THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty

Audit Quality — Abridged

experience integrity judgement CULTURE objectivity consultation PROFESSIONAL SCEPTICISM

Audit Quality — Abridged

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The Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales (***the Faculty***) is a leading UK authority on both external and internal audit and other assurance services. It is recognised nationally and internationally by members, professional bodies and others as a source of expertise on audit issues. The Faculty provides members with services designed to provide competitive advantage and to improve professional performance.

The membership of the Faculty has steadily grown since it began in 1995. Faculty's membership consists of approximately 10,000 members drawn from practising firms of all sizes, internal auditors from a wide range of organisations, and accountants working in the public sector.

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Foreword

by Melanie Johnson MP

The independent audit is an important contributor to business trust and confidence. Shareholders rely on financial statements prepared by the directors presenting a true and fair view of the financial position and performance of a company. The purpose of the company audit is to provide independent assurance that this is the case. Carried out effectively, an audit enhances shareholder confidence.

This publication brings together leading edge thinking from a wide range of acknowledged practitioners and identifies vital ingredients that contribute to audit quality.

I am grateful to the Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales for producing this document. Its publication comes at an important time. Public faith in the integrity of corporate governance, including the role of the independent audit, has been badly dented by the high profile collapses of Enron and others in the US. It is therefore more important than ever that here in the UK we do all we can to ensure that audits are, and are seen to be, of the highest quality. I believe this document will be of great benefit not just to the members of the accounting profession but to all those with an interest in promoting economic stability and progress. The accountancy bodies have a crucial role to play in helping us to keep the UK at the cutting edge of best practice in audit provision. I look forward to working with the Faculty as its members continue to develop its thinking in this important area.

Melanie Johnson
Parliamentary Under-Secretary of State for Competition, Consumers and Markets
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Introduction

At no other time has the role of the audit been more important or under such public scrutiny. In this era of the global economy, shareholder confidence in financial information can impact across markets with an immediacy and force which can either boost share prices or wipe billions off the value not just of companies but whole market sectors. Even for the smallest companies, confidence in the financial systems and safeguards within which they operate is pivotal to that stability. The company audit is one such safeguard and now is a good time to re-examine what it represents. The nature of auditing means that a loss of confidence and reputation or a reduction in trust, for whatever reason, undermines its effectiveness. Perception matters.

Whatever the regulatory background and the requirements of financial reporting, it is important not to lose sight of the fact that auditing is a practical discipline that relies on human beings. This publication looks at the fundamental practical issues that arise from these basic facts and sets out the characteristics that, we think, facilitate audit quality.

Many of the strategies and techniques contained in this publication are already in place. We hope this will encourage all auditors to stop and take stock of the inputs to audit quality and consider where they may be able to improve. This publication is not an auditing standard or further regulation. The emphasis is on how audit quality is achieved in practice and illustrations and examples of good practice are given throughout the text.

While this publication is primarily aimed at auditors, it is also intended to help inform wider stakeholders about the remit, purpose and limitations of an audit and to give reassurance on the audit profession's commitment to audit quality in the UK. Audit quality is not simply about following a rulebook of auditing standards and regulations. Further rules may not necessarily be helpful. It is about professionals reaching the appropriate judgement in difficult and complex circumstances. Cultivating and maintaining the right skills to be able to exercise this judgement is the responsibility of each and every auditor and audit firm. Audit quality depends on a number of critical factors; people and their training, audit firms and their processes, clients and corporate governance. Each of these factors is explored in detail in this publication.

We hope that everyone with an interest in the integrity of financial information will gain from reading this work.

Andrew Ratcliffe
Chairman
Audit and Assurance Faculty
November 2002

Illustration

One firm distributes the full version of *Audit Quality* to individuals with quality-related responsibilities in the firm seeking feedback on the inputs to audit quality in the firm. The central technical team, in association with practice management, summarises the feedback and arranges internal seminars to discuss that feedback.

A smaller firm allocates each chapter to different audit partners. Each partner considers the firm's own working practices in the light of the commentary and illustrative good practices. The findings are discussed at partner meetings over a period of time.

One audit partner in a large firm distributes a copy of this version of *Audit Quality* to the non-executive directors at his listed clients and offers to answer questions on how his firm achieves audit quality in practice.

Throughout this publication the male pronoun has been used to cover references to both the male and the female. The term audit partner refers to any partner, director or other engagement leader who is the responsible individual for audit engagements.

This publication is addressed primarily at quality within external audit in the private sector in the United Kingdom.

This publication is the abridged version of *Audit Quality*. The Faculty has also published a full version comprising of the material in this publication and five detailed chapters discussing the drivers of audit quality including practical illustrations.

To receive a copy of the full publication, contact the Faculty on 020 7920 8493.

