored by oversight bodies. For firms working in the regulated area of audit, which are required to comply with the Audit Regulations and Guidance, the oversight body is the Financial Reporting Council (FRC).

These oversight bodies monitor our work to ensure we maintain the highest standards in our regulation. Our oversight regulators carry out regular on-site inspections, selecting files for review and publishing reports about the quality of our work.

Independent regulatory and disciplinary committees monitor compliance with the regulatory requirements of firms and insolvency practitioners (IPs). They consider QAD's monitoring reports and can order firms/IPs to take remedial actions or, where work is very poor, they will consider withdrawing licences or registrations.

- Read more about ICAEW's role as an improvement regulator

EXTERNAL OVERSIGHT BY THE FRC

The FRC is the UK Competent Authority for audit and delegates responsibility for licensing, monitoring and enforcement work relating to non-Public Interest audits and auditors to recognised supervisory bodies, including ICAEW. It carries out an annual inspection of ICAEW's audit licensing, monitoring and enforcement work and publishes the results of its inspections. The FRC also undertakes reviews of complaints about ICAEW's handling of audit and accountancy complaints.

OVERSIGHT BY THE ICAEW REGULATORY BOARD (IRB)

The IRB has overall responsibility for overseeing the regulatory and disciplinary work carried out by PSD staff and the effectiveness of the regulatory and disciplinary committees. Its members (and chairs/vice chairs) are appointed by the Regulatory and Conduct Appointments Committee.

It holds five to six meetings per year and reviews updates from the PSD Chief Officer on the department's progress on current initiatives and the impact of proposed regulatory changes.

The IRB's quality assurance programme includes IRB members observing meetings of the regulatory and disciplinary committees and meeting with committee chairs to discuss feedback on committee performance and ideas as to how to make the committees more efficient and effective.

The board receives and reviews all the 'delegated powers review' reports prepared by the regulatory committees and the Investigation Committee. It also reviews the final inspection reports prepared by each of ICAEW's external oversight regulators.

THE AUDIT REGISTRATION COMMITTEE (ARC)

All significant decisions on audit regulatory matters are made by the ARC. This committee is independent from staff and comprises of a parity of lay and chartered accountants with a lay chair who has a casting vote. This maintains an important balance of technical insight from the chartered accountant members and public interest insight from the lay members.

Where regulatory action may be appropriate following a QAD audit monitoring visit, the committees will consider whether such action is appropriate, which could include one or more of the following outcomes:

- audit registration withdrawal
- imposing conditions/restrictions
- proposing a regulatory penalty.

Every year a lay parity or lay majority subcommittee of the committee carries out a 'delegated powers review'. Sub-committee members review PSD files to check that licensing decisions taken by staff on new audit applications are within the criteria set by the committee and to check whether staff follow-up on remedial action recommended by QAD or required by the committee following a visit. They also review the grading of a sample of QAD visits to gain assurance that remedial action is taken against all firms whose audit work has fallen below standard. Each delegated powers review report is considered by the committee and then submitted to the IRB.

- Access ICAEW Regulatory Board and Governance
- View an organisational diagram of our oversight structure
- Information on our regulatory and disciplinary committees

