



Audit and Assurance Faculty

Audit Quality

experience integrity
judgement CULTURE
objectivity
consultation
PROFESSIONAL SCEPTICISM

Audit Quality

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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For further information on the Faculty, please visit www.icaew.co.uk/auditassfac or contact 020 7920 8493.

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.

A handwritten signature in blue ink that reads "Melanie Johnson". The signature is written in a cursive style with a horizontal line above and below the name.

Melanie Johnson

Parliamentary Under-Secretary of State for Competition, Consumers and Markets
Department of Trade and Industry

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 *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 the abridged 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 full version of *Audit Quality*. The Faculty has also published an abridged version comprising of the chapter on the role and nature of the quality audit, a chapter summary of the full version and background information on the regulatory arrangements.

To receive a copy of the abridged publication, please 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.

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. 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 need to 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 of the chapters in the remainder of this publication 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 through 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 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. The firm should foster consultation with peers and individual self-belief.

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.

¹ Reproduced on page 5

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 should 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 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.

² Refer to appendices.

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 arrangements². 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.

Leadership

Overview

Whatever the size of firm and however it defines audit quality, this will only be achieved if its importance is central to the strategy and objectives of the firm's leadership and it is translated into practical actions.

Audit quality is a collective responsibility but the tone has to be set from the top and people have to be accountable. The key aspects of good leadership covered by this chapter are as follows:

- > setting the strategies and objectives;
- > recognising the commonality of commercial and professional approaches;
- > ensuring the organisation will deliver the required quality;
- > setting the right tone at the top;
- > ensuring quality is consistently communicated.

The following sections explore the role of the senior partner responsible for setting policy and others involved in leadership and identify some of the challenges they face.

Strategy and objectives

Audit quality should be the keystone of the firm's strategy, whatever its size. Firms and individuals that aspire to be professional should never compromise on quality because it is important to every firm's reputation and success. The principles of the Auditors' Code should be embedded in the firm's processes and constantly underpin decisions.

When the leadership is setting the firm's strategy and objectives, quality should be recognised. It should be central to the strategy so that it is built-in rather than being an add-on. The leadership's attitude to audit quality will be critical in all cases. Decisions taken by the leadership on issues such as recruitment, rewards, people development, client assessment policies and audit fees will affect the firm's capability to deliver quality over time.

The firm's overall strategy should align personal and business objectives of partners, staff and business units with the need for audit quality. Consultation with fellow partners and staff should ensure that there is a consensus on the firm's approach to audit quality, and that this permeates throughout. This means that the objectives and strategy are agreed and understood and that everyone is working to common overall objectives of which quality is an intrinsic part.

Illustration

A high level set of objectives for a firm might comprise:

- > being recognised as a market leader for quality service in chosen practice areas;
- > investing in processes that improve quality of service;
- > rewarding people for quality work;
- > leading the debate on business and professional issues.

Each member of staff should set personal objectives to reflect these firm-wide objectives. Achievement of these detailed objectives should be managed and monitored; without this the high level objectives are no more than words.

Firms should regularly review their strategy and objectives in the light of their changing circumstances. As the inputs to quality are just as important as the outputs, the availability of the inputs needs to be taken into account. The *Guide to Professional Ethics* issued by the ICAEW emphasises the importance of competence in the acceptance or continuance of work. For example, a firm may decide that it wants to develop a particular business sector. But if people of sufficient quality or expertise are not available in this sector then the strategy may need to be revised.

Commonality of commercial and professional approaches

Private sector auditing has to be a commercial proposition. The viability of firms is dependent on maintaining margins (and if possible increasing them), either by increasing audit fees (either through billing more chargeable hours or better prices) or reducing costs, or a mix of these measures. But the leadership has to ensure that margins are not increased at the expense of quality.

Market conditions over the last few years have caused firms of all sizes to manage operations more efficiently, and to examine the risks and rewards of dealing with particular types of audit client. Firms have also considered their methods for delivering audit services and monitoring staff efficiency. To deliver a quality professional service, firms seek to recruit, develop and retain the right professional staff and invest in technology, knowledge management and other support systems. Investing in people and systems for delivering more efficient audits is both costly and time-consuming. This could create pressures to compromise an investment in order to maintain margins in the short-term.

The leadership will recognise that this is not a compromise that should be made. Quite apart from the potential dissatisfaction of clients if poor quality services are delivered, a firm will know that its ability to perform audits will be removed by the regulator if it does not deliver audit quality. This could damage its reputation and viability.

The leadership needs to be sufficiently experienced to understand where there may be threats to audit quality, either through pressure from client management or internal efficiency targets. The leadership needs to know what action needs to be taken and when. Pressures from client management can put the firm in an economically weaker position in the short-term, because if the firm stands up for its view and qualifies an audit report, it may lose the audit fee. It will certainly lose the fee if the firm resigns as auditor.

In short, quality costs money, but failure to invest in quality will cost more in the long-term.

While some may view a loss of fees as a failure, the leadership should have the individual and collective wisdom to take the long-term view and support the tough decision being taken. In a busy firm decisions like these are taken frequently. The leadership needs to be satisfied that the firm has processes for identifying these threats and for responding to them. In most firms one person cannot take all such decisions, so structures and delegated responsibilities become important, such as channels for consultation in certain circumstances.

Organisation

The way in which the firm is organised and the roles and responsibilities of key staff will need to be considered to ensure that there is a successful execution of a strategy driven by quality.

Auditing standards recognise the importance of good leadership in achieving quality. For example, *SAS240 (Revised)* require that firms establish an appropriate structure including the appointment of a senior partner with responsibility for setting the quality control policy and procedures and, preferably, another senior partner to monitor the quality of work performed. While splitting the role is feasible in a larger firm, it may not be practical for a smaller firm and is impossible for a sole practitioner. Clearly the policies and procedures adopted by a firm will vary depending on its size. Smaller practitioners need to find less complex and practical solutions that achieve the same objective, such as a judicious use of consultants without abdicating responsibility.

To be effective, the two named senior partners need to understand and have direct influence over the policies and procedures that drive quality (such as employing the right people, the right training and the right ethical values). Both need significant front-line audit experience in a variety of situations to understand the pressures on auditors and how they can best be handled, to be a good judge of character and to be aware of the risks of quality not being achieved, both to individuals and to the firm. They will need to be articulate, visible, principled, respected and pro-active. They should consult, be prepared to take advice, and be able to work well with whatever team of people is responsible for different aspects of quality. The senior partners will be accountable internally and externally, for example to the Audit Registration Committee (ARC) of the ICAEW. The ARC will expect these partners to explain how the firm ensures quality, address any concerns expressed and implement any recommendations made.

The larger the firm the more likely it is that there will be a formal leadership or management structure and more individuals will have quality-related responsibilities. For example, in a larger firm:

- > the practice leader is responsible for all key decisions affecting the practice;
- > an experienced audit partner known for his technical knowledge and respected for his application of quality standards in practice leads the technical, quality and risk functions;
- > a compliance partner is responsible for the day-to-day compliance matters for the firm's audit registration;
- > a partner is responsible for managing the firm's day-to-day risk management;
- > specialist partners will run different aspects of the technical and quality review function.

In a smaller firm some or all of these roles will be combined.

Illustration

A large firm debated internally who would be the right person to fill the role of senior partner for the purposes of SAS240 (Revised). Although there was a senior partner in charge of the firm's technical, risk and quality review functions with the title 'Head of Quality', it was decided that the practice leader should be designated senior partner responsible for quality. This was because the 'Head of Quality' was accountable to the practice leader and achievement of quality was an essential element of leading the audit practice. All key decisions that could affect quality would necessarily be made by or referred to the practice leader – the buck stopped with him. He would continue to delegate certain quality-related responsibilities to other senior partners.

A smaller firm had formed a technical group of qualified staff headed by one of the audit partners. The same partner also had responsibility for training and recruitment. Following the issue of the new auditing standard it was decided to nominate this partner as the senior quality partner to be responsible for the firm's quality policy and implementation.

In larger firms structures need to encourage and strengthen the professional judgements of staff. Firms can be organised by, for example, industry or other specialist sectors, by physical location or by partner-led teams. As partners will have different skills and roles within a firm, the leadership has to ensure that it is clear who is responsible for audit quality.

If there is pressure on partners or if the firm is complex and diverse, it is important to ensure a clear line of responsibility from the top down through unit management to each audit partner and his staff, as well as accountability upwards.

Good practice

A large firm is divided into industry-specific units in London and more general units outside London. Each unit has a local leader and a number of other partners who are providing a range of audit and related services. Each industry group has a leader focusing on how the partners active in the sector help develop the firm's industry expertise and practice development.

Audit quality within each unit is the formal responsibility of the local leader, assisted by a partner in each unit with a risk management and technical quality role. Audit partners, the individuals who are responsible for the quality of judgements made and the conclusion reached on individual engagements, are accountable to the local leader who in turn will report to the senior partner. Industry specialists have specific responsibility for the quality of their own work.

Setting the right tone from the top

The leadership and all those involved in practice management needs to set the right tone and put in place checks and balances to facilitate and monitor quality. It is the responsibility of the leadership to set the values that it wants the practice to follow, to communicate them and reinforce them at every opportunity. Audit quality depends heavily on the professional values and attitudes of staff at all levels and particularly those leading the firm.

The behaviour of audit partners and managers is particularly important. The partnership culture should encourage a collegiate, consultative approach. Although one audit partner has responsibility for the judgements supporting an audit opinion, the collective knowledge and experience of the partners can support him, provided that wisdom is sought at the right time. Consultation is a powerful force for getting the right answer when facing difficult issues.

Firms need to promote the core ethical values required by the ICAEW and may wish to supplement them with their own quality values in order to help develop a consistent culture. Firms of all sizes may obtain benefit from using key events to emphasise and review professional values, such

as an event to discuss the results of the JMU visit or the yearly staff appraisals.

Good practice

A firm identifies core values of "excellence, teamwork and leadership"; these are supported by "integrity, responsibility, consultation and innovation". All training events contain reminders and include stories of success and pitfalls (and how to avoid them), whether based on experience outside or inside the firm. In addition, the firm conducts an annual internal quality control review that includes interviews with a range of staff to assess local culture, strengths and weaknesses.

The role of communications

A consistent quality culture is more likely to develop if there is consistent communication of key messages. Two-way communication is a fundamental element in the leadership's approach to implementing strategy. Communications need to be clear, relevant, targeted, timely and sustained and their effectiveness needs to be monitored. Face-to-face communications are best, although alternative media can also be useful until there is comprehensive evidence that the message has got through.

Communications on audit quality should reinforce:

- > the leadership's views on audit quality and how it is to be achieved;
- > risk and quality-related policies and processes;
- > measurement processes, including rewards for quality and sanctions for poor quality;
- > key new training messages and periodic reminders on how to achieve quality – practical rather than theoretical.

Good practices

The senior partner explains to all audit partners that in order to improve quality the firm is investing in more training and attendance is obligatory. To set an example, the senior partner attends himself. Audit partners are expected to coach their staff and lead internal change programmes, so if the audit partners do not attend the training by a certain date their authority to sign audit reports will be removed.

continued

The senior partner informs audit partners in advance of the annual quality control review that audits not meeting the required standard will trigger a review of the partner's other audit work. This could adversely affect the partner's evaluation.

Challenges

Reputation builds over a long period of time but can be destroyed relatively quickly.

Many firms have developed risk management expertise. Letting standards fall or non-compliance with regulations are risks to audit quality.

Consequences would include adverse publicity, disruption caused by investigating and responding to complaints, time involved in dealing with clients and third parties, the costs of settling claims and any attendant litigation. In extreme cases, actual or perceived audit failure can have severe consequences for partners and staff, even if they are not directly involved, as well as for the firm.

The senior partner needs to understand and be satisfied with the process followed by those setting the objectives and strategy, and the way in which policies and decisions are communicated down through the firm. His responsibility includes identifying what can prevent the firm achieving its objectives and putting in place controls to assess and minimise the risks. Change in the factors that shape the objectives and strategy will also need to be kept under review.

Change presents both opportunities and risks. There are incentives for firms to improve their quality in that, over time, they can achieve recognition in the marketplace. But there are also many threats to quality from, for example, allowing standards to slip when a new practice area is developed or reducing time spent training and developing people when time pressure is high or costs are rising too fast.

All firms face challenges to their quality standards: it is a measure of the firm and its people and whether those challenges are identified and reacted to in the right way. It helps if the leadership, and the senior partner in particular, have considered the following questions, and those at the end of the

subsequent chapters, and adopted clear policies and processes that address the risks:

- > How well are the *Auditors' Code* and the *Guide to Professional Ethics* understood by all staff?
- > Does the firm, and the audit practice in particular, have clear values and how can the leadership be satisfied that they are applied properly?
- > Is quality embedded in the culture of the firm, is it consistent and is it satisfactory? If not, what needs to be done about it?
- > What part does practice leadership play in developing and maintaining the desired culture?
- > If the practice leader is not the conscience of the firm, is it the senior partner? If not, who is it who ultimately decides on the most difficult client decisions?

People

Overview

Audits are performed by people, so audit quality depends on their quality. Some may claim that it is a cliché to say that people are an organisation's greatest asset but it is certainly true for an audit firm. This chapter addresses the key personal qualities specific to the people who perform the audit.

In order to meet the fundamental principles of the *Auditors' code*, in particular competence, integrity, objectivity and rigour, firms need to ensure that audit partners and staff:

- > are intelligent and discerning;
- > genuinely believe in the public interest purpose of audit;
- > are curious and enquiring by nature with strong inter-personal skills;
- > have sufficient strength of character to be robust in challenging or confrontational situations;
- > have up-to-date technical knowledge and understanding of their clients' business;
- > are able to use this technical knowledge and business understanding to make sound judgements about the matters reported in the financial statements and to communicate them clearly;
- > are motivated, both personally and by their working environment, to deliver quality efficiently and to the best of their abilities.