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Auditors' code

Auditing standards reflect the fundamental principles of independent auditing through the Auditors' Code. The APB expects that auditors, in complying with auditing standards, will also adhere to the fundamental principles which are as follows:

Accountability

Auditors act in the interests of primary stakeholders, whilst having regard to the wider public interest. The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholder is the general body of shareholders.

Integrity

Auditors act with integrity, fulfilling their responsibilities with honesty, fairness and truthfulness.

Confidential information obtained in the course of the audit is disclosed only when required in the public interest, or by operation of law.

Objectivity and independence

Auditors are objective. They express opinions independently of the entity and its directors.

Competence

Auditors act with professional skill, derived from their qualification, training and practical experience.

This demands an understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion.

Rigour

Auditors approach their work with thoroughness and with an attitude of professional scepticism. They assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purposes of their audit.

Judgement

Auditors apply professional judgement taking account of materiality in the context of the matters on which they are reporting.

Clear communication

Auditors' reports contain clear expressions of opinion and set out information necessary for a proper understanding of that opinion.

Association

Auditors allow their reports to be included in documents containing other information only if they consider that the additional information is not in conflict with the matters covered by their report and they have no cause to believe it to be misleading.

Providing value

Auditors add to the reliability and quality of financial reporting; they provide to directors and officers constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector.

Source: The Auditors' Code, The Auditing Practices Board

The role and nature of the quality audit

This publication describes an audit, its nature and its scope and then examines the major factors that contribute towards audit quality. Auditing is not a static discipline: committed professionals in any field continually strive for improvement and audit is no exception. Auditing is a dynamic process and this publication itself represents another step in the ongoing development of the profession.

Auditing as part of the economic infrastructure

Audit has been a vital function of economic activity since medieval times. For that economic activity to continue to flourish there has to be trust. An important contributor to trust and confidence is the independent audit of the information provided to shareholders. It is a vital component of efficient capital markets.

While the audit is a crucial part of providing assurance on financial information to shareholders, it does not stand alone. It is the statutory responsibility of the directors to prepare financial statements for shareholders that show a true and fair view. The audit has to be seen in the context of a range of interwoven laws, regulations and guidance, all of which promote good corporate governance.

Auditing is the giving of an opinion

The auditor makes an independent examination of the financial statements. This remains the overarching role of an auditor, whether from a small or large firm, whether he is auditing a local charity or is reporting on the world's largest commercial enterprises.

There can be a difference between what shareholders expect an audit to achieve and what it can realistically be designed to achieve. There can be a perception that the audit does indeed certify the financial statements or that an audit can uncover every fraud within a company, however small.

It needs to be stressed that the purpose of the audit is to express an opinion with reasonable assurance that the financial statements give a true and fair view; it is not to provide a certificate or a legal warranty that they are completely accurate and without error. Such certification is simply not possible without re-performing every single financial transaction made by the company. In any case, such a task would be prohibitively expensive and may even then not achieve certification.

A continuing challenge facing those with an interest in corporate governance and every auditor is communicating the purpose, ambit and limitations of the audit.

Auditing is a practical discipline involving judgement

An audit is not a commodity. Every company needs an individually tailored audit and the audit of an individual company may vary from year to year.

Auditing is a cumulative process of gaining assurance by understanding the way in which the company's performance is reflected in its financial statements through enquiry, observation and examination of evidence. The financial statements themselves may reflect a wide range of judgements and accounting estimates made by client management: accounting for transactions that are not yet complete; assets that are not yet realised; and liabilities that may not yet be certain.

An audit is not an exhaustive verification of every detail nor can it create precision where precision is inherently impossible.

During the course of their work auditors gather evidence, often on a sample basis, on which to base the audit opinion. The quality of the opinion lies in that of the judgements the auditor makes. These in turn are dependent on the quality of the evidence that has been gathered and the quality of the people gathering it.

Many audits are complex. Auditors, particularly those of listed companies, can be put under pressure to complete their work to a demanding timetable and much of the work can be intellectually challenging when complex companies or sophisticated financial and business transactions are involved. Auditors need the co-operation of company's employees to complete their work, yet have to maintain their objectivity and exercise professional scepticism.

The judgement of the auditor is focused on whether the financial statements approved by the directors give a true and fair view. 'True' is generally understood to mean that the information in the financial statements is not false and conforms to reality. In practice, this means that the information is presented in accordance with accounting standards and the law. In practical terms this means that the financial statements have been correctly extracted from the underlying records and those records are a reflection of the actual transactions that have taken place. 'Fair' is understood to mean that the financial statements reflect the commercial substance of the company's underlying transactions and that the information is free from bias.

