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AUDIT MONITORING

Audit Essentials

2017

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- group audits
- audit compliance review
- accounting estimates, valuations, impairment and the use of experts
- audit work on internal controls
- fraud
- substantive testing – substantive analytical review and tests of detail.

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Got a question? Our technical advisory team is able to help with any accounting queries.

Call us on +44 (0)1908 248 250.

Overview and recent developments

In this report we present the results of our 2016 audit monitoring activities.

The results of our monitoring reviews show a similar picture to 2015, with a significant majority of our visits showing positive results.

2016 saw some significant developments. We saw audits of financial statements completed under FRS102 for the first time, with largely encouraging results. However, there are some learning points for firms and we cover these in detail later in this report. International Education Standard 8 (IES8) came into effect in July 2016, which created more precise requirements for the competence of responsible individuals. The auditing and ethical standards have also been revised, although we will not see these in practice until later in 2017.

The new Audit Regulation and Directive (ARD) (effective from June 2016) led to some changes in the split of work between ourselves and the Financial Reporting Council (FRC). A significant number of large private company audits have come back into our scope, and the FRC is now directly responsible for all audits of Public Interest Entities (PIEs). We reviewed a number of these large private company audits at the largest firms in 2016, and the results will be reported in 2018 as our visits to these firms were completed in 2017.

We also made some adjustments to selecting firms for visit in response to the ARD. These are effective from 2017. The ARD and the FRC make it clear that RSBs should now take a risk-based approach to selecting firms for their next visit as part of an overall objective of supporting and improving audit quality and should not, for instance, default to a six-year visit cycle (the maximum period allowed). We fully support this approach. For some years we have been visiting the largest firms every year, and other firms with listed audit clients every three years. Many firms already on a shorter visit cycle (for example large firms or those firms with AIM listed clients in our remit) find the more regular visit contact very helpful. Additionally, firms that were the subject of a detailed report to the Audit Registration Committee (ARC) following their last visit have been revisited after three years.

We will now visit some additional firms more often, after approximately three years rather than every six years. These firms include those with significant audit practices where it is likely there will be more public interest. We will also go back sooner to any firms that were required to submit evidence of improvement in audit quality after their last visit. Our experience shows that firms in this category can struggle to sustain improvements.

Six years is a long time between visits and much can change over that period. We have found that earlier onsite visits provide a better framework to help firms sustain improvements. They also provide an opportunity to discuss risks and other topical issues and to share experiences in areas such as new UK GAAP implementation and the revised auditing and ethical standards.

Our revised approach has been welcomed by the FRC and the ARC.

We continue to develop how we use annual return data and access information from other sources to identify potential risks. Therefore, we may select a small number of firms for visit outside of the normal three or six year cycle, or contact firms with specific enquiries from time to time.

The Companies Act 2006 requires recognised supervisory bodies (RSBs) to license and monitor statutory audit. ICAEW is the largest RSB in the UK; we register over 3,000 audit firms.

We are responsible for monitoring firm-wide procedures at all our firms except for those with audits of PIEs whose firm-wide procedures are monitored by the Audit Quality Review (AQR) team of the FRC.

Reviews in 2016

We completed 662 audit monitoring reviews in 2016, 654 as a UK RSB and 8 under the Crown Dependencies' recognised auditor oversight regime.

On the visits we completed, we reviewed 994 audits, including 37 AIM and ISDX companies, 9 market-traded entities (under the Crown Dependencies regime), 157 charities, 21 pension schemes and 58 companies that applied FRS102 for the first time. We found that 76% of these audits were either satisfactory or generally acceptable, 17% required improvement and 7% required significant improvement. These percentages are unchanged from 2015, although a higher proportion of audits were satisfactory; 31% in 2016 compared with 26% in 2015. So, while audit quality has remained consistent overall, there is some good progress at the upper end, but still room for improvement.

We reviewed limited aspects of a further 148 audits and 228 engagements completed under the Solicitors' Regulation Authority (SRA) Accounts Rules that require registered auditor status.

Audit quality is fairly similar across the different types of audit that we review. 76% of AIM and ISDX companies and 75% of charities that we reviewed in 2016 were either satisfactory or generally acceptable.

