

ICAEW audit monitoring report (Lecture A848 – 21.55 minutes)

On 16 November 2023, the ICAEW issued their audit monitoring report for 2022/23. During the year, the Quality Assurance Department (QAD) reviewed 496 audit monitoring review visits, incorporating the review of firms' work on 893 audits.

There were some positive signs coming out of the largest firms in Tier 1 (being either good or generally acceptable). However, on the flip side, QAD note a drop to 71% (from 76%) of audits rated good or generally acceptable, although it is recognised that the list of firms reviewed in 2022/23 would have been different to the list of firms reviewed in the prior year.

1.1 Key points raised

41 reports were raised by QAD to the Audit Registration Committee (ARC). The ARC imposed conditions and restrictions on the continuing audit registration of 33 firms and withdrew audit registration from a further five.

Three particular areas have been identified by QAD as the main 'drivers' behind audits requiring improvement or significant improvement. These are the more challenging aspects of an audit, such as:

- Group audits
- Stock and long-term contracts
- Valuation
- Revenue

Group audits

ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* must be closely followed in a group audit. Consolidation adjustments must be properly audited according to their underlying purpose.

Goodwill and intangible assets arising on consolidation must also be assessed for indicators of impairment and by audit work done on a full impairment review conducted by the audited entity where appropriate.

Investments in a parent entity's balance sheet must also be carefully compared to the consolidated position of the group which those investments represent. Where a group member is loss-making, those investments must be carefully assessed for impairment bearing in mind the primary risk for a loss-making entity is that the investment is **overstated** in the balance sheet. Work on valuations of the consolidated group must include a proper explanation where investments are higher than the net asset value and be supported by robust and justifiable forecasts and assumptions relating to future performance.

For non-PIE audits, it is common for the audit firm to provide non-audit services relating to the preparation of group financial statements. This is permissible provided there are robust safeguards put in place to ensure that the audit engagement team applies the same level of scrutiny that would be expected on the same financial statements if the non-audit work had been carried out by the client.

The audit of group accounts presents its own challenges where the group engagement team is also directing and supervising the work of component auditors to support the group audit opinion.

Issues might arise where audited entities appoint a relatively small audit firm as group auditor of a worldwide group (possibly with component auditors that are members of a large international network). QAD reminds such audit firms that while group audit fees are likely to be lower than fees that would be charged by the UK member firm of an international network, it is essential that these smaller audit firms are just as robust in their involvement (including direction and supervision of the component auditor) as when dealing with another lower profile firm.

Conversely, UK audit firms may be dealing with a component auditor who is unable to communicate in English. The UK audit firm is responsible for obtaining its own language skills and translation such that effective direction, communication and review takes place on the audit.

Stock

Stock is usually a material aspect of the balance sheet and we have covered some aspects relating to attendance at stock counts in this quarter's update. QAD have identified certain risks for trading companies, including retail and wholesale businesses in respect of existence, valuation and cut-off.

Existence can be checked in smaller, more simple audits through attending the full inventory count at the year end. Stock quantities must be checked through to the final stock valuation with any variances properly investigated in order to form a conclusion.

Larger entities often have multiple stock locations and could operate a perpetual inventory counting system. While multiple locations do not have to be visited annually, the auditor is expected to plan and justify a suitable cycle (ideally with an element of unpredictability) so that the audit client does not have a significant period of notice that a certain site will be visited.

Straightforward valuation tests for stock usually include checking to purchase invoices for cost and recent sales invoices for evidence of net realisable value. Where there are no recent sales invoices, checks are sometimes performed on the last two to three years sales invoices and QAD have seen firms ignoring the evident risk of the need for full or partial provision over the value of that stock.

Long-term contracts

These will typically occur in construction and engineering sectors (but this is not absolute). There are inherent accounting complexities with long-term contracts which present challenges for auditors. For example, there are often complex judgements and estimates required as well as a need to rely on experts.

QAD recognise that it is hard to envisage circumstances where it is deemed effective to audit individual financial statement line items as opposed to taking a holistic approach to auditing a sample of the contracts in the accounts with their respective contributions to revenue, expenditure, assets and liabilities.

Reliance on controls must be based on evidence that the relevant controls are operating effectively. This is not the same as obtaining an understanding of the controls that are in operation. QAD highlight that typical controls in a long-term contract business will include a process for contract management and regular contract review meetings between members of the finance team and operational staff. Auditors will need to attend at least one of these meetings as part of their tests of control to understand key elements of the meeting, such as:

- standing agenda items;
- financial information prepared as a basis for discussion; and
- the process to resolve and feedback on any questions, requests for further information or uncertainties raised; and
- to document and record the key points raised.

The most common weakness identified where long-term contracts are concerned is in the assessment of provisions and costs to complete.

Property valuations

Audit firms must assess evidence in respect of property valuations objectively and test the assumptions in the valuation against whatever reliable data is available. Specialists may often need to be called upon when auditing property valuations.

QAD has stated that they often find little evidence to support valuations and, where there is a valuation that has been carried out by a specialist valuer, there is little or no evidence of evaluating the valuer's competency and objectivity, the relevant and reasonableness of assumptions or completeness and accuracy of source data.

Management estimates are inherently riskier due to the fact that they are internally generated. In some cases, QAD have seen no attempt by the auditor to challenge these sorts of valuations objectively. Audit work is sometimes limited to obtaining a written representation, but this does not provide any evidence by itself (written representations should complement other forms of audit evidence).

In addition, QAD has come across situations where professional valuers have valued the bulk of an investment property portfolio but has left one or two exceptions which the audit firm has done nothing to consider.

QAD have also come across situations where auditors have stated they do not have the expertise to assess assumptions. In these situations, the auditor must consider whether to engage their own expert and, of course, these are issues that should be considered prior to accepting the audit engagement. In some cases, however, auditors should be able to test estimates for non-specialist properties (eg, residential, office or light industrial properties) using suitably reliable, publicly available information without having to engage the services of a specialist.

Business valuations

QAD report similar challenges in business valuations with estimates and judgements being a key component of frequently complex valuation models. The first step is to verify the integrity of the model. Once this is done, the auditor will then need to consider whether there is a need for an expert.

QAD have identified a small number of audits that have problems in this area.

Revenue

The audit of revenue seems to crop up a lot. QAD have noted that revenue issues are common across all audits requiring improvement or significant improvement and, in some cases, are linked to the approach to long-term contract accounting (see above). There is also interaction with judgements and estimates relating to the determination of revenue.

Income completeness is also a key area that QAD finds weaknesses on. The first step in the audit of revenue is to understand the client's accounting policy (eg, whether revenue is recognised on dispatch of the goods; or whether revenue is recognised when the customer receives those goods). Hence, the auditor must then determine whether the point of revenue recognition is appropriate.

When tests of detail are carried out, the auditor should 'stand back' and consider the sufficiency of the audit evidence. Methodologies which 'cap' sample sizes often give a false sense of security. Hence, a business with huge amounts of small transactions, a sample of 60 or 100 represents a small proportion of the activity.

Substantive analytical procedures and reviews of the operating effectiveness of controls can provide high-quality audit evidence, provided they are used in the correct circumstances. All of the inputs into a substantive analytical review will need to be fully audited and verified; and controls must be seen in operation consistently throughout the period through observation, examination of documentation or tests of IT controls.

QAD have stated that despite a wide range of weaknesses which may result in them concluding that the audit of revenue needs improvement, or significant improvement, in some cases, it appears to be a lack of audit work (either in relation to material revenue streams, or even revenue as a whole) that contributes to such a conclusion.