

## Common audit issues (Lecture A836 – 18.54 minutes)

There are many issues that get flagged up during the course of file reviews – some more than others. In this quarter's update, we will examine some of the more common deficiencies that are found during audit file reviews to help firms avoid the many pitfalls that exist where audit work is concerned.

### 1.1 Income completeness

Revenue (turnover/sales) is tested primarily for **understatement**. Remember, from a directional testing methodology, liabilities and income are tested for understatement; whereas assets and expenses are tested primarily for overstatement.

When testing revenue for completeness, the objective of the substantive income completeness test is to identify whether there are any goods and/or services that have been dispatched/rendered that have not been invoiced. The starting point, therefore, for substantive procedures over income completeness must be from 'outside' of the accounting system. For example, a customer's order will often trigger the transaction and income completeness testing should start from this order, through to goods dispatched notes, through to the sales invoice and then through to the various ledgers.

It is not uncommon to see the starting point for income completeness testing being from the sales invoice. Effectively, this renders the test meaningless because the whole point of the procedure is to test income for understatement. If the auditor starts from the sales invoice, then clearly the good and/or service has been invoiced and revenue has been recognised.

It is not just understatement that the auditor is concerned about where revenue is concerned. Another principal audit risk is that revenue is **overstated**. This could happen because the entity has recognised sales in the current year's financial statements that should be recognised in the next accounting period and could have arisen because cut-off's have been applied incorrectly or because of deliberate manipulation. The entity could also overstate its revenue figure by recognising fictitious revenue (i.e. sales that have not occurred).

Overstated revenue distorts the financial statements by falsely improving the financial performance of the business for the year and could lead to a user believing the entity is more successful than it really is. Deliberate overstatement of revenue also affects the balance sheet because the trade debtors figure will be inflated by the value of the overstatement.

#### The Tesco scandal

In 2014, Tesco was found to have overstated its profits by some £263m due to aggressive revenue recognition policies. This scandal resulted in the involvement of the Financial Conduct Authority and the Serious Fraud Office.

Tesco had once dominated the grocery industry but increasing amounts of competition meant that it saw

a decline in the value of its reported profits.

A decline in profits leads to questions being asked by the shareholders as to why this is happening and can call into question the ability of the directors.

Rather than try to remedy the situation ethically, management decided to falsify the information in its financial statements by increasing revenue and delaying the recognition of costs to make the financial statements look more healthier than they actually were. Quite often, this can appease the shareholders who assume that the company is still in a highly profitable position and the directors are ensuring shareholder wealth is maintained.

Tesco recognised revenue in the form of supplier rebates that were dependent on the company hitting certain sales targets. Some employees became aware that the sales targets would not be met and struck deals with the suppliers concerned. The 'deal' was that the supplier would still make the payment on the condition that they would receive benefits in the next accounting period.

Once the issue was in the public domain, Tesco's management asked one of the 'Big Four' accountancy firms to carry out an independent and comprehensive review which is said involved the accelerated recognition of commercial income and delayed accrual of costs. The firm involved in carrying out this review was not the official auditor of Tesco.

The conclusion reached was that Tesco had overstated its profits by £118m in the first half of 2015; by £75m in the 2013/14 financial year and by £75m prior to that. This sent shockwaves around the business community and the general public. Questions were also asked of the audit firm who had not (on the face of it) challenged these aggressive accounting policies.

Unorthodox practices such as manipulating the financial statements to achieve a desired outcome can lead to serious punishment, including lengthy prison sentences because it is fraud. Tesco, itself, was fined £129m by the Serious Fraud Office for overstating its profits.

As you can see from the Tesco scenario above, it is important that revenue is adequately covered by audit work and sufficient appropriate audit evidence is obtained to provide the auditor with reasonable assurance that revenue is fairly stated. Inappropriate or incorrect audit procedures can lead the auditor to missing key issues (and fraud risk factors).

Situations which could give rise to fraud risk factors include the client wishing to raise finance. Remember, a 'fraud risk factor' does not mean a fraud has taken place – it means that the risk of fraud is effectively higher. The principal audit risk here is that revenue may be overstated so that the entity presents a healthy set of financial statements to the bank/financier to secure the finance. Conversely, the entity may wish to suppress revenue to influence the tax liability.