This is a slightly better picture than for other non-specialist private companies – 69% of these audits were either satisfactory or generally acceptable.

Market-traded entities are a small population but it is worth noting that eight out of the nine files we reviewed (89%) were either satisfactory or generally acceptable.

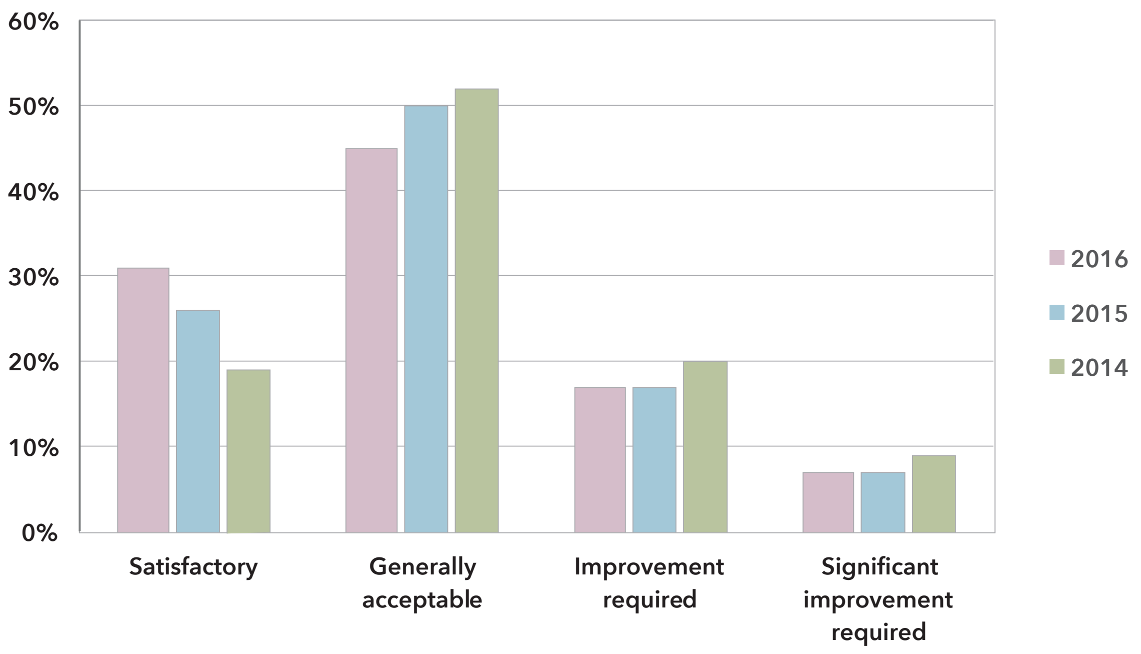
Audits needing improvement

So, what are the factors that lead to our conclusion that improvements are required on an audit?

AIM and ISDX

We identified nine audits of these publicly-traded companies that needed improvement in 2016. On two of these audits our concerns related to the financial statements; in one case the disclosure of liabilities and in the other a more technical issue relating to the new UK accounting framework. On one audit we had significant concerns about the independence of a component auditor relied on by the group auditor.

Weaknesses in the other six audits related to evidence or the documentation of audit work. The principal areas of concern were the audit of intangibles and impairment, and work on revenue and expenses.



These audits always require a second partner, or EQCR. We sometimes question the involvement that this individual has had in the review of audit strategy, and the extent to which they considered evidence in the key risk areas of the audit where we also focus our reviews.

Charities
We concluded that 40 of the 157 charity audit files we reviewed required improvement. Our principal concerns on most of these files related to a lack of audit evidence. Some of these issues relate to the particular circumstances of charities, with several issues around the valuation and ownership of properties and historic assets, and audit evidence over the designation and use of restricted funds.

Other private companies
24% of the audits of private companies we reviewed required improvement and 7% needed significant improvement. Over half of the audits needing significant improvement showed extensive weaknesses throughout the audit file. Some of these firms are no longer registered to do audits, but those that are needed to commit to significant training and external assistance to bring the quality of their work up to a reasonable standard.