But financial reporting is not a mechanical process. Every company and then the auditor make judgements on the application of GAAP (Generally Accepted Accounting Principles). Some would argue that the answer is to reduce flexibility and have detailed rules that attempt to cover every eventuality. However, it is widely accepted in the UK, and increasingly world-wide, that this approach leads to excessive rule making with the standard setters playing a game of cat and mouse with those seeking to exploit gaps in standards. No set of rules can capture every future possible transaction. A more effective alternative is to have principles and guidance against which particular transactions or complex situations are rigorously examined.

Every auditor knows that any judgement can be called into question, often with the benefit of hindsight. The major defence against such questioning is to show that the work was performed with skill and care and that there were sound reasons for the judgements made and the conclusions reached at the time. In other words, a quality job was done.

Auditing is a profession

Auditing is an essential part of the regulatory infrastructure of the economy and therefore represents an activity of significant public interest. Auditors fulfil their public interest obligations by ensuring they perform quality audits. If auditors are to operate in the public interest it is important that they are always aware of their responsibilities. This is not just to the firm employing them but also to the community as a whole. Quality independent audit is a crucial function that should be nurtured.

Auditing in the private sector has generally been carried out by privately owned partnerships with a commercial purpose. Some criticise the very structure whereby such privately owned firms carry out a public interest function. These critics say that the motivation to earn fees cannot be reconciled with the need to perform an objective audit. The Faculty disagrees with this assertion. The essence of a profession is that qualified individuals perform a complex task with integrity, marrying the public interest function with sufficient reward for the risks they take and the value they provide. Auditors will only achieve profitability over the long-term if they provide a quality service. Poor audit quality damages the professional reputation of the firm and leads to loss of clients and subsequently loss of fees, as well as increased litigation and professional insurance costs. In extreme circumstances, it can lead to the demise of the firm itself.

To keep pace with the continually changing business world, firms need to invest in recruiting, training and developing talented people to deliver audit quality. They must also invest in infrastructure and support such as technology and knowledge management systems. As with all professionals, auditors require monetary reward for the skills applied and the capacity for future investment only comes through financial success. It is through a sense of professionalism that auditors meet the potentially conflicting demands on them – the need to ensure audit quality that is in the public interest with the need to be financially successful. The resolution of conflicts lies in the way that audits are performed day-to-day, and in the motivations and characteristics of the individuals who carry out audits.

What is audit quality?

Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition. Auditing standards provide guidance on what auditors need to do to perform audits with satisfactory quality. Compliance with the standards, therefore, provides evidence that a quality audit has been done. However, standards can never cater for every situation so there will always be an element of audit quality that has to be addressed by firms and individuals within firms. The revised auditing standard, *SAS 240 (Revised) 'Quality control for audit work'*, sets certain standards for what firms need to do to achieve quality across their audit practice. These elements are referred to as appropriate throughout this publication.

As with any regulation, SAS 240 cannot encompass all the activities that need to go towards maintaining and improving audit quality in a firm. For this reason, the profession itself needs to be forthcoming about the many practical things that firms can do to build and maintain audit quality. Because good practices are continually evolving to respond to the environment, all firms should be alert to the available sources of information on good practice and adopt a policy of seeking continuous improvement.

This publication is a contribution to that process. It aims to cover a wide range of quality-related activities and identify good practices used by firms of different types and sizes. It is for each firm to decide which of the practices explained could be implemented, having regard to its current position on quality, its plans and what will be appropriate to its own circumstances.

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgements.

Ultimately, auditors provide a quality service to shareholders if they provide audit reports that are independent, reliable and supported by adequate audit evidence. As a professional body, the ICAEW takes the issue of audit quality extremely seriously. Audit quality is a collective responsibility and should be reinforced at every level of the audit firm.

Below is a summary highlighting the major factors underpinning audit quality.

The major factors driving audit quality

Committed, experienced professionals are producing good quality work and are continually exploring ways to improve the audit they perform. This publication sets out illustrative good practice but it does not set out to codify. There is no one model for audit quality that will work for all audit firms or for all companies being audited. Firms will come to their own solutions.

Audit quality has many contributing factors including good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices and effective quality control and monitoring review processes.

Leadership

Quality audits do not just happen. As in other fields of professional work, quality audits are the result of people working together and being prepared to take on the responsibility of ensuring that the right result is achieved. Senior people within an audit firm have to take on a leadership role. While leaders may be assisted by management systems, the desire to perform a quality audit will result from the sense of professional obligation and the character of those in charge of the firm.

Audit quality is achieved only if it is the keystone of the firm's overall strategy. Every strategic decision taken by the firm will ultimately impact on quality including the firm's policy on audit fees, recruitment, reward and training. The way in which the firm is organised, the roles and responsibilities of staff and the firm's policies and procedures at all levels need to be aligned to ensure the successful execution of the strategy.

