Inspect the results

AUDIT MONITORING 2019
Improving the quality of audits

Audit is in the spotlight more than ever. Following recent high profile corporate failures, questions about the effectiveness and role of the auditor resulted in the launch of the Kingman Review, a Competition and Markets Authority investigation and the Brydon Review.

Our role as the UK's largest recognised supervisory body (RSB) and your firm's role as an auditor is to ensure the standard of audit work remains high. This helps to protect the interests of the public.

Our philosophy is to be a robust, proportionate and transparent regulator, and at the same time offer help and support where appropriate. To find out more about our audit quality monitoring review process please visit icaew.com/auditguidance

As in previous years, a significant majority of our monitoring reviews show positive results. This is good to see, but we are not complacent. We are keen to see improvements, in particular, to reduce the number of audits that need significant improvement.

Using insights from audit quality monitoring reviews during the last 12 months – from the Big Four to sole practitioners – this report highlights areas to improve ahead of your next ICAEW monitoring review.

As well as looking at the most common areas for improvement (our ‘top 10’), we take a closer look at three very key audit areas: revenue, going concern and group audits. We highlight some examples of good practice in these areas as well as points for improvement.

You will also find a comprehensive guide to the many resources available to you as an ICAEW registered audit firm, which includes our series of Insights from audit monitoring webcasts and Audit News, your regulatory update containing the latest audit and assurance technical guidance and best practice advice. A full list of the audit-related resources available from ICAEW appears on pages 11 and 12.

We hope your firm is able to use this report and these resources to focus on best practice and maintain a high standard of audit work.
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Audit quality in 2018

In this section we look at the results of our audit file reviews.

HOW WE CLASSIFY THE RESULTS OF OUR AUDIT FILE REVIEWS

• Satisfactory audits: we have no concerns about audit quality although we may identify some minor improvement points.

• Acceptable audits: we have limited concerns in relatively isolated areas. Firms should aim for all their audits to be at least acceptable.

• Audits needing improvement: these may have more gaps or weaknesses in evidence, or more widespread weaknesses in documentation.

• Audits needing significant improvement: we have significant concerns over the adequacy or appropriateness of audit evidence or judgements in one key area, or multiple issues across several different areas. This doesn’t mean the audit opinion was incorrect, although there may be some instances where we think that could be the case.

Audits needing improvement or significant improvement are likely to attract some strong follow-up action unless firms can demonstrate these are isolated examples and that they have taken appropriate steps to understand root causes and prevent recurrence.

The chart shows that audit quality continues to be acceptable or better on a good majority of the audits we review. However, around a quarter of audits are not as good as they should be and we are keen to see an improvement in the overall profile.

The picture is similar across different types of audit client, except for pension schemes. A higher percentage of pension scheme audits required significant improvement (13%) than for other categories. The weakest pension scheme audits were performed by firms that had failed to recognise the specialist knowledge required and had not invested sufficiently in training and tailored procedures. Typically these firms have very few pension scheme audits. Firms that use specialist pension scheme teams generally produce good quality work.
**2018 overview**

**AUDIT MONITORING REVIEWS:** +590

- **353** visits to smaller firms with no obvious risks
- **35** desk top reviews for audit registered firms with no statutory audits
- **72** visits to large/medium firms with either audit clients listed on AIM or substantial audit client portfolios
- **134** visits to firms subject to follow-up action due to weaknesses in audit quality at the previous visit.

**VISIT RESULTS**

<table>
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<th>%</th>
<th>Visits closed without follow-up action</th>
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**CROWN DEPENDENCY VISIT NUMBERS:** 7

- No issues requiring follow-up action (3)
- No market-traded entities (3)
- Significant improvement required (1)*

* In this case, we found a range of issues requiring ARC’s consideration.
  
  - The market-traded entity audit we reviewed needed significant improvement.
  - Gaps in audit evidence and an independence issue the firm had not identified and concluded that the engagement quality control review process was ineffective.
  - The audit had not been subject to cold file review within the required timescale (each market-traded entity audit should be subject to cold review every three years under the Crown Dependency Audit Rules).
TOP 10
- our most common findings

We link all of our findings on audit quality back to auditing standards. Below are the top 10, starting with the two most common areas; audit evidence (ISA 500) and documentation (ISA 230). We found audit evidence issues on just over half the audits we reviewed, and documentation issues on just under a third. These are by far the most common types of issues, with findings falling under the other eight auditing standards listed arising on around 10% or fewer audits.