Another issue that seems to crop up is the rebuttal of the presumption of fraud in respect of revenue recognition. ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* singles out revenue as containing a fraud risk.

Only in very rare situations should the auditor rebut this presumption. Hence, the auditor must ensure they devise procedures which address this risk and must not simply state that they do not believe a fraud has arisen during the year as this also fails to demonstrate professional scepticism.

Auditors can be reprimanded by the professional body or regulator for inappropriately rebutting such presumptions that are in the ISAs (UK). Remember, if such presumptions are in the ISAs (UK) it means they are viewed as significant risks.

Simply stating that the risk of fraud due to revenue recognition is 'not applicable because we have not detected fraud in previous audits' demonstrates a fundamental lack of professional scepticism and contravenes ISA (UK) 240 which requires previous experience of management's integrity and honesty to be set aside by the auditor.

## 1.2 Audit evidence

Audit evidence crops up a lot in terms of deficiencies. ISA (UK) 500 *Audit Evidence* requires the auditor to obtain **sufficient** and **appropriate** audit evidence. ISA (UK) 500 defines 'audit evidence' as:

*Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.*

ISA (UK) 500, para 5(c)

Audit evidence is made up of information that supports and corroborates management's assertions and also information that contradicts management's assertions. Both types of information can provide evidence that will help the auditor to form an opinion on the financial statements.

It is not unusual to see material areas of the financial statements that have not been properly corroborated through sufficient appropriate audit evidence.

**Sufficient** audit evidence means there is the right amount (quantity of evidence). Sufficiency will be determined by factors such as the level of risk associated with the item in question, by the quality of evidence obtained and the links to materiality. The auditor must use judgement to decide when sufficient evidence has been obtained, and in reaching this decision the type of procedures that have been used to obtain that evidence must be considered. For example, it is important to appreciate that inquiry alone does not usually provide sufficient audit evidence on the operating effectiveness of controls, or on the absence of a material misstatement.

**Appropriate** audit evidence means that the evidence is both **relevant** and **reliable**. Relevance means that evidence should be pertinent to the assertions inherent in the item in question. For example, when gathering evidence about a property, a physical verification will provide evidence of existence, but not of the right to recognise the property on the balance sheet. So further audit procedures would be necessary to obtain evidence on the client's right to recognise the property on the balance sheet.

Reliability means that the auditor can trust the audit evidence. If the information used as the basis of an audit procedure is not auditor-generated, i.e. has been provided by the client or by an auditor's expert, the auditor must carefully evaluate the accuracy and completeness of the information and whether it is detailed enough to support the planned audit procedure.

The reliability of audit evidence is influenced by factors, such as:

- The source of the evidence (e.g. client-generated or auditor-generated).
- The nature of the evidence (e.g. whether it is documentary or based on inquiry).
- The circumstances under which it is obtained (e.g. whether there were effective controls over the preparation of the audit evidence).

ISA (UK) 500, para A31 provides a guideline as to the reliability of evidence summarised:

Type of reliable evidence	Examples
Generated by third parties independent of the client	<ul style="list-style-type: none"><li>• Confirmation of a trade debtor balance by a customer</li><li>• A letter from the bank confirming an overdraft limit, rates of interest, etc</li><li>• Evidence obtained by an auditor's expert, for example, a specialist property valuer</li></ul>
Generated by the auditor rather than by the entity	<ul style="list-style-type: none"><li>• Financial performance measures such as trends and ratios prepared by audit software</li><li>• Recalculations of complex computations such as foreign exchange gains or losses</li></ul>
Documented in a written form rather than an oral representation	<ul style="list-style-type: none"><li>• Written management representations</li><li>• Written confirmation of matters discussed with people outside the audited entity such as lawyers and finance providers</li></ul>
Gathered from original documentation rather than photocopies or scanned documents	<ul style="list-style-type: none"><li>• Original signed documents such as lease agreements, loan covenants, contracts with suppliers and customers</li><li>• Original version of board minutes and meetings with shareholders</li></ul>
Produced by the entity when controls are deemed to be effective	<ul style="list-style-type: none"><li>• Evidence obtained from a well-organised and well-controlled inventory count</li><li>• Evidence based on the audited entity's accounting records when controls are effective</li></ul>

Sufficiency and appropriateness should not be considered in isolation. For example, the more reliable the source of evidence, a lesser quantity of it may be needed.