In other cases, the issues were more isolated. Areas for firms to pay attention to are:

- **Revenue**
  A presumed audit risk and typically the largest figure in financial statements. Firms sometimes focus on trade debtors and rely on untested client IT systems instead of planning and conducting appropriate audit work.
- **Stock**
  One of the more difficult balance sheet assets to audit. It is necessary to attend stocktakes and do appropriate work on completeness, existence, book and net realisable value.
- **Tangible and intangible assets**
  Valuations often need particular focus in the audit as they are accounting estimates that require judgement and can be susceptible to manipulation.
- **Group audits**
  Auditors need to pay enough attention to significant components in a group audit situation. Information from a component auditor must be sufficient to support the group audit opinion, or the group auditor may need to do additional work itself.

Finally, irrespective of the apparent quality of audit work, ethical issues can cast significant doubt over the quality of an audit opinion, and we saw a few cases where fee dependency, business and other relationships with an audit client meant that the auditor was not sufficiently independent.

Market-traded entities
One market-traded entity that we reviewed under the Crown Dependencies regime needed significant improvement. This was an unusual case where the audit team had not concluded appropriately on unadjusted errors during the audit. Following our review and its own further investigation, the firm concluded there had been a flaw in its approach to assessing the materiality of the unadjusted errors. This led to the need for further work to more accurately assess the potential misstatement.

For more information on the common findings from our audit monitoring reviews, see our new series of short webcasts available in the useful resources section on icaew.com/auditguidance

Focus on FRS102

The implementation of new UK GAAP is one of the biggest technical challenges faced by accounts preparers in the UK for many years. Given the timing, only a very small proportion of our reviews covered audits of financial statements prepared under FRS102. Results of these reviews were generally reasonable, although we found a number of cases where documentation relating to the impact of transition was weak. In order to obtain some further evidence about implementation, we carried out an additional desktop review of a substantial sample of audited financial statements filed at Companies House. Our review was limited as we did not have access to the audit files, but on the whole our reviews yielded encouraging results. In a clear majority of cases, we raised no or only minor queries. However, our onsite and desktop reviews have identified a number of problem areas which we outline in this section.

We recommend your firm watches out for these points.

1 **Primary statements**
In some cases the totals in the Statement of Financial Position, Total Comprehensive Income Statement and the Statement of Changes in Equity (SOCIE) don't tie up. We have also seen errors in presentation of non-controlling interests (NCI), and some cases where there was no disclosure of NCI where it would have been relevant.

Be careful to ensure transactions are presented in the right place in the right statement. We have seen misclassifications between profit or loss, other comprehensive income, and equity.

2 **Accounting policy disclosures**
Generally we find that good accounting policy disclosures are more detailed under FRS102. At one end of the scale we have seen accounting policies that are largely unchanged from the previous audit year. At the other end, the policies were often up to date but sometimes incomplete. On transition firms should review the impact of FRS102 on accounting policies, ideally on a line by line basis. Also, remember to ask exploratory questions and look out for the indicators where accounting policy changes are more likely, such as business combinations and goodwill, financial instruments, investment property and deferred tax.

3 **Transition disclosures**
Many entities have no transition adjustments, although the impact of FRS102 is not always clearly disclosed. If there are no transition adjustments it is good practice to state this fact.

Better disclosure is sometimes needed where entities have numerous or complex transition adjustments. The disclosure also needs to separately explain any errors identified and corrected as part of the transition.

4 Financial instruments (including financing transactions and derivatives)

Disclosure around financial instruments often needs some improvement, despite our observation that most private companies appear to have only basic financial instruments to contend with.

In particular, disclosures around long-term debt terms often need enhancing to include details of interest rate, maturity, repayment schedule and any associated restrictions the debt places on the entity.

Financing transactions are a new concept which some firms are struggling with, although these transactions are fairly common in private entities. We sometimes have doubts about the presentation or the measurement of loans due to directors or group companies with no (or low) interest rates, which usually fit the definition. Firms should be challenging presentation of such loans as long term, when there is no formal written agreement setting out a repayment schedule at the year end.

We have not seen many examples of discounting, where loans (including financing transactions) are treated as long term. The impact is often argued to be immaterial, although we suspect that difficulty with the calculations is also a factor.