Risks change over time. The external economic environment in which firms operate constantly changes. The same is true for the attitude and circumstances of individual clients. Change presents both opportunities and threats. Particular threats arise when a new practice area is developed, or when the firm is under economic pressure, or when recruitment and retention of suitably qualified staff is difficult. These circumstances need to be recognised and addressed.

Private sector auditing has to be a commercial proposition if firms are to recruit, develop and retain the right staff and make the investment required to achieve a quality, professional service. Compromising audit quality either by impaired objectivity or by cutting the work is not acceptable. The leadership of a firm needs to be sufficiently experienced to understand where there may be threats to audit quality either though short-term pressure from client management or through general economic pressures. Decisions need to be taken on how to manage these threats.

Under auditing standards, the ultimate responsibility for audit quality within a firm rests with a senior partner. He needs to establish the quality control policy and procedures, needs significant audit experience and should understand and have direct influence over the factors that contribute to quality. These may include rewards for achieving quality and practical reminders on how to achieve quality through case studies based on actual experience. Each firm will approach these tasks differently.

Leaders need to support audit quality and promote a quality culture throughout the firm. They have to ensure that they communicate the importance they attach to the issue to their staff, their clients and potential clients.

People

Audit quality is highly dependent on the quality of the people.

The Auditors' Code[1] issued by the Auditing Practices Board sets out nine fundamental principles of independent auditing. Several of the principles of the Code (especially judgement, integrity, objectivity and rigour) are essentially personal qualities. The ICAEW sets standards for those who have the authority within firms to sign audit reports. Firms may place further restrictions and conditions such as internal licensing or training on those seeking to sign audit reports for certain sectors or clients.

An audit is usually performed by a team with varying levels of experience, often involving specialists, who work together to gather the audit evidence needed by the partner to form the judgements that underlie the audit opinion. Auditors make judgements often in areas where there is no clear-cut answer provided in auditing and accounting standards, guidance or precedent. The ability to make the correct judgement comes from personal aptitude, knowledge, experience and consultation with others. In particular, personal aptitude includes qualities such as integrity, objectivity and scepticism. Auditors need to be both competent and motivated. Firms need to look for these characteristics when recruiting at all levels.

Firms are learning organisations where training and development is an integral part of the professional life of all auditors. This continuous training and development will include regular monitoring, testing and assessment. The firm has to ensure that the

1 Reproduced on page 6

learning reflects the firm's stance on contentious issues, otherwise behaviours developed through training courses may be negated when staff return to work. The culture of the firm should ensure that feedback and criticism are constructive.

The personal desire and drive to arrive at an appropriate opinion on a set of financial statements is the most important aspect of motivation to deliver audit quality. The firm needs to recruit people with personal values required to be a professional and these need to constantly be reinforced through clear communication.

Auditors make difficult decisions, potentially under pressure from the client management. Audit partners need to know that the firm has a strong consultation ethos and will listen to and support their judgement even when it may mean losing the audit; partners should never feel their careers are dependent on retaining a significant audit client.

Reward structures need to ensure that the best people are attracted and retained within the audit profession and this includes reward for quality work.

Client relationships

To achieve audit quality, firms have to manage their overall client base and work with the individual clients from day to day.

Auditors act in the interest of the shareholders while having regard to the wider public interest. The board of directors is a separate body to which the shareholders have entrusted the management of the business. On a day-to-day basis, the auditors usually deal with the executive directors and senior and middle management. In owner-managed businesses, the distinction is less clear as the directors and shareholders are the same individuals.

There is a concern that auditors may think of the directors, and more specifically the senior management, as the primary stakeholder. For listed companies, recognition of the dangers inherent in this situation has led to significant developments in corporate governance. This is particularly true in the evolution of the oversight role of audit committees, comprising non-executives. Auditors have responded to these developments and view communication with the audit committee as an integral part of effective client management.

Managing client relationships involves the following:

> clearly defining the responsibilities of the auditor and management, usually through discussion with the management and the audit committee and then through the engagement letter.

> assessing whether the audit partner and the firm is objective and independent but paradoxically close enough to obtain a good understanding of the business.

> managing communications with the client management and the audit committee so that issues are dealt with on a regular and timely basis, especially if there are difficult issues.

Each firm should ensure that it only accepts and continues to work with those audit clients where it can deliver a quality audit. An acceptable client is one that the audit partner feels he can have an open and honest relationship and where there is mutual trust and respect. Auditors need to have in place client assessment procedures to help in identifying whether a client is acceptable to the firm. Many firms use some form of scoring to make the acceptance or continuance decision but ultimately the decision is subjective and depends on the judgement of one or more partners. Issues to be considered in the acceptance and continuance decision include the firm's resources and experience, potential conflicts and threats to independence as well as the honesty and integrity of the client management.