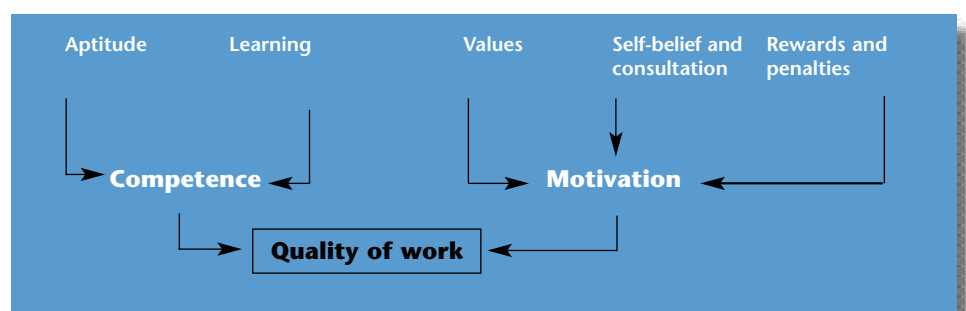
Nowadays, a significant number of audits are performed by audit teams. These teams comprise staff with varying levels of experience who work together to gather the audit evidence needed by the audit partner to form the judgements that underpin the audit opinion. In larger firms, audit teams may also include specialists in certain areas.

Staff need to have the ability to make sound judgements that are objective, ethical and apply relevant knowledge to specific situations. It is essential to have the ability to understand and assess the reliability of information obtained from client management and to have the backbone, both individually and collectively as a firm, to disagree both privately, and if necessary publicly, with client management.

Personal characteristics of quality

The quality of a firm's people and their performance depends on their competence and their motivation. People may be well motivated with a desire to do the right things, but if they are not competent they will not achieve good results. On the other hand, even highly skilled and knowledgeable people will not achieve quality unless they are determined to do so.

Competence depends on an innate aptitude for particular types of task and on what has been



learned from experience and training. Motivation factors broadly fall into three groups: values, self-belief and consultation, and rewards and penalties.

Competence

The ICAEW regulates those who have the authority to sign audit reports as registered auditors of the ICAEW. The *Audit Regulations* contain the key concept of the responsible individual, someone not necessarily a partner, who is responsible for audit work and who can sign an audit report in the firm's name.

The firm itself may also choose to restrict who can perform audits in relation to specific industries or types of clients. Firms may wish to introduce internal licensing arrangements, including training and/or experience requirements, before an individual can work on the audit of specific entities. These may cover specialised and complex products or services such as banking or insurance.

Good practice

In one medium-sized firm all audit partners apply to the technical department annually for a licence if they wish to work on specific audits. They demonstrate their competence and provide details of their Continuing Professional Development (CPD) together with a list of their relevant clients in the area. The technical department takes account of the results of ongoing quality control reviews and assesses the information in awarding the relevant licences.

A list is kept of all audit clients, their audit partners and other partners involved, according to category. The list is kept up-to-date and is reviewed on a regular basis to ensure that only the partners with the relevant licences are leading particular audits.

Aptitude

Auditors need to make sound judgements, often under pressure and often in grey areas where there is significant uncertainty as to the eventual outcome and no clear-cut answer set out in standards, guidance or even precedent. The ability to do this comes partly from experience, partly from knowledge, partly from internal consultation and personal aptitude.

Aptitude for auditors is made up of a number of qualities:

- > integrity: the strength of character to do the right thing, especially under pressure;
- > objectivity: the ability to express an independent opinion;
- > scepticism: an auditor should not accept information or explanations unquestioningly, but should seek evidence to corroborate them.

Aptitude needs to be assessed at the recruitment stage. For more experienced people this can be done by seeking references and by understanding their past experience. For new graduates or school-leavers this can be done by asking for evidence of having to make difficult decisions or by finding out how they react under pressure.

A firm needs to recruit the right people if it is to achieve audit quality. The more clearly the roles in the firm and the expectations of progress are defined, the easier it is to design recruitment and development processes to satisfy long-term needs. The recruitment process should identify those people who will fulfil the proposed role and also those who will in the future be able to take on other more senior roles.

Good practice

One firm has defined the following roles (among others) within audits:

The audit partner – The person responsible for the performance of the audit in accordance with legal and professional requirements and the firm's own requirements.

Planner/reviewer – The person responsible for planning the audit and reviewing the work to ensure it has been carried out in accordance with the plan.

Producer – The person responsible for carrying out the work in accordance with the plan. There will often be several producers involved in an engagement.

Sometimes an individual may fulfil more than one role. For example, on smaller engagements the audit partner might also act as the planner/reviewer.

continued

The competencies required for each role are pre-determined including the ability to demonstrate such competencies. For example, a producer may be required to carry out all work, and make all decisions, with regard to the business context in which the company operates. One method of displaying competence in this area is by demonstrating an understanding of generally accepted business practices. Competencies will clearly be developed over time, so this is further broken down according to the stage of progression of the individual. For example, in a medium-sized firm, competencies at various stages might be described as follows:

After 6 months in the firm – able to explain general business processes, dynamics and relationships.

After 18 months in the firm – able to demonstrate an understanding of business processes, dynamics and relationships as applied in three business sectors.

After 30 months in the firm – able to demonstrate an understanding of business processes, dynamics and relationships as applied in five different business sectors.

Learning

Induction

Having recruited people with the right aptitude, their learning and development should start as soon as they join the firm. This involves a form of induction process.

Good practice

In a smaller firm where the recruit is to be closely supervised on a day-to-day basis by a single person, induction may involve a preliminary discussion focusing on practical matters such as the firm's working methods, administration procedures, and so on.

In a larger firm where the recruit will work in different teams and report to a variety of people, induction may comprise formal sessions covering:

- > the firm's overall ethos;
- > the firm's structure and reporting lines;
- > the firm's audit approach, systems and software;

continued

- > the firm's approach to, and tools for, knowledge sharing;
- > who to contact for help, information, advice or whistle-blowing;
- > administrative procedures and systems.

Different types of induction will be relevant for experienced or more senior recruits compared to those who are less experienced. Recruiting people with relevant knowledge avoids the need for intensive induction training. It often makes sense to bring in a significant number of relatively inexperienced people with a view to training them under close supervision so that they soon become effective on simple tasks and rapidly develop broader expertise.

Simple, written reference material is valuable at an early stage. This cannot contain all the answers itself, but can point the recruit to where to find them.

Monitoring and assessing performance

All firms have processes (formal or informal) for monitoring and assessing people's performance. The best method of monitoring performance is through 'on-the-job' coaching. All staff benefit from learning from more experienced people. Less experienced staff are able to ask questions about the context of their work, have complex problems explained to them clearly and benefit from observing a role model in the workplace. Feedback given to staff there and then is much more effective than that given sometime after the event when it may be taken out of context.

It is important that the assessment criteria are aligned with the firm’s overall values. No amount of exhortation to “Do the right thing” through written guidance or training will ultimately achieve quality unless criteria for assessment are aligned.

Techniques for assessment that may be used include:

- > dealing with issues as soon as they arise, not a long time later. This way they do not become out of proportion;
- > making criticism constructive and pointing to the possible consequences. Try to point out what

people should have done, not just what they should not have done and ask the reviewee to assess his own performance against the relevant criterion. People will accept criticism better if they believe that the appraiser will help them solve the perceived problem.

Providing development feedback to senior members of the audit team can be different to that of audit staff. There are a number of sources of feedback available to partners:

- > 360° feedback with input from peers and junior staff;

Type of work undertaken	Monitoring
The number and size of engagements in which each individual is involved is assessed. An annual discussion is held between the monitoring partner and the audit partner, to consider their audit portfolio and the overall risk profile and ability of the individual to deliver appropriate quality on that portfolio.	Firms are required to perform quality control reviews. These may take place either during or after the audit. In all cases the firm may take action on other audits performed by an individual where a weak result is identified.
Self-assessment	
The individual assesses his own ability and may be required to self-certify an annual return of competence. The self-assessment should be based on feedback received from individual assignments and superiors responsible for ‘on-the-job’ coaching.	
Training undertaken	Testing
Regular and ongoing training is important in a changing environment. Technical training should be mandatory and action is taken for those not undertaking training. This may result in removal of responsible individual status or mandatory second partner review of audits performed by such individuals.	Where appropriate, testing techniques may be used in learning programmes to facilitate the learning process. In the United States this model is extended to the extent that CPD is only recognised if the attendee passes a test at the end of the course. However, an exam-style test may not always be appropriate.

When an appraiser finds shortcomings, he needs to communicate clearly to the staff member not only the shortcoming but also the possible effect this could have on audit quality and the fact that similar failures should be avoided in future. This process should not be adversarial but reviewers should not avoid the issue through a reluctance to engage in constructive criticism. Leaving people with the impression that they are performing satisfactorily when that is not the case will likely inhibit improvement. Some possible solutions include:

- > developing a culture of trust, in which people understand that criticism or negative feedback is not intended to score points or injure, but to help. Make criticisms privately and face-to-face, not just in writing as written comments can be stark and cannot carry the nuances that a discussion can. Discussion also gives the person being assessed the opportunity to respond;

- > feedback from independent partners;
- > outputs from quality control reviews;
- > feedback from the firm’s technical department.

Where feedback has been given, objectives should be set to respond to the feedback. This provides an opportunity to revisit the issues later and see whether behaviour has changed. It also further rewards the person who has made an effort to better himself if he is able to demonstrate the results of that effort and take credit for it.

Training or learning?

The process by which people gain new awareness, understanding and skills can be thought of in two ways:

- > as 'training': the firm decides what training people will receive and then supplies it, for example, all staff need regular (at least annual) technical updates.
- > as 'learning': people are in charge of their own learning and development, agreeing with their line managers what will help them and obtaining it from appropriate sources including formal training provided by the firm.

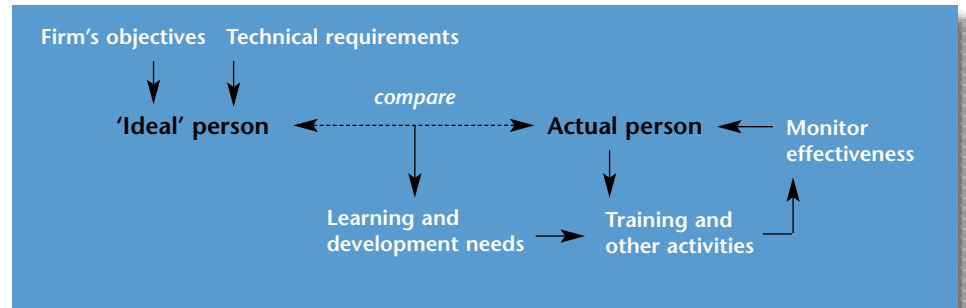
Firms and staff will likely derive most benefit from a balance of mandatory training supplemented by a tailored learning programme to meet further personal development needs.

Illustration

The firm periodically reviews the need for update training and discusses proposals with the practice management team. A central team, working together with the audit managers, designs the training. Business units commit to providing some of their most senior and best people to lead training, which is generally conducted at unit level with appropriate central assistance. Training effectiveness is monitored at time of delivery and after three months in the practice so that improvements can be considered. The quality control review includes a review of whether additional training is required and what further behavioural changes or process improvements are needed.

If people are to share in the responsibility for their own learning, they should be given a clear idea of what is expected of them. This can be done through the firm's assessment process. The person can then participate in the decision as to how he is to gain

the knowledge and skills he needs. It also provides a basis for subsequent review of the learning's effectiveness in helping the person meet his development targets.

One model for the setting and execution of learning plans for individuals*Timing*

It is easy to say that training and learning should happen at the right time. In practice, the logistics can be difficult. Possible answers to this are to:

- > use learning methods such as self-study packs and on-line training material which can be used at any time;
- > plan people's courses so that they fit with practical experience;
- > provide each course several times during the year. This may not provide a perfect fit but will be better than a single event.

Learning methods

The methods available include on-the-job experience, mentoring and coaching, classroom training, self-study, computer-based training and secondment. Firms should consider which method will serve best to equip each person with the knowledge and skills he needs to play his part.

The most enduring form of learning is that which comes from practical experience that is appropriately directed, supervised and reviewed. This requires that audit staff be subjected to a variety of situations that will give them the opportunity to learn new skills from role models which, through feedback, corrects or reinforces what they have learned. Good practice should promote a coaching process that is constructive, demonstrating an underlying trust of those coached but asking key questions about important aspects of

work performed. This is to ensure that they have properly met the objectives set and understand the relevance of their work to the audit as a whole.

New experiences develop skills and technical knowledge, as well as challenge existing beliefs. They help people develop a more balanced view that assists in making independent judgements. Secondments can be very beneficial in this respect and can take various forms, including performing a similar role in another office or transferring to another discipline, for example tax or corporate finance, or even experience from outside the firm. It is important that the return process is managed smoothly and effectively. This involves setting objectives for the individual before the secondment and identifying what has been learned afterwards.

Training follow-up

To ensure that training actually improves the quality of a person's work, the matters learned should be reinforced through experience. As well as the 'just in time' principle, many firms follow up after a suitable interval with a check on how the person has applied the knowledge and skills gained and whether any remaining or consequential learning needs or development opportunities emerge.

One important factor in achieving the right quality of work is that people should receive consistent messages from different sources about what is expected of them. Those preparing training material should reflect the leadership's view on contentious issues, otherwise behaviours developed through training courses may be negated when staff return to normal work. Therefore it is important that the leadership forms a view on contentious issues and clearly communicates that view to those preparing training material in advance of its presentation.

Motivation

The personal desire and drive to arrive at an appropriate opinion on a set of financial statements are the most important aspects of motivation to deliver a quality audit. This behaviour is supported by the firm's values, by the leadership consistently demonstrating these values, and by rewarding appropriate behaviour.

Values

Personal values

To deliver consistently appropriate, quality opinions, auditors need to be independent of the company and management. Independence is as much a state of mind derived from personal values as it is a fact. The firm's leadership, rules, regulations, codes of conduct and culture create the right conditions for the auditor to exercise these values and demonstrate independence.

