

## ICAEW AUDIT MONITORING 2018 (LECTURE A640 – 22.07 MINUTES)

The ICAEW have released their findings of their 2017 audit monitoring visits. During 2017, the ICAEW conducted 619 audit monitoring visits, 611 as a UK Recognised Supervisory Body and 8 under the Crown Dependencies' recognised auditor oversight regime.

The ICAEW have stated that:

*'Although audit quality has remained relatively consistent overall, there is still room for improvement.'*

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In addition, ICAEW also reviewed 1,019 audits including 26 AIM and Nex companies, five market-traded entities (under the Crown Dependencies regime), 199 charities and 44 pension schemes. 473 audits were of entities which would have applied FRS 102 for the first time (excluding early adoption).

Of these reviews:

- 76% were either satisfactory or generally acceptable;
- 16% required improvement; and
- 8% required significant improvement.

ICAEW also reviewed limited aspects of a further 161 audits and 238 engagements completed under the Solicitors' Regulation Authority's Accounts Rules which require registered auditor status.

ICAEW are required to make a report to the Audit Registration Committee (ARC) where there are significant concerns about a firm's compliance with the Audit Regulations. In 2017, one in ten audit monitoring reviews resulted in a report to the ARC.

Poor audit quality has been cited as a key issue by ICAEW in 36 out of 60 reports to the ARC in 2017. Some, but not all, cases, also contained significant financial reporting issues.

Insufficient audit evidence is the most common significant weakness on audit files according to ICAEW and they have identified the top three ISAs which cause audit quality weaknesses:

- ISA 500 *Audit Evidence*
- ISA 230 *Audit Documentation*
- ISA 315 *Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment*

The next three most common ISAs where non-compliance was noted are:

- ISA 530 *Audit Sampling*
- ISA 580 *Written Representations*

- *ISA 570 Going Concern*

### **1.1 *ISA 500 Audit Evidence***

ICAEW cite insufficient audit evidence as the main weakness on audit files. Most issues surround revenue testing, fixed assets, stock and work in progress, and other areas where professional judgement is needed such as goodwill and intangible assets.

Problems frequently encountered include the sufficiency of audit evidence for:

- completeness of revenue;
- ownership;
- rights and obligations relating to fixed assets; and
- the valuation of stock and work in progress.

### **1.2 *ISA 230 Audit Documentation***

ICAEW have said that there are 'significant issues' where audit documentation is concerned. Common problems include firms failing to record material aspects of their audit work, or the link between the audit evidence and the final conclusion of the audit.

In some (limited) instances, ICAEW have found significant parts of audit files which 'go missing' or the file has not been assembled and archived within 60 days of signing the auditor's report (as required by ISQC (UK) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*).

### **1.3 *ISA 315 Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment***

ICAEW confirm that where the auditor does not adequately assess risk through lack of understanding of the client's activities and internal controls, this can lead to an inappropriate audit plan and, consequently, audit evidence which fails to address the risks of material misstatement of the financial statements.

ICAEW have found a number of cases where inspectors are unable to see how well the auditor understands the business and the risks. In addition, inspectors have also found cases where there are apparently significant risks which the auditor does not appear to have addressed.

### **1.4 *ISA 530 Audit Sampling***

Audit sampling must reflect the materiality and audit risk of the relevant balance or class of transaction. ICAEW audit inspectors often find that a sample has been taken from a restricted population (e.g. overdue trade debtors) with no testing of the material trade debtors within credit terms at

the year-end. Focussing on overdue debts will identify whether a client's general or specific bad debt provision is adequate, but regard must be had to other trade debtors who may be within credit terms to verify the valuation and existence assertions.

### **1.5 *ISA 580 Written Representations***

ISA 580 (note the 2018 audit monitoring report cites ISA 570 under the 'Other Common Issues' section of the report (which is going concern) rather than ISA 580) requires certain management representations to be obtained on all audits, which often go beyond standard clauses. ICAEW have found that in areas requiring significant judgement, an auditor has not requested specific management representations to supplement their detailed audit work, where appropriate. Conversely, ICAEW have also found that the auditor has over-relied on representations rather than doing supporting detailed audit work. Over-reliance on written representations must be avoided as they are designed to complement other audit evidence and can also increase audit risk (the risk that the auditor expresses an incorrect opinion on the financial statements). On their own, written representations are insufficient as audit evidence because they are internally generated.

