ICAEW

Audit Essentials 2016

Help and support from ICAEW

We provide a broad range of information and guidance to support our audit firms.

- **QAD webinars and webcasts** on topical issues that audit firms face are available at icaew.com/qadonline
- **Audit advice and guidance to help your firm remain compliant** – access previous monitoring reports, *Audit News* and other guidance on applying the audit regulations at icaew.com/auditguidance
- **The Audit and Assurance Faculty** operates as a centre of excellence in audit and assurance matters. It sponsors the Audit Quality Forum, runs the AuditFutures initiative and has shown the value of the profession with its Audit Insights initiative. Its assurance thought leadership programme explores new services and techniques to meet emerging market needs and share best practice. The faculty is proactive on audit quality matters, having hosted a series of webinars in this area. Subscribers also receive 10 editions of the faculty's magazine, *Audit & Beyond*, which provides valuable content on best practice and topical issues in the audit and assurance profession. The faculty produces a range of technical publications with topics including group audits, related parties and ISQC1. It also organises regional roadshows and evening lectures, which are also repeated as webinars. Join now at icaew.com/faculties
- **UK GAAP** – from 2016, small companies are no longer immune from the revolution in UK GAAP reporting that took effect in 2015 for larger private companies. The FRSSE has been withdrawn for accounting periods beginning on or after 1 January 2016 and small entities are now within the scope of FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland. A new optional standard has also been issued for micro-entities – FRS 105, the Financial Reporting Standard applicable to the micro-entities regime. More information is available at icaew.com/newukgaap
- Members of the **Financial Reporting Faculty (FRF)** have access to regular webinars, factsheets and a bi-annual journal. Recent FRF publications provide extensive coverage of the new UK GAAP. Faculty members also receive complementary access to online IFRS standards and access to our member-only IFRS and UK GAAP conferences. You can also download the FRF's free app or follow us on Twitter: @ICAEW_FRF. Join now at icaew.com/faculties

If you would like to find out more about ICAEW's help and support for the audit profession, please visit icaew.com/audit

Overview

The results of our monitoring reviews in the last year show our firms continue to maintain a good level of audit quality. There are also indications that this level of sustained quality is improving.

It is important to acknowledge that any audit review is likely to identify aspects of the work that could be improved. Difficult aspects of any audit may include audit judgements, understanding and testing complex revenue models, and substantive analytical review.

Auditors must continue to focus on independence, ethics and quality control of audit work. Audit compliance reviews, and particularly cold file reviews are key to effective self-regulation.

When the Department for Business, Innovation and Skills (BIS) confirmed the increase in audit threshold for accounting periods commencing 1 January 2016, it highlighted that audit and auditors would continue to have an important role in supporting small businesses. Even before this latest increase in the threshold, many small entities have continued to have an audit, whether to meet the expectations of other parties, or for added value and peace of mind. While the new thresholds will have an impact, it is generally expected that a significant number of small entities will continue to want an audit.

The introduction of FRS 102 will be a significant challenge for firms. Firms will be called upon to educate and support their audit clients. At the same time, they will need to safeguard their independence and objectivity throughout the audit process.

In this report we present the results of our 2015 audit monitoring activities. We highlight some of the common findings from our reviews, the ways that we support firms and explain where audit firms can find more information and support from ICAEW.

ICAEW audit monitoring activities

The Companies Act 2006 requires recognised supervisory bodies (RSBs) to license and monitor statutory audit. ICAEW is the largest such body in the UK; we register over 3,400 audit firms.

We are responsible for monitoring firm-wide procedures at all our firms except for the very largest whose firm-wide procedures are monitored by the Audit Quality Review (AQR) team of the Financial Reporting Council (FRC).

Although we monitor the quality of individual audits at all our firms, the audits of fully listed clients and others designated as major audits fall within the FRC's remit. Since 2013, we have also reviewed some of these listed and major audits and firm-wide procedures under delegation from the FRC. However this delegated work will end after the implementation of the new EU Audit Regulation and Directive (ARD) on 17 June 2016.

Under the ARD, the AQR team will be responsible for the review of audits of Public Interest Entities (PIEs), together with firm-wide procedures at firms that have PIE audits. We will still carry out reviews of non-PIE audits at these firms along with a limited amount of work on firm-wide procedures to maintain our understanding.