For example, consider an auditor is obtaining evidence in relation to a lease that has been entered into. If the audit client can present the auditor with the original signed copy of the lease, which is a reliable source of audit evidence, then limited further procedures need to be performed. However, if the client presents the auditor with a photocopy of the lease, or cannot produce the document in any form at all, further procedures will be necessary.

### **Risk and audit evidence**

Remember, audit evidence is always persuasive in nature – not conclusive. ISA (UK) 330 *The Auditor's Responses to Assessed Risks* indicates a link between the auditor's assessment of risk and the persuasiveness of the audit evidence obtained. The correlation is that the higher the assessment of risk, the more persuasive the evidence will need to be. To obtain more persuasive audit evidence, the auditor can:

- Increase the quantity of evidence obtained
- Obtain evidence that is more relevant
- Obtain evidence that is more reliable

Quite often, it is clear from audit file reviews that there is little consideration of the overlapping risk.

For example, a circularisation of trade debtor balances has indicated a higher risk than previously identified during the audit planning. The auditor could respond in a few ways to improve the persuasiveness of evidence, such as:

- Extending the sample of trade debtors that were circularised.
- Extend other audit procedures which are relevant and reliable, such as after-date cash receipts testing.

### **1.3 Related parties**

Related parties can be a tricky area to audit. A key problem for the auditor is that unless management tells the auditor about the existence of related parties, they can be hard to identify. Even where management are willing to inform the auditor about related parties, management may not themselves understand the complex definition contained in FRS 102, Section 33 *Related Party Disclosures* which can lead to incomplete or inadequate related party disclosures. This is particularly the case in smaller audits which may lack informed management.

Internal controls are often not set up to specifically deal with related parties and transactions with them. So, for example, if two companies under common control trade with each other, these transactions may not be separately identified within the accounting system as related party transactions, so again there is a risk of incomplete disclosure.

Management may also deliberately conceal related parties and transactions with them. This is because related parties are sometimes used as a vehicle for fraud, and this type of fraud often involves senior management.

Care must be taken with related parties due to their subjectivity and it is an area that frequently crops up in file reviews as one of the most deficient. In some, more serious, cases, the only audit evidence on file concerning the completeness of related party disclosures is a written representation letter.

#### Example – Fraud and related parties

One of the most famous frauds involving related parties involves the US company, Tyco. This is an old case, dating back to 2002, but it demonstrates how related party transactions can be used to carry out significant frauds by senior management. Remember, that ‘key management personnel’ are, by definition, related parties according to ISA (UK) 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*.

In the Tyco case, the company’s CEO, Dennis Kozlowski and CFO, Mark Swartz, were found to have given themselves loans amounting to \$120m, often disguised as bonuses, which were interest-free or had very low rates of interest. The company had a legitimate Key Employee Loan Programme, which was set up to help senior management to acquire loan stock in the company. However, Kozlowski and Swartz abused this policy, making loans without appropriate authorisation leading to significant theft from the company as the loans were never intended to be repaid.

In addition to the unapproved loans, the company’s funds were misused by Kozlowski for extravagant personal expenses, famously including a \$6,000 shower curtain, works of art and houses worth many millions of dollars, and a \$2m birthday party for his wife. Kozlowski clearly believed that the company’s assets were ‘his money’ – a concept known as ‘commingling’.

Both Kozlowski and Swartz were found guilty of grand larceny, falsifying business records, securities fraud and conspiracy in 2005. They both received lengthy prison sentences and ordered to pay fines totalling over \$230m.

In addition to the misappropriation of assets, on investigation it was discovered that Tyco’s financial statements were misstated by a \$5.8bn overstatement of profit.

The company’s auditor, PwC, was investigated by the Securities and Exchange Commission. The audit engagement partner was found guilty of recklessly violating the anti-fraud provisions of federal law and of engaging in improper conduct, and was barred from acting as an accountant. PwC ultimately paid \$225m in settlement of legal claims against the audit firm.

There is a separate ISA (UK) which deals with related parties, that of ISA (UK) 550 *Related Parties*. ISA (UK) 550 recognises that transactions with related parties may carry no more risk than other transactions with non-related parties. However, a fraud between related parties is something that the auditor must consider because it is relatively easy for individuals, especially senior management, to collude with a related party of the entity in order to commit fraud.

