

AUDIT NEWS

INTRODUCTION

Welcome to the first 2012 edition of Audit News. As promised in our December edition of Audit News, we have prepared a number of informative and relevant articles, which we hope are of great use. The first article, and the largest part of this edition, is our annual summary of key findings from the monitoring visits that we have carried out in 2011, and this

is designed to provide firms of all sizes with some points to consider in upcoming audit engagements. In addition, we would strongly recommend that each firm utilises this article when conducting cold file reviews as part of the Annual Compliance Review, and the matters noted could also be kept in mind when performing RI or manager reviews of audit engagements.

We then have two articles regarding the current audit and accounting landscape – the first relates to the EU proposals to revitalise the audit market following the Green Paper consultation which concluded in 2011, and the second article relates to the future of UK GAAP, and will also be highly relevant to all firms.

AUDIT MONITORING FINDINGS FOR VISITS CARRIED OUT IN 2011

Our audit monitoring team (ICAS AM) visited 56 firms, of all different shapes and sizes, throughout the UK in 2011, compared with 50 visits in 2010. This article provides a summary of the key, and most common, issues identified during those visits.

Our work

ICAS currently registers approximately 230 audit firms, ranging from sole practitioners to national firms based across a number of offices. In 2011, our reviewers visited 56 audit firms and reviewed over 120 audits in full, including both paper and electronic based audit files. All reports prepared by the audit monitoring team are considered by the Audit Registration Committee (ARC), and a summary of the overall outcomes can be found in the table later in this article. We are responsible for monitoring firm-wide procedures at all our firms, with the exception of the very largest firms, where this responsibility rests with the Audit Inspection Unit (AIU) of the

Financial Reporting Council (FRC) (www.frc.org.uk/pob/audit/). We monitor the quality of individual audits at all our firms but do not review audits of fully listed clients and others designated as major public interest clients, as these fall within the AIU's remit.

Audit in 2011

Audit has been in the headlines throughout 2011, particularly at a European and national level, with the EU and the House of Lords debating the role of audit, and audit firms. The latest developments arising out of the EU discussion are discussed later in this edition of Audit News.

In the UK, in August 2011, the AIU published reports on its 2010/11 inspections of individual audit firms and smaller firms (frc.org.uk/pob), which highlighted a number of challenges for the audit profession. Following these reports, the audit monitoring team, and other representatives from ICAS and our registered firms, held a very informative

meeting with the AIU to clarify some of these findings, and the applicability of these findings to ICAS-registered audit firms. The results of that meeting were reported in Audit News 48B, and a summary of the AIU key findings was provided in Audit News 48C. Both of these editions are available on the ICAS website at the following link (please ensure you login as a member to access these documents). icas.org.uk/Audit_News.aspx

Our own findings show that firms of all sizes are capable of delivering high quality audits, however we recognise all of the issues that the AIU raised, and we have seen some consistency in the

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nature of matters raised, particularly with regards professional scepticism. We see many examples of firms — large and small — that have a very strong compliance structure, investing time and effort into audit procedures and training for their staff, resulting in a good standard of audit work.

In some cases, however, firms do need to make improvements to this standard of work, and it is our objective to help firms improve. We attempt to identify any underlying causes of the weaknesses in audit work and discuss steps that the firm can take to resolve these issues. The results of our visit then feed into the follow up action that is concluded upon by the ARC and the results of our visits for 2011 are shown in the following table:

Outcomes	2011	2010	2009	2008	2007
No follow up action needed	27 (48%)	30 (60%)	33 (65%)	18 (33%)	21 (51%)
Firm to submit evidence of action taken after the visit (typically, but not restricted to cold file reviews, CPD records, or hot file reviews, or a combination of these)	21 (37%)	17 (34%)	13 (25%)	24 (45%)	14 (34%)
Committee imposed conditions and/or restrictions, or in worst cases, the issuance of a minded to withdraw audit registration	8 (15%)	3 (6%)	5 (10%)	12 (22%)	6 (15%)
Total firms visited	56 (100%)	50 (100%)	51 (100%)	54 (100%)	41 (100%)