We occasionally come across derivative financial instruments in private entities, for which recognition is mandatory in UK GAAP for the first time under FRS102. These are mostly forward currency contracts. When no derivatives are recognised, it's not always clear whether this is appropriate, either because the disclosures need enhancing, or because the firm may not have asked all the right questions and needs to gain a better understanding of its client.

5 Business combinations and goodwill

Some improvements are needed in goodwill disclosures. Useful life needs to be disclosed along with the reason for choosing that period. Disclosure of the reason was often missing when particularly important, because the useful life exceeded 10 years.

Some entities continued to assume that goodwill has an indefinite useful life (despite this no longer being permitted), disclosing this as a departure from FRS102. It is difficult to see that departure from the requirement to amortise goodwill is justified, particularly when no reason is disclosed.

Disclosures relating to business combinations are sometimes very weak. Detailed disclosure requirements omitted include the:

- name/description of combining entities;
- date of acquisition;
- percentage of voting instruments obtained;
- cost of combination; and
- amounts of assets and liabilities acquired.

There is little recognition of other intangibles as a result of business combinations. Restatement of business combinations in the year before first time adoption (post transition date) is also rare. We sometimes have doubts about the extent of firms' enquiries and review of current and prior year business combinations to identify possible other intangible assets.

We have come across some significant errors in recognition of goodwill. Some firms did not know that UK GAAP no longer permits goodwill to be adjusted when an entity increases or decreases its stake in a subsidiary, where there is no change in control (ie, when the other entity was a subsidiary both before and after the transaction). Any such transactions in the year before first time adoption (post transition date) should give rise to a transition adjustment. The difference between cost/proceeds and share of net assets acquired/disposed, which could have been recognised as an addition or disposal of goodwill under old UK GAAP, is now recognised directly in equity.

6

Investment property and property, plant and equipment (PPE)

Gains and losses on investment property and PPE are sometimes incorrectly presented. Errors include taking investment property gains to Other Comprehensive Income rather than profit or loss and vice versa, in respect of PPE revaluations.

In some cases the disclosure around current accounting policy and transition was unclear where entities transitioned PPE using a past revaluation or fair value as deemed cost.

7

Deferred tax

Deferred tax was not always recognised on unrealised gains in investment property or PPE when it should have been. Deferred tax should be recognised on all timing differences between taxable profits and total comprehensive income. Any unrealised gains of this nature existing at the transition date would give rise to a transition adjustment.

We have also seen errors in presentation of the movement in the deferred tax provision. The deferred tax impact should be recognised as expense/income in the same component of total comprehensive income as the underlying transactions; with the exception of deferred tax arising on fair value adjustments as part of a business combination, in which case the goodwill is adjusted by the amount of deferred tax.

Underlying causes

Problems with implementation of FRS102 tend to stem primarily from weaknesses at a whole-firm level, including insufficient CPD, over-reliance on software and policies around preparation and review of financial statements.

While most firms we visited had undertaken FRS102-related CPD, in some cases further training is needed. This could be targeted on certain aspects, or a general refresher. Repetition of key messages in ongoing CPD helps them to sink in. Refresher training now should also pick up on the more recent developments in guidance and understanding of FRS102 throughout the profession.

Accounting software is an invaluable tool, but is not foolproof and can't do the whole job on its own. Some firms place too much reliance on their software, being quick to blame it for not picking up errors and omissions. Comments from firms often focused on problems with the latest updates, including software not prompting or automating the required primary statements or disclosures; mapping problems leading to presentation errors; and inflexible accounts formats. Firms that plan ahead and implement enhanced review procedures, for example on first time adoption accounts, and make full use of disclosure checklists, have more chance of identifying problems at an early stage.

In some cases, the questions we've asked have highlighted the need for firms to obtain a better understanding of their clients. This means asking the right questions to ensure all the appropriate items are identified and recognised in the accounts. Knowing what questions to ask ties in with CPD and familiarity with the standard.