It is important, therefore, for firms to recruit people with the appropriate personal values in the first place and ensure that training, learning and on-the-job coaching reinforce these values consistently.

Firm's values

The establishment and communication by a firm of a clear set of values to its people is important to audit quality. To ensure that people do not get confused by mixed messages, a firm should set out its core values clearly and unambiguously. This statement should then be used to communicate them to its people regularly, in a variety of ways and in a range of different contexts.

Good practice

A firm:

- > sets out its core values covering all disciplines, not just audit;
- > ensures that any subsidiary statement of aims (for example, for specialist departments) fully reflects the core values;
- > includes tests of people's personal values in recruitment processes for new staff and in vetting processes for new audit partners;
- > ensures that guidance emphasises relevant values when dealing with technical or procedural matters, to give them a sense of purpose and context;
- > uses the firm's values in periodic performance reviews as part of the quality criteria against which people are judged;
- > ensures that when partners and senior managers are speaking at internal events, they emphasise these core values;
- > refers to the firm's values in external material (this creates an expectation which partners and staff must then live up to).

Self-belief and consultation

Leadership needs to foster consultation and individual self-belief.

Auditors have to make difficult decisions, potentially under pressure from client management. Consultation may be formalised in certain circumstances such as the requirement for a second partner review and the requirement to consult technical experts. However, the motivation and ability of an audit partner to walk down the corridor and ask another colleague for his viewpoint should not be underestimated.

Nevertheless, each audit partner needs significant self-belief in order to form his own judgements. To support individual self-belief, leadership should manage the need for people to follow the leadership line, whilst still fostering and encouraging a sceptical and questioning approach.

Consultation in practice is explored in more detail in the Working Practices chapter.

Rewards and penalties

Auditing can be complex and needs to attract and retain the best people to ensure that quality audits are delivered. All firms need a framework to, recruit, measure, monitor and reward the best people. People will do things for which they are rewarded and will stop doing things for which they are penalised. In some circumstances, they will stop doing things for which they are not rewarded.

To attract and retain the best people it is usually necessary to pay at least a competitive salary as well as offer an interesting and rewarding working environment. Many people are driven as much by non-monetary factors such as professional pride, 'a need to get it right', a feeling of serving the public interest, a need to deliver quality service to the client, and a need to act in the interests of the collective firm. Firms need to identify what it is that each person values and tie rewards to the behaviours the firm desires, and if practicable take into account what will best motivate the individual.

Being recognised for doing a good job motivates many people. Firms can use this by making it known when someone has done a particularly good

piece of work or has made a good decision. Career advancement should favour those who display the right motivation and competence.

People also tend to deliver what is measured. Knowing that a particular aspect of performance is being measured is a stimulus. Firms should therefore ensure that quality is measured. Measuring quality is subjective but seeking feedback from a range of people will ensure a consistent and balanced view.

Good practice

A firm applies a balanced scorecard approach to unit performance, whereby performance targets and related action programmes are agreed with each unit and are aligned to the practice's strategy. A section of the scorecard addresses technical, risk and quality objectives and performance in relation to improvement programmes.

Each month the unit self-assesses its performance. Others with relevant information, such as the quality monitoring function, also assess unit performance. Individual partners and managers identify their own objectives, aligned with those of their unit and the balanced scorecard approach; they self-assess their performance every six months and once again others with relevant information can add their comments.

Measures that can be used as indicators of staff quality include:

- > results of pre-clearance reviews of work and quality control reviews;
- > assessment programmes (not necessarily looking for the most satisfied client management, but for indicators of audit quality such as respect and a feeling that they were properly audited);
- > 360° feedback (looking for feedback from a number of sources).

Practical support

All audit partners and staff have to keep themselves up to date on technical matters and be familiar with the firm's own procedures and current best practices. No matter how good learning activities are, partners and staff will still encounter situations in which they need technical and ethical support. Firms of different sizes provide this support in different ways.

The larger the firm, the more likely it is that there will be a central technical and risk management function. Sometimes, however, impersonal information sources will not suffice and people need to be able to discuss a problem.

Smaller firms may only need outside advice on technical and ethical matters. The Ethics Advisory Services Helpline gives ICAEW members free confidential advice on ethical issues. The advisers have several years' experience and can assist firms in applying the ethical framework principles to the circumstances that they encounter in their professional lives.

Illustration

A firm highlights a possible threat to objectivity and contacts the Ethics Advisory Services Helpline (see bibliography). One of its audit clients is involved in a joint venture with a wife of one of the firm's audit partners. The partner, who is not the audit partner responsible for either the audit client or the joint venture, is concerned that he will be seen to be too close to the client. He has no personal involvement in the joint venture and the joint venture is separate from the core business of the audit client. The firm also acts for one of the directors of the joint venture.

Advice given

Firstly there are two clients, the audit client and the director as an individual. The joint venture is separate from the audit client. Statement 1.201 of the *Guide to Professional Ethics* and the Best Practice Guidance implementing the EC Recommendation on auditor independence advises that the relationship with the audit partner's wife is a connection or association that may threaten or be seen to threaten the auditor's independence.

The firm should take steps to establish the significance of the joint venture interest. If the venture is significant to the audit client or to the audit partner's wife, the threat will be greater. Possible safeguards, which are commensurate with the threat identified, should be introduced. These might include excluding the audit partner from the audit team, procedures to monitor how significant the joint venture is and how close the relationship between the audit client and the audit partner's wife becomes. Ultimately if the firm cannot preserve independence and the appearance of independence, it should decline the appointment.

Challenges

Every firm needs to recruit intelligent and discerning people and ensure that its people have the necessary tools and have structures in place to provide them with the technical knowledge and the ability to make sound judgements, in order to enable them to perform quality audits. At the same time the firm needs to provide an environment that nurtures and supports objectivity and integrity.

A firm should consider the following questions when assessing audit quality:

- > **Is the firm recruiting people with the right competencies and values to operate in the public interest?**
- > **Does the firm's culture encourage objectivity and consultation?**
- > **Is there a focus on learning, not just training?**
- > **Are people provided with the right experience opportunities throughout their careers?**
- > **Are good role models promoted and used actively for 'on the job' coaching?**
- > **Is learning linked to people's actual work?**
- > **Does the firm let people know what is expected of them?**
- > **Are people motivated to deliver quality?**
- > **What is seen as most important – loss of reputation or the loss of a client?**
- > **Do people get consistent messages from all sources?**
- > **Is there monitoring and controlling of who can do what?**
- > **Does the firm strive to measure and reward quality?**

Client relationships

Overview

Firms manage relationships with their clients on two levels

- > by managing their overall client base by accepting and continuing to act only for those audit clients where they can deliver a quality service;
- > by managing their client relationships appropriately on a day-to-day basis so that an efficient audit is undertaken while achieving audit quality with an appropriate level of financial return.

Who is the client?

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

For companies the board of directors will be a separate body to whom the shareholders have entrusted the management of the business. On a day-to-day basis the audit partner and his staff usually deal with the executive directors and senior and middle management. For owner-managed businesses, the distinction is less clear as the directors and shareholders are the same individuals.

When auditors talk about the “client”, it is often shorthand for the directors and senior management. But auditors should always be conscious of their ultimate responsibility to shareholders while maintaining their relationship with management.

For listed companies at least, recognition of the dangers inherent in a situation where the responsibility for business decisions rests solely with the executive directors has led to significant developments in corporate governance. In particular, the audit committee, comprised of non-executives, with its oversight role is now seen as critical to ensuring that the interests of the shareholders are represented. Auditors have responded to these developments and communication with the audit committee has become an increasingly important part of effective client management so much so that the trend is for the auditors to regard the audit committee as their most important channel of communication about the audit. In the case of small or owner-managed businesses the relationship is likely to be much more direct and the auditors need to be aware of the interests of any shareholders who do not work in the business.

Whatever the specifics of the situation, the auditors' responsibility remains to the shareholders. Effective client management involves managing the auditor's relationships with management, both executive and non-executive, such that the auditor can perform an effective, independent audit and report his professional opinion to the shareholders. The auditor-management relationship needs to be close enough to enable the auditor to understand the business, but distant enough to permit the auditor to assess, objectively and sceptically, whether the information and evidence he is being presented with is reasonable and makes sense.

Relationships with management

An effective relationship with management is important.

Audit partners and staff need to be well informed about the company's business and the audit risks, by anticipating and responding to key issues, and by demonstrating a commitment to audit quality. They do this by forming a good working relationship with client management and, where applicable, the audit committee.

So what makes an acceptable client?

An acceptable client is one with whom the audit partner feels he can have an open and honest relationship, where there is mutual trust and respect. Good management sees significant value in the audit process and is prepared to seek advice in advance of deadlines, where he keeps the audit partner informed of business developments and is willing to pay appropriate fees for the work performed. Such a relationship is much more likely to result in a quality audit.

However, such a client does not exist in isolation.

An acceptable client needs a good auditor – a technically competent audit partner with good experience and knowledge of the client's business supported by staff with an appropriate mix of skills. He needs to be prepared to convey difficult messages, respond to issues in an appropriate and timely manner, and bring issues to the client management's attention, and the audit committee, so that they can be dealt with before they lead to a crisis.

The audit partner needs to decide which of his higher risk clients can be made more acceptable by means of devoting more time and effort in order to achieve a good working relationship. For those clients where, for whatever reason, the auditor comes to the judgement that he is incapable of providing a quality audit, the firm should consider what steps can be taken to reduce this risk to an acceptable level, such as changing the audit partner or other members of the audit team, involving independent review partners or even resigning from the audit. Resignation, however, is not to be regarded as a soft option. Auditors need to face up to their responsibilities and deal with them in the most appropriate way. Nonetheless, it should be recognised that there are circumstances where the best solution is for another firm, who is better equipped to deal with the perceived risks, to act.

How do auditors assess the risk?

Client assessment procedures help in identifying whether a client is an acceptable client for the firm. A history of lawsuits, unfavourable press reports, late financial statements, qualified audit reports, and frequent changes of auditor can all give some indication that a client is likely to be higher risk.

However, these do not tell the whole story. They do not demonstrate the individual relationships between a client's management and the auditors. In reality, it can often be difficult to tell if a client will be an acceptable client before the firm actually becomes the auditor. For this reason the auditors' evaluation of the client should continue beyond the acceptance stage and firms need to re-evaluate their clients. This is best done in respect of the following year shortly at the time of or shortly after completing the annual audit.

Can clients ever change?

Clients and client relationships always change, sometimes for the better, sometimes for the worse. Often these changes are precipitated either by a change in management or external factors.

Illustration

The auditor and XYZ PLC had had a good relationship for a number of years. XYZ had been a family firm with conservative accounting policies and had floated. A couple of years later an expensive new product launch was unsuccessful, leading to profit warnings, emergency refinancing and a more aggressive interpretation of the management accounting policies. The relationship between the client and the firm became strained due to differences of opinion on significant issues and a perceived lack of openness by the client. Audit fees increased due to the increased level of work required. The audit opinion was about to be qualified when the banks required the client to change its Chairman, Chief Executive Officer and Finance Director. The replacement directors agreed to the changes required by the auditors and the audit opinion was signed with a fundamental uncertainty paragraph. During this period the management had changed from conservative to aggressive and back again to conservative. The firm had to increase the amount of work performed and therefore fees in response to the increased risks.

Accepting and retaining the right clients

Accepting and retaining the right clients is the most effective way for a firm to reduce the risk of issuing an inappropriate opinion.

Many firms use some sort of scoring method to make the acceptance or continuance decision easier, but, ultimately, the decision is subjective and is dependent on the judgement of one or more partners. The matters to be considered include:

- > **The firm's resources and experience** – Firms need to consider their resources, skills and ability to service the client. This should be considered on several levels, for example by considering whether the firm's industry expertise and geographical reach matches that of the client, and by ensuring that the right audit partner and audit team are available for a particular client. Clients need to be considered in relation to the firm's existing client base. Is a potential client in a sector in which the firm is experienced? The need to balance risk across sectors needs to be weighed against the need to specialise. Smaller firms face a particular risk from engaging on specialist audits, for example, charities, pension schemes and solicitors. There needs to be careful consideration of the necessary competence or required experience and whether the firm has that expertise.
- > **The firm's independence and objectivity** – Conflicts of interest can be as much of a problem for small firms as large firms. Firms should consider potential conflicts before, rather than after, taking on new audit clients. Problems of this nature are not always clear and, as with all risk assessment, judgement is required. Independence checklists are useful, and simply being aware of other relationships with the prospective client and its competitors is essential. All firms need to consider the impact of the pressure to build revenues that individual partners face. They also have to consider, however, the potential impact on the firm's reputation of taking on work where there could be a perception of lack of independence even if on a balanced assessment there is no actual threat.

- > **Management** – A key risk for the firm is the honesty and integrity of client management. In some cases the risks may centre on an assessment of the client's reputation including the presence of a dominant individual within the management team. Risks could also include the client's solvency level, the nature and history of the client's business – the industry life-cycle, revenue streams, and the quality of management and control – and management plans. Any client that is, or is likely to be involved in a flotation or other such transaction involving third parties is likely to represent a higher risk. It is with these transactions, where short-term financial reward is possible, that there is the greatest risk that management may act aggressively in terms of accounting practices, or even dishonestly.

Illustration

During an audit, the team identifies material errors in the draft financial statements. The audit fee is nine percent of the total fee income for a relatively new audit partner who is trying to build up his portfolio. The directors refuse to adjust the financial statements, and make it very clear to the partner that if the audit report is qualified the firm will not be acting as auditors next year.

How can the partner deal with this?

The simple answer is that the partner should not. It is the firm's responsibility.

A smaller practitioner may wish to consult externally, possibly with the Ethics Advisory Service (see bibliography).

In a larger firm, the partner should discuss this matter with more senior partners in the firm and ensure that he obtains their backing. The client may be making an idle threat: when it becomes clear the firm will not alter its opinion then the financial statements may be changed. If this is not going to happen, then the firm must accept that the client may be lost. It should qualify the audit report, and accept the consequences.