While the above table suggests that there has been a decline in the standard of audit work during 2011, it must be remembered that a different population of audit firms have been visited which makes direct comparisons from year to year difficult. That being said, we have seen a number of common themes, which has resulted in an increased number of firms having to comply with conditions imposed by the Committee:

COMMON THEMES

- **Fee pressure:** a reduction or squeeze on audit fees has resulted in some firms “cutting corners” in audit work;
- **Under-declaring audits:** there has been an unusually high incidence of firms under-declaring audit clients to the monitoring team which are then found to have little or no audit work supporting the audit opinion. The Audit Registration Committee takes robust action to such cases;
- **Less face to face training:** some firms have restricted or withdrawn from attendance at training courses and are using internet, or CD based training, instead. There has been a higher incidence of poor quality audit work arising from ineffective CPD. ICAS AM would stress the importance of regular face-to-face audit training, particularly given the introduction of the Clarified ISAs within the past year;
- **Programmes not fully applied:** a number of firms have not used the full suite of audit programmes because the client in question was small. Whilst each Clarified ISA now provides a useful guidance paragraph on the adoption of the standards in a small company environment, there are no exemptions from the Auditing Standards for small companies, and the same level of documentation and compliance should apply regardless of client size;
- **Reliance on accounts production:** where an audit firm is also responsible for the accounts production for an audit client, we have seen some cases where there has been an over reliance on this work in obtaining audit comfort, particularly where there is limited segregation of the two services provided. These instances tend to go hand in hand with an ineffective RI review, resulting in some areas that have potentially been insufficiently audited; and
- **Ineffective cold file reviews:** not all firms are conducting cold file reviews, despite it being an annual requirement. Where cold file reviews have been performed, many are focussed on procedural or disclosure issues, rather than the standard of audit quality, or fail to identify and conduct appropriate follow up action. It is also imperative that an up to date checklist is used for these reviews, which covers the Clarified ISAs, and if any firm requires this please contact Linda Laurie from the Institute’s Practice Review Service on 0131 347 0249.

Supporting our firms

Whilst our role is regulatory, ICAS Audit Monitoring has been active in providing help and support to member firms and trying to encourage improved compliance.

The statutory requirement for every audit firm to be visited every six years (or three years if a firm has listed clients) can be too long a gap, and therefore the ARC may agree upon a shortened cycle to provide assurance that issues are being addressed on a timely basis. This appears to be an effective measure in improving audit quality, as of the 16 shortened cycle visits undertaken in 2011, 13 firms (81%) demonstrated significant improvements (2010: 73%).

In addition, as has been referred to in many editions of Audit News, the ICAS Audit Monitoring team are now presenting a course which, whilst mandatory for Audit Compliance Partners (ACPs), has also been well attended by other RIs and senior members of audit staff. In order to minimise the burden to firms, mandatory ACP attendance is required only once every five years, at a subsidised cost. Five courses have been run since this was introduced in late 2010, with over 150 participants, and the feedback is that the course is well received, and the detailed notes and information provided is valuable. As mentioned, the course is delivered by the monitoring team who provide detailed examples of common issues found, along with useful hints and tips of how to avoid pitfalls. In addition, there are detailed notes on upcoming and recent regulatory changes, including an update on the clarified ISAs, providing an extremely useful annual update. Details of the dates and locations for 2012 are provided at the end of this edition of Audit News.

A help sheet for Audit Compliance Partners was also recently developed, and this provides a useful reference guide on the key responsibilities of this role. While this is handed out at the mandatory course referred to above, it is also available on the ICAS website at the following link: http://ek-pre.icas.org.uk/Audit_News.aspx?LangType=2057#Helpsheets

Audit quality

As noted, some audits reviewed were of a high quality, however, there will always be inconsistencies in the standard of work at different firms, and even within the same firm. We have, therefore, identified a number of areas below for firms to focus on to try to maintain a consistently high standard of audit work.