APPENDIX AND OUTCOMES

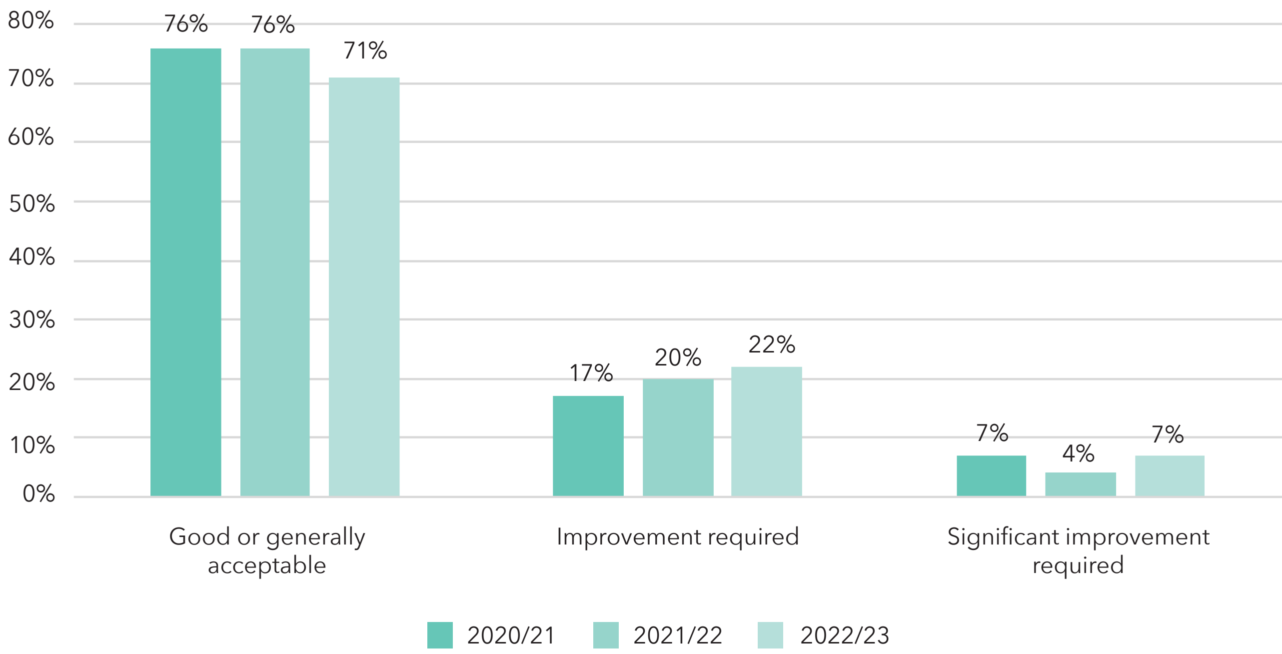
APPENDIX: DATA AND VISIT OUTCOMES

AUDIT QUALITY: ALL FIRMS

This chart shows the results of all audit file reviews carried out for the year ended 31 March 2023 compared to the year ended 31 March 2022 and the 15 months ended 31 March 2021.

Results of 775 audit file reviews in 2022/23 show that 71% of these audits were either good or generally acceptable, and 29% required improvement or significant improvement. This is a worse position than in previous years, including reversal of the temporary improvement last year in the number of audits attracting the lowest quality grading.

Audit quality 2022/23 – all firms



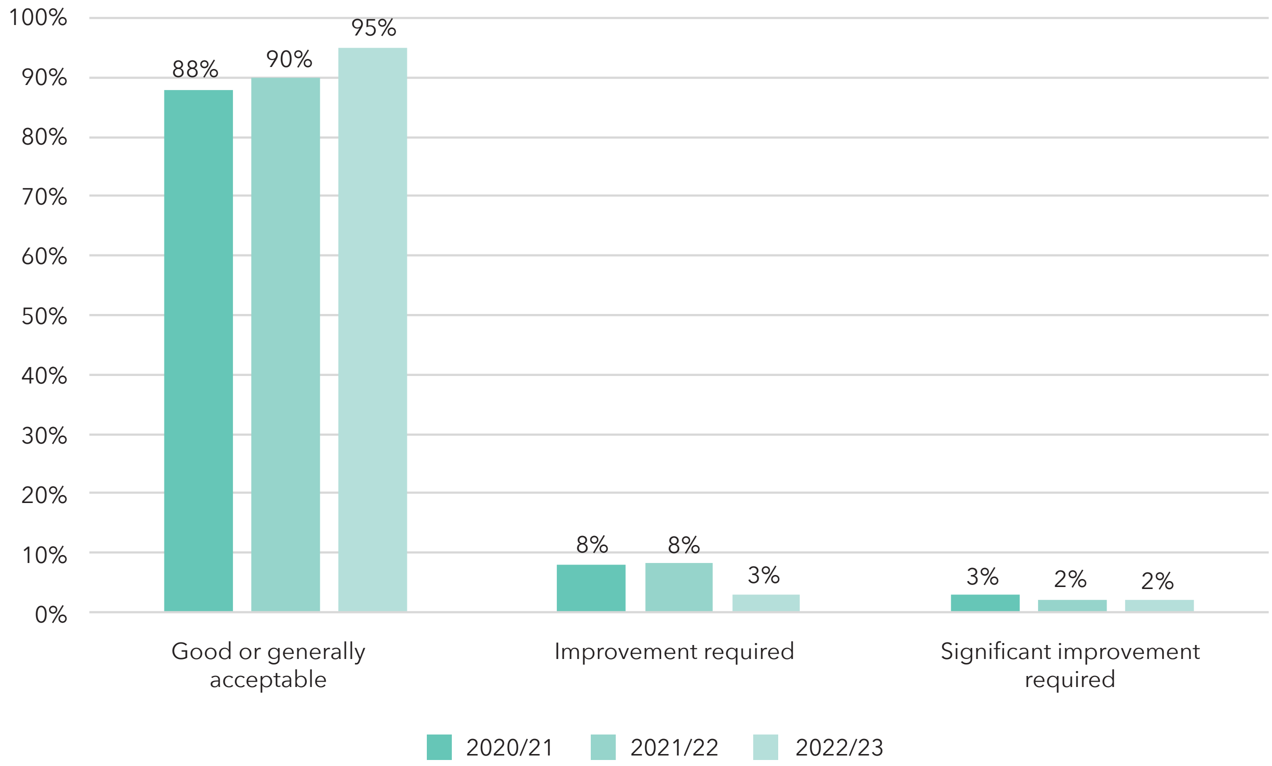
AUDIT QUALITY: LARGEST PIE AUDIT FIRMS (FRC TIER 1 FIRMS)