Managing higher risk clients is likely to take more time and will often involve more experienced people. Firms charge fees based on what they consider appropriate fees for the skills employed, the value provided and the efficiency with which the firm believes it can undertake the audit. Auditors should be wary of client management where the only objective seems to be keeping the audit fee as low as possible.

Working practices

Good working practices need to be embedded in the audit process; they are an intrinsic part of the firm's quality control procedures. Strong team work, effective communication and knowledge sharing are essential if audit quality is to be achieved.

It is essential that team members have a clear understanding of the roles and responsibilities and that they are properly qualified to perform them. The audit partner who takes responsibility for the quality of the audit opinion will need to keep in regular touch with the audit team. The audit manager needs strong project management skills and junior staff need to be empowered so that the audit is performed efficiently while still delivering quality.

The single most important audit technique is the application of sufficient thought at every stage. Most firms use standard audit approaches and documentation but a successful audit is not about mere box ticking. Instead auditors must use professional judgement to reach an appropriate audit opinion.

Having developed an understanding of the business, the accounting processes and risk, it is necessary to develop an appropriate audit plan and allocate staff with the right skills and experience to the appropriate tasks. It is crucial that audit work is performed with alertness of mind, professional scepticism and rigour. Audit staff need to look for the unexpected and consult with senior auditors when such matters are spotted. It is important to instil awareness that an anomaly may or may not have an innocent explanation. When audit failures arise it is often because an identified risk or issue was not adequately followed through.

Reviews of audit files should be performed on a timely basis by people with appropriate experience who will encourage alertness, originality of thought, a thorough investigation of anomalies and the adoption of professional scepticism. Firms need to ensure that an audit has proper completion procedures that all necessary evidence has been obtained and that the audit conclusions have been carefully considered. This work needs to be properly documented to ensure that there is adequate audit evidence supporting the auditor's judgements.

There are few audits that are not subject to some form of time pressure. Whereas deadline for delivery of material to the auditor may be flexed, the deadline for signature will often appear fixed. Auditors need to be robust in ensuring that all issues are resolved before they sign the audit opinion.

The audit has a recognisable cycle of planning, execution and evaluation so an appropriate time for reflection should be included in that cycle.

Internal monitoring

Internal monitoring establishes whether quality control processes, designed to maintain and improve quality, are working effectively. Monitoring also determines whether partner and staff teams are applying the firm's policies and procedures on individual audits and in accordance with auditing standards. It is also a requirement of *Audit Regulations* and is reviewed by the Joint Monitoring Unit (JMU).

The processes are similar to risk management procedures, as the largest risk a firm faces is that of claims resulting from poor work. Quality processes effectively represent an 'internal audit', performed by staff independent of the audit teams.

The leadership sets the tone by ensuring internal and external monitoring processes are seen as constructive, rather than being regarded as a regulatory or internal compliance burden. It is best if:

> responsibilities for policy and execution of monitoring and taking corrective action are clear;

> reviewers are of the right quality and respected;

> those subject to review know that the findings can affect both rewards and sanctions;

> recommendations are acted upon swiftly;

> communications about review findings are given maximum impact;

> monitoring processes work in harmony with the checks and balances within working practices. These include independent reviews and pre-clearance reviews, other procedures affecting people development, independence compliance, risk management and internal communications.

Because people are the key drivers of quality, especially the quality of individual judgements and the development of individuals, monitoring has to be informal as well as formal. Tick box compliance is not the full answer; where there are shortcomings a combination of learning and education, coaching and other motivational action is needed. Informal monitoring can, for example, include the discussion of quality-related issues at partners and staff peer group meetings. Such discussions should cover the root causes of quality problems, for example undue time pressure, not just the symptoms.

If problems are identified, the senior partner responsible for quality should ensure effective action, including raising awareness of the issues. The way forward should be identified, including what further monitoring will take place to assess the success of the action plan and whether extra rewards or sanctions will flow.

External monitoring

By law, an auditor needs to be registered with a Recognised Supervisory Body and an important element in firms achieving audit quality is the impact of the regulatory arrangements[2]. A particular feature of the arrangements is the external monitoring carried out by the Joint Monitoring Unit (JMU).

Reports from the JMU provide valuable independent feedback on a firm's quality review processes, providing an opportunity to measure them against good practice elsewhere.

The objective of the external monitoring system is to encourage and assist all firms to improve the quality of their audit work and monitor compliance with regulations and auditing standards. Quality processes, including monitoring, can always be improved as the results of lessons learnt.

To receive a copy of the full publication, *Audit Quality*, please contact 020 7920 8493.