New client acceptance procedures

All firms should document their risk assessment procedures when they are taking on new clients. The form of that documentation will vary, but should cover all of the risk areas set out above. While this assessment is crucial in deciding whether or not to accept a potential and it is equally crucial after acceptance has taken place. In simple terms all audits include some degree of risk. The important point is that the auditor should be aware of, and deal with, those risks.

Good practice

One firm has a formal acceptance procedure for new clients, which involves a questionnaire. This needs to be fully completed by one partner and authorised by another partner before the client is accepted. At the same time, the client is given a risk management category, which will drive the procedures that need to be undertaken on that client. To ensure this happens, a new client charge code cannot be set up without a properly authorised questionnaire. The accounts department allocates the charge code.

Some of the information that should be obtained in assessing whether or not to accept clients is objective, and can be dealt with through means such as checklists. Examples might be obtaining the latest financial statements, undertaking a company search, checking whether or not there are any statements of circumstances associated with the previous auditor's resignation and undertaking credit agency checks. Other matters will be judgmental. The auditor needs to consider the risk associated with the potential client's business, its financial strategy, its management and its financial position.

Good practice

One firm requires the audit partner to review the accounting policies before the first year's audit is accepted. This review is performed in consultation with a technical expert.

It can often be useful to have a hierarchy of acceptance procedures. Basic procedures need to be undertaken in all cases. As the risk associated

with a potential client increases, for example because it is in a regulated sector or listed, then further procedures are often required. Similarly, the number of people involved in a decision may vary. As the potential risk increases, more partners need to be involved in the decision, ideally including those with risk management experience.

Managing clients

Managing clients is all about effectively identifying and managing the risks to the firm. Failure to manage clients effectively, whether in aggregate or individually, can damage the reputation of, or even destroy, a firm.

Higher risk clients

Every firm has to consider whether it can adequately address the risks associated with higher risk clients to enable it to deliver audit quality.

Managing higher risk clients requires more time and will often involve more experienced people. Specific risks need to be addressed by ensuring that sufficient audit effort is directed towards them, and that specialists are involved where necessary. Dealing with pervasive risks is more difficult. If, for example, a company is attempting to sell all or a significant part of the business then there might be a risk of overstatement of income and assets, and understatement of expenses and liabilities. Such a risk affects virtually the whole of the financial statements, not just one particular area. If the auditor has a good relationship with management then such matters can be addressed.

Good practice

It can be useful for firms to hold regular client risk assessment meetings. Depending on the size of the firm and its client base, these may either cover specific clients, for example, listed or public interest, or look at a range of clients.

Specific client meetings are useful for pooling all the knowledge the firm has, and the judgements that have been reached. The perspective of tax partners and staff, for example, may differ from that of the audit team. The risks associated with a client and

continued

how they have been addressed should be discussed with individuals who have no contact with management. They can bring a fresh perspective to issues and suggest solutions.

Smaller firms may find it more useful to consider the risks associated with clients by discussing several clients at once, for example by reviewing a particular partner's audit portfolio.

Whatever form such meetings take, the key requirement is to assess whether the risks associated with a client are too high, and whether the firm should therefore cease to act for them.

Auditing standards, and many firms' own rules, sometimes require partners other than the audit partner to be involved in key decisions, and in an overall review of the audit and the approval of the audit report. Auditing standards and basic common sense dictate that partners should consult with other individuals within the firm over particular issues or problems. Such consultations are not a sign of any weakness in the audit partner; instead they are a sign of strength in the firm and demonstrates a willingness to use all available resources in order to ensure the quality of the firm's audit work and its reputation.

What is an acceptable fee for audit quality?

The need for auditors to combine running a successful practice with serving the public interest puts a premium on their objectivity. In a professional environment, there can be no such thing as a standard audit fee. Firms are free to charge whatever they consider appropriate, and fees will vary according to the skills employed, the value provided, and the efficiency of the audit, as well as the nature, complexity and structure of the business being audited.

Firms should avoid charging unreasonable fees causing time constraints that put pressure on audit staff to cut corners. This can result in giving insufficient attention to the issues. The fee should cover the work that the firm considers necessary in order to meet all its legal, regulatory and

professional obligations – its professional reputation depends on this. All identified risks need to be addressed, and both the nature and the extent of the necessary audit procedures will be affected by the client's risk profile. Greater risks involve more work, both in terms of skills employed and time taken, and more work means higher fees.

Auditors should beware of client management whose only objective for the audit seems to be to keep the audit fee as low as possible. Nobody wants to pay more for anything than they have to, and attempting to keep audit fees low is a perfectly legitimate objective for any company, as long as audit quality does not suffer. If a potential client is not willing to accept a fee that is sufficient to enable the auditor to undertake his work to the standard required in the interests of shareholders, then the firm should be extremely cautious.

Illustration

A firm is asked to tender for an audit. The directors of the company make clear that the audit will be given to the firm with the lowest quote, regardless of other matters covered in the tender. Should the firm tender at all?

There is no obligation for a firm to tender when requested. If the firm does not feel that the client is one they would be happy to work with, or does not feel there is any chance of achieving an acceptable fee then it need not quote. But is there anything wrong in the firm tendering? No. The firm should tender if it wishes, but should quote the fee necessary to provide the appropriate professional expertise to the shareholders. Most firms have experienced situations where potential clients say that they will accept the lowest fee and then do not. It is sometimes simply a negotiating tactic to try and keep fees as low as possible.

The right partner

In the book *'Behind Closed Doors: what company audit is really about'*³ one conclusion is that the relationship between the audit partner and the

³ See bibliography

finance director is an important factor in determining audit quality. Firms should therefore ensure that the audit partner has the technical competence and ability to form sound judgements, and the ability to form a good working relationship with the finance director, audit committee and other members of the company's management.

A good working relationship is based on respect for the auditor's point of view, the integrity of both the audit partner and management, and an understanding that it is the auditor's job to challenge. The relationship does not just happen, but needs to be planned, worked on and monitored.

There are a number of factors to consider when deciding which audit partner is right for the client. In selecting the right team, one also needs to assess the balance of attributes required and the relative experience of client management. A new audit partner may suffer from a lack of credibility with more experienced or assertive management. However, inexperienced management matched with a new audit partner may not be the best match either. The right partner for a client is one who has an appropriate amount of industry expertise, is technically competent, independent and objective, and has personal qualities that will facilitate an appropriate relationship with management. The skills and qualities of the audit team should complement those of the partner. Finally, the audit partner should have sufficient time and resources to ensure that audit quality is delivered.

In the changing regulatory environment deciding on the right partner will need to become a more regular process for the audits of all listed companies. All key audit partners, who may well include those working as one of a team of head office partners, are required by ICAEW pronouncements to limit the period they work on that audit.

Changing an audit partner can give rise to risks and partner rotation, due to regulation, resignation or retirement, and should be planned in advance if possible. Firms need to invest resources into succession planning and matching audit partners to client management. The company should be informed at the earliest possible opportunity and

sufficient time should be allowed for handover and shadowing between the outgoing and incoming audit partners. This ensures that there is a good transfer of knowledge, that the business and audit risks are well understood, and that there is minimum cost to the company and the firm.

A request by the management to change the audit partner should be treated with caution. In some cases such requests are due to personality clashes. In other cases the partner may be described as not understanding the business because he is 'too technical' or 'lacks commerciality'. The reality might be that management disagrees with the partner and is seeking a partner over whom it believes it may have greater influence. At the very least, the firm ought to consider whether there is another, underlying reason for the change. In every case, the firm should reconsider whether or not this is a company with whom it should continue to work.

Although these particular issues apply equally to large firms and smaller firms, larger firms do have the luxury of having a number of partners to choose from.

Illustration

The finance director at an audit client complains to the audit partner about a member of the audit team. The staff member is described as aggressive. Should the audit partner agree to remove the staff member from the audit team?

Not automatically, although it may be appropriate to remove him temporarily to give the firm time to investigate. One possibility is that the finance director is correct. Another possibility is a genuine personality clash. These do happen and when they do, the firm should consider complying with the management's request for removal. But the firm should also consider the possibility that the staff member is actually doing a good job. Aggression may actually indicate a refusal to accept inadequate responses and partial evidence, exactly the traits required in a good auditor. If this is found to be the reason, then the firm should be more concerned about management than the staff member.

Clearly, all firms should regularly assess their ability to perform their work with due regard for objectivity and independence. The ICAEW's *Guide to Professional Ethics* requires that an auditor should always observe the fundamental principles of integrity and objectivity. Integrity implies not merely honesty but fair dealing and truthfulness. An auditor's work needs to be uncorrupted by self-interest and not be influenced by the interests of other parties. The Guide includes examples of threats that might arise in particular situations and suggests appropriate safeguards. But these are illustrative and not comprehensive. The auditor should be able to demonstrate that, in the particular circumstances, the fundamental principles have in fact been observed.

Setting the tone

Some of the most difficult problems that audit partners can face occur when directors, both executive and non-executive, perceive an inconsistency or tardiness in the messages they are being given. This applies even where there is, in fact, no such inconsistency. An accounting treatment that was previously considered acceptable or an error that was immaterial one year but not the next, can be difficult for management to understand or accept. Equally, if an issue is raised at the last moment that could have significant implications for the financial statements or the business, this is a very unpalatable message to give or receive.

There are three important aspects to managing client relationships that the audit partner should try to get right from the start, and throughout the relationship.

> First, it is important to establish expectations and allocate responsibilities between auditors and management at the beginning, normally in the form of an engagement letter. The terms should be discussed with management and with the audit committee. Discussion should take place before the audit work commences so that there are no surprises for either party in relation to responsibilities, scope of work and fees. Auditors should treat with caution any attempts made by management to alter the scope or terms of the audit.

> Second, to establish that the audit partner is objective and independent and, having considered all the evidence, is prepared to give his honest and professional view, even if the answer is not what management wants. This should enable the audit partner to give consistent messages and make it easier to give bad news, in an objective way.

> Third, to manage communications with the audit committee and client management and ensure that issues are dealt with well in advance of them becoming a crisis. Management is usually able to cope with bad news, if there is enough time to consider the implications and to reach a balanced judgement.

Illustration

In the course of a new audit, a firm discovers that a client is not complying with a financial reporting standard but the amounts involved are not material. Companies are not required to comply with financial reporting standards in these circumstances as such standards only apply to material items. Should this still be brought to the attention of management?

Yes, every time – this is a requirement of *SAS 610 (Revised)*. The amounts involved may be immaterial this year, but may not continue to be so. If the amounts grow so that next year the auditor insists on a change to the accounting treatment then the client may well question why the same treatment, previously accepted, is no longer acceptable. The auditor would still be right, but the client is unlikely to be easily persuaded. It is much better to explain why the treatment is wrong, and probably suggest a change, but to note that no change is required, solely on the grounds of materiality. This makes management aware that any increase in the amounts involved may lead to a necessary change in accounting treatment.

Maintaining relationships

Nature of relationships

Audit Committees

Most listed companies, and an increasing number of public interest entities, will have an audit committee comprising non-executive directors.

An audit committee's responsibilities include:

- > making recommendations to the board on the appointment of the external auditors, the audit fee, and any questions of resignation or dismissal;
- > discussion with the external auditors about the nature and scope of the audit and any problems arising from the audit;
- > discussion with the external auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern;
- > making recommendation to the board on the approval of a policy for the provision of non-audit services by the external auditors, and approving contracts and fees for non-audit services by the external auditors, to ensure that such work will not compromise their independence or objectivity.

The audit committee reviews the financial statements and other financial information reported externally. One of its objectives is to ensure that the business is being run in the long-term interests of the shareholders as a whole. The objective of an audit can be seen as ensuring that the information available for this purpose is appropriate, albeit that the information is at a high level. So the goals of non-executives and auditors should coincide.

It is essential that the audit partner has an open relationship with the non-executive directors and, in particular, the Chairman of the audit committee. This will help ensure that there is mutual understanding of each party's views on any issues affecting the audit.

Client management

Regular round-the-year contact is a necessity, so that information can be passed both ways. The auditor

needs to inform the management of any changes that may affect them, such as changes in financial reporting requirements.

Good management keeps in touch with its auditors. Such contact is not usually disinterested, and good management usually wants to be made aware of the audit implications, if any, of actions it intends to take. Audit planning meetings with clients are a must, but no substitute for having a relationship that means the auditor is aware of many of the changes before such a meeting even takes place.

Discussions with management need not focus exclusively on what are normally considered to be audit issues. Background on the general progress of the business or the industry is just as valuable. All of the information obtained will be considered during the audit planning, thereby facilitating the identification and documentation of risks and the briefing of staff on key issues affecting the client's business.

Internal audit

Another key relationship that external auditors need to manage is with internal auditors. Both internal and external auditors have a vital role to play in corporate governance. Internal audit plays a key role in providing assurance to client management across a range of issues. Internal and external auditors need to establish a good working relationship, both at a strategic and at a practical level, in order to work together effectively.

Relationship assessment

Firms need to undertake regular reviews of client relationships and the quality of service they are providing. This covers all aspects of work by the firm, and all the parties to whom its work may be relevant.

Firms need to consider how good their relationship is with management, internal audit, the audit committee and the other non-executive directors, how efficiently they are undertaking the work, and whether other services being provided impact on the firm's independence and the company. The nature of such assessments will depend on the size of the firm and its clients. Large clients may

warrant individual reviews, smaller clients may be considered as part of a review of a partner's portfolio. Whatever approach is adopted, the questions should address whether the firm is providing a quality audit to parties with whom it wishes to deal.

Revisit client acceptance and continuance

For potential new appointments, refusing to act is generally easier as the firm does not accept the engagement. The more difficult situation is where the firm is already acting and decides, for whatever reason, that it no longer wishes to act.

It is usually a mistake to reconsider this solely when a new audit is expected to start; it is much better if the auditor considers this at the conclusion of each audit, prior to reappointment for the following year. This is the time when the information that will be most relevant to the decision is likely to be fresh in the auditor's mind.