The seriousness of the finding will depend on the context and the impact on the audit. Many findings will not be the source of significant concern about the audit overall; for example, some of these findings can occur in audits assessed as acceptable.

1. AUDIT EVIDENCE (ISA 500)
The most common significant area of weakness on audit files we review, in particular: revenue testing, fixed assets, stock and work in progress, and other areas of professional judgement such as goodwill and other intangibles. See our Focus on revenue on page 6.

2. AUDIT DOCUMENTATION (ISA 230)
Significant issues with documentation arise when firms have not recorded important aspects of their audit work on key assertions in material areas, or key areas of judgement. We also sometimes find that key working papers have not been attached to electronic files, or that electronic files are not archived on a timely basis.

3. IDENTIFYING AND ASSESSING RISK (ISA 315)
We cannot always see how well the auditor understands the client’s business and activities or that the required design and implementation testing has been done. We also sometimes identify apparently significant risks not identified as such by the firm.

4. AUDIT SAMPLING (ISA 530)
Audit sampling should reflect the materiality and risk of the relevant balance or class of transactions. Samples are sometimes taken from a restricted population, for example overdue trade debtors, with no testing of the – possibly lower risk, but very material – trade debtors within credit terms at the year end.

Firms sometimes reduce sample sizes for controls reliance or substantive analytical procedures without carrying out the appropriate testing to justify it.

5. AUDITOR’S RESPONSIBILITY RELATING TO FRAUD (ISA 240)
There is sometimes no evidence of discussion about fraud with management or consideration within the engagement team discussion. We also raise a number of points on testing of journals to address the risk of management override. Sometimes audit teams incorrectly rebut the risk of management override. The risk of fraud in revenue recognition is also sometimes rebutted without a strong enough justification.
In areas other than the auditing standards, we raise a significant number of points on financial statement presentation and disclosure which firms haven’t identified. We report the most significant of these to the Audit Registration Committee (ARC). We found issues in this area on around 14% of audits we reviewed.

We also raise a number of issues relating to compliance with the FRC Ethical Standard 2016, although many of these will involve a lack of clear analysis of threats and safeguards, often amounting to a documentation weakness, rather than more serious ethical issues.

6. GOING CONCERN (ISA 570)
For many profitable and financially sound businesses, going concern may not be a particular risk; however in other cases, judgements can be difficult making this a high risk area. See our Focus on going concern on page 6.

7. SPECIAL CONSIDERATIONS - AUDITS OF GROUP FINANCIAL STATEMENTS (ISA 600)
Group audits can present major challenges to firms, especially when there are overseas components and where the firm lacks experience in dealing with these situations. See our Focus on group audits on page 7.

8. AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION (ISA 402)
Firms sometimes place reliance on service organisations without going through the required steps. Firms do not always identify all relevant service organisations at the outset, and sometimes there is no evidence of consideration at the planning stage. Firms sometimes obtain controls reports from third parties but do little more than place them on the audit file. A number of our findings in this area relate to pension scheme audits.

9. RELATED PARTIES (ISA 550)
Our most common finding in this area is a lack of evidence that the firm has made appropriate enquiries of those charged with governance. We may be convinced from our discussions that the firm has sufficient knowledge of the relevant parties to assess risk, but the audit file does not always demonstrate this. We sometimes identify related party transactions from documentation on the audit file that the firm has failed to identify and which are not disclosed in the financial statements.

10. WRITTEN REPRESENTATIONS (ISA 580)
Firms do not always obtain all the required representations. This may be because they haven’t used a standard template or because they have deleted some items without realising they were specifically required by auditing standards.
In this section we focus on three key areas of the audit. We highlight some examples of good practice and areas for improvement. Poor audit work in these areas can seriously undermine the audit.

1. FOCUS ON REVENUE

Revenue is a key area in many of the audits we review.

Good practice
We have seen some very good audit work in this area, including:

• strong testing of design and implementation of controls over revenue, with a thoughtful approach to potential risks and good mapping of risks to controls;
• good use of data analytics; and
• effective testing of all relevant assertions, going beyond those where they have identified a significant risk.