2 Refer to Appendices.

Bibliography

Audit and Assurance Faculty selected publications

Towards Better Auditing v.3

Towards Better Auditing deals with developments in areas such as change management, business risk, audit efficiency, developing people and fraud, as well as established areas such as documentation and review.

The Auditor at Risk

Auditor at Risk is an effective training package in video form that can be used within any audit firm to train staff on a number of key audit areas including: stock; creditors; the importance of adequate supervision and review; and knowledge of the client's business. The package contains everything you need to conduct effective training sessions, including the 45-minute video case study, a presenter's guide, handouts and participants' notes. A comprehensive guide is provided, which includes choosing the training room, preparing notes, using visual aids and leading a group discussion.

Investing in an audit

The purpose of this publication is to help practitioners focus on the unique merits of audit. It explains why so many companies choose to invest in an audit and it will help practitioners advise existing and potential clients – persuading those that should have an audit of its value, and ensuring that those who opt out understand the risks.

Benefits of an audit

This publication explains why some companies are required by law to have an audit, what exactly it is that auditors do and why it is good for companies to have an audit.

An introduction to risk management for practitioners

The publication follows a series of Faculty conferences on risk management. Risk management is important because, ultimately, it enhances practice performance. It can help prevent losses to the practice arising from bad debts, the loss of goodwill or clients, and claims from clients and third parties.

To purchase the above publications, please contact the Faculty on 020 7920 8493.

Other selected publications:

"Behind closed doors – what company audit is really about" Beattie, Fearnley and Brandt

Earnings quality and auditor independence are major current concerns of the accountancy profession, as well as the bodies responsible for regulating listed companies and the accountancy profession itself. Yet the audit of listed companies remain a very private activity. This book uncovers what really goes on behind closed corporate doors. (ISBN 0-333-74784-4)

ICAEW advisory service help sheets

The ICAEW advisory service provides help sheets to ICAEW members addressing practice management and financial control issues including practice development and structure, compliance and regulation, starting in practice and employment matters.

ICAEW members can obtain these free help sheets from the members' section of the ICAEW website, see under "services".

ICAEW helplines:

The ICAEW offers the following services to ICAEW members:

> **Ethics Advisory Helpline**	**ethics@icaew.co.uk**	**01908 248258**
> **Library and Information Service**	**library@icaew.co.uk**	**020 7920 8622**
> **Technical Enquiries Service**	**—**	**01908 248025**
> **Practice Advisory Services**	**judith.creasey@icaew.co.uk**	**01908 248032**

APPENDIX 1

The regulatory arrangements

Overview

The regulation of auditors is a requirement of the Eighth European Union Directive on Company Law. This became effective in company legislation in Great Britain from October 1991, in the Republic of Ireland from December 1992 and in Northern Ireland from March 1993. In addition to the requirements of the Directive to register auditors the then Government added a requirement to monitor the work of registered auditors in Great Britain and Northern Ireland.

The Accountancy Bodies register firms to carry out audit work in the UK. The Chartered Institutes co-operate (through the Joint Audit Committee that consists of members of each Institute) by using a common set of *Audit Regulations*. The only differences relate to the differing arrangements of each Institute for disciplinary matters.

Each Institute has a committee that is responsible for registering auditors. These committees include independent members who are not accountants. The ICAEW believes this is important as a demonstration of determination to act in the public interest. Monitoring is conducted on behalf of the Institutes by the Joint Monitoring Unit (JMU), and decisions about audit registration are made by the registration committees. The Joint Audit Committee of the three Institutes carries out an annual review of the work of the JMU. The Institutes produce an annual report on audit monitoring that is submitted to the DTI and an annual meeting is held with the DTI to discuss the annual report.

Alternative regulatory mechanisms do exist including the system of peer review (firm on firm reviews) that was operated in the US and mixed models operate in other parts of Europe. Following the high profile corporate scandals, the US peer review system has fallen from favour and the new regulatory mechanism that has been brought in, headed by the Public Companies Accounting Oversight Board (PCAOB), has many features that are similar to the UK regulatory regime, including an independent inspectorate.

The whole of the UK regulatory process, including the activities and decisions of the registration committees is subject to independent scrutiny by the Review Board of the Accounting Foundation and the DTI.

Audit regulations

The *Audit Regulations* published by the three Institutes have always taken a wide view of audit quality. As well as engagement specific regulations there are regulations relating to firm wide policies and procedures that are important to the quality of audit work carried out by the firm as a whole.

In addition to the regulations requiring compliance with auditing standards and statutory requirements there are regulations covering independence and conflicts of interest, acceptance and continuance and the prevention of undue influence in the conduct of individual audits.