Obtaining the right audit evidence

The key focus of reviews performed by ICAS AM is to assess the level of audit work performed over relevant financial statement assertions, and it is sometimes the case that audit work on file does not provide enough evidence to confirm that each of these has been appropriately tested and concluded upon. Common evidence issues we see include:

COMMON EVIDENCE ISSUES

- **Fixed assets brought forward:** evidence of the existence of fixed assets is obtained through testing of additions and disposals but without testing any items brought forward from the previous year;
- **Property title:** existence of property has been confirmed by visiting the client's premises, but no testing over the title to the property has been performed;
- **Debtors recoverability:** recoverability of trade debtors has not been fully considered, particularly where the debtor is a group company or other related party;
- **Accruals completeness:** accruals have not been tested for completeness: i.e. are there any "missing" accruals, or unrecorded liabilities; and
- **Bank confirmations:** bank letters have not been obtained, or differences have not been investigated. See below.
- **Profit and loss account testing:** See below.

It is disappointing to see that bank confirmations are still not being obtained in all cases, despite Practice Note 16 stating that only in rare cases, where banking arrangements are very simple, would it be appropriate not to request a bank confirmation letter. ICAS AM understand the difficulties firms can have in obtaining timely responses to requests, however if the main bank account number is provided then this should speed up the process. Obtaining bank confirmations was discussed fully in Audit News 46A icas.org.uk/Audit_News.aspx

In addition to the above, the work performed on profit and loss account balances could also be improved, particularly in relation to turnover. Firstly, given this is a credit balance, all audit files should test this balance for understatement or completeness. As audit monitors, we ask the question "how have the audit team satisfied themselves that turnover has been fully recorded?" We

would encourage audit teams to ask similar questions on their audits to ensure this assertion is properly tested. It is often the case that firms have carried out a test in this area, but more often than not, the starting point is an extract from the sales ledger. This defeats the purpose of the test, which is trying to identify sales which haven't been recorded, therefore the sample should not be selected from recorded sales. The sample should be selected from the origin of the sale. In a manufacturing or other trading company, this may be fairly straight forward as there will be an order form, or quote given. A sample of these should then be traced through to recorded sales and eventual receipt of payment. However, it may be a retail or other environment is more complicated as orders are not placed. Where this is the case, thought should be given as to how best to tackle this. Are there till receipts which could be used to make sure they are properly transferred into the accounting system?

The second issue with profit and loss account testing (for both turnover and expenses) often stems from the use of substantive analytical review and an over-reliance on work performed on the balance sheet. Therefore, firms may perform a review of variances in the profit and loss account, but this does not often provide sufficient audit comfort, and raises questions about the level of professional scepticism applied, which is consistent with issues raised in 2010 and to those raised by the AIU.

EFFECTIVE SUBSTANTIVE ANALYTICAL REVIEW REQUIRES

- setting a valid and independent expectation. This can often be the prior year figure, or a budgeted figure, but there should be justification as to why the expected figure is appropriate, e.g. is it to be expected that costs would remain in line with last year?
- documented justification on file as to the appropriateness of the source of the data used to formulate this expectation;
- comparison between the expectations set and the actual figures being audited;
- receiving an explanation of the variance;
- corroborating the explanation: these must be validated/audited to source documentation and challenged to ensure that sufficient audit comfort is obtained to support the audit opinion.

A worked example regarding salaries:

Based on discussions with management, and a review of their budget, salary levels are expected to remain the same in the current year.

In order to assess underlying data the figures were agreed to prior year financial statements and work papers and the budget was reviewed to gain an understanding of how management derived the assumptions underlying it.

On reviewing the actual figure for the year, the recorded salaries figure is materially higher than the expected figure, with a variance of 2.5%. This is discussed with the finance team who confirmed that a pay increase was approved part way through the year.

In order to obtain audit comfort from this test, the award of the pay increase must be corroborated. This could be done through a review of board minutes, or a sample of contracts issued by HR.

Incomplete documentation

The reviews performed by the monitoring team are approached with the following ISA 230 requirement in mind:

“The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand.”