Improvement points
Many of the points we raise on adequacy of audit evidence relate to revenue. Here are some common examples.

• Firms do not always test the completeness assertion when appropriate. This may be because they didn’t carry out a planned test in the way it was designed, or because the test design was flawed, for example because it tested back from the accounting records rather than forwards from outside the accounting system.

Sometimes completeness is not assessed as a risk. This may be justified, but sometimes we consider the assessment is inappropriate given the nature of the business.

• Firms do not always test all material income streams. The audit team may not have identified a new income stream at the planning stage, and so have planned to carry out the same tests as the previous year. Or they may have tested the most significant income streams, leaving a smaller, but nevertheless material income stream untested.

• Use of substantive analytical procedures can provide very persuasive evidence if done well, but firms do not always apply sufficient rigour or work through all the required steps. Sometimes expectations are set which are not precise enough in the light of the materiality level, and sometimes we find flaws in the logic applied in setting expectations. Firms sometimes use data provided by the client to set expectations without testing its reliability.

Firms do not always properly explore differences that exceed thresholds; sometimes explanations from management are accepted without corroborating them. It can sometimes appear that there is too much focus on making the test work rather than carrying out a robust independent check.

• Auditing of revenue from construction contracts is often challenging because of the judgements involved. If audit teams are not experienced in auditing such businesses they sometimes fail to tailor their approach sufficiently to reflect the way that revenue is recognised and end up with a fragmented approach as a result.

With IFRS 15 now in place (for periods beginning on/after 1 January 2018) bringing more prescriptive rules for revenue recognition, firms need to pay extra attention to ensure their clients’ accounting policies are appropriate.
2. FOCUS ON GOING CONCERN

Against the backdrop of economic uncertainty due to Brexit and other factors, going concern continues to be a crucial audit area. It can also be a challenging area due to the judgement and inherent uncertainties involved.

**Good practice**

We have seen some very strong auditing in this area, for instance:

- very strong challenge of management’s assumptions;
- detailed sensitivity analysis on forecasts;
- thorough documentation of thought processes supporting conclusions, for example in the form of a formal detailed memorandum; and
- successfully persuading the client to include additional disclosures on going concern in the financial statements.

**Improvement points**

Firms do not always give this area enough attention, with either inadequate testing or showing insufficient scepticism, or with documentation failing to demonstrate the challenge that may have taken place.

Here are some examples.

- Lack of evidence to show that management has looked ahead for the required period of 12 months from the date of approval of the financial statements. Sometimes firms explain that the client does not have formalised forecasts, but do not explore what alternative less formal evidence may be available.
- Audit files may contain copies of detailed forecasts, but no evidence of review or analysis by the audit team.

- When the financial statements show significant net liabilities or net current liabilities, with perhaps losses to date, assessment of going concern can sometimes be rudimentary. Sometimes firms accept management’s high level profit forecasts, with no cash flow forecasts and no detailed work.
- The audit file may refer to relying on ongoing support from shareholders, or a group company. There may be no request for confirmation of that support, or no consideration of whether the relevant individual or company has sufficient resources to provide the support needed.
- Our discussions with responsible individuals (RIs) may give us some confidence that they have considered going concern carefully and have a very good understanding of the client’s business and industry risks. However, the audit file may not demonstrate this level of consideration.

In the light of high profile corporate failures, stronger requirements for the audit of going concern are on the way. The FRC recently released a consultation paper setting out the need for robust challenge and evaluation of management bias, more transparent reporting and a ‘stand back’ requirement to consider both corroborative and contradictory evidence.
3. FOCUS ON GROUP AUDITS

Not all firms are experienced in auditing groups, and some will never have tackled the audit of a group with overseas components where they need to rely on component auditors. ISA 600 contains requirements to ensure the group auditor takes responsibility for the group audit opinion, requiring the group auditor to obtain a proper understanding of the group and to carry out sufficient procedures of its own. This includes the need to review the working papers of component auditors if relying on that work for the purpose of the group audit.