The seven largest audit firms are subject to an annual review of their PIE audit work by the FRC and to non-PIE audit file reviews by ICAEW every one or two years. The FRC retains full responsibility for whole-firm procedures, including compliance with ISQM1. ICAEW is solely delegated the review of non-PIE audit work and additionally undertakes some monitoring of individual CPD for non-PIE audit staff in the firms.

2022/23 data reflects the results of 60 audit file reviews across six firms (2021/22: 51 files at five firms, 2020/21: 60 files at six firms).

This chart shows the aggregate results of reviews of non-PIE statutory audits at these largest firms over the past three years, with 95% of audits reviewed judged to be either good or generally acceptable in 2022/23. The results of ICAEW reviews of non-PIE audits at individual large firms can be seen in the FRC's July 2023 Audit Quality Inspection Reports.

Audit quality 2022/23 – FRC Tier 1



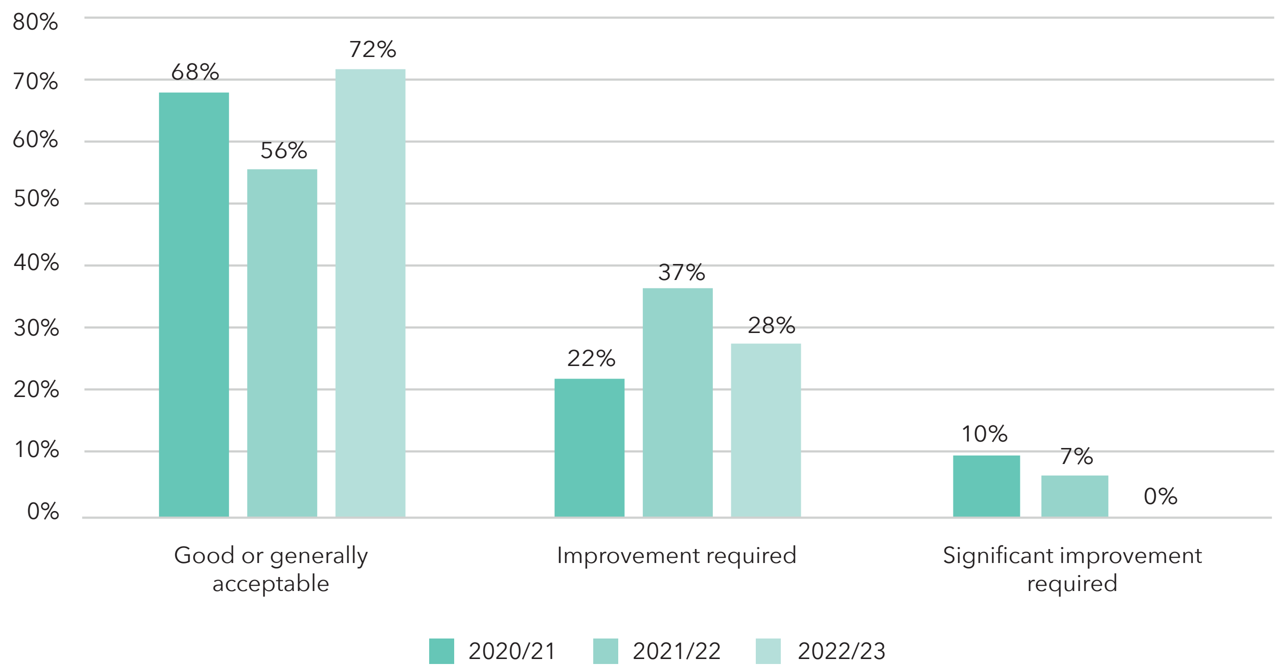
AUDIT QUALITY: OTHER PIE AUDIT FIRMS (FRC TIERS 2 AND 3 FIRMS)

Other PIE audit firms are subject to review of their PIE audit work and non-PIE audit work by FRC and ICAEW, respectively, over cycles of between two and six years. The FRC retains full responsibility for whole-firm procedures including compliance with ISQM1, ICAEW is solely delegated the review of non-PIE audit work and additionally undertakes some monitoring of individual CPD for non-PIE audit staff in the firms.