Regulations also deal with firm-wide procedures covering independence and confidentiality, the fit and proper status of individuals involved in audit work, developing and maintaining competence, implementing and maintaining appropriate audit systems and the requirement for firms to carry out an annual review of procedures and audit work.

Guide to Professional Ethics

For the public to have confidence in the quality of audit it is essential that auditors should be, and should be seen to be, independent of the companies which they are auditing. In the United Kingdom, the ICAEW requirements for auditor independence are embodied in the *"Guide to Professional Ethics"* supplemented by the best practice guidance on the European Commission Recommendation on auditor independence.

The United Kingdom's approach to setting independence requirements for auditors uses a conceptual framework and has proved a model for many others. It has been adopted by both the Fédération des Experts Comptables Européens (FEE) and the International Federation of Accountants (IFAC). The European Commission has taken a similar line in its Recommendation on auditor independence.

In broad outline, the framework approach works as follows:

> Fundamental principles are set out which must always be observed by a professional accountant. In the case of audit, the key fundamental principles are integrity and objectivity, which necessarily require the auditor to be independent;

> The auditor must conscientiously consider, before taking on a piece of work, whether it involves threats to his independence. Both actual threats and situations that might be perceived as threats by a reasonable and informed observer must be considered;

- Where such threats exist, the auditor must put in place safeguards that eliminate them or reduce them to clearly insignificant levels. All such measures need to be recorded in a form that can serve as evidence of compliance with due process;
- If unable to implement fully adequate safeguards, the auditor must not carry out the work.

The ethical guidance based on this framework includes illustrative examples of threats to objectivity that might arise and the appropriate safeguards to deal with them. The ethical code identifies five threats to objectivity:

- self-interest;
- self-review;
- advocacy;
- familiarity or trust;
- intimidation.

The auditor must be able to demonstrate that, in the particular circumstances under consideration, the fundamental principles have in fact been observed: it is not sufficient to demonstrate that particular examples of threats and safeguards have been addressed by merely going through the motions.

Auditing Standards

SAS 240 (Revised)

The issue of *SAS 240 "Quality Control for Audit Work"*, revised in September 2001, represented a departure from the usual style and content of auditing standards. It deals with policies and processes that affect both individual audits and firm wide procedures, and individual and collective responsibilities for audit quality. It does not solely focus on the conduct of clearly defined aspects of individual audits. *SAS 240 (Revised)* recognises the importance of good leadership in achieving quality, requiring firms to appoint a senior partner to set the firm's quality control policy and procedures and monitor compliance. This senior partner is accountable internally and also externally to the Audit Registration Committee.

APPENDIX 2

External monitoring

Overview

An important element in the achievement of audit quality is the impact of the regulatory arrangements applying to auditors, in particular the independent external monitoring carried out by the Joint Monitoring Unit (JMU). This comprises every registered firm submitting an Annual Return for scrutiny and the annual programme of visits undertaken by the JMU.

JMU visit selection, the frequency of visits and the visit process are designed to identify potential threats to audit quality. JMU inspectors use their independence, objectivity and experience to assist firms to maintain and improve the quality of their audit work. Follow-up action on problems identified during visits is designed to address specific problem areas for that firm.

The promotion of quality in the regulatory process

Audit quality features heavily in the discussion that the JMU holds with firms during the course of monitoring visits. The JMU has therefore observed firms' approach to quality and has been active in discussing the most appropriate and effective ways of complying with regulatory requirements and auditing standards. Issues that have arisen and been discussed with firms have included the separation of roles and responsibilities for quality review processes and monitoring the quality of audits, and the identity and status of the individuals who can carry out independent reviews.

Reports from the JMU often provide very valuable independent feedback on a firm's quality review processes, providing an opportunity to measure them against good practice elsewhere. The current arrangements use education, positive encouragement of audit quality and ultimately the sanction of preventing firms and individuals from practising.

The JMU review of engagements will concentrate not on procedural compliance but on the quality of the work carried out as demonstrated by compliance with auditing standards. Questions will be asked and discussions held on professional judgements made during the audit. Where the JMU has concerns over the thought processes or evidential support for these judgements, the matter will be carried forward for further discussion with the firm and potentially for reporting to the Audit Registration Committee (ARC).

The JMU will also review and assess the effectiveness of the firm's own quality assurance processes. The way in which these processes are developed and implemented will give a good insight into the firm's overall attitude to quality and compliance with professional standards.

The conclusion of the visit, whether by the JMU or by referral to the ARC, will, if necessary, include follow-up action by ARC to encourage and assist improvement. If there are concerns over a firm's commitment or ability to implement effective action to improve the quality of its work then the action will be kept under review. In serious cases the options available to ARC to ensure improvement in the quality of work will include conditions such as external 'hot' or 'cold' reviews on all audits until satisfactory improvement is demonstrated. In some cases the issues raised by the regulatory process have been fed back to the standard setting bodies for consideration.