This is not to say that the issue should not also be considered when each new audit is about to be planned. Changes may have occurred since the end of the last audit that mean the firm no longer wishes to act. Equally, where there have been some reservations but not enough to lead the auditor to resign, then the time elapsed since the last audit may have enabled the client to address the concerns.

Communication

Constructive observations

For all companies there is a requirement⁴ for auditors to inform those charged with governance of weaknesses and problems that they identify during the audit. However, there is no requirement for all controls to be tested and as a result the auditor is unlikely to identify all control weaknesses that may exist.

For smaller companies communication may be relatively informal. There may be a single meeting where the matters are discussed, without any formalised report being produced. For larger companies the form of reporting will reflect the company's size and nature. Discussions may be held

with different levels of management and the audit committee, according to the impact and relevance of the points being raised. For significant issues, such communication should be recorded formally in writing, after the initial discussions have taken place.

Difficult messages

Audit reporting is important and should not be left until the end of the audit. The audit partner should aim for early communication with management, when corrective action may be required, particularly if a qualification or fundamental uncertainty within the audit report would otherwise result. This is also an area where it is vital to consult internally. For example, a change in a financial reporting standard may have an adverse impact on a client's apparent financial position or profitability. Waiting until the latter stages of the audit is only likely to lead to an aggrieved client.

Illustration

As a result of the introduction of FRS 19 *Deferred Tax*, a company's net assets are likely to be reduced by ten percent. The directors argue that the new standard is nonsense, and that they do not consider that the financial statements can give a true and fair view if they contain provisions for items that will never, in practice, be paid. What can the audit partner do?

It can be difficult to distinguish between those who disagree with particular accounting requirements as a matter of principle, and those who disagree because of the effect on particular company financial statements. It is noticeable that a significant number of such apparently principled stands are in cases where changes would adversely affect reported profits or net assets. The audit partner may sympathise with the client, or even agree in principle. But the new standard needs to be applied. The audit partner should make it clear that failure to comply with the standard will result in an audit qualification, on the grounds of disagreement.

Qualified reports

Qualified audit opinions should always be discussed at the earliest opportunity with management, and,

⁴ SAS 610 (Revised) "Reporting to those charged with governance" – APB

if there is one, the audit committee. Auditors should explain the precise reasons for the qualifications and the implications. Not surprisingly, management often resists qualifications. The auditor needs to stress that this is not an option that has been taken lightly; it has only been taken because it is necessary.

Where a potential qualification is identified at a very early stage the auditor should consider if it is appropriate to act. Auditors should not act at all where the qualification will be on the grounds of limitation of scope, and management has imposed that limitation. There is a fundamental difference between limitations imposed by circumstances and those imposed by the management of the company.

Illustration I

A firm is approached to act as auditor of a medium-sized company with offshore connections. In the course of initial discussions with client management it becomes clear that the auditor will not be given with access to some of the details of potential related parties; the reason given is a wish to provide confidentiality to those involved. Should the auditor agree to act?

No.

Management imposes this form of limitation. If the auditor is not free to perform the audit properly he should not agree to perform it at all.

Illustration II

A firm is approached to act as auditor of a medium-sized company with offshore connections. In the course of initial discussions with client management it becomes clear that the auditor will not be able to gain access to some of the accounting records due to a fire at one of the company's branches which destroyed some key documentation. Should the auditor agree to act?

There is no reason why he should not.

While this will involve a limitation of scope, as in the previous example, management does not impose it and it does not in any way call into question their attitude to accounting matters or the audit.

Providing non-audit services

There continues to be significant debate over the appropriateness of auditors performing non-audit work for a client. There are some defined restrictions for auditors of UK and US listed companies. But on the whole, there are still areas where it makes sense, subject to safeguards, for the auditors to perform the work.

The ICAEW sets out fundamental ethical principles that need to be observed, describes possible threats to these principles and gives guidance on safeguards that may be used to respond to these threats. While recognising that there are some situations where it is reasonable to have rules to the effect that the audit firm cannot provide both audit and non-audit services, the ICAEW considers that the framework approach, adopted by the European Commission and by IFAC⁵, is a more rigorous means to ensuring auditor independence than a wholly rules-based approach. This is because:

- > the onus is placed on the auditor actively to consider independence issues rather than slavishly following a set of rules. There is an onus on the auditor to consider possible threats in respect of all engagements and implement appropriate safeguards or decline the engagement;
- > narrow legalistic interpretations cannot be used to circumvent the spirit of auditor independence;
- > the principles and analysis of threats and safeguards can be applied to an infinite number of circumstances.

What is clear is that auditors should implement safeguards to offset threats, to ensure that such work has no impact on their objectivity and independence in their role of auditor in the public interest.

Challenges

A firm should consider the following questions to assess whether its client policies are contributing to audit quality:

- > **Is the firm satisfied that it will not accept or retain clients that could prejudice quality standards?**

⁵ International Federation of Accountants

- > What is the pricing policy when tendering for new work or retaining existing work? If fees are reduced over previous levels, what procedures will ensure that quality standards will not be adversely affected?
- > If another firm resigns from a risky audit in what circumstances might the firm take on such work and with what risk management procedures?
- > Does the firm have ways of assessing whether partners are taking on too much work and prejudicing the quality of existing work?
- > How does a firm make sure that the audit team does not become so close to a client that its objectivity is impaired?

Working practices

Overview

An important element in assuring quality is the need for individual auditors and audit teams to employ good working practices during the audit process. Good working practices enable the right people to perform the right work at the right time and the audit team to operate efficiently and effectively, both within the team, and with the rest of the firm.

One size does not fit all. An important aspect of the audit partner's role is to use professional judgement to determine which audit processes are relevant to the nature of the business being audited and its associated financial misstatement risks. Ensuring that procedures are relevant to circumstances depends not only on the audit partner's actions, but also on the actions of the whole team.

The main points that need to be considered are:

- > getting the right working practices for the audit team. This includes each member clearly understanding his role, timely communication of important audit issues within the team and the proper use of empowerment;
- > applying original thought to planning and execution of an audit in order to tailor the approach to the client's particular circumstances;
- > developing staff to be alert to the unexpected, or something out of the ordinary, and instil an attitude of professional scepticism;
- > the importance of challenging purported facts and representations by client management and obtaining properly documented audit evidence which supports the auditor's judgements;

- > ensuring that there are appropriate resources for consultation, and fostering a culture whereby seeking consultation is seen as a strength, not a weakness;
- > review procedures and the completion of audits performed in an effective way so that all issues are addressed appropriately and time pressure is dealt with robustly.

A key cultural issue for firms is whether to base their working practice on the development of operating principles, understood and properly applied by competent, motivated and experienced people, or whether to develop an approach, with standard procedures and less flexibility. A more flexible and judgmental approach, tailoring work methods and responses to the situation, requires the early involvement and consultation of more experienced people and can require more of their time. A more standardised approach requires more investment in its development and training but can, in some respects, be applied by less experienced people. Technology can support working practices, but it is not a substitute for the effective use of people with the right knowledge, experience and professional judgement.

The right policies are important but quality in practice requires effective implementation through a combination of people with the motivation, skills and working practices.

Some examples of good practice are set out below, but it is recognised that there are many ways of achieving audit quality. Each firm should consider how its existing working practices contribute to audit quality.

Roles and responsibilities

Teamwork

With increased audit exemption thresholds, fewer audits are performed by one person. There is normally a group of people working as a team to gather the evidence to support the audit opinion.

To perform a quality audit, it is essential that firms promote effective communication and knowledge-sharing within the team. Typically there are two broad types of formal communication and interaction that the team use throughout the audit:

- > **briefing** with the objective of informing team members about progress and the next steps being planned, and of validating the decisions taken to date on audit risks and the nature and extent of audit procedures;
- > **brainstorming** with the objective of consolidating and focusing the knowledge and experience of the team members upon a particular issue.

Good practice

Arrange team meetings at appropriate times throughout the audit. For example for a larger or more complex audit, the following meetings may take place:

- > at the initial planning stage, where the team is brought together and the tone of the audit is set;
- > at key milestones, such as when the planning and interim work are nearly complete, to assess outstanding risks and decide on responses;
- > to review findings, at the start of the final audit to provide focus;
- > prior to the audit clearance meeting, in order to ensure that all issues which have been identified are properly addressed;
- > at the end of the audit, to debrief the audit team and identify points to address in the following year.

Encourage all members of the audit team to contribute to these discussions.

Team roles

It is vital that people have a clear understanding of the roles they are to play and are properly qualified to perform these roles. People have positions within the firm, be they partner, manager, senior or assistant. However, it is important that roles are also recognised and defined within each team, and that these are agreed and communicated in advance of the audit.

Working practices are highly dependent on the audit partner who, under auditing standards, takes responsibility for the audit opinion. He will keep in regular contact with the team and arranges for another partner to be available if there are unavoidable absences. A manager, who has responsibility for ensuring the audit approach is followed and work is performed to an appropriate standard, will support the audit partner. An effective manager will need strong project management skills including the ability to motivate and support the team to deliver audit quality within the timetable. Overall, the manager needs to ensure that the right people take the right actions at the right time. In most circumstances one person who, depending on the size of the audit, will either be a manager or senior, will be recognised as the 'in charge' who is responsible for the detailed day-to-day running of the audit.

With the complexity of modern businesses some specialist input is often required. This may relate to tax or information technology, or to the nature of the client's business. In any event, the team roles and responsibilities may include these specialists. Specialist input to a team tends to be more focused and of more value to the audit if the specialist has sufficient understanding of the client and is involved in the team rather than being treated as a consultant for a discrete area of work.

Empowerment

Junior staff need to be empowered both in order to relieve time pressures on more senior staff, and to meet the need for staff development. Effective empowerment is a good way of ensuring efficient use of staff while still delivering quality. It also helps the audit team to draw relevant conclusions early in the audit process.

Empowerment does not involve simply finding more junior staff to do the work and telling them to get on with it. It requires thorough professional development through ongoing monitoring and coaching. Senior staff need to coach and supervise less experienced team members, providing support and advice throughout the audit so that they can take on the relevant responsibilities and feel comfortable that they will achieve the required objectives.

Empowerment involves matching roles and responsibilities to team members on the basis of the inherent difficulty of performing particular audit tasks, the expected risk of error and the risk of not identifying wider implications for the financial statements. For example, all members of the audit team will obtain audit evidence. However, if high risk means that strong persuasive audit evidence is required, or the area is sensitive, it may be better if the work is performed by the manager or audit partner, subject to second review, rather than someone less experienced.

Good practice

The audit partner, manager and senior should discuss possible audit approaches (using the exercise as a coaching opportunity) and agree the approach before the fieldwork begins. The team should regularly discuss progress and issues arising, assess the approach taken and resolve any issues.

People should be accountable for the responsibilities assigned to them; they need to have a sense of ownership of their part of the audit and they need to be empowered to perform their duties. All team members need to understand that they are expected to take ownership and be responsible for the performance and quality of their work. Team members should be able to perform their assigned part of the audit to their own satisfaction and identify initial conclusions for presentation to the audit partner. It is important that they understand how their responsibilities relate to those of others in the team, are able to distinguish the significant from the insignificant, and recognise when they need to consult.

Planning

Auditing standards establish standards and provide guidance on planning the audit. This includes standards on knowledge of the business, materiality and working papers. The following section considers some of the working practices and the key issues that face firms in practice.

Thinking about the audit issues

The single most important audit procedure at all stages of any audit is the application of sufficient critical thought. Client circumstances can vary enormously. It is all too easy to accept incorrect evidence or to draw an inappropriate conclusion, particularly as there can be people who believe, incorrectly, that it is in their own or the company's best interests to mislead auditors and misrepresent financial information. Auditors need to focus on whether the financial statements fairly present the substance of what has occurred.

Most firms use standard audit approaches and documentation to assist them in performing and recording their work. Documentation normally consists of a mixture of pro-forma schedules, checklists and work programmes. But a successful audit is not about mere box ticking through the completion of standard audit tests and documentation. Auditors use professional judgement to reach an appropriate audit opinion against a background of differing circumstances. Therefore it needs to be recognised from the outset that audit work has to be tailored to meet the client's circumstances. Auditors need to acquire a sound understanding of management and the business to adequately address the risk of misstatement.

Good practice

In order to respond to the different circumstances of their clients, various firms have a range of audit documentation (which include industry-related considerations and risks, suggested audit procedures and specimen communications). These are designated as best practice within the firm, and are tailored further based on auditor judgements about the risks and issues identified.

When planning an audit, a pitfall to avoid is merely repeating the same procedures as the previous year's audit. The risks of material misstatement need to be properly reassessed. This involves a proper team briefing by the audit partner on any issues of which he is aware, updating the team on his knowledge of the business (both internal and external developments), and assessing new risks which may affect the business as a whole. Such risks may include economic factors, the quality and motivations of management, and those that may affect specific areas of the financial statements such as stock obsolescence or the recoverability of debtors.

Illustration

One firm bases its criteria for identifying misstatement risk on an empirical study of past audit failures and misstatements. This encourages teams to focus on accounting estimates, non-systematic transactions, cut-off, the history of error and industry risks.

Risks may be the same as in the previous year, requiring the same work programme, but this can only be established after proper consideration of the business and the associated misstatement risks.

To achieve quality, audits should not be carried out by rote.

Development of the audit plan

Having developed an understanding of the business, the accounting and reporting processes and risks, it is necessary to develop an audit plan and allocate staff with the right skills to the appropriate tasks.

From an audit quality perspective, there are several pitfalls to avoid, including:

- > not involving appropriate specialists, particularly, for example, in relation to IT systems, derivatives and other financial instruments, actuarial matters and filings in other jurisdictions;
- > performing insufficient or inappropriate substantive testing;

- > the audit work not adequately addressing the risks; for example, insufficient attention to the profit and loss account and revenue recognition in particular; and
- > not performing enough work on journal entries and one-off transactions, particularly immediately prior to and post period ends.

