Audit News – Winter 2021/22

All Responsible Individuals in your firm should receive a copy of Audit News by email. If this is not the case, please contact us, however, note that the most common issues are when:

- ICAS do not hold an up-to-date email address for the individual; or
- The individual has indicated elsewhere (such as on their own annual return) that they do not wish to receive email communications from ICAS; or
- Emails get caught in an anti-spam filter.

Note that the best way to ensure you receive all communications from ICAS is to give permission to the email that these communications come from (the vast majority come from update@update.icas.com). You can do this by:

- Adding us as a contact on Outlook and marking us as a safe sender.
- On Gmail, marking messages as 'Not Spam' when finding them as well as adding us as a contact.
- On Apple Mail, search for any messages in Junk, go to 'more' and mark as 'not junk'

Audit Monitoring update

2022 Audit Monitoring visits

From 1 October 2021, given the easing of lockdown restrictions, we have returned to conducting onsite visits. We will, however, look to maximise our time onsite and have made some changes to our approach to achieve this, including holding the opening meeting in advance of the visit by telephone or video call, and requesting more detailed pre-visit information to assist our planning process.

If an onsite visit is not possible because of a change in government guidance or if you have not yet returned to your office, your reviewer will discuss whether we can carry out a remote visit instead.

Please note that we are conscious of the difficulties that everyone is facing within the profession at the moment, however, are also required to ensure that our regulatory responsibilities are undertaken.

Mandatory audit quality course: Keeping Audit on the Right Track

This course aims to educate Audit Compliance Principals (ACPs) and Responsible Individuals (RIs) in developing a strong compliance function and preventing some of the recurring issues identified on audit monitoring visits. The COVID-19 pandemic, and related restrictions, resulted in the planned 2021 face to face courses being cancelled until further notice. Please note that in 2020, the Authorisations Committee ("the Committee") approved the following changes to the course, and to mandatory attendance going forward:

- A video recording of the course is available on the ICAS website, which is free for ICAS members and RIs to access any time they wish and is split into seven modules which can be viewed together or individually. The course material can be accessed (by logging into icas.com) at https://www.icas.com/regulation/regulatory-monitoring/keeping-audit-on-the-right-track

While only mandatory for RIs, we encourage all audit staff to view the course modules, and firms may find benefit in arranging group / team sessions to aide discussion and understanding.

- **Firms are reminded that the mandatory aspect of this course has been updated. All ACPs and RIs are now required to view all modules of the online course once every 2 years (commencing from 1 September 2020). In addition, all new RIs or newly active RIs must view all modules of the online course within 12 months of becoming active**.

- **We do not expect to present the mandatory course 'face-to-face' in 2022. The Committee considers that the availability of the course online will ensure that the mandatory aspect will be easily adhered to, and that this will maintain the focus on audit quality**. **Going forward, firms will be required to confirm adherence to the mandatory requirements via the Firm's Annual Return.**

2020 Audit Monitoring Annual Report

Our annual report for 2022 is available to download from icas.com (this can be found here or by searching for 'annual report on monitoring activities').

As in previous years, this report aims to provide transparency over our work and includes:
- An overview of the activities of ICAS Audit Monitoring during 2020; and
- Key messages and detailed findings arising from monitoring visits.

Whilst we identified a number of areas where audit firms had improved against previous findings, 2019 proved to be another challenging year for firms, particularly with ongoing developments in the reporting and regulatory environments. As such, we have unfortunately seen that, for the second year, the Authorisation Committee has put more firms on follow-up than those it has not.

We hope that you find the report useful in considering how effectively your firm is complying with regulatory requirements. We encourage you to share the report with your colleagues, and also to utilise the key messages when conducting your own Audit Compliance Review process, and firms may find benefit in arranging group / team sessions to aide discussion and understanding. If you have any comments or questions, please contact us at auditandpracticemonitoring@icas.com

Changes to the ICAS file grading structure

A reported in our Spring 2020 edition of Audit News, the FRC have requested that all RSBs report file gradings to firms to facilitate trend analysis. The FRC considers that reporting each file grading will further clarify the significance and severity of key audit quality issues and will support each firm, and those Responsible Individuals (RIs) in measuring the improvement or deterioration of audit quality over time.