Documenting the audit work performed is by far the most common issue we raise on visits. Through our discussions with the audit teams, we are often given additional explanations to show how audit evidence has been obtained, however as this is not evident to us from the audit file, it often means that the work is not documented appropriately. The Clarified ISAs stress the fact that responsibility for the overall direction and control of an audit rests with the engagement partner, and therefore it is disappointing that these documentation weaknesses are not identified by the quality control reviews undertaken before the audit opinion is signed.

Risk assessments

Most firms understand their clients and the related audit risks, however they often do not document this knowledge properly using the framework set out in ISA 315 and ISA 240 (the risk and fraud ISAs). In particular, many firms are still not carrying out an assessment of the design and implementation of key controls. This is an integral part of the risk assessment process in order to confirm the controls are operating as expected, and to identify additional audit risks to be incorporated into the audit plan. A detailed article was prepared on this point for Audit News 48C which was issued in December 2011. http://icas.org.uk/Audit_News.aspx

Similarly, there are still issues with the documentation of work performed around fraud – particularly recording the client's assessment of fraud and what steps have been taken to mitigate this. The Clarified ISA 240 brought in some additional requirements in respect of fraud and these are considered below, however the requirements of the extant ISA also remain, therefore it is important that these are also addressed by firms.

Financial statement disclosures

With HMRC requiring accounts to be tagged using iXBRL, most firms we visit use an accounting software package to produce financial statements. This appears to have had a positive impact on the standard of disclosure, as we are seeing fewer serious errors and omissions during our reviews. That being said, firms need to ensure that they are not over-relying on these systems as we have seen a number of instances of irrelevant accounting policies and notes. Specific disclosure issues which have cropped up a number of times include:

COMMON DISCLOSURE ISSUES

- dividends being posted after the year-end – these are non-adjusting post balance sheet events and therefore firms should ensure that proper approval is made before the year-end;
- medium and large company disclosures being omitted from the directors' report, including future developments, a fair review of the business, principal risks and uncertainties and key performance indicators;
- accounting policies not sufficiently tailored for the business, particularly regarding revenue recognition; and
- auditors' remuneration not disclosed, or not split between audit and non-audit services.

Acting Ethically

The APB issued revised Ethical Standards in December 2010, which became applicable in April 2011. Only a small number of new requirements were introduced in relation to consideration of cumulative threats, connected parties and reorganisation services. Further details of the key changes can be found in Audit News edition 48A from June 2011 icas.org.uk/Audit_News.aspx

In our experience, firms do generally act in accordance with the spirit of the Ethical Standards, but they sometimes take on work when they shouldn't and sometimes fail to identify or adequately safeguard potential threats to their independence. It is often the case that the firm is unaware of the rules and requirements, rather than acting in a wilfully unethical manner, and, therefore, we would encourage all firms to ensure they undertake appropriate training, refer to the Ethical Standards when required, or contact ICAS for advice using the following email address: accountingauditing@icas.org.uk

The most common issues we see include:

- Audit partners who have acted for unlisted clients for over 10 years need to safeguard this long association, and Ethical Standard 3 requires rotation or an external hot file review before the audit report is signed. The Standard, however, does allow an alternative safeguard which is less onerous where, if a firm records on the audit file why the partner is considered to be independent and objective, AND reports this to those charged with governance, then this is considered to be a sufficient safeguard, and a much more useful option for the majority of our firms; and
- Fee dependency issues which are not compliant with Ethical Standard 4. For the avoidance of doubt, if total fees (audit and non-audit) from one audit client exceed 15% of a firm's total income, then the audit firm should resign from this audit, and there are no safeguards considered appropriate to reduce this threat to an acceptably low level. However, if the fees from one audit client are regularly between 10% and 15% of the total fee income for the firm, then an external hot file review should be performed before the audit report is signed. Provisions are available for new firms whose fee base is growing and therefore if this applies to your firm, we would recommend you consult the Standard.

More generally, we quite often find that firms do not fully document their consideration of threats and safeguards. In the case of non-audit services, for example, it may not be clear:

- whether the PASE (Provisions Available for Small Entities) has been adopted;
- which particular threats arise (e.g., self-review or management threats); and/or
- what, if any, safeguards the firm has implemented.