In a small number of cases, we were very concerned to see that firms had prepared the accounts but had not adopted FRS102 when they should have done. Some of these cases were a result of misinterpreting the revisions to the accounts regulations, Companies, Partnerships and Group (Accounts and Reports) Regulations 2015 (SI 2015/980). The interaction between these regulations and FRS102 can be confusing. For example, companies that were previously medium-sized might be able to take advantage of the small companies regime by early adopting the new size criteria (effective 1 January 2016), but they would also need to early adopt FRS102 (September 2015).

And finally, if mistakes are made, it's important to learn from them. Identification of root causes is an essential part of the process and this helps ensure the same mistakes aren't repeated. A software weakness is unlikely to be the whole story.

Regulatory action

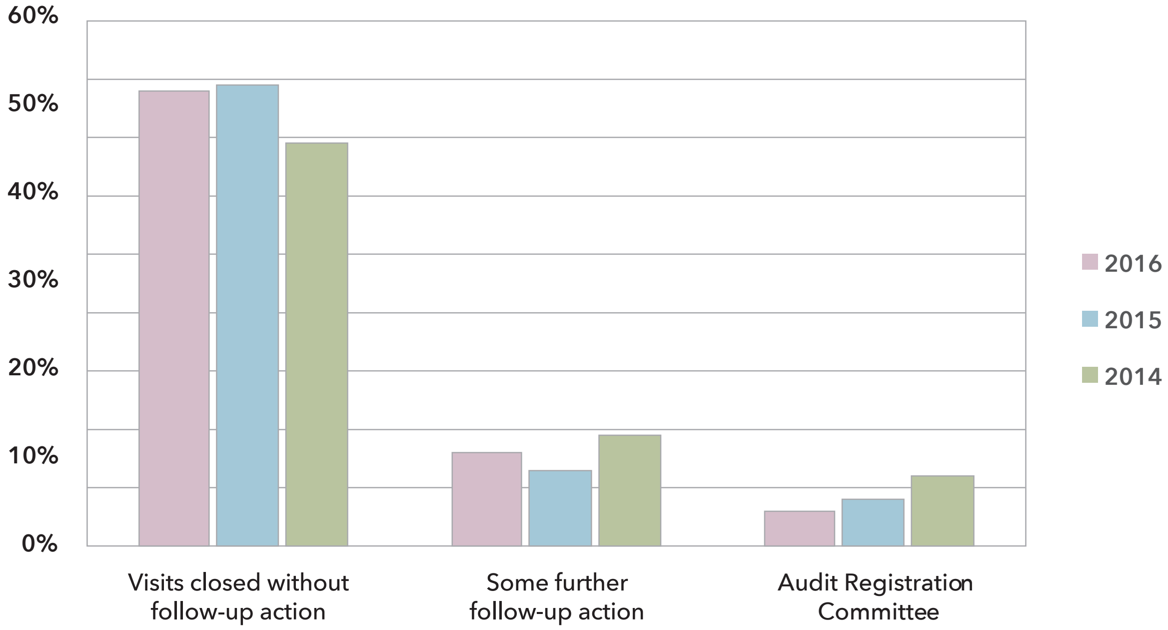
Consistent with previous years, we concluded the vast majority of our visits without any further regulatory action. The results of our reviews in 2016 indicate a similar position with a small shift between the categories of firms requiring some further action.

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 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.



Actions the ARC took in 2016

(figures include some visits carried out in 2015)

	2016	2015
Registration withdrawn	4	4
Firms where conditions and restrictions imposed	18	24
Firms where conditions imposed	16	18
Voluntary withdrawal accepted after an adverse monitoring visit	2	3

The ARC imposed 19 regulatory penalties on firms in 2016. Most of these penalties related to quality control procedures, independence or eligibility issues. This is a significant reduction from 2015 when there were 37 regulatory penalties. In 2016 we saw fewer issues with independence and eligibility and we hope this continues.

The ARC highlights changes relevant to audit firms and any emerging concerns in *Audit News*.

Topics covered in recent issues include:

Audit News 57, June 2016:

- changes to the audit regulations
- new responsible individual application form
- ATOL reporting

Audit News 58, November 2016:

- International Education Standard 8
- FRC monitoring of PIE auditors
- timing of monitoring visits under the new ARD regime

Audit News 59, March 2017:

- the new Audit Regulations
- auditing framework for Ireland
- improving audit quality using root cause analysis

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