Any firm subject to an audit monitoring visit going forward will be provided, at the finalisation stage of the process, with grades for each file review conducted. These are based on the FRC's file grading structure which has recently changed from the previous system of 1/2A/2B/3 to

1/2/3/4 grades. Please note that the grading descriptions have also changed however the effective definition for each grading has not:

Grade	Description	Guidance
1	Good	• No concerns regarding the sufficiency and quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. • Only limited weaknesses in documentation of audit work. AND • Any concerns in other areas are limited in nature (both individually and collectively).
2	Limited improvements required	• Only limited concerns regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. AND/OR • Weaknesses in documentation of audit work are restricted to a small number of areas. AND/OR • Some concerns, assessed as less than significant (individually and collectively), in other areas.
3	Improvement required	• Some concerns, assessed as less than significant, regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. AND/OR • More widespread weaknesses in documentation of audit work. AND/OR • Significant concerns in other areas (individually or collectively).
4	Significant improvements required	• Significant concerns regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed (not limited to the documentation of the underlying thought processes). AND/OR • Very significant concerns in other areas (individually or collectively).

Compulsory ethics training for ICAS members – a reminder

You are reminded that in 2020, following a joint recommendation by the ICAS Ethics Board and ICAS Regulation Board, ICAS Council gave approval for compulsory ethics CPD to be introduced for all ICAS Members.

ICAS Council believes that the introduction of ethics CPD will serve as a reminder to Members of their ethical responsibilities and highlight the necessity to keep ethics at the forefront of their mind.

Note that this does not necessarily involve compulsory attendance at ethics courses, or the purchase of ethics material, and could simply involve some ethics-related reading which is freely available online including from ICAS ethics resources.

The Ethics CPD requirement was introduced with effect from 1 January 2021 with the first ethics CPD declaration of compliance sign-off being required in the 2022 Annual Return. As part of ongoing monitoring procedures, the ICAS Audit Monitoring team will review compliance with the requirements on all audit monitoring visits going forward.

Note that ICAS is adopting a revised Code of Ethics from 1 January 2022, incorporating revisions to promote the role and mindset expected of professional accountants.

In a recent webinar session, James Barbour CA, Director – Policy Leadership, discussed the changes being made to the Code, why they are necessary and how they might impact CAs working in business and practice. He also highlighted some of the resources that are available to help you meet your ethical obligations.

The webinar can be viewed at: https://www.icas.com/thought-leadership/events/ask-icas-webinar-episodes/9-december-ask-icas-code-of-ethics-changes-your-essential-update

For reference, some other examples of online ethics resources are noted below:

- ICAS ethics resources – ethics publications, guidance, news articles
- ICAS Code of Ethics and related articles and guidance, e.g., articles on changes to the Code
- ICAS The Power of One publications
- ICAS Speak up? Listen up? Whistleblow? research and webinar
- Other ICAS ethics research
- ICAS ethics case studies
- ICAS responses to ethics-related consultations
- International Ethics Standards Board for Accountants (IESBA) – news, meetings, consultations
- IFAC Knowledge Gateway – articles
- Financial Reporting Council – Ethical Standard, news, disciplinary cases
- Institute of Business Ethics – publications, events, webinars
- CCAB (Consultative Committee of Accountancy Bodies) – news, case studies

Financial Reporting Council (FRC) update

FRC report – what makes a good audit?

In 2021, almost 30% of audits reviewed by the FRC did not meet acceptable standards. With reference to the file grading structure above, this would comprise all files awarded a 3 or 4 grading by the FRC as part of their review process (under the previous grading structure this would be all files awarded a 2B or 3 grade).

The FRC has, for the first time, published a blueprint for what is required by UK audit firms to deliver high-quality audit, sufficient for investors, employees, pensioners and savers to rely on the performance and prospects of UK companies.

A new report from the Financial Reporting Council (FRC) has set out the key elements required by audit firms to ensure they are delivering high quality audit.

The FRC's report, What Makes a Good Audit?, highlights the attributes that the FRC considers essential to the running of high-quality audit practices. The FRC considers there are three key elements; risk assessment and planning; execution of the audit and completion and reporting. Delivery of the various aspects within these elements depends on a high performing audit practice. The FRC considers there are six elements to achieving this; assessing firm quality risks; mindset, culture, governance and leadership; performance monitoring and remediation; quality monitoring; resources (including recruitment and training) and information and communications. The paper sets out these nine elements, highlighting best practice the FRC has seen in each.