Clarified ISAs

The Clarified ISAs came into effect for periods ending on or after 15 December 2010 and, whilst we visited a small number of firms who were not aware of these, there has generally been an awareness of their existence. A large number of the files reviewed towards the end of 2011 were Clarified ISA audits and, whilst many firms had obtained up to date Clarified ISA audit programmes, and undertaken training in this regard, there were many firms who hadn't fully adopted all of the new requirements. Therefore, we have included a short list of the common issues and requirements which weren't fully addressed, and we would recommend that this list is used by firms in their training and cold file reviews to ensure that these are considered and addressed:

COMMON CLARIFIED ISA ISSUES

- **Performance materiality:** Clarified ISA 320 requires performance materiality to be calculated in addition to materiality. Performance materiality is "an amount set at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole". We are often finding that firms are either not calculating this, or are not justifying the level of performance materiality, and we would encourage firms to utilise the guidance paragraphs in the ISA to assist in this process;
- **Presumed fraud risks – revenue recognition and management override:** there are two presumed risks of fraud in Clarified ISA 240. The first is in relation to revenue recognition and can be rebutted but should be documented on the audit file (this is not a new requirement and appeared in the original ISA). The second risk is new, and it cannot be rebutted. The ISA requirement states "management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities". Auditors are therefore required to test year-end journal entries, and consider whether they should be tested throughout the year, in order to mitigate this risk. However, as this is an area which is new, firms are not often identifying, or addressing, this risk fully on audit files;
- **Risk of fraud in related party transactions – discussions at planning:** related party transactions have received greater attention in the Clarified ISAs, and ISA 550 now requires that the engagement team discussion held at planning should include specific consideration of the risk of fraud that could result from related party transactions, and it is now explicit in the ISA that any related party transactions out with the course of normal business should be treated as an audit risk. We would encourage all firms to update their planning meeting agendas to include this as a standing item; and
- **Management representation letters not being used as audit evidence:** finally, it is now explicit that management's representations are not considered to provide audit evidence in the absence of any audit work performed, and we have seen some instances where such letters are still being used to provide audit comfort, which is not deemed appropriate. In order to reflect this, a revised template has been produced, and in order to ensure firms remain up to date, we would recommend that firms update their template using the model version in ISA 580 which can be found at www.frc.org.uk/apb/publications/isa/oct2009.cfm

In conclusion, the results of the findings from 2011 have varied, and although some progress has been made in a number of areas, it is evident that firms still need to focus on recording all aspects of their audit work. Completion sections in particular have generally been of a good standard, with improvements seen in relation to obtaining management representation letters; evidence of timing and sign-off of reviews, and reporting to those charged with governance. In addition, many firms are now using standard agendas for their planning meetings and detailed planning memos which help ensure audit work is properly directed, and risks are concluded upon.

The largest challenge for firms has been the implementation of the requirements of the Clarified ISAs, but there has been a definite trend of improvement throughout the year as firms get to grips with their audit programmes and perform more audits using these.

EUROPEAN COMMISSION PROPOSALS FOR AUDIT REFORM

On 23 November 2011, the European Commission (EC) released a set of proposals in the form of a draft regulation and a draft directive which it believes will strengthen the independence of auditors and make the statutory audit market more dynamic.

Draft Regulation (Applicable to Public Interest Entities (PIE))

The key EC proposals contained in the draft regulation which are only applicable to PIEs, are as follows:

- Mandatory rotation of audit firm – companies will be forced to rotate their auditors every 6 years, (where companies opt to have joint auditors, the maximum engagement period will be increased to 9 years). Additionally, there will be a cooling off period of a minimum of 4 years before firms can be re-engaged by the client.
- Mandatory tendering – public interest entities will be obliged to have an open and transparent tender procedure when selecting a new auditor.
- The potential creation of “Pure Audit” firms for firms of a certain size.
- Prohibition of non-audit services – audit firms are to be prohibited from providing non-audit services to their

public interest clients other than “audit related services” and subject to a financial limit of not more than 10% of the audit fee.