Good practice
Proper planning is clearly essential where component auditors are involved. We have seen some particularly good examples where the audit file contained a detailed analysis and assessment of components, setting out a clear strategy for significant and other components. We have also seen good examples where firms have reviewed the working papers of the auditors for all significant components, and made informative notes to support this review process.

Improvement points
We have found some significant weaknesses in audits of groups, especially where firms are not experienced in dealing with them. Here are some examples where work has fallen short of the requirements.

• Some audit files did not include details of the group structure or any analysis of components, or there was no evidence of consideration at the planning stage of the approach to components.
• We have come across significant components that were not identified as such.
• In some cases the firm relied on consolidation questionnaires alone, with no review of component auditor working papers for significant components. In one extreme situation, all of the group’s activities were within the components.
• Other problems with communications include:
  − a case where group audit instructions and questionnaires were sent to component auditors too late to be effective;
  − a case where completed questionnaires were not received for all relevant components with no consideration of the implications or alternative procedures;
  − in some cases completed questionnaires are put on the audit file with no evidence of review or follow-up of issues or outstanding points.
• We have noted a lack of evidence of consideration of differences where components have applied non-UK GAAP, and sometimes found working papers provided by component auditors in a foreign language with no translation.
• We have come across instances where the materiality level for a component exceeds that for the group, and sometimes no materiality level was set for the group.
• Sometimes there was a lack of evidence of testing the consolidation process.

Firms can expect to end up with difficulties if they take on audits with overseas components without ensuring they have the appropriate skills and resources. Or without exploring the potential pitfalls, including, for instance, any potential lack of cooperation by component auditors or other restrictions.
Overall visit outcomes for 2018 and committee actions

Our overall visit outcomes reflect our conclusions on both whole-firm procedures and reviews of audit files, the quality of the firm’s response and our assessment of their commitment and ability to address our findings. They do not, therefore, represent a pure measure of audit quality, although there is some correlation with our audit file review results (above).

We had no major concerns on the majority of our visits. However, some form of follow-up action was needed in just over a quarter of cases. In around 10% of cases, the issues were significant enough to report to the Audit Registration Committee (ARC) for consideration of regulatory action.

POOR AUDIT QUALITY IS THE MAIN REASON FOR REGULATORY ACTION

As in previous years, most of our reports to the ARC reflected significant weaknesses in audit work, often combined with ineffective internal cold file review processes. These firms must submit evidence of improvement, and in some cases are restricted from taking on new audits without prior permission.

Firms that previously needed follow-up action for poor audit quality may make the required improvements in the short term but can be at risk of slipping back. We therefore go back to see these firms more often. In a number of these cases we have seen firms making significant improvements as a result of external assistance in the form of hot or cold file reviews.

The two case studies on page 10 illustrate how the regulatory process works constructively to help bring firms up to the required standard.

MORE VIGILANCE NEEDED IN OTHER AREAS

Other areas of non-compliance or other risks include:

- Serious independence/ethical matters (not necessarily linked to poor work) – for example, principals or persons closely associated with them holding shares in audit clients, and fee dependency issues.
- Breaches of the eligibility requirements – for example, a firm that appoints a new principal who isn’t an ICAEW, ICAS, CAI or ACCA member, or a registered auditor, without applying for affiliate status.
- Errors in a firm’s annual return which are deemed to be misleading.
- Misplaced audit files/audit files not made available to ICAEW for review.

These are the sort of issues that attract regulatory penalties. In 2018 we saw a significant increase in the number of firms falling foul of the independence and eligibility rules, and the requirements for audit compliance reviews/cold file reviews, so firms need to be particularly vigilant in these areas.

HOW TO AVOID THESE PROBLEMS

- Our webcast on ethical standards at icaew.com/auditguidance provides useful insights into common independence issues.
- We recommend you read the Audit Regulations carefully to check eligibility requirements.
- Please remember to notify us promptly of any changes in principals or structure.
- The ARC highlights changes relevant to audit firms and any emerging concerns in Audit News. The current and previous issues of Audit News are available at icaew.com/auditnews

If your firm has any questions about requirements, please do not hesitate to contact us.
CASE STUDY: FIRM WITH THREE RIs

We recently visited a firm we’d previously visited three years before. The firm has around 30 audit clients, mainly owner-managed businesses and a number of charities.