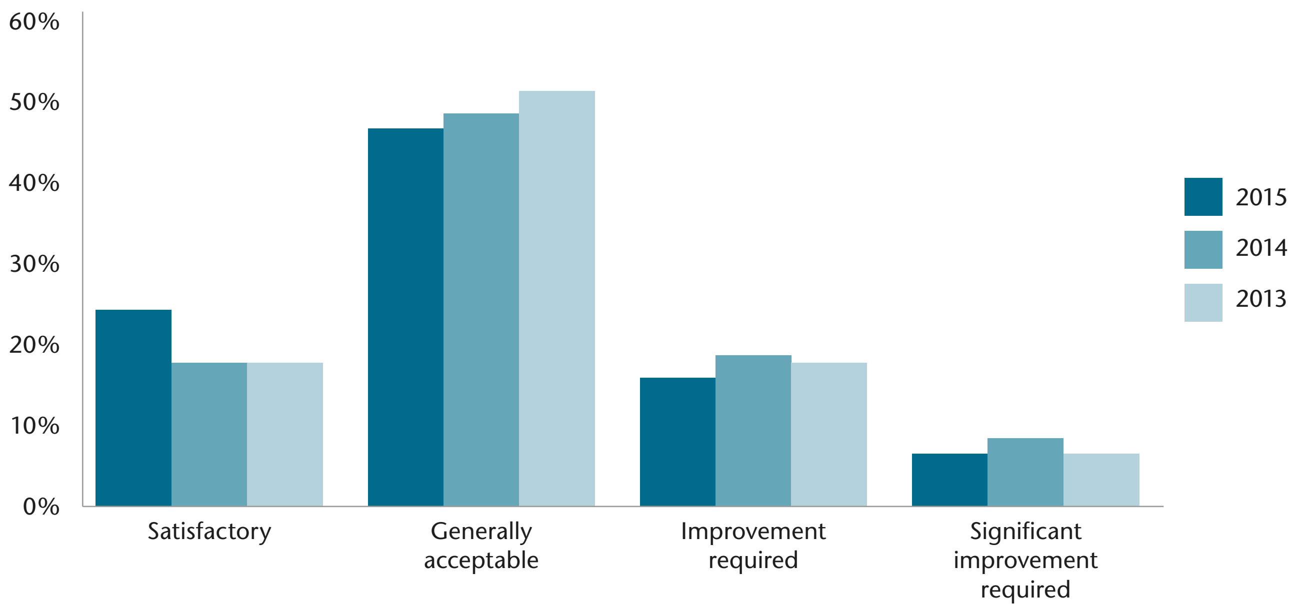
Conversely, the ARD will result in the return to our review scope of a significant number of large entities previously classed as major audits. These will include the audits of large private companies, including many economically significant entities owned outside the UK, charities and pension schemes. At the other end of the scale, the recently announced increase in the audit threshold for accounting periods commencing on or after 1 January 2016 is likely to reduce the number of audits completed by many of our firms.

Monitoring reviews

We completed 700 audit monitoring reviews in 2015, 693 as a UK RSB and 7 under the Crown Dependencies Recognised Auditor oversight regime.

We reviewed 1,129 UK audits, including 40 AIM and ISDX companies, 12 major audits (under delegation by the FRC) and 178 charities. Our reviews of five market-traded entities under the Crown Dependencies regime were either complete or in progress at year end.

We found 76% (2014: 71%) of these audits were either satisfactory or generally acceptable, with 26% classed as satisfactory (2014: 19%), a good increase in the top band. 17% (2014: 20%) required improvement and 7% (2014: 9%) required significant improvement. Although we review audits at different firms each year, comparison with the last two years suggests an improvement in audit quality.



We reviewed limited aspects of a further 155 audits and 255 engagements completed under the Solicitors' Regulation Authority (SRA) Accounts Rules that require registered auditor status.