- European supervision – proposed co-ordination of auditor supervision activities within the European Markets and Securities Authority (ESMA) framework, thereby ensuring adequate supervision from a European / International perspective.
- The introduction of a more explanatory audit report which will be restricted to no more than 10,000 characters.
- The creation of a single market for statutory audits across Europe by introducing a European passport for the audit profession.
- The potential widening of the auditor’s role in relation to forming an assessment on the company’s system of internal controls.

Draft Directive

- The potential prohibition on professional accountancy bodies providing an audit monitoring function.

What happens next?

The EC’s proposals are now being considered by the European Parliament

and the Council of Ministers in the co-decision process. Working groups have been established by the Council and the Parliament’s work will be led by 2 of its committees namely the Legal Affairs Committee and the Economic and Monetary Affairs Committee. They are currently still in the process of taking evidence.

UK Competition Commission (CC) Investigation into UK Listed Audit Market

On 7 December 2011, the CC published an Issues Statement, which follows the first stage of gathering information, views and evidence and identifies the specific questions and areas that the inquiry is examining at this stage. High barriers to entry and low levels of auditor switching are just two factors which have been identified as factors for concern within this market. The findings of the CC, although not due until September 2013, are likely to lead to some legislative recommendations and, most likely, changes to the way that the UK statutory audit market is allowed to operate. This investigation whilst separate from the EC’s proposals could potentially have some impact on the EC recommendations.

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THE FUTURE OF UK GAAP

The Accounting Standards Board (ASB) of the Financial Reporting Council has published financial reporting exposure drafts (FREDs) 46 to 48 setting out revised proposals for the future of financial reporting in the UK and Republic of Ireland. The ASB is issuing these FREDs following feedback to its previous exposure drafts (FREDs 43 to 45) the result of which has led to it proposing significant changes to its previous proposals. The ASB's objective in developing its revised proposals is to enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. The revised proposals recommend:

(i) Replacing all current accounting standards with a single FRS.

The ASB is proposing (consistent with its previous proposals) to use the IFRS for SMEs, as issued by the International

Accounting Standards Board, as the base for FRED 48. This will reduce the volume of accounting standards from approximately 2,500 pages to 250 pages.

(ii) introduction of a reduced disclosure framework.

The framework permits certain entities (mainly subsidiaries) to apply the measurement and recognition requirements of EU-adopted IFRS with reduced disclosures.

(iii) retaining the financial reporting standard for smaller entities (FRSSE).

As a consequence of feedback to its previous exposure drafts the ASB will:

- not proceed with the tier system previously proposed. The application of EU-adopted IFRS will not therefore be extended beyond that required by Regulation or by, for example, the rules of the Alternative Investment Market;

- introduce accounting treatments permitted under current accounting standards; e.g. options to revalue land and buildings, the ability to capitalise borrowing costs or carry forward certain development expenses have been incorporated into the FRED 48. The ASB is proposing to retain accounting treatments permitted under current accounting standards and international accounting standards rather than its previous policy to make minimal changes to the IFRS for SMEs.

The ASB is proposing that the revised proposals should take effect from for accounting periods beginning on or after 1 January 2015 with earlier adoption permitted. The exposure drafts are open for comment until 30 April 2012. Subject to the feedback received the ASB expects to issue the final standard by the end of 2012.

ICAS COURSE FOR AUDIT COMPLIANCE PARTNERS

When you are considering your training plans for 2012, we would like to take the opportunity to remind firms of the mandatory course for Audit Compliance Principals (ACPs), which is delivered by the Audit Monitoring team – it's the only audit update course you will need in 2012!

In order to ensure mandatory attendance is not too onerous, ACPs

are required to attend only once every five years. In addition, ICAS is subsidising this course for ACPs and the rate for 2011 is only £80 plus VAT for ACPs for the full day. We are also keen to open the course up to others involved in audit, and the course rates for other attendees is £100 plus VAT for a half day course, and £150 plus VAT for the full day course.

The 2012 locations and dates have now been released and information on how to book, together with an outline of each course, can be found at www.icas.org.uk/businesscourses

- 28 March 2012 – Edinburgh;
- 19 April 2012 – Inverness; and
- 4 October 2012 – Glasgow.