Focus on risk and the public interest

Of the nearly 1,000 audit visits that are carried out every year, the majority are selected on a risk basis. Through analysis of information provided in the annual return and application of risk criteria that have been developed over several years, firms that appear to have more likelihood of producing poor quality audits are selected for visits. Additionally, during the course of a visit, the selection of specific offices, audit partners and audit engagements to review will be based on an assessment of risk.

The JMU maintains a review of press and other media announcements for both firms and their significant clients and will follow up matters of concern, including reference to known risk industries and advice from other regulators.

The regulatory arrangements recognise the greater public interest in the quality of audits of companies that have shares traded on a public exchange (listed companies) by a more frequent monitoring programme of the firms that carry out these audits. There are approximately 100 firms registered with the ICAEW that audit listed companies in the UK. The frequency of visits to the firms is based on the Institute's agreement with the DTI. To date, the 80 or so firms other than the largest national firms (the top 20) that audit listed companies have received a visit at least every four or five years. From 1 January 2003, the JMU will visit all auditors of listed companies at least every 3 years. The largest firms (the top 20), which audit about 95 percent of the listed companies, have a full visit every three years, with a shorter interim visit in the intervening years.

For a larger firm, a full visit may take up to 100 (inspector) days and an interim visit may take up to 30 (inspector) days. The work carried out on an interim visit is not significantly different from a full visit; however, fewer files will be reviewed and fewer offices visited. Approximately 30 percent of JMU inspecting time is spent on larger firm visits.

Broad scope

All JMU visits address a wide range of issues, in addition to the detailed reviews of audit files and whole-firm procedures. These include consideration of the firm's risk management procedures, the firm's internal compliance procedures and the firm's quality control and quality review processes. The firm will be probed as to how it is ensuring compliance with new auditing, accounting, ethical and other pronouncements, and changes in legislation. The inspectors will also follow up on matters arising from the previous visit and any specific matters of concern to the ARC.

Over a number of years the JMU will seek to visit all offices and review all audit partners. However, visits will be made to any problem locations as it is deemed necessary and there is not always a strict adherence to covering all audit partners or offices in a set period of time. The amount of time since a particular location has been reviewed will form part of the process of file selection on all visits. The JMU always submits a detailed long-form report on all listed visits for consideration by the ARC. The reports on the top 20 firms include an appendix setting out the firms' audit systems and quality review processes. This appendix is updated on each visit to form a permanent record of the key procedures maintained by the firms and to enable developments in the systems to be recorded. The JMU will comment on systems developments in the body of the report.

Evidence of improvement?

It is difficult to draw empirical evidence from the regulatory process to show that the quality or standard of auditing has improved since regulation of auditors was introduced. With the exception of the largest firms and specifically requested follow up visits, each year's sample of visits is mainly comprised of a selection of different firms. It should also be remembered that since the introduction of the *Audit Regulations*, the regulations have been substantially rewritten and, perhaps more importantly, UK auditing standards have been significantly expanded and enhanced. A further factor that is also difficult to quantify is the expectation, from the ARC and external observers, of higher standards being required from firms over time.

In the early days of regulation there was an initial emphasis on getting procedures in place. At this time many firms, especially the smaller practices, had little in the way of formal or documented audit or firm-wide procedures. This omission was addressed by the production of a number of 'off-the-shelf' audit and firm wide procedure manuals and systems that were supported by training and support facilities. As the possession of a suitable set of procedures has become more the norm the focus of JMU findings has shifted more to the proper application of those procedures or how they have been tailored to address particular audit issues in non-standard situations. The key focus remains quality. An assessment of quality needs to be made in the suitability of the system and the use of that system by the audit partners and staff.

Improvements in the quality of firms' audit work and compliance with professional standards can also be demonstrated by looking at the follow-up to a visit. Most firms that are required to take additional action following the visit are normally judged to have made sufficient progress within an acceptable period of time to be allowed to continue audit work without conditions or restrictions. The action that may be required of firms following a visit can range from a request to submit 'cold' (after the event) file reviews that the firm had already arranged to the imposition of external 'hot' (during the audit process) file reviews. When the required action has been taken and reviewed an assessment is made to judge whether sufficient improvement has been made.

In 2001 88 visits were reported to the ARC requiring consideration and imposition of follow-up action. The comparable figure in 2000 was 79. The number of firms that had registration taken away following reports to ARC was 17 in 2001 and 10 in 2000. Exclusions from registration are low compared to visits on which significant issues were identified but registration is continued. The vast majority of firms where problems are identified have been able to demonstrate a satisfactory improvement in standards after the visit.

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