The FRC considers the paper relevant to audit in any sector (including the public sector) and that it should be used by the major firms to support their plans to improve audit quality; by challenger firms to help frame their considerations of audit quality as they move and/or expand into the PIE (or local audit) market; and by audit committees to support their engagement with their auditors.

FRC announces areas of supervisory focus for 2022/23

The Financial Reporting Council (FRC) has announced its areas of supervisory focus for 2022/23, including priority sectors, for corporate reporting reviews and audit quality inspections.

The FRC's Supervision programme of **audit quality inspections** will pay particular attention to areas of investor/public concern and/or heightened risk areas giving rise to recurring findings in audit inspections; findings of cross-firm Supervisory reviews; and findings arising from recent FRC Enforcement cases. Specifically:

- Climate-related risks
- Fraud risks
- Cash and cash flow statements
- Provisions and contingent liabilities
- Impairment of assets
- Revenue
- Group audits

These **priority sectors** are considered by the FRC to be higher risk, for corporate reporting and audit, by virtue of economic or other pressures

- Travel, Hospitality and Leisure
- Retail
- Construction and Materials
- Gas, Water and Multi-utilities

The FRC’s Supervision Corporate Reporting Review team will supplement its routine reviews of corporate reporting with six **thematic reviews**. These reviews will identify scope for improvement, as well as examples of better practice, in areas of key stakeholder interest:

- TCFD Reporting and Climate-related Reporting in Financial Statements
- Business Combinations (IFRS 3)
- Earnings per Share (IAS 33)
- Deferred Tax (IAS 12)
- Discount Rates
- Judgements and Estimates

The FRC will aim to stagger the work and release the findings, which may take a range of forms, over the course of the year.

FRC publishes latest developments in audit

The Financial Reporting Council (FRC) has published its latest edition of **Developments in Audit**, which sets out the FRC’s annual assessment of UK audit and ongoing expectations for how audit firms should deliver audit quality improvements to deliver a more effective audit market in the public interest.

In this edition, professional scepticism and challenge of management remain the two key areas where deficiencies continue and improvement still needs to be made.

FRC staff factsheet: climate-related matters

The FRC has issued a new FRC staff factsheet, *Climate-related matters*, part of a series that accompanies FRS 102.

Demand from stakeholders continues to increase the focus on how Environmental, Social and Governance (ESG) matters can affect companies' financial position and performance, and the associated risks that they face. This increased focus has led to legislation and guidance on the content of the narrative sections of the annual report, such as requiring disclosure of greenhouse gas emissions or providing information about emissions reduction strategies.

The factsheet notes that "for entities not currently captured by these legislative changes, stakeholders may differ but may still demand climate-related information, including to meet their own climate-related reporting needs (e.g., high street banks providing finance to small businesses)". The factsheet is therefore not specific to any particular size of entity but instead sets out information useful for any FRS 102-preparing entity needing to enhance its consideration of climate-related matters

This staff factsheet is a response to the commitments by the FRC to issue such guidance. Further developments in this field can be expected as this is a fast-moving agenda that has the potential to impact corporate reporting significantly in the future.

A link to the factsheet is available here.

Audit sampling – ISA (UK) 530

Audit sampling provides an efficient and practical audit approach, however there are inherent risks, where:

- **the sampling method used is not sufficiently robust or does not follow a risk-based approach in line with the ISA requirement;**
- **the sample is not representative of the entire population; or**
- **sample sizes have been reduced to an inappropriate level based on perceived comfort obtained elsewhere.**

ICAS Audit Monitoring have encountered a large number of issues on recent monitoring visits with regards to the documented justification of audit samples, and issues on some visits have been exasperated by changes to audit approach caused by the pandemic and remote auditing.

Common issues identified include:

- insufficient documentation of the sample size basis;
- using 'judgmental sampling', with no justification of the judgments taken, in particular where a 'standard' sample size has been used;
- sample 'capping' and 'flooring';
- a lack of support of the risk assessment as a contributing factor; and
- selecting items within a population due to accessibility.

In a number of instances these matters can be easily addressed by effectively using sampling plans or methodologies within a firm's audit programmes; ensuring that the samples are based on appropriate criteria and in line with the auditor's risk assessment; and recording this in sufficient detail on the audit file.