### **1.6 *ISA 570 Going Concern***

Going concern has to be addressed on all audits and the standard requires the auditor to assess the work done, and conclusions reached, by those charged with governance. In a lot of audits, this assessment can be relatively straightforward (particularly for smaller audits). However, in other audits it is less straightforward and the report cites businesses which operate on small margins with little headroom over loan covenants and these types of audits will involve difficult judgements.

ICAEW clarify that it is important that the auditor can demonstrate how it has challenged management's forecast (hence demonstrating professional scepticism also) when the assumptions contradict recent trading results or other available evidence.

### **1.7 *Financial reporting issues (case study)***

ICAEW visited a small firm with five audit clients. Two of these files highlighted financial reporting issues.

On the first file, a material liability had been recognised on the balance sheet. Questions asked by the inspector revealed that this was more likely to be a contingent liability, which is disclosed rather than recognised.

On the second file, ICAEW queried a large intra-group debtor which the firm had identified as doubtful and a review of the file also indicated that the doubtful debt was a legitimate concern of the auditor. However, the auditor had not proposed any adjustments to the client and had expressed an unqualified audit opinion.

ICAEW confirm that these issues indicate an ineffective review process of the audit work at the firm. The firm in question agreed to discuss these points with the clients at the next audit and ICAEW were satisfied that this was an appropriate response in the circumstances.

While ICAEW were satisfied with the firm's response, it was a significant concern and they subsequently made a report to the ARC to recommend imposing external hot file reviews of all audits (to include a review of the draft financial statements) until ICAEW is satisfied that the quality of the financial statements is of an appropriate standard.

### **1.8 Compliance with the Ethical Standard (case study)**

All auditors are required to comply with the Ethical Standard issued by the Financial Reporting Council. In addition, independence and objectivity are fundamental aspects which auditors must comply with and the ICAEW/ARC take breaches of the Ethical Standard very seriously.

While the report confirms that breaches of the Ethical Standard are not as prevalent as issues with audit quality and financial reporting, the ICAEW do come across instances where breaches of the Ethical Standard have arisen.

The ICAEW have included a Case Study in their report where a previous auditor resigned due to a threat to independence. The threat arose because the firm's sole equity partner because a director of the audit client. The new auditor agreed to use two of the former auditor's staff as sub-contractors on the audit.

ICAEW state that while this arrangement may make practical sense to help the new auditor, in this particular instance these sub-contractors would not be independent as they were employed by a director of the audit client.

Notwithstanding the fact that ICAEW's review of the audit work performed was of a good standard, there were clearly independence issues. ICAEW recommended that the ARC impose an external hot file review of the next audit of this client to provide evidence that all threats to independence have been resolved.

Other aspects of breaches of the Ethical Standard include a partner of the audit firm being a trustee of a trust which owns a material interest in an audit client. ICAEW recommends audit firms review the helpsheet *Covered person* which sets out who is included in the definition of 'covered person' because a failure to understand these issues may result in a breach of the Ethical Standard which could result in a report to the ARC.

### **1.9 Eligibility**

The final point which the ICAEW raise in their report concerns eligibility to practise as a registered (statutory) auditor. In order to be a statutory auditor, all firms must continue to meet the criteria for eligibility set out in the Audit Regulations.

The report acknowledges that structural changes within a firm may result in short periods where a registered auditor is unable to fulfil the eligibility requirements. Where the firm consults with ICAEW on a swift basis, they can usually help to resolve the issue and arrange for a dispensation to allow it to continue signing auditor's reports for an interim period of three months while the firm resolves the matter. Where firms fail to notify ICAEW about these changes, there is a risk that independence and objectivity is impeded and, in some cases, may result in the firm underpaying audit registration fees.

When firms have been ineligible for audit registration for a significant period and have saved registration fees as a result, ICAEW notify ARC. The report cites an example of when a firm appoints a new principle who is not an ICAEW, ICAS, CAI or ACCA member or a registered auditor, but does not apply for audit affiliate status for the new principal. In order to continue audit registration, the ARC will ensure that the firm makes the appropriate changes to become eligible for audit registration and may impose a regulatory penalty. The ARC's starting point for calculating this penalty is likely to be the amount of underpaid registration fees so that all firms pay their appropriate share of the costs of ICAEW regulation.

In 2017, ICAEW made eight reports to the ARC in respect of eligibility issues.