Reviews of audit files often find weak procedures in the area of related parties. Remember, the principal audit risk is that of inadequate or incomplete disclosures. Auditors must keep in mind that some disclosures are material in nature.

Management may not want to make certain disclosures because they could be considered to be too sensitive, for example details of salaries, bonuses and pension contributions. Just because a transaction, or a series of transactions, may be considered sensitive, it does not preclude the directors from disclosing them as related party transactions.

Quite often, it is also unclear whether there has been a discussion among the engagement team at the planning stage of the audit as to the susceptibility of the financial statements to fraud because of transactions with related parties. This is a specific requirement of ISA (UK) 550.

### Management representation

While there is a requirement for the auditor to obtain a written representation in respect of related parties (ISA (UK) 550, para 26), this representation cannot be used as sole audit evidence. ISA (UK) 580 *Written Representations* acknowledges that written representations, on their own, are insufficient audit evidence, primarily because they are internally generated (see **10.4** below). If the auditor is unable to obtain sufficient appropriate audit evidence through other procedures, it is likely the audit opinion will have to be modified (qualified).

### 1.4 Written representations

ISA (UK) 580 *Written Representations* provides guidance to auditors on the requirement to obtain written representations from management and, where appropriate, those charged with governance.

During file reviews, the content of the written representation frequently gives rise to review points. For example, incomplete representations or missing representations. Also, as noted above, reliance on written representations as sole audit evidence is also sometimes noted during reviews which contravenes the requirements of ISA (UK) 580 because written representations must complement other forms of audit evidence – on their own they are insufficient forms of evidence because they are internally generated.

The Appendix to ISA (UK) 580 contains a list of paragraphs in other ISAs (UK) which must be included in the written representation letter. This list is reproduced below:

ISA (UK)	Paragraph number
ISA (UK) 240 (Revised May 2021) <i>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</i>	40
ISA (UK) 250 (Revised November 2019) Section A – <i>Consideration of Laws and Regulations in an Audit</i>	17

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*of Financial Statements*

ISA (UK) 450 (Revised June 2016) <i>Evaluation of Misstatements Identified during the Audit</i>	14
ISA (UK) 501 <i>Audit Evidence – Specific Considerations for Selected Items</i>	12
ISA (UK) 540 (Revised December 2018) <i>Auditing Accounting Estimates and Related Disclosures</i>	37
ISA (UK) 550 <i>Related Parties</i>	26
ISA (UK) 560 <i>Subsequent Events</i>	9
ISA (UK) 570 <i>Going Concern</i>	12-2(f)
ISA (UK) 710 <i>Comparative Information – Corresponding Figures and Comparative Financial Statements</i>	9
ISA (UK) 720 (Revised November 2019) <i>The Auditor’s Responsibilities Relating to Other Information</i>	13(c)

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## **1.5 Opening balances**

ISA (UK) 510 *Initial Audit Engagements – Opening Balances* provides guidance to auditors on opening balances which are those account balances in existence at the start of a new accounting period.

For new audit clients, company law makes provision for the auditor to be provided with access to the predecessor auditor’s working papers file in order to obtain audit evidence concerning opening balances. However, certain audit clients are not covered by such a requirement (e.g. pension funds) and so additional audit work will need to be carried out to determine if the opening balances have been correctly brought forward into the current period and whether audit evidence can be obtained to support those opening balances. In some situations, this can result in a modified audit opinion being expressed due to a limitation of scope.

Incoming auditors should remember that just because the prior year’s financial statements may have been audited, this does not mean that they can just assume that the opening balances are correct. This is often evident during file reviews and the conclusion reached is that insufficient audit work has been carried out on opening balances.



The incoming auditor must be satisfied, through obtaining sufficient appropriate audit evidence that opening balances are free from misstatement and have been correctly brought forward into the current year from the prior year.

Where the previous auditor has expressed a modified (qualified) audit opinion on the previous year's financial statements and that modification remains relevant and material to the current year's financial statements (e.g. non-attendance at the inventory count), the incoming auditor must modify the auditor's opinion as well.

### **Client requires an audit for the first time**

It may be the case that an existing client breaches the audit exemption thresholds and requires an audit for the first time. If the comparative financial statements have not been audited (e.g. because the client was able to take advantage of audit exemption in the prior year), the auditor must ensure that the auditor's report discloses the fact that the comparatives are not audited.