Where ICAS AM identify sampling issues, this often results in related evidence issues on the file. Unfortunately, in these circumstances, the matter is often systemic and will be replicated across a large number of files.

Inappropriate reliance on controls or substantive analytical review to reduce sample sizes

There have historically been a number of serious issues where firms have reduced sample sizes due to:

- placing reliance on controls, where tests of control have not actually been completed or sufficiently carried out; or
- placing reliance on substantive analytical review, where the extent of the analytical review is not sufficient to justify such an approach.

Often it is the case that this work has simply not been completed, often through a misunderstanding of when and how an auditor can rely on controls; and the definition and process of substantive analytical review under ISA (UK) 520.

In more marked cases, this has resulted in ICAS AM concluding that there is a lack of evidence over a particular balance or assertion, often impacting significant areas of testing such as completeness of income; and existence and validity of purchases.

<u>Reliance on internal controls</u>

Substantive testing may be reduced in some areas by placing reliance on internal controls, however in order to achieve this the auditor must perform an appropriate test to assess the operating effectiveness of the relevant control and determine whether the control has been properly designed to prevent or detect a material misstatement in the financial statements.

The more common types of controls selected for testing include authorisation of transactions; reconciliation procedures; and assessment of segregation of duties. ISA (UK) 530 provides a significant level of guidance regarding the determination of sample sizes, and the consideration of the impact of reliance from other areas of the audit engagement, including determination of tolerable misstatement; and the consideration of risk in determining whether a smaller or greater sample size is required.

Put simply:

a) There must be a formal control in place to test.
b) It must relate to a specific assertion over a balance or transaction stream being tested.
c) It must be tested sufficiently (i.e.; using an appropriate sample)

As noted, the control must be attributable to the assertion being tested, and this has caused a number of issues on files reviewed by the monitoring team – for example, where a firm has assumed a control designed to safeguard authorisation of a transaction also provides comfort or evidence over completeness of that transaction stream. Often, the monitoring team finds that, where controls testing has been utilised, testing of one control is used to inappropriately reduce the sample size across all assertions relating to that balance.

Common issue – where the auditor has completed walkthrough tests as part of systems confirmation work, often this is either assumed to represent a test of control or used to conclude that controls can be relied upon for the purposes of reducing sample sizes.

The monitoring team have also come across a number of instances where firms have treated a single 'walkthrough' test, conducted as part of the required risk assessment procedures under ISA (UK) 315, as giving sufficient assurance to inappropriately reduce substantive sample sizes, without any dedicated compliance/controls testing being conducted in accordance with ISA 530.

Under the ISAs neither approach is correct, and firms are reminded that work performed of this nature is solely to conclude over whether the system operates to the auditor's understanding and cannot be relied upon for the purpose of providing audit evidence.

<u>Reliance on substantive analytical review</u>

Analytical review can be a valuable substantive audit procedure; however, it can often be the case that the reviews performed by firms are not sufficient to meet the definition of substantive procedures and, as such, should not be relied upon for the purpose of reducing sample sizes.

As a brief reminder, in order for this review to be robust, there are considerations to be addressed by the audit team and a well performed analytical review will address the following key steps:

- Ensure the substantive analytical procedure planned is suitable for the specific assertions that are being tested.
- Build an expectation – this should be based on reliable data, and therefore if the firm uses last year's figures, then they should justify why they consider this to be reasonable and not to have fluctuated in any way.
- Compare with actual values – this will enable levels of variance to be determined and, if material, whether these should be investigated.
- Corroboration of explanations – once the difference has been quantified, these should be independently verified, including corroboration of management's explanations.

Without these steps the analytical review does not meet the definition of 'substantive' under the standard. Note that substantive analytical review, by its nature requires a significant amount of corroboration of management explanations, often by way of detailed testing which must be documented fully in line with ISA (UK) 230.

Common issues:
– where the auditor has completed the preliminary analytical review process or a basic variance analysis and assumed that this is either sufficient to reduce the sample size; or there has been a misunderstanding of the difference between preliminary analytical review (ISA (UK) 315) and substantive analytical procedures (ISA (UK) 520).

- where the auditor has completed a reasonable analytical procedure which does not give assurance over all relevant assertions and has then not performed dedicated testing over these omitted assertions (a frequent example on monitoring visits is where analytical procedures are conducted over payroll costs which do not address whether employees exist).

