After a brief consultation, in July 2017 the Financial Reporting Council (FRC) withdrew Practice Note 16 *Bank Reports for Audit Purposes in the UK* (PN 16), with effect from 15 December 2017.

This withdrawal may have some significant implications for approaches to the audit of bank and cash by some firms. In the November 2017 edition of *Audit & Beyond*, we considered why and how, focusing on matters around the value of bank confirmations and internet banking screen shots as audit evidence. In this follow-up we focus on risk and fraud and other matters such as data analytics and internal control issues.

This article also shares more insights based on the interviews we conducted with practitioners from a wide range of firms, training providers, staff at the FRC and ICAEW's Quality Assurance Department (QAD), prior to the withdrawal of PN 16.

SHARING INSIGHTS

With the withdrawal of Practice Note 16, **Katharine Bagshaw** and **Phil Lenton** offer pointers on why and how some firms will need to consider the implications carefully

To date, the wording in PN 16 has led firms to obtain confirmations as a matter of course, regardless of risk or the other evidence obtained, as the PN stated: "...it will not normally be practical to obtain sufficient appropriate audit evidence from other sources". The replacement of PN 16 with footnotes to *International Standards on Auditing (UK) 330 (The Auditor's Response to Assessed Risks)* and *505 (External Confirmations)* has the effect of making it clear that the decision to obtain a bank confirmation may be taken in the context of the risk assessment.

JAMIE JONES/IKON

RISK AND FRAUD

With a few exceptions, risk in this area is invariably assessed as low. It was noted that the FRC's Audit Quality Review team and ICAEW's QAD rarely, if ever, comment on the audit of bank and cash. Our interviewees highlighted two areas in which risk may be heightened: where foreign exchange is involved and where there are overseas accounts.

It is not uncommon for clients to forget about such accounts if they were used at a point in time for a specific purpose and were kept open just in case. Obtaining confirmations of small, old balances from overseas banks is often difficult. Where firms try to contact such overseas banks in several different ways without success, interviewees noted the importance of understanding why the entity had such a bank account in the first place, and why an entity might have more bank accounts than might be expected more generally – and whether the reason is 'lethargy or strategy', or potentially something more sinister, which may affect the risk assessment.

Interviewees noted that it is not particularly easy to fabricate bank accounts or websites and that cash frauds generally remain simple. They include setting up bogus suppliers, colluding with real suppliers or opening accounts with other banks auditors are unaware of, and making payments into them appear to be transfers to suppliers. Fraud in this area remains relatively unusual and fraud risk assessments, particularly in larger entities, now focus on financial reporting rather than the misappropriation of assets.

Interviewees noted that audit firms are becoming more vulnerable to being chased by insurers in situations in which there has been a fraud, and there is a crossover of responsibilities between management and auditors.

For example, in most charities trustees are duty bound to investigate and report fraud to avoid personal liability. They therefore usually report it, and sometimes suggest that auditors should have found it. The question then becomes whether it is reasonable for the firm not to have spotted it. In one case, auditors had selected invoices that were subsequently found to be fraudulent in a sample, but there was little to indicate a problem and the trustees had authorised them anyway. The firm ended up splitting the difference with the charity and settling out of court.

In addition to discussions about bank confirmations, the interviews also considered testing of bank and cash more generally.

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DATA ANALYTICS

Data analytics is now sometimes used by larger firms, and some smaller firms, to test 100% of populations in situations in which sampling was previously necessary. Some interviewees pointed to the use of three-way matches (between orders, received or despatched documentation and invoices) being supplemented by checks to the related cash transaction. This is now possible in some cases and can provide powerful evidence across different audit areas that were harder in the past to tie up. It is now possible to analyse 100% of the cash transactions recorded and cut and slice them in different ways – some firms consider this to be a useful exercise.

CONTROLS

All interviewees noted increasing concern with internal control issues across the audit. In particular, they noted issues with a lack of segregation of duties in the context of IT access controls. In particular, they noted problems with super user access and a failure to track access permissions of people moving across departments. On controls generally, one interviewee noted that "people are still paying lip service to the need to assess the design and implementation of controls" where they do not intend to test them. Firms are improving methodologies but interviewees agreed that ensuring that the effect of weak controls is appropriately reflected in the audit strategy is equally important.

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While access controls to bank accounts are generally better than in other areas, interviewees noted fewer walk-through tests and greater reliance on the organisational controls of the bank itself than is always warranted.

Specifically, it seems that sharing of passwords is very common in some smaller entities and there is little segregation of duties and a great deal of management override, even in this area. When things go wrong it can be difficult to see who authorised which transactions, not least because banks will not provide that information retrospectively. Training providers noted that some smaller firms do not understand controls over access to the internet and assume that payment authorisation is well controlled.

LARGE AND UNUSUAL ITEMS

A significant area of difference between firms appears to be in approaches to the review of cash books for large and unusual items. Several approaches, as detailed below, were described by interviewees.

- The firm has abandoned the review and believes it rarely surfaced anything of value when it was done, partly because higher-risk large and unusual transactions are unlikely to appear in the cash records.

Instead, the firm approaches the area ‘from the other side’ through journals testing and/or analytical procedures performed on revenue and expense accounts in the nominal ledger. There is a strong feeling among such firms that this is more efficient and more likely to highlight large and unusual items than approaching it from the cash side.

- The firm is doing less than it used to on cash-book tests requiring the identification and inspection of large and unusual items and such tests are often marked as ‘N/A - dealt with through nominal ledger testing’.
- The firm believes strongly that some attempt to review cash books for large and unusual items is necessary because the starting point is ‘outside the system’ and because there is value in looking for regular round sum payments and transactions with related parties. Such firms also note that performing the review means that less needs to be done on year-end balances. Such firms do not believe that approaching the area ‘from the other side’ is adequate. Various ways of performing the review were described, including downloading bank statement data to spreadsheets and/or using the banks’ proprietary analytics tools, particularly those provided by Lloyds and NatWest. Others again take screen shots of all the bank statements/pages and perform the review that way.
- The firm believes both approaches are equally valid and that the most appropriate depends on the risk analysis and other available sources of evidence.

In considering the wider implications of the withdrawal of PN 16 for approaches to the audit of bank and cash, some firms may want to revisit the FRC’s Feedback Statement and Impact Assessment

Firms do not seem to be performing analytical procedures of cash balances, although some larger firms are using data analytics to identify, for example, repeated payments, payments to different individuals into the same account and repeated payments just below a regulatory or other cut off point. However, the data analysed in such cases is not from the cash book, but from payroll, purchases and so on.

In considering the wider implications of the withdrawal of PN 16 for approaches to the audit of bank and cash, some firms may want to revisit the FRC’s *Feedback Statement and Impact Assessment* (at tinyurl.com/AB-FRC-FSIA).

Many will also find it helpful to refer to our earlier article on the post PN 16 audit of bank and cash, in the November 2017 edition of *Audit & Beyond* (tinyurl.com/AB-Nov17). ●

Comments and observations on this matter are welcome. Please send to katharine.bagshaw@icaew.com

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