Major audits

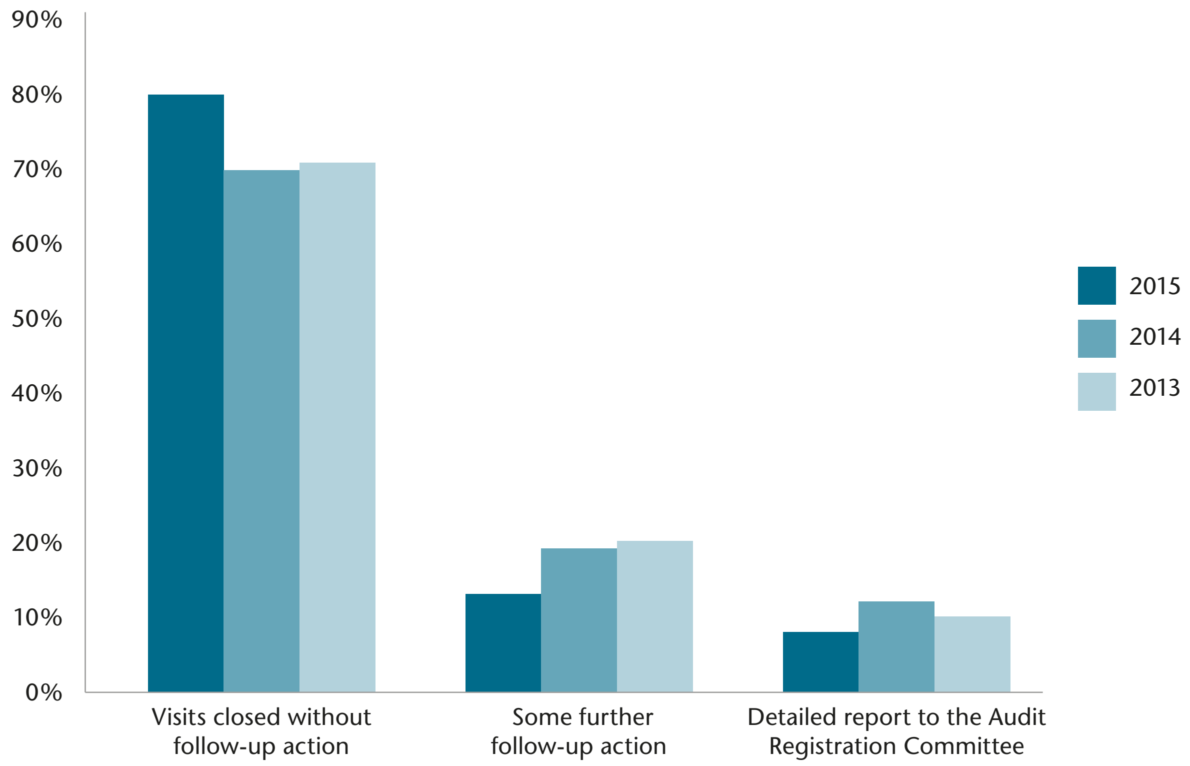
25% of the major audits we reviewed needed improvement or significant improvement. This is a marked improvement on 2014 when we had concerns about more than half (12) of the 20 major audits we reviewed.

Crown Dependency audits

All the audit file reviews we completed in 2015 under the Crown Dependencies Recognised Auditor oversight regime (three) were satisfactory. Two further reviews were in progress.

Regulatory action

Consistent with previous years, we concluded the vast majority of our visits without any further regulatory action. The results of our reviews in 2015 indicate an improvement in audit quality although the results of our visits may be partly influenced by the increasing number of registered auditors that don't have any audits and are unlikely to require follow up action.



Where some follow-up action is needed, we may ask firms to provide further information such as the results of external cold file reviews, details of training courses or improved audit programmes. In more serious cases we write a detailed report for the Audit Registration Committee (ARC) so it can decide what actions to take.

In response to a detailed report, the ARC may decide to:

- impose conditions and restrictions;
- offer a regulatory penalty or refer the firm to the ICAEW Professional Conduct team for further investigation; or
- withdraw audit registration (in the most serious cases).

The ARC rarely withdraws registration from a firm without giving it a chance to make the necessary improvements.

ARC imposed 37 regulatory penalties on firms in 2015. In the majority of cases, these penalties related to quality control procedures, independence or eligibility issues. See the sections on these topics later on in this report.

The ARC highlights changes relevant to audit firms and any emerging concerns in *Audit News*. Topics covered in recent issues include:

Audit News 54, May 2015:

- reminders from the Audit Registration Committee – including accurate completion of annual returns
- support with audit CPD
- audit arrangements for the Crown Dependencies.