Our previous visit
At the previous visit we’d found extensive weaknesses in audit work, especially on the firm’s charity audits where the RI did not appear to have been sufficiently involved. The firm’s cold file reviews had raised similar issues some time before our visit, but the firm had not taken any specific action to address them. In response to our visit, the firm put together an action plan including second partner hot reviews and additional training. The ARC noted the firm’s positive plans but was concerned that it hadn’t acted sooner. It imposed a condition requiring the firm to have external cold file reviews, to be performed by a training provider or equivalent, and to submit the results.

Follow-up process
The firm submitted the results of its first round of external cold reviews within six months, including a review of a charity. The results showed some improvement but we considered there was still some way to go. We therefore asked the firm to submit the results of further reviews which it did nine months later. The results of this second round of reviews showed better grades. There were still areas for improvement, but, with a positive response and action plan from the firm, we were satisfied the firm had made sufficient progress to release it from the condition. We were pleased the firm had decided voluntarily to continue to have external reviews.

Our next visit
We found the audit work to be of much better quality compared with our previous visit. Although it was not perfect, we saw the positive impact of the continuing second partner and external cold file reviews. The firm had made a significant investment in training, especially in the charity sector. The three RIs responded very positively to our visit and the firm put together a comprehensive action plan which covered all, including the more minor points we raised. The firm had clearly demonstrated its commitment and ability in addressing the matters from our previous visit and subsequent cold file reviews. We were therefore happy to conclude that the firm’s audit registration should be continued with no need for further follow-up action.

CASE STUDY: SOLE PRACTITIONER

During a visit in 2011, we found some significant documentation weaknesses and the firm was required to submit the results of external cold file reviews.

The results of these reviews continued to show similar weaknesses in documentation, so we went back to visit in 2015. We concluded that the external cold file reviews had not been effective, and the committee imposed a condition for hot file reviews and restricted the firm from taking on new audits without prior approval. A hot file review safeguards the quality of the audit as it takes place before the audit report is signed.

We recently returned to the firm and found a significant improvement in the quality of documentation. As well as providing a safeguard, the hot review process had provided more timely feedback than the cold review process and had been more effective in helping the practitioner understand the level of documentation required. We were able to recommend lifting all conditions and restrictions.
ICA EW audit resources

As well as our monitoring work and this report, there is a wealth of audit support and guidance available to your firm. Here’s a guide to some of these resources.

INSIGHTS FROM AUDIT MONITORING WEBCASTS
For more information on the findings from our audit monitoring reviews, together with tips for avoiding pitfalls, watch our Insights from audit monitoring webcasts available at icaew.com/auditguidance
- Ethical Standards
- Group audits
- Audit compliance review
- Accounting estimates, valuations, impairment and the use of experts
- Audit work on internal controls
- FRS102 implementation
- Internal controls
- Fraud
- Substantive testing - substantive analytical review and tests of detail.
These short webcasts were developed and presented by our reviewers who have first-hand experience of visiting firms of all sizes.

AUDIT REGULATIONS AND GUIDANCE
Regulations and guidance for those working in the regulated area of audit in the UK, Ireland and the Crown Dependencies.

BREXIT
Find a range of resources to help prepare for Brexit, including technical guidance at icaew.com/brexit

UK GAAP
Access a wealth of information including free content at icaew.com/ukgaap

WITHOUT QUESTION
ICA EW’s second corporate training film, Without Question, provides an impactful and interactive way for audit firms to develop the whole audit team. The film explores the challenges audit teams face on a daily basis and the underestimated importance of effective communication.
Representatives from firms who used ICAEW’s first film (False Assurance) contributed to the development and script and this ensures the film focuses on current and real themes and topics that are seen as being important for their teams and clients to be aware of.
Set in a family business that seeks expansion, the audit scenario is accessible to firms of all sizes. The film highlights the importance of professional scepticism, a key skill for everyone from juniors through to audit partners and board members to have and continually develop. In addition, a tax storyline highlights risks to independence and objectivity, and the importance of appropriate safeguards and risk management policies. The growing influence of social media and its risks also features. To find out more about these films visit icaew.com/films

Audit News is your regulatory update containing the latest audit and assurance technical guidance and best practice advice. We email audit compliance principals and responsible individuals when a new issue of Audit News is available. Audit News is also available to all ICAEW members - please select the Audit and Assurance topic from your list of preferences and we will notify you by email when a new issue is available. The current and past issues of Audit News are also available at icaew.com/auditnews
TECHNICAL AND ETHICS ADVISORY SERVICES

Our Technical Advisory Service provides advice on a wide range of subjects, including accounting, company law, charities and auditing, but not taxation, which is dealt with through the ICAEW Tax and VAT helpline provided by Abbey Tax or TAXconnect. In addition to advice provided through the helplines, common topics are addressed in a series of helpsheets written by our technical advisers.