Good practice

One firm explicitly requires an analysis of the segregation of duties in all areas. While this is not required by auditing standards and will not find collusive fraudulent acts by management, it may be useful in identifying fraud risk.

Another firm permits the independent review partner to demand that more specialists be involved on the audit. He has authority to challenge the audit partner in this area, even though ultimately the latter has responsibility for the audit opinion.

Materiality

Another area that needs attention is the determination of materiality and its use in the development of the audit plan. Materiality needs to be assessed carefully for entities where, for example, profit is volatile, or where there are high values for assets and liabilities relative to reported profit.

Good practice

Have clear guidelines on who needs to be consulted where there are difficult materiality judgements or when errors or misstatements are discovered.

Dealing with extended enterprises

An area that is becoming increasingly important is the 'extended enterprise'. These are often in the form of groups with operations in many separate places and lines of business. Local standards and cultures will not only vary within the audited company but also within the audit process, as there may be local teams involved using different audit procedures and applying different auditing standards depending on their location.

The working practices adopted will need to address the various challenges which multi-location group audits pose. Some of the potential practical pitfalls include:

- > not auditing enough of the group;
- > applying group materiality when local statutory materiality also needs to be used;
- > insufficient challenge of other auditors' independence or competence;
- > not giving sufficient central direction, particularly on matters for follow-up;
- > not giving sufficient consideration to where the risks are likely to arise from a group perspective.

Too much focus can be placed on the audited company in isolation. Staff need to think more laterally and, in particular, to consider the broader issues, particularly related parties in complex 'groups'. Questions that need to be considered may include:

- > Why do complex group relationships exist?
- > Are there going concern issues given the nature of the relationships?
- > Are transactions in the best interests of the shareholders?
- > Is the economic substance of transactions reflected in the financial statements?

Executing the audit plan

The *Auditors' Code* states that auditors should approach their work with thoroughness and with an attitude of professional scepticism. Where audit failures arise, all too often a relevant risk or issue was identified but not adequately followed through.

Points to bear in mind include:

- > the importance of adequately briefing all staff;
- > the importance of setting aside enough time, and people with sufficient experience, to deal with the testing of one-off transactions;
- > the usefulness of being unpredictable in the timing and extent of testing;

- > the importance of effective substantive analytical procedures;
- > the need to test controls on which the management relies rather than controls that may be convenient to test, but of little relevance to the audit opinion;
- > the usefulness of file interrogation software in identifying anomalies within accounting populations;
- > the increasing need for work to be performed early in order to meet financial reporting deadlines which are getting tighter for listed companies;
- > the need to understand complex transactions rather than gather documentation which supports them. A key need is to keep asking whether the transactions make sense and are within the proper authority limits which have been laid down;
- > the futility of relying on controls where the overall control environment has been shown to be weak and the need to do more substantive work to make up for this;
- > the need to focus sufficient testing on areas of risk;
- > the importance of obtaining, where relevant, additional corroborative evidence.

With shortening reporting periods for listed companies, pressures to be more efficient, and ambitious deadline setting by clients, the time available to perform all of these actions is reduced in many modern audits. The team needs to plan how to deal with all of these points, deal with the unexpected, and be able to monitor time spent, so that deviations from the plan can be pinpointed and responded to as early as possible. The auditor needs to be robust in assessing if more time will be needed to complete the audit as issues arise in the course of the audit that require an immediate response.

Good practice

One firm has a database that sets out specimen business controls and possible tests to address audit risks related to particular accounting processes.

Judgement is applied to tailor, or include additional, tests to meet the client's circumstances.

Electronic audit programmes can include sign-off procedures that ensure that the next stage cannot be started until certain procedures have been carried out. For example, SAS 240 (Revised) requires a summary of non-audit services to be prepared at the beginning of each audit so that the partner can consider whether there are threats to independence and implement appropriate safeguards. This schedule may constitute one of the first documents to appear on the audit file and no further procedures may be electronically signed off until the audit partner and, where necessary, the independent review partner are satisfied the firm and the team are independent. Once the work has commenced, auditor independence should be kept under review during the course of the audit.

Alertness of mind and scepticism in practice

Audit staff need to look out for the unexpected, and to consult with more senior staff when such matters are identified. This needs to be developed and encouraged in all audit staff. It is important to instil an attitude that an anomaly may or may not have an innocent explanation and it needs to be investigated and resolved. Considering how and why an error could arise, and indicators of this is a useful development technique to adopt.

Fostering professional scepticism in people involves encouraging a desire to challenge information and seek evidence. The firm needs to encourage this not only formally, by recognising curiosity and enquiry as a key competence of an auditor, but also informally in day-to-day working practices. Challenge should be seen as positive and staff should not be penalised for making waves or generating cost overruns, even if they cannot be recovered from the client.

Audit partners need to ensure that the audit team applies an appropriate level of professional scepticism by giving clear messages on the importance of quality. Partners should emphasise

to the team that they should consider whether information and explanations make sense, appear reasonable in the light of what they know of the client's business and whether there are alternatives to the approach suggested.

Yet what constitutes an appropriate level of scepticism is subjective and involves mature judgement. How, then, can junior members of staff be expected to achieve this? Good briefings, effective supervision and review of audit work and appropriate responses to anomalies can help to achieve this objective. Junior staff need to receive a good briefing and be told "If in doubt, shout". Whenever they have doubts about what they are to do or what they find, they should report these to someone more experienced, preferably after having formed an initial view of the appropriate action to take.

Good practice

One firm requires the audit partner to sign-off on adherence to the APB's Auditors' Code before signing the audit opinion.

Give regular updates to all audit partners and staff on going concern problems in the economy, current accounting issues (including reports of alleged restatements), and what should be done to counter them. Some recent examples include inflated revenue, expenses wrongly capitalised, the use of side agreements and the use of special purpose entities.

Brief the whole team on relevant fraud risks and possible symptoms. Such a briefing helps maintain scepticism throughout the audit, and enables the team to consider how to address fraud risk.

There is a risk that, over time, an individual's view of what is an appropriate level of scepticism may drift, or they adopt the view: "My clients aren't like that".

The antidote to these risks is communication and sharing with others. It is important that partners and staff discuss real client situations with each other regularly. Seminars and workshops can also cover the subject by using case studies and letting participants work together to form a consensus view on what is acceptable and what is not. Case studies should not be simplistic, however, or participants will not associate them with real life situations, in

which circumstances are always complicated and a lot of information needs to be considered in making high quality decisions.

Rigour

Audit failures may result not from a failure to identify the risks, but from a failure to respond to them appropriately. Audit staff need to give sufficient thought as to what the draft figures may indicate. In particular, given the increasing pressure on client management to deliver better results, attention needs to be given to whether the figures are symptomatic of aggressive earnings management or fraudulent financial reporting.

Illustration

Experienced auditors are always deeply suspicious of situations where profits are being shown but where there are net cash outflows from operations. Besides being a possible indicator of fraud, it can also be a sign that there is an inappropriate accounting policy in respect of revenue recognition.

One well-known case involved a sceptical audit manager and an experienced audit partner who were alerted by the fact that part of the group operated out of a secretive jurisdiction. They questioned relationships in greater depth than normal and avoided signing an inappropriate opinion.

The effective performance of predictive analytical review is a powerful audit tool. Ineffective analytical review can amount to little more than the production of a table of ratios with unquestioning acceptance of explanations from management as to apparent changes, in other words 'conversational auditing'. The explanations provided by management should be credible, consistent with the auditor's knowledge of the business, and be supported by other audit evidence wherever possible.

Good practice

Firms should put a strong emphasis on asking the question: "Show me evidence to support the explanations given".

Good auditors are curious and enquiring by nature with strong inter-personal skills. In practice, it is important that staff avoid giving too much attention to describing what is working well at the client and not enough to what is broken and what is under-resourced. Staff need to ask direct questions such as "Were there any accounting problems in this area during the year?" and "Were there any breakdowns in the accounting process?"

Good practice

Every audit should include:

- > asking management whether frauds, illegal acts or related party transactions have occurred;
- > not accepting explanations, however plausible, which are unsupported;
- > having proper procedures for whistleblowing to third parties.

Consultation

Consultation is important for an effective audit firm, either formally or informally, and should be encouraged.

Consultation within the firm helps ensure that the approach adopted is consistent throughout the firm and takes account of the skills and experience of staff.

Illustration

The senior partner, supported by partners specialising in technical and risk management issues, consults monthly with a representative group of audit partners on proposed new or changed policies and processes. The group considers their practicality and arrangements for their introduction before any communication to the practice. New or changed policies are disseminated to staff in face-to-face meetings at 'unit' level and electronically, with the emphasis on clear messages backed up by changes, where necessary, to the firm's audit software and to training programmes.

Consultation should be encouraged wherever it is likely to be beneficial. Certain aspects of audit can be particularly challenging and require effective support mechanisms. Examples include unusual transactions, questionable accounting practices and circumstances in which modification of the audit opinion might prove necessary. These matters require focused attention, particularly when risks are identified or issues come to light.

Discussing and exploring a problem with a colleague not directly involved in the audit is an invaluable way of standing back from a problem and checking personal judgements.

Firms need to invest to ensure that there are sufficient resources available for consultation. Larger firms have extensive technical departments. For smaller firms, various bodies provide consultation services on a subscription basis. The Institute's own technical enquiry service (See bibliography) is a valuable and knowledgeable source of technical advice for ICAEW members. If they cannot answer a question themselves, they can usually find someone who can.

It is important to foster a culture in which consultation with colleagues is seen as a sign of strength, not weakness. People need to feel that they can always seek a second opinion on a matter about which they feel uncertain or uncomfortable. Apart from the benefits in terms of reaching the right conclusion on a particular issue, consultation transfers knowledge and approaches to resolving issues and is therefore a strong aid to learning and development.

Review

Team review

The traditional audit model involves a member of the team preparing the work and then a more experienced person reviewing it. Effective review techniques should focus on the issues and judgements formed, not merely on procedure completion. It is important to ensure that the audit work is necessary and achieves the desired objective, and that issues arising have been properly dealt with.

Audit file reviews should be performed promptly by persons with appropriate experience who will encourage alertness, originality of thought, thorough investigation of anomalies and the adoption of professional scepticism.

Good practice

Review analysts' reports on clients where available. Seek to understand if management is under pressure to report a particular result.

Use a 'file check' procedure that identifies where procedures have not been completed, such as documents not signed off or reviewed, risks not dealt with and review notes not cleared.

Remind all audit staff about any changes to money-laundering regulations, the need for prompt reporting to the firm's money-laundering reporting officer and avoidance of tipping-off.

For further information:

The Faculty's publication entitled "*Towards Better Auditing*" contains further information on audit efficiency, documentation and review techniques. (See bibliography)

Supervision and review while the job is in progress is also an important way of learning. Merely expecting junior staff to 'pick things up' as they go along is not effective on-the-job training. Reviews should give constructive input to those reviewed, so that they learn from the experience. Face-to-face reviews are therefore more effective than purely written ones.

Illustration

Firms apply different approaches to pre-clearance or 'hot' reviews.

One firm has a number of designated technical review partners and senior managers in those situations where there is a potential qualification to the audit opinion. The role of these reviewers, who need to be entirely independent of the audit client, is to review financial statements, reports to audit committees and management letters for higher risk clients prior to their release. These review partners are also available for consultation on any issues that may have an impact on the audit opinion.

continued

Another firm has a dedicated 'hot' review department entirely independent of the audit partner and manager. This department comprises full-time partners and senior managers with significant technical and practice experience. The department reviews all financial statements that the firm issues an audit report on before it is signed. Depending on the assessment of risk, the department may also carry out a file review. Such reviews are carried out as a matter of routine and cover the work of all audit partners.

Independent review

Auditing standards require audits of listed companies to have an independent partner review. Firms are also required to implement such reviews on other public interest and higher risk clients, as defined by the firm. Even where not strictly required, consideration by someone who has not been involved in the day-to-day performance of the audit is almost always useful. It is often easier for someone not caught up in the detail of the audit work to undertake a critical assessment of the audit evidence obtained.

The independent partner needs to have sufficient experience and authority within the firm, be technically strong and be capable of sound professional judgement. His role includes reviewing key audit documentation, including statements of independence, and assessing the rigour and results of the audit work and the appropriateness of the draft audit opinion. If there are particular issues that need to be addressed, he will also need to review all relevant audit evidence and discuss these issues with the audit team. This should enable him to reach a balanced and informed view, and to reach a consensus opinion with the audit partner.

Higher risk audits can also be subject to further reviews, depending on the firm's policy and procedures, which are performed before the audit opinion is issued. In addition, further reviews may be undertaken at random on normal risk audits to ensure that audits are being performed appropriately. In smaller offices, which may not have such formal procedures, the monitoring partner could choose to select a file on an ad hoc basis and check judgements, procedures and documentation.

Completion

The completion of the engagement is important. This is the period from the review of the audit work, through communication with those charged with governance, to signature of the audit opinion and what has to happen after that point. Sufficient staff time needs to be dedicated to completion of the audit files – this is a crucial part of audit quality. It needs to be appropriately staffed, timely and be scheduled in the audit plan.

Completion is the stage of the audit that is often the most time pressured and critical. There are often deadlines, whether imposed by the team, the partner, the client or external requirements. There are few audits that are not subject to some form of time pressure as the time of signature approaches. Whereas the deadlines of delivery of material to the auditor for audit are often missed, the deadline for signature of the accounts is often less flexible.

For larger entities significant pressure can be brought on the auditor to sign their audit opinion on the required date no matter what the circumstances. At this stage auditors need to be robust in ensuring that all issues are resolved before they sign. Use of relative deadlines may prove useful in ensuring that the time for completion of the work is actually available. The firm needs to be willing to support the audit team when it says "We need more time to complete our work" especially when key evidence becomes available, or significant changes are made at the last minute.