2022/23 data reflects the results of 40 audit file reviews across seven firms (2021/22: 27 files at five firms, 2020/21: 41 files at six firms).

The chart shows the aggregate results of reviews of non-PIE statutory audits at other PIE firms over the past three years, with 72% of audits reviewed at these firms judged to be either good or generally acceptable in 2022/23.

Audit quality 2022/23 – other PIE audit firms



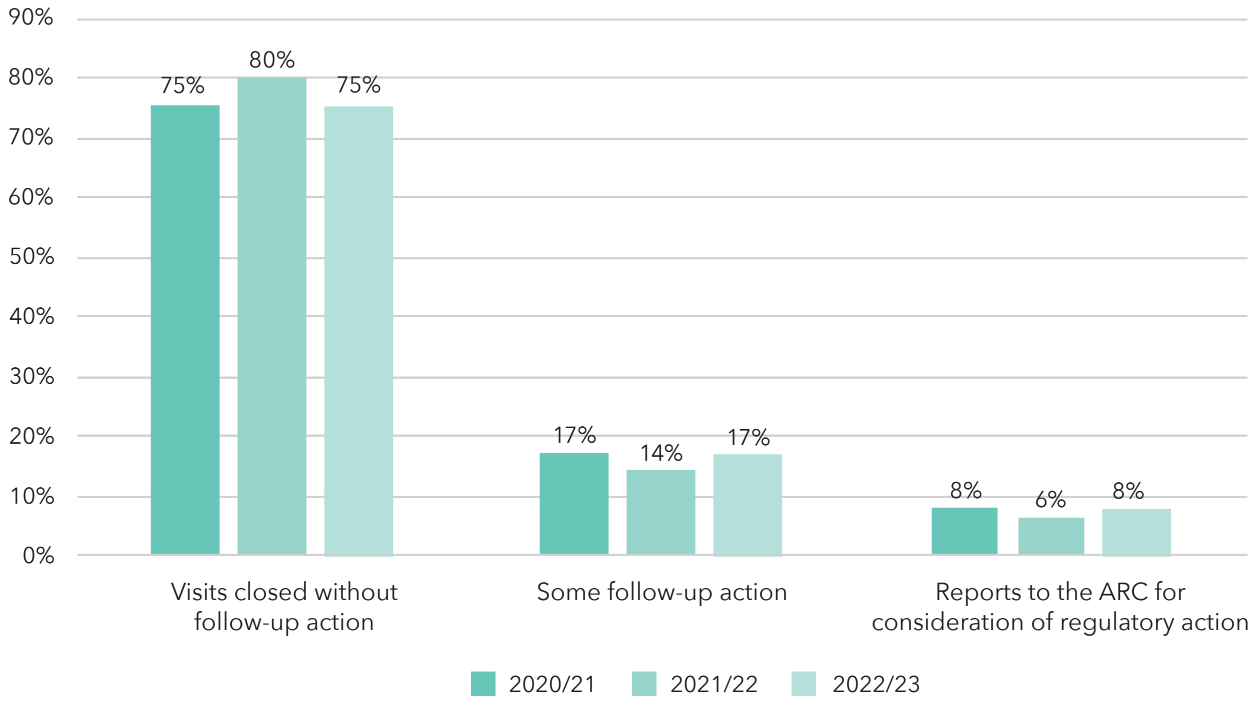
AUDIT MONITORING VISIT OUTCOMES: ALL FIRMS

Overall conclusions are drawn at a firm-wide level for each monitoring visit. The visit outcome for each firm incorporates not only an assessment of overall audit quality (taking into account all file reviews carried out at the firm) but also an assessment of the adequacy of the firm's policies and procedures (non-PIE firms only), evaluation of the firm's root cause analysis for more significant findings, and the firm's commitment and ability to address the findings. These assessments can result in very different visit outcomes.

Visits closed without follow-up action

As part of the visit process, firms must provide a written response to the matters raised, including details of actions planned and taken. If ICAEW is satisfied with the firm's response and considers the firm has both the commitment and ability to make any improvements needed, the visit will close without any further action. The final assessment takes into account a range of factors, including the scale of improvement required and previous visit history.