We advise on ethical dilemmas in both business and practice sectors, including providing guidance on interpretation and compliance with the Regulations, Standards and Guidance which incorporates the Code of Ethics, section 3.

Our helpline offers advice on all aspects of complying with the Money Laundering Legislation. Our advisers can answer calls on general issues concerning the regulations and reporting suspected illegal activity; and specific issues, which can be discussed anonymously.

Whatever your technical or ethical query, phone +44 (0)1908 248 250 for objective, confidential advice.

HELPSHEETS

Access technical helpsheets, ethical guidance and practice resources from ICAEW’s Technical Advisory Service at icaew.com/helpsheets

AUDIT AND ASSURANCE FACULTY

The Audit and Assurance Faculty is the professional and public interest voice of audit and assurance matters for ICAEW and a leading authority in its field. Internationally recognised as a source of expertise, the faculty influences regulation and standard setting and provides a range of resources to professionals. It also offers practical assistance in dealing with common audit and assurance problems. It is a major partner and supports the work of the Audit Quality Forum, runs the AuditFutures initiative and shows the value of the profession with its Audit Insights initiative. Subscribers gain access to the faculty’s webinar programme and receive 10 editions of the faculty’s magazine, Audit & Beyond. The faculty’s current areas of focus include UK audit reform and support on Brexit, as well as looking at developments in smaller entity audits and quality control. Join now at icaew.com/joinAAF

FINANCIAL REPORTING FACULTY

With significant changes on the horizon as a result of continuing developments in IFRS and UK GAAP, keeping up to date with the latest financial reporting changes is vital. The Financial Reporting Faculty (FRF) provides highly accessible and practical assistance on financial reporting issues to keep you informed. Members of FRF have full access to practical online guidance, career advancing webinars and events, exclusive use of our online factsheets, monthly ebulletins, the benefit of our bespoke accounting standards pages and biannual journal, By All Accounts. Faculty members also receive unlimited access to the IASB’s eIFRS service (normally £295pa). You can download the FRF app or follow us on Twitter @ICAEW_FRF.
Without Question provides an interesting and impactful way to highlight the challenges of directors and professional advisers seeking assurance on difficult issues, as well as the underestimated importance of effective communication.

With its focus on professional scepticism and everyday business challenges, Without Question is designed for use by firms and companies of all sizes, and all around the world.

To find out more about ICAEW films visit icaew.com/films
ICAEW's regulatory role is distinct from its representative role. Managed by our Professional Standards department, we protect the reputation of ICAEW, our members and the chartered accountancy profession. We ensure our students, members and firms act with integrity and are competent. Our role is to:

- authorise our members and firms to undertake work regulated by law: audit, local audit, investment business, insolvency work, and probate;
- monitor firms and insolvency practitioners to ensure they undertake work correctly and to the highest standards;
- investigate complaints and hold members and firms accountable where they fall short of standards;
- lobby and comment on proposed changes to the law and regulation affecting our stakeholders; and
- provide guidance, advice and award-winning training films to ensure our stakeholders comply with laws, regulations and professional standards.

There are over 1.8m chartered accountants and students around the world – talented, ethical and committed professionals who use their expertise to ensure we have a successful and sustainable future.

Over 180,000 of these are ICAEW Chartered Accountants and students. We train, develop and support each one of them so that they have the knowledge and values to help build local and global economies that are sustainable, accountable and fair.

We’ve been at the heart of the accountancy profession since we were founded in 1880 to ensure trust in business. We share our knowledge and insight with governments, regulators and business leaders worldwide as we believe accountancy is a force for positive economic change across the world.

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