Risks are not only to be identified at the outset of the audit. Risk assessment is an ongoing activity enabling the auditor to respond appropriately to matters that are discovered later on in the audit. The recording of identified risks and responses needs to take place, and there needs to be a clear trail right through the audit file showing how they are dealt with. They should not be lost in the middle of the file, which should be designed to indicate clearly to the audit partner what has been done to respond to the identified risks. An effective way to ensure that quality procedures have taken place is to implement checks and balances that are built into the firm's day-to-day operations.

Good practice

Various firms have designed electronic audit files that automatically flow identified risks throughout the file from the point at which they are identified so that they are given sufficient attention. An identified risk should not be lost in the audit file.

Conclusions need to be reached at every stage of an audit, from individual audit tests to the final audit opinion. The final audit conclusion included in the opinion section of the audit report needs to be considered very carefully. Every auditor needs to ask if all the necessary evidence has been obtained, if all of that evidence is consistent, and whether there are any areas where it is simply not possible to obtain all the evidence necessary to ensure that the financial statements give a true and fair view.

It is therefore important to ensure that there is adequate audit evidence on file, with notes of discussions with management, or other persons, where such evidence is needed to support the auditor's judgements.

Good practice

Give guidance during training programmes on the way to record evidence and complete files. This should ensure that key evidential documents are referred to and that good meeting notes are prepared. For example, although important discussions may take place in an informal setting via phone calls and e-mails, sufficient records of the conclusions reached and reasons for them need to be retained on the file.

Firms often require a summary of the key audit issues that arose and provide a completion checklist that requires the manager and staff to highlight how issues have been resolved. Encourage the audit partner to discuss these issues with the audit team before reaching his audit opinion.

An audit has a recognisable cycle of planning, evaluation and completion. The working cycle should include time for reflection after the opinion has been signed – the whole team should examine both the audit approach and its own performance

in retrospect and determine how they can improve further next year.

Challenges

A firm should consider the following questions to assess how its working practices contribute to audit quality:

- > Is there sufficient teamwork, empowerment and communication both within the audit teams and between them and the rest of the firm?
- > Does the firm encourage the adoption of the right attitude of mind on matters such as ensuring that the audit team has employed the most appropriate audit approach, professional scepticism, rigour and has consulted others in appropriate circumstances?
- > Are all audits properly planned, avoiding merely repeating the previous audit, and do they incorporate sufficient knowledge of the business and audit risks?
- > Are staff trained to look out for the unexpected and do they understand how misstatements of the financial statements are most likely to occur?
- > Are the review procedures of the firm sufficiently challenging and are they considered a constructive contribution to audit quality?
- > When an issue arises, is the exact nature of the issue and its resolution properly followed through and documented?
- > How long has it been since partners and staff attended a course on the audit requirements for specialist audit clients?
- > Do the audit partners actually meet the owners and client management of all audit clients before the start of the audit?
- > Is the partner and senior staff's knowledge of the audit client fully used in planning the audit and designing appropriate audit work?

Monitoring quality processes

Overview

The other chapters in this publication consider the key inputs to audit quality such as the firm's people, the effective management of client relationships and the 'checks and balances' embedded in the firm's working practices, including technical support. This chapter addresses how firms monitor the quality of their work; for example, what procedures are established, both formal and informal, that provide ongoing assurance of whether a firm complies with the policies and procedures laid down to achieve audit quality. These processes are performed throughout the year and/or during the annual compliance review.

Apart from monitoring compliance, quality processes identify good or redundant procedures and can lead to change. Often they are the same as, or closely allied to risk management procedures. Quality processes effectively represent an 'internal audit', performed by staff independent of the audit teams, of the operation of the checks and balances around audit quality. The Joint Monitoring Unit (JMU) visit is therefore the 'external audit' and is an important indicator to firms as to whether their quality control processes meet the standards required.

While it is important to monitor compliance with auditing standards and other requirements, firms may well benefit from extending the process to include other quality elements. These elements will form part of the firm's strategy, such as client service in terms of the broad scope of communications to clients, audit efficiency in terms of use of staff, maintenance of effective relationships with the client and identification of efficiencies which could be achieved in the future.

It also follows that quality monitoring can extend to the key inputs to audit quality covered elsewhere in this publication and need not focus simply on the outputs of the auditor's work.

The important points to be covered are:

- > Quality processes should be designed to assist the leadership and practice management in improving and refining audit quality, managing risk and improving both inputs and outputs.
- > Quality processes need to be seen as constructive rather than as an annual regulatory burden imposed on practitioners. Steps should be taken to maximise the impact of the main findings.
- > Quality processes need to work in harmony with the checks and balances within working practices such as independent reviews and hot reviews, and also external monitoring such as that of the JMU.
- > Quality processes should recognise the key ingredient of people; especially quality of individual judgements and the development of individuals. This is harder to measure and monitor than simple tick box compliance.
- > Quality processes themselves can usually be improved as the results of lessons learnt. Members of staff are more likely to be co-operative if they consider that the reviewers themselves are constantly re-appraising, and where necessary, modifying their own procedures.
- > Firms should treat JMU visits as a valuable independent review of the effectiveness of their own quality assurance processes, discuss relevant matters constructively and act on recommendations to improve quality.

- > Structures will and have to vary from firm to firm – firms can develop their own way of monitoring. A ‘risk-based’ approach will often be most effective.

Roles and responsibilities

The leadership of the firm, in particular the designated senior partner, has ultimate responsibility and an overarching role in selecting, establishing and monitoring quality policy and procedures. Auditing standards⁶ also require firms to appoint a senior audit partner to take responsibility for monitoring the quality of audits carried out by the firm. Where possible, firms may seek to appoint a partner to be responsible for monitoring who is not the one responsible for establishing quality control policy and procedures; this provides a more independent approach.

The monitoring partner has primary responsibility for monitoring and reporting on the firm’s quality processes. He needs the trust of the partners in the firm and should report to the managing partner, board or other partners depending on how the firm is constituted. Smaller firms may benefit from using an outside consultant or another small practitioner to assist with the monitoring.

Practice size and infrastructure will vary from firm to firm. While lead responsibilities for audit quality may be assigned, quality is a collective responsibility. The larger the firm the more people will have defined quality-related roles, but it is still imperative that all partners and staff take responsibility for quality.

What and when to monitor?

The inputs to quality need to be monitored as well as the outputs. Inputs can be judged by the quality of the output. If errors are often made or poor judgement is exhibited, then the inputs need to be considered. These include the quality of staff training; for example, is it compulsory, do all staff have to complete a certain number of hours a year and are the trainees of sufficient calibre? The inputs are all areas covered in earlier chapters: monitoring needs to cover their effectiveness.

Monitoring has to cover the outputs. They are measured by the quality of the audit report, the financial statements, communications to the client and the audit file. Measurement and monitoring are generally ongoing throughout the year as well as taking place during the annual compliance review required by *Audit Regulations*.

Informal monitoring

There are various ways that informal monitoring is carried out. All partners and staff need to be aware of quality procedures and the risks of not meeting the required standards. Once awareness is instilled, through training and learning, office memos and a constant emphasis, then it is more likely that informal procedures will be effective.

Firms’ procedures for ensuring quality and effective risk management need to be embedded in the culture. Quality and risk management are therefore often best discussed in regular meetings of partners and staff peer groups, whether on an office, regional or national basis. Often this highlights good practice or where change is needed. The need for more formal procedures can be discussed, if it is thought that informal processes need to be supplemented.

If the feedback indicates problems in a particular office, the firm will need to devise a programme of action, which will range from pointing out to the senior partner in the particular office that there is a problem which needs resolving, to deploying stronger or more experienced partners.

Good practice

Most firms, of whatever size, have a technical resource, whether this is embodied in one person with a particular interest, or in a department. They will often be alerted to areas where quality procedures are not being followed by the questions they are asked or by audit files and financial statements they review on a regular basis. They are then in a position to alert the monitoring partner that action needs to be taken.

⁶ SAS 240 (Revised) “Quality control for audit work” – APB

Formal monitoring

Annual monitoring

There are two key reasons for annual monitoring, also called quality control reviews, compliance reviews or audit reviews. Firstly, annual monitoring is mandated by the *Audit Regulations*, which require registered auditors to confirm, at least once a year, how effectively they are complying with the regulations. In addition, *SAS 240 (Revised)* includes a requirement for an independent assessment of the following:

- > the appropriateness of the audit report;
- > the conduct of the audit in accordance with auditing standards, ethical and other regulatory requirements;
- > the proper application of the firm's own quality control policy and processes, in particular appropriate consultation in relation to difficult or contentious issues.

Secondly, and perhaps more importantly, a firm will want to know that audits are being carried out properly, efficiently and effectively and are not exposing the firm to undue risk.

Generally, this results in a two-part approach to annual monitoring:

- > 'whole firm' reviews where a firm's procedures in respect of all matters required by *Audit Regulations* affecting the firm as a whole are monitored for compliance. This can also cover matters of risk and quality on which the firm itself requires assurance. This will check whether the procedures outlined in earlier chapters and above, for the firm as a whole, are taking place.
- > 'cold' (after the event) reviews of completed audits, also called file reviews, to ensure that the audit has been carried out in compliance with auditing standards and regulations and that the financial statements comply with statutory and other requirements. This would cover the proper application of the firm's own policies and procedures, including risk procedures, and might also address issues of audit efficiency. It is a sample of the audits conducted by the firm.

Often the monitoring takes place in one annual exercise, but it can be split up into the two parts above, done at different times and with different people or any different combination, provided the annual review required by *Audit Regulations* takes place. For the purpose of this chapter, it is assumed that it is all done in one annual exercise.

The way in which this is done will vary considerably from firm to firm. For example, federations or small local firms may use a consortium specialising in technical and training services for auditors. In some federations, member firms may review each other; indeed it may be a condition of membership that this takes place.

Local one-office firms, if of sufficient size, may arrange for individual partners and managers to review each other's files, bearing in mind the need to ensure that the reviewers are independent of those who carried out the audit. Alternatively, firms may prefer to use the services of a suitably qualified external consultant (which is specifically allowed for by auditing standards). This is also an option for sole practitioners, though they may choose instead reciprocal arrangements with other small practices in a locality. However, some practitioners may understandably be reluctant to open up their files to inspection by a competitor or potential competitor.

Whole firm reviews

Whole firm reviews have to establish whether the firm has complied with its overall obligations under the *Audit Regulations* and look for evidence that the firm's policies and procedures have been carried out; they are alert both for good practices and those in need of improvement.

The review checks the operation of the firm's policies and procedures in areas such as technical material, working papers, independence, personnel, training and competence, consultation, and the carrying out of cold reviews. A typical review would cover personal training plans, questionnaires on fit and proper status, confirmation of independence and CPD records and confirm that these are completed for all partners and staff involved in audits. The firm's register of complaints would also be inspected. Firms will often also cover human

resources issues such as assessment of performance on the assignment and training effectiveness, although these may be dealt with separately. Checking these areas in the whole firm review has the merit of ensuring that the firm's procedures in areas other than those strictly relating to audit, working papers and audit opinions are being carried out.

In a multi-office practice, the cold reviewers need not carry it out in every office every year, as the firm is considered as a whole. The largest offices and those with significant higher risk clients may perhaps be visited every year, and others on a rotation basis. Information derived from previous reviews, and from day-to-day monitoring (see above) should also be taken into account in deciding which offices to visit.

Illustrative framework for a review report (for multi-office firm)

Standard procedures and documentation:

Significant points on whether the firm's standard procedures and documentation are being appropriately used within the office. Detailed points on individual files may be included in an appendix with major points for concern highlighted in the body of the report.

Points raised by the previous office review, and actions taken:

Refer to points raised in the previous summary report on the office. Has the office now adequately addressed these? Also consider points listed as arising from the previous JMU review. How has the office addressed these?

Cost effective auditing:

Whether the office has adopted the most cost-effective approaches to the audits.

IT:

Whether the office has properly implemented any computer-based audit programmes and is using them effectively (tailored for feedback on implementation; compliance with policies/procedures). Any points on use of the financial statements preparation software or any other IT tools.

continued

Points for national consideration:

Any points arising from the review that need consideration at national level; for example, whether there is lack of understanding of firm policy, or whether firm procedures or approach may need to be reviewed.

Training points:

Any points arising related to office training needs or involving the firm's training programme.

Audit Regulations:

Any matters arising on the review of the requirements of the *Audit Regulations*. For example, rather than treat the annual compliance return as just another burdensome task requiring yet more form filling, firms should make their own compliance process robust and challenging, to ensure that the results are properly disseminated within the firm and acted upon. This is best done, where it is not a one-off omission, by preparing a plan which contains targets with dates, which will be followed up.

Cold file reviews

The reviews have to establish whether individual audits have been conducted in accordance with *Audit Regulations*, including auditing standards and ethical requirements regarding independence and the fit and proper status of audit staff. They also cover the application of the firm's own quality control policy and processes, such as any requirements for pre-clearance file reviews (commonly known as 'hot' reviews), consultation on technical or ethical issues, involvement of a second partner or specialists.

However, these are the minimum requirements. Firms may benefit from extending the process to include other elements, for example the efficiency of the audit in terms of use of staff, maintenance of effective relationships with the client and identification of efficiencies which could be achieved in the future.

Firms may also wish to extend the scope as well as the depth of the reviews to cover non-audit engagements such as lower level assurance engagements, financial statement preparation and

tax. Although these are not statutory regulated areas, failure to follow the firm's procedures could well have serious adverse consequences both in terms of client retention and professional indemnity claims.

Firms need to make several decisions of a practical nature with regard to the file review process. Practices will need to consider who does the reviews, how often they should be conducted, how many files should be reviewed, how the sample should be selected and when the identity of the files selected for review is communicated to the staff concerned.

Who does it?

Auditing standards require that competent individuals perform these reviews, who are, where possible, independent of those who carried out the audit. They clearly need sufficient experience and technical knowledge to appreciate the importance of issues they come across. Equally important, they need sufficient status and authority (or support from individuals who have it) to ensure that issues arising are properly addressed. If the audit is highly specialised (examples are pension schemes, financial services, certain public sector organisations) it is desirable for the reviewer to have appropriate sector knowledge, but it will not always be possible to satisfy both this and the independence requirement except in the larger firms.