Audit News 55, November 2015:

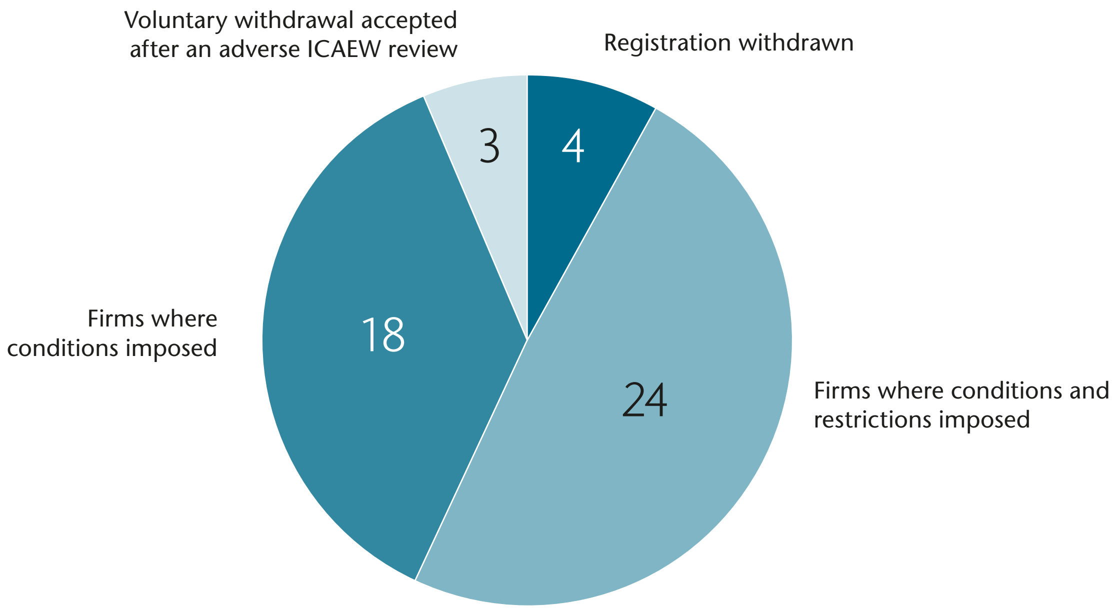
- applying to become an ATOL Reporting Accountant
- the transition to FRS 102
- advice from the FRC on signing Co-operative and Community Benefit Societies audit reports.

Audit News 56, March 2016:

- reports under the SRA Accounts Rules
- International Education Standard 8
- auditor insights into the retail and insurance sectors.

View previous issues of *Audit News* at icaew.com/auditnews

Actions the ARC took in 2015
(figures include some visits carried out in 2014).



Audit quality

Positive signs

We review audits at different firms each year so an accurate comparison of audit quality over time is difficult. However, the results from the last two years suggest improvements.

We see that firms are more cautious about the use of substantive analytical review. In the past this technique has been poorly applied or sometimes misunderstood as being a quicker and easier way to obtain audit evidence. Increasingly we see firms understand that while substantive analytical review can provide very good quality audit evidence, it requires considerable time and effort to do it properly.

Clarified ISAs introduced a requirement for auditors to establish a record of related parties in addition to covering the completeness and disclosure of related party transactions. Continuing focus on this area in CPD and commercially available audit programmes have helped to improve the work we see on audit files.

Outside the larger audit firms, group audits and the need to apply ISA 600 remain relatively rare. However, when we come across group audits, we see that firms are more aware of the level and timing of the input they should have into work done by component auditors. However, there is still room for improvement. Results of our audit monitoring activities in 2015 show that firms need to continue to focus on many of the points we have covered in previous reports.

Top 5* ISA weaknesses 2015

1. ISA 500 Audit evidence
2. ISA 230 Documentation
3. ISA 315 Risk assessment
4. ISA 530 Audit sampling
5. ISA 240 Fraud

*based on the number of times we identified weaknesses in application of individual ISAs during our audit file reviews

Key findings

In our audit reviews we look for appropriately planned audit work to address areas of risk. Here are three key areas where we conclude that some firms can improve audit quality.

1. Quality of audit judgements

   Estimates, judgements and uncertainty are the most challenging aspects of any audit. Audit teams may be faced by challenging audit judgements in the valuation of goodwill, properties or other assets, or events that may result in liabilities, provisions or contingent liabilities.