It is important to understand the role of analytical review through the audit process and how it impacts the risk assessment evidence gathering and financial statement review processes. ICAS AM recommends these areas as regular topics of revision in training plans of RIs and audit staff.

Standardised sample sizes – including sample capping and flooring

There are a number of internal and off-the-shelf sample methodologies which advocate standard sample sizes. These are most commonly:

- Use of a single standard number
- Setting a minimum sample for all tests (typically 10-15)
- Setting a maximum sample for all tests (typically 50-60)

Under ISA (UK) 530, sample size is affected by sample risk – basically the lower the risk the auditor is willing to accept, the higher the sample size will be. There is therefore a clear link with the risk assessment process.

Use of a single number is often noted within firm's own methodologies. Using one number across all tests is risky as it assumes a standard level of risk across all populations, and often the monitoring team has raised an issue where the same number is used to test a low-risk balance as a high-risk balance in the same set of financial statements.

Sample caps are noted frequently in off-the-shelf audit procedures. In a risk-based process, the use of sample caps can be difficult to justify where the auditor's risk assessment, including the assessment of material misstatement or risk of error within a population indicates a higher sample is required than the sample cap applied.

Sample floors are similarly not in line with a risk-based approach, however, it has been noted by the monitoring team that the sample floor or minimum test policy applied by some firms has actually been a factor in ensuring that representative samples have been tested. The most common issue by far is where the sample has been calculated incorrectly in the first place (usually due to the controls and substantive AR issues noted above) leading to an artificially low number, but the test has been 'saved' by the sample floor applied.

As with all sample methodologies, as well as following a risk-based approach, the monitoring team always recommends that audit teams consider a stand back review of samples to consider whether these are sufficient or appropriate, even where a sample calculator has been used.

Sample not representative of an entire population

Issues can occur where a sample has been calculated for a specific test, however, the auditor has either:

a) omitted one or more material balances within that population for testing; or
b) focussed on higher value items only within a specific population.

In the case of example (a), we see this happening most often in the directional testing of sales / income and purchase / expenditure, and specifically where the audit team has focussed on a prominent balance within that area of the financial statements.

In the case of example (b), we have raised issues where testing has been restricted to high value items in a population without consideration of the characteristics of the population from which that sample has been drawn. In most cases this has been where the auditor has restricted testing to a sample of key items or high value transactions. Firms are reminded that under ISA (UK) 530, the auditor must select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Consequently, we have reviewed files where sample bias has resulted in a lack of testing or evidence over entire categories of sales and purchases.

Example – on an ICAS AM visit we reviewed the audit of a company which sold new and used motor vehicles. In testing completeness of vehicle sales, the auditor had removed key items from the sample, with the purpose of testing all key items plus a sample from the residual population. At the end of key item testing the auditor decided that a representative sample of the population had been tested and 'stopped' the test.

ICAS AM noted that in doing this, the auditor had only tested new vehicle sales, and had ignored used vehicle sales which represented over 35% of the company's turnover and which were actually maintained under a different invoicing system.

Splitting a sample across one or more assertions

There have been recent issues on files where a sample has been calculated appropriately but has then been split across assertions, for example where a sample to test completeness of turnover is calculated of 30, and the auditor goes on to test 10 items for completeness; 10 items for cut-off; and 10 for existence / occurrence.

In these instances, ICAS AM will often conclude that a lack of evidence has been obtained over one or more assertions, and it is therefore important to ensure the calculated sample is applied appropriately.

Why are my sample sizes so high?

This is a question we are asked frequently on audit monitoring visits, and not one we can often answer where the auditor has used and followed a specific methodology correctly. From our reviews, there are some common areas to be considered:

- Risk assessment – whether the correct risk factor has been applied to the sample size calculation under the methodology;
- Materiality – whether the materiality or performance materiality figure is appropriate;
- Key item testing – a form of sample stratification where key items are extracted and tested, and which may reduce the residual population and sample.

The importance of the review process

The most important consideration in ensuring adequate sample sizes, is the review process, in particular where the original sample calculation has been made by a more junior member of the audit team. The RI and manager review processes should be robust enough to identify inappropriate sample calculation or justification at the planning stage. The process should also identify, in a timely manner, where an insufficient sample size has been used during fieldwork, to allow further testing to be completed before signing the audit report.