However, the auditor must also ensure that they are not aware of any possible material misstatement in those opening figures. If the auditor is unable to obtain sufficient appropriate audit evidence that the opening balances are free from material misstatement, the audit opinion must be modified on the basis that the comparative financial statements may not be comparable.

Only auditors of listed entities are mandatorily required to include a Key Audit Matters (KAM) section in the auditor's report in accordance with ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*. Where the auditor encounters difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain material misstatement, this is likely to be a KAM and should be referred to as such in the auditor's report.

Regardless of any potential modification to the auditor's report in respect of opening balances, where the comparative financial statements were not audited, the auditor must include an 'Other Matter' paragraph in the auditor's report which states that the comparative figures are unaudited. This is often forgotten about and an illustration is set out below:

#### **Example – Other Matter paragraph**

##### Other matters which we are required to address

Without qualifying our opinion, we draw attention to note 2 'Basis of preparing the financial statements' and the fact that the company's comparative financial statements were unaudited. For the year ended 31 December 2022, the company qualified as small and the directors took advantage of the exemption in section 477 of Companies Act 2006 and did not require the company to have its financial statements for the year then ended audited.

## **1.6 Ethical requirements**

Often, it is apparent that auditors forget about their obligations under the FRC's Ethical Standard (ES) as they are wholly focussed on ensuring compliance with the ISAs (UK). Compliance with the ES is as important as compliance with the ISAs (UK). Any breaches of the ES must be notified to the competent authority (being the FRC). However, auditors of private entities (i.e. non-PIE audits) are required to notify their relevant professional body of breaches of the ES. This is an issue that is often either forgotten about, or audit firms are unaware of it.

### **Long association**

There are strict rules in place in respect of PIE audits and these must be clearly understood. For non-PIE audits, the long association rules are often overlooked; or, where they are considered, the safeguards applied are often clearly documented.

Where there is a long association threat, the typical safeguards that are implemented are cyclical pre- and post-issuance reviews (or 'hot' and 'cold' reviews as they are commonly referred to). These can provide suitable safeguards to reduce the threat to objectivity, independence and objectivity to an acceptable level, but it is not necessarily the case that such reviews will always reduce the long association threat.

Where there is long association with an audit client, the audit file must include the relevant safeguards that have been applied. In addition, the file should also document the reasons why those safeguards are considered appropriate (it is not enough just to document the safeguard). Reviews of files often indicate neither safeguard nor rationale have been documented adequately.

### **Non-audit services**

The provision of non-audit services is common among non-PIE audit clients. For example, it is not uncommon for the audit firm to be involved in areas such as preparing the statutory financial statements from a trial balance or dealing with the tax computation.

For smaller audits, Section 6 of the ES contains the Provisions Available for Audits of Small Entities. Where there is informed management, the auditor can rely on these provisions provided reference is made to such in the auditor's report. It is often the reference in the auditor's report that is missing.

The primary threat where non-audit services are performed for the client is a self-review threat. This is where the auditor may, for example, be involved in a non-audit activity that involves including an amount or disclosure in the financial statements and then auditing that area. As with all threats, the self-review threat must be mitigated to an acceptable level.

One of the main ways of minimising self-review threats is to have two (or even three) separate teams. For example, where the audit firm is involved in calculating the corporation tax liability, someone from the tax department could calculate the liability; a member of the accounts preparation team could include the liability in the financial statements; and a

member of the audit engagement team could audit that area. This reduces the self-review threat because the auditor is not auditing their own work.

Again, it is important that the safeguards applied are clearly documented on the audit file, together with the reasons why those safeguards are appropriate.

For PIE audits, there are strict rules which essentially prohibit most non-audit services being performed. Where a client is a PIE, a sound understanding of these rules is crucial to avoid breaching the ES.

Another issue which crops up every now and again is the performance of due diligence work when an existing client acquires a new business, particularly valuation services. Remember, there are prohibitions on auditors carrying out valuation services where the valuation involves a significant degree of subjective judgement and has a material effect on the financial statements.

Where a client asks the audit firm to carry out due diligence work (particularly that which may involve the provision of valuation services), there must be a clear understanding of the rules. Remember, the ES strictly prohibits the provision of valuation services on the grounds that the self-review threat is considered too high where the valuation involves amounts with a significant degree of subjectivity and which have a material effect on the financial statements.