   Faced by complex audit judgements, firms should ensure their challenge of management assumptions and consideration of other evidence that either supports or contradicts those judgements is clear, for example:

   - whether rental yield implied by a property valuation is supported by market transactions for similar properties in the area;
   - the correlation between forecast profitability for a business and operating results in the period after year end; and
   - if long-term growth forecasts can be supported by reviewing past performance and/or independent economic data.

   This is the area where auditors can really demonstrate their professional scepticism by documenting their audit testing carefully. In discussion with firms, we often find they have thought carefully about key judgements but the audit file does not tell the full story – simply a brief conclusion. To demonstrate high quality audit judgements, the full story is critical.

2. Understanding and testing revenue

   The audit of revenue is a key area of focus in our audit file reviews due to the importance of revenue to most types of company, and charities in particular. Weaknesses in revenue testing are some of the more common weaknesses in audit evidence that we identify on our reviews.

Remember:

The most common areas where audit evidence is lacking are turnover/revenue, stock/inventory, asset valuations/impairment and going concern.

It's important firms properly understand the revenue business cycle in order to test revenue effectively. In many cases the revenue cycle is relatively straightforward, but auditors sometimes focus their testing on invoices rather than a test of relevant documentation from the start of the sales cycle – for example sales orders. In more complex cases, auditors sometimes ignore complex contract terms that need to be unbundled – products or services provided over different timescales and with a different point of recognition although sold under a single contract. And sometimes auditors focus on the main income streams, but ignore other less significant streams, even though they may be material.

This is also one of the more common areas where we identify weak substantive analytical review. A substantive analytical review that forms most, if not all of the audit evidence for revenue must be appropriately designed including expectations of the balance and a threshold for further investigation. A simple comparison with prior years and brief explanation is rarely sufficient audit evidence alone.

3. Tests for completeness of transactions and balances

   Completeness of transactions – or designing tests to identify information that is not in the accounts – is usually more difficult. Work on creditors, accruals and provisions must consider not only the balances included in the accounts, but also the risk that further amounts have been overlooked, which might reduce profit and net assets.

   Auditors need to ensure they design tests of completeness effectively, whether that is a review of invoices and payments after the balance sheet date, a review of legal correspondence for potential litigation; or making enquiries with audit client personnel outside the accounting function to explain or corroborate facts and observations noted during the audit work.

   All auditors must rely to a certain extent on representations from management for completeness of transactions. This makes the notes of meetings with management, and carefully drafted management representations important and these must be included in the audit documentation.

Insufficient documentation

One of the most common findings on our visits is insufficient documentation. Good documentation can certainly be a challenge. If it falls short, we are often still able to conclude, following discussion, that the underlying audit work was basically sound. The audit team typically knows a great deal about the client's business and systems and is able to describe to us in some degree of detail how they approached their testing. But sometimes it's impossible to follow files without these additional explanations. Clearly, a good final review should ensure documentation is appropriate and complete. So when there are gaps, we question whether the review process has been carried out in sufficient depth.

> Remember:
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> Controls must be quite formal and well documented in order for firms to take the extra step of reliance on operating effectiveness of controls as audit evidence.

> Remember:
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> ISAs allow considerable judgement in audit sampling, but we sometimes find a material component of the population is excluded from sample testing, or the sample size is clearly inadequate.

> Remember:
>
> Documentation of key judgements is sometimes weak and important documents are sometimes missing from electronic (and paper) audit files.

Beware of these pitfalls

Independence issues can result in regulatory penalties

We continue to come across partners with trustee shareholdings in audit clients. In previous reports we have referred firms to *Audit News* 52 (icaew.com/auditnews) which sets out the basic requirements of Ethical Standard 2 and highlights the potential pitfalls. There is further guidance available at icaew.com/auditconnection to help firms decide whether their arrangements are appropriate and, in particular, who in the firm may be in a position to influence the audit.

Audit fee dependency issues are a common reason for detailed reports to the audit registration committee, in particular when fees for audit and non-audit services have exceeded 15% of the firm's revenue for several years. The Ethics Advisory Service has identified a number of FAQs on fee dependence that firms may find helpful icaew.com/feedependence

Lack of evidence of consideration of threats and safeguards relating to non-audit services is still a fairly common theme although, in many cases, firms are taking reasonable steps in practice and are not continuing as the auditors when it's inappropriate.

Cold file reviews are key to effective self-regulation by firms

If done well, cold file reviews (reviews of completed audit engagements) enable audit firms to identify areas where audit work should be improved on a timely basis.