Illustrations

A large firm concentrates its financial services work in a single business unit in London and it is difficult for a reviewer from any other part of the firm to carry out a review that can really challenge what has been done. Therefore, to achieve a rigorous result and to be able to provide recommendations on best practice, specialist financial services review teams from other parts of the global network, supplemented by local technical experts familiar with UK requirements, perform an annual review.

For smaller firms, Practice Advisory Services of the ICAEW can provide an independent cold file review service. See bibliography for contact details.

How often?

Some file reviews in support of the whole firm review should take place every year and the review process should be systematic, so an occasional ad hoc review will not do. Most firms operate on an annual basis, with reviews concentrated into a fixed period as this tends to make it easier to focus attention and ensure time is not wasted. However it is equally acceptable to spread reviews throughout the year or to carry out a certain number each month or quarter.

How many?

Audit Regulations give guidance on the frequency with which audit partners work is reviewed. This could range from annually to a three-year cycle for larger firms. Whatever basis is used it needs to be justified given the circumstances of the firm. It is also advisable to cover all audit managers regularly, not only in the interests of fairness, but also to pick up any differences which may have developed in applying audit techniques and procedures, thus enabling efficiency gains to be made by adopting across the firm those considered superior.

How to select the sample for file review?

Wide discretion can be applied in practice. A totally random sample is not recommended, as it could result in some audit partners not being reviewed for some years and also lead to over-concentration on small or low-risk assignments. A common approach would be to start with a reasonably representative sample of audits of all sizes, aimed at reflecting the profile of the firm's client base, and then put additional emphasis on areas perceived as above average risk. Past experience may suggest a targeting of particular offices or individuals whose work has failed to achieve the standards expected.

Illustration

In addition to a third of audit partners being reviewed each year, a firm identifies for review each year candidates for advancement to that role, and also selects for review audit partners recently assigned to greater risk or specialised work; for example, listed company or public interest work.

When to communicate identity of files selected?

One option is to give no prior notice, but ask for the selected files on the day of the review. This will usually cause practical problems, because there may be good reasons why selected files are not immediately available – or indeed the individuals who worked on them. Time will therefore be wasted making substitute selections, and the balance of the original selection may be upset. It may be more efficient to notify the individuals concerned a few days in advance, but not so far in advance to allow any large-scale further work on the files.

What should reviewers look for?

Reviewers should look for evidence of compliance with auditing standards and with the firm's procedures. A key focus is the judgements made, particularly in problem areas or where there are unusual accounting issues. They should ensure that there is sufficient justification and documentation for them. They may also choose to look at audit efficiency questions and staffing and training issues.

Reviewers will need to examine a file in some detail as well as looking at the audited financial statements on which the audit opinion has been given. If the firm's quality control procedures including 'hot file' review have been working properly, there should be no matters of concern here. Where there are matters, they could point to a failure of the firm's systems or a lack of identification of a problem by the audit team. Alternatively, the audit team may not have carried out the firm's procedures or simply been deficient in their work.

The review should not only consider compliance but also the general quality of work: good communications with clients, follow-up of review points, probing of explanations, sufficient high quality information and evidence of scepticism where there are areas of concern.

File reviews are usually carried out with the aid of a checklist or aide-memoire to ensure that certain basic elements are looked for on every file. There will inevitably be some variation amongst reviewers as to the emphasis placed on any critical findings, but factual questions such as "Was an up-to-date engagement letter issued and a signed copy

returned?" should always be brought out regardless of who the reviewer is. Consistency of approach will be greatly helped if reviewers are suitably experienced and properly briefed before the review starts, either through face-to-face meetings or written instructions.

Reports from the JMU often provide valuable independent feedback on a firm's quality processes, providing an opportunity for a firm to measure itself against best practice elsewhere. The nature and benefits of the JMU's visit are explored below.

Benefits from independent external monitoring

The JMU performs an objective assessment of the suitability and effectiveness of firms' audit systems and procedures and of the quality of their work as part of the monitoring process. All inspectors are independent of the firms being monitored. Inspectors will have had exposure to a number of systems, both 'off-the-shelf' and those developed by firms, and as used by all sizes of firms. If a firm seems not to be using a system effectively the inspector will investigate why and suggest ways in which the firm could make improvements. In extreme cases where the system is clearly the wrong one for the firm, normally because it is out of date or no longer supported by the supplier, the suggestion will be to purchase and undergo training in the use of a new system. In some cases the JMU inspector may consider that a firm is applying a system too rigidly or without appropriate consideration of the particular features of the audit.

Illustration

A firm may have diligently completed all of the standard forms in the planning section of its off-the-shelf audit system but the planning record does not explain the auditor's assessment of the significant audit areas and how they will be addressed.

The JMU would suggest that the firm replaces some of the standard schedules or supplement them with notes of the audit partner and audit team's professional judgement of the key audit areas and specific audit work designed to address those areas. A well-constructed planning section that demonstrates how the knowledge and skills of the audit team will be applied to the circumstances of the client, is more likely to produce audit quality than the automatic completion of a set of standard schedules.

The monitoring process can help firms implementing new systems or developing existing systems. The JMU recognises that such changes can put strain on firms and there are times when problems may occur in audit quality. This may be a result of unfamiliarity with the new system, misunderstanding of new concepts or procedures, or simply the amount of resource that such a task can divert from other quality control and review processes. Inspectors' observations on system changes will be objective and draw on experience of many systems and development projects in all sizes of firm. Systems change and development occurs possibly more often and with potentially more far-reaching consequences in the larger firms. These organisations, although having a great deal of skilled resource at their disposal, also value the observations of the JMU. The greater frequency of visits to the large firms also means that the JMU can comment on systems developments regularly.

A further benefit of the monitoring process is that the JMU is able to have open and frank discussions with audit partners and staff on issues arising during the course of the inspection on a timely basis. All visits are formally concluded and closed down through on site discussions that are valuable to both the firm and the inspector because of the immediacy and personal level at which issues can be raised, discussed and as far as possible resolved. These discussions are generally more useful than formal correspondence in understanding the causes of problems and considering relevant solutions. The inspectors' breadth of experience can often assist in bringing a view of 'best practice' to discussions with firms, particularly the ones having little contact or interaction with other firms.

Illustration

Most firms now obtain letters of representation from their audit clients. It is important that the letters are not simply standard proformas that have not been adapted to the circumstances of the company. They should cover representations that are key to the auditors' overall conclusion on the financial statements. The JMU will encourage firms to ensure that their guidance, training and audit processes lead to audit teams thinking carefully about how best to use management representations so that they provide valuable audit evidence.

Review findings and follow up

Even the most efficiently planned and conducted review will be of little value if its findings are not properly followed up.

Matters arising from the review should initially be discussed face-to-face with the relevant partners and managers concerned at the time of the review to avoid misunderstandings and confirm findings. Recommendations and corrective actions should be discussed and agreed. This enables minor matters to be dealt with quickly and helps to ensure that the review findings focus on major issues and are not obscured by over-concentration on minor lapses in procedures.

Communication within the firm

A summary of the more important matters arising from the review will normally be circulated to all staff. These can be anonymous, as it is a learning process and not a naming and shaming exercise. In multi-office firms, it may also be appropriate for matters specific to a particular office to be dealt with in more detail with relevant staff at that office.

Illustrative extract from a communication to all audit staff on the findings from a review

"On occasion during the course of an audit we seek to place reliance on the work of others. Examples include internal audit, experts such as property valuers, actuaries and service organisations. Auditing standards set out the various requirements to be followed before placing reliance on another party, mainly requiring us to consider their professional qualifications, independence from the client and the scope of their work.

Within our audit programmes, most of these requirements are dealt with in the planning section, and in the case of specialists and service organisations there are general file sections that should be duplicated and completed for each party used. Our reviews showed that we did not always document adequately the basis for placing reliance on the work of a third party.

For more detailed considerations refer to Chapter X of the Audit Manual on Relationships with other auditors; Chapter Y of the Audit Manual on Using the work of experts; and Chapter Z of the Audit Manual on Using the work of internal audit."

It is good practice to require offices or individuals to respond in writing to points, both to impress upon them the importance of taking corrective action and to demonstrate that the firm has followed the regulatory requirements.

If an office has not performed well, a detailed plan should be formulated with specific targets. A further review should be made of that office either next year or within some other reasonable timeframe, which may not be related to the next round of reviews.

Additional professional development

New training courses or a change of emphasis on existing courses may be needed or simply greater efforts to ensure that each individual attends courses more frequently. However, as described in the 'People' chapter, learning requires other approaches, including ongoing communication, and those responsible for review follow-up should liaise with those in charge of learning, whether internal or outsourced to an external organisation.

Where review findings indicate a failing in audit behaviour, the firm needs to recognise that it may not be easy to change these issues for the better without a concerted change management programme. This programme may involve not only attitudes but also perhaps new processes and development of skills together with ongoing monitoring. Refer to the most recent edition of the Faculty's publication "*Towards Better Auditing*" for some basic guidance on change management relevant to audit firms (see bibliography).

Changes to the firm's policies and procedures

The review needs to get to the root cause of non-compliance and may sometimes reveal aspects of the firm's procedures that are not followed because they are seen as impracticable or not constructive. Individuals within the firm may have developed alternative procedures. If those in charge of quality policy and processes are convinced that these procedures are better, they should revisit the firm's procedures and make appropriate improvements.

Equally, the review may reveal areas where the firm's procedures are weak and need to be

strengthened or changed. These changes should be implemented without delay and communicated to the relevant staff.

Illustration

A review found that technical advice on an accounting treatment was sought orally by the audit team. No written record was kept, other than a note that the technical department had been asked for its view on the most appropriate accounting treatment. The reviewer considered the accounting treatment adopted to be inappropriate and checked with the technical department to see what advice had been given. This showed that the question actually asked by the audit team did not include all of the salient information on the scenario.

Lack of full written records can lead to misunderstandings about the advice given or even the specific question asked. The change made in this case involved asking for questions to be submitted to the technical department in a pre-determined format and responded to in the same way. The responses were kept both on the audit file and in the technical department.

If speed is of the essence, an oral response should be followed by a written one, which includes the question being answered.

Regulatory follow-up

The Audit Registration Committee (ARC) will take a strong stance where firms are found not to have honoured previous commitments to improve standards. Registration may have been continued on the basis of undertakings given by a firm, for example to amend audit procedures to address a particular weakness in audit work or to attend specialist-training courses. If a subsequent JMU visit identifies that these undertakings have not been met, the ARC may take a range of action against the firm. If a subsequent visit identifies that the standard of audit work has deteriorated, the JMU will endeavour to establish the cause. In the event that the deterioration is due to lack of application by the firm, the ARC will again consider rigorous regulatory action. If there are other reasons then the action taken will be designed to address the underlying cause of the problem.

The aim of the ARC and JMU is to encourage and assist all firms to improve the quality of their audit work and compliance with auditing standards and regulation. Finally, the ultimate sanction available to ARC is the exclusion from the register of auditors.

Good practice

Often firms as part of their internal training or technical update procedures use the findings, observations and comments raised by the JMU during the course of the visit. In some cases the firm will use the JMU visit as a separate topic or session. In other firms, particularly the larger ones, the JMU comments are often combined with findings from the firm's own compliance or quality reviews. When these sessions are properly constructed and delivered they can prove to be effective mechanisms for getting key quality messages across to audit partners and staff.

Future planning

If the full benefit is to be gained from quality processes, relevant points arising should be fed into the planning process on individual audit engagements for the subsequent period.

Disciplinary action

This is obviously a sensitive area and different firms will have different ways of dealing with it. However it is important that any partners or managers who persistently refuse to follow the firm's procedures are dealt with, because it puts the firm's reputation for audit quality – and in extreme cases perhaps its very survival – at risk. It also sends the wrong signal to others within the firm who follow the procedures.

One way of dealing with the issue is via whatever system is in place for partner and staff performance appraisal. This is discussed further in the People chapter. Conscientious compliance with quality procedures – especially if under difficult circumstances – can be praised and rewarded and non-compliance criticised and taken into account in decisions on remuneration and career progression. In some more severe cases individual written warnings may be required. As a last resort, audit partners who persistently refuse to follow the firm's procedures can have their responsible individual

status removed. This may seem a drastic step, but if not done by the firm, the external regulator could well impose it.

For more information

Various firms have benefited greatly from the Audit and Assurance Faculty publication "*An introduction to Risk Management for Practitioners*" which includes material on effective review processes, efficient systems and adequate documentation.

Free help sheets are available to ICAEW members addressing practice management and financial control issues, including more information on whole firm and cold file reviews. (see bibliography)

Challenges

All firms can face challenges to their quality standards; it is a measure of the firm and its values, its leaders and its people, whether those challenges are identified and addressed. Firms need to consider:

- > Do they take internal and external monitoring seriously; is the attitude of reviewees to learn from such processes or are they looked on as a nuisance?
- > Are the best people engaged in performing reviews or is it a chore to be delegated to the less busy?
- > Is audit quality and risk management a regular feature of internal meetings of leaders, other partners and staff?
- > How is the firm's commitment to quality communicated and are communications honest about the real position, including good and bad features?
- > Is the firm alert to information on audit quality published in *Audit News*, the annual report to the DTI and other articles or presentations on the issues identified by JMU or the ARC?
- > Can the Annual Compliance Review be made more challenging and relevant to the needs of the firm? Is it actually used as a means of assessing and developing the quality of the firm's audit work?

- > Should an external consultant (with no product to sell) or another practitioner be engaged to come in for a day or so, do some cold reviews and look at the audit systems?
- > Are the firm's audit procedures appropriate for the skills of the audit staff and the client base? Are they too mechanistic or too general? Is there scope for tailoring or amending to direct the attention of the audit teams to key audit issues?
- > How long has it been since partners and staff attended a course on the firm's detailed audit requirements, including that applied to the firm's specialist audit clients?

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 the 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 should 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 should 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 should be considered;
- > Where such threats exist, the auditor should 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 should 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 should 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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