Visit outcomes – 2022/23



Some follow-up action needed

Where some follow-up action is needed, firms are asked to provide further information. This ranges from providing further details of planned actions to submitting the results of external cold file reviews, details of training courses or improved audit programmes. Submission of this information usually gives ICAEW the reassurance required that the firm is addressing the matters raised. If not, additional evidence of improvement may be required, or we may decide to bring forward its next review visit.

Where audits require improvement

This will attract strong follow-up action unless firms can demonstrate that these are isolated examples and that they have taken appropriate steps to understand root causes and prevent recurrence. If, for example, four audits are found to be generally acceptable with only one needing improvement, ICAEW may conclude that the firm is able to address any issues. However, ICAEW still needs to be satisfied that the firm has explored the root causes of the audit needing improvement and that it has developed an appropriate action plan. If ICAEW is not convinced about the firm's response, we will put in place some follow-up actions to enable the firm's progress to be monitored.

Where audits require significant improvement

If the QAD reviewer considers that the quality issues are more widespread, or serious in nature, the firm will be reported to the ARC and some form of regulatory or disciplinary action is likely to follow. The ARC has a range of options at its disposal. It can:

- impose conditions that typically would include external hot or cold file reviews with the submission of the results in order to monitor firms' progress;
- impose restrictions, for example restricting a firm from taking on any new audits without approval from the ARC;
- offer a regulatory penalty or refer a firm to the ICAEW Conduct team for further investigation; or
- withdraw the firm's audit registration (in the most serious cases).

The ARC will usually seek to provide an opportunity to a failing firm to show it can improve by imposing conditions, requiring checks be made on future audits, while protecting its clients and the wider public. If sufficient improvements are not seen, the ARC may move to withdraw a firm's registration. The majority of our 2022/23 visits concluded without any further regulatory action.

The proportion of visits requiring follow up and consideration of regulatory action has returned to the levels seen in 2020/21 following a temporary improvement last year. This is in line with changes in the proportion of audit files that require significant improvement.

ICAEW's regulatory and conduct roles

Our role as an improvement regulator is to strengthen confidence and trust in those regulated by ICAEW. We do this by enabling, evaluating and enforcing the standards expected by the profession, oversight regulators and government.

ICAEW's regulation and conduct roles are separated from ICAEW's other activities through internal governance so that we can monitor, support and take steps to ensure change if standards are not met. These roles are carried out by the Professional Standards Department and overseen by the ICAEW Regulatory Board and oversight regulators including the Financial Reporting Council, Office for Professional Body Anti-Money Laundering Supervision, the Insolvency Service and the Legal Services Board.

We:

- **authorise** firms and individuals to undertake work regulated by law: audit, local audit, investment business, insolvency and probate;
- **support** professional standards in general accountancy practice through our Practice Assurance scheme;
- **provide** robust anti-money laundering supervision and monitoring;
- **monitor** registered firms and individuals to ensure they operate in accordance with laws, regulations and expected professional standards;
- **investigate** complaints and hold ICAEW Chartered Accountants and students, ICAEW-supervised firms and regulated and affiliated individuals to account where they fall short of the required standards;
- **respond** and comment on proposed changes to the law and regulation; and
- **educate** through guidance and advice to help ICAEW's regulated community comply with laws, regulations and expected professional standards.

Chartered accountants are talented, ethical and committed professionals. ICAEW represents more than 202,450 members and students around the world. All of the top 100 global brands employ chartered accountants.*

Founded in 1880, ICAEW has a long history of serving the public interest and we continue to work with governments, regulators and business leaders globally. And, as a world-leading improvement regulator, we supervise and monitor over 12,000 firms, holding them, and all ICAEW members and students, to the highest standards of professional competency and conduct.

We promote inclusivity, diversity and fairness and we give talented professionals the skills and values they need to build resilient businesses, economies and societies, while ensuring our planet's resources are managed sustainably.

ICAEW is the first major professional body to be carbon neutral, demonstrating our commitment to tackle climate change and supporting UN Sustainable Development Goal 13.

We are proud to be a founding member of Chartered Accountants Worldwide, a network of 750,000 members across 190 countries which promotes the expertise and skills of chartered accountants around the world.

We believe that chartered accountancy can be a force for positive change. By sharing our insight, expertise and understanding we can help to create sustainable economies and a better future for all.

www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com

* Includes parent companies. Source: ICAEW member data March 2023, Interbrand, Best Global Brands 2022

ICAEW
Professional Standards Department
Metropolitan House
321 Avebury Boulevard
Milton Keynes
MK9 2FZ, UK

T +44 (0)1908 248 250
E contactus@icaew.com
icaew.com/auditguidance

Chartered Accountants Worldwide Member

GAA Global Accounting Alliance

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