We sometimes also come across firms that have very thorough reviews, but fail to take appropriate action to address the findings. So we may see the same issues recurring time after time.

Audit Regulation 3.20 requires firms to have cold file reviews at least once a year. In our experience, firms often benefit greatly from having external reviews, as this provides a fresh perspective. Reviews can be done in-house as long as there is an independent review (ie, a review by an individual who had no involvement in the audit) at least every three years. Smaller firms may not have enough experienced staff to conduct independent cold file reviews so they should engage an external cold file reviewer at least every third year. They must also continue to conduct cold file reviews in each intervening year, but these could be carried out in-house, as long as they are effective. Any smaller audit firms that need a periodic external cold file review should now have arranged at least one, and be planning for their next external review.

The ARC has imposed regulatory penalties on firms that stated on their annual return they had done cold file reviews when this was not the case.

Eligibility

Audit regulations set criteria for the ownership and control of audit firms to safeguard audit quality and the independence of the firm. All audit firms must inform us of changes in principals and structure within 10 business days. Legal changes, such as incorporation of a sole practice, will need a new application for audit registration. New principals who are not members of ICAEW, ACCA, ICAS or CAI need to apply for audit affiliate status. A number of firms have missed this requirement and have received regulatory penalties as a result.

The ARC can grant temporary dispensation from the requirement to comply with any regulation but it must be informed of issues promptly. We encourage firms to discuss proposed changes with us in advance if they have any questions or concerns.

Remember:

Trustee shareholdings continue to be an issue, firms should refer to *Audit News* 52 and the further guidance on who may be in a position to influence the audit.

Remember:

Firms must inform ICAEW in writing of certain changes within 10 business days of the event. Audit Regulation 2.11 sets out the circumstances we require notification of.

Other activities to improve audit quality

We continue to contact firms between visits, where appropriate, to review their progress. Last year, we phoned 67 firms to discuss a range of topics including the results of annual compliance reviews and the steps being taken to address the matters raised. And we also wrote to all firms with just one responsible individual to remind them of the need to have an independent cold file review at least every three years (February 2015).

The implementation of FRS 102 is the biggest change in UK GAAP for companies in a generation. We will feed back key messages from our early reviews of these audits as soon as possible for the benefit of all audit firms.

Later this year we will start a project to review the quality of audited accounts prepared under FRS 102. This will allow us to assess the success of implementation and inform our audit monitoring work and support for audit firms.

Remember:

Cold file reviews are key to effective self-regulation. Firms should have cold file reviews at least once a year.

Remember:

Smaller firms may not have enough experienced staff to conduct independent cold file reviews so they should engage an external cold file reviewer at least every third year.

Looking forward

The ARD passed in 2014 have an effective date of 17 June 2016. The UK Government (through BIS), the FRC, ICAEW and the other RSBs have been working towards this implementation. It will fundamentally change the audit regulatory environment and the codes and standards that auditors have to follow, especially those relating to the audits of PIEs. Firms should look out for information about the revised codes and guidance in the coming months.

ARD and monitoring reviews

Firms may see changes in their audit monitoring regime as a result of the ARD.

- Direct monitoring by the FRC for firms auditing PIEs.
- ICAEW to monitor most of the non-listed entities that were formerly major audits.

On 1 July, a new International Education Standard (IES) issued by IFAC's IAESB comes into force. IES 8 sets new professional competence requirements for audit engagement partners.

The new standard builds on the existing focus on professional competence that is already a requirement of legislation, professional body licensing requirements and registered auditors' internal due diligence. IES 8 will therefore be complementary to firms' current procedures and practices. Nevertheless, it's important to be aware of the change and to take appropriate steps. You can download IES 8 from the IFAC website www.ifac.org/publications-resources/ies-8-professional-competence-engagement-partners-responsible-audits-financ-0

We will amend the application process for responsible individuals (RIs). It will become necessary for applicants and their firms to confirm that those proposed as RIs have achieved the competencies listed in IES 8 through their work experience and CPD. The application form will require examples.

IES 8 and monitoring reviews

From 1 July 2016 we will look to see that:

- firms have appropriate procedures in place to meet the requirements of IES 8; and
- selected engagement partners and other RIs are using a planned programme of CPD to ensure they are maintaining the competencies required by IES 8.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 145,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

Because of us, people can do business with confidence.

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