February 2024

Audit Monitoring: 2023 common findings

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Introduction

2023 was another transitional year for ICAS Audit Monitoring, with a number of changes in the review team taking place through the year, and ongoing development of new monitoring methodologies and documentation, including the incorporation of new ISQM(UK)1 requirements.

There were 25 visits completed in 2023, which was 11 more than the previous year, though this figure continued to be impacted by resourcing challenges, and the extensive training and induction process for new reviewers. In early February 2024, the monitoring team reached full complement for the first time in a couple of years, and as such we'd expect the number of visits completed in 2024 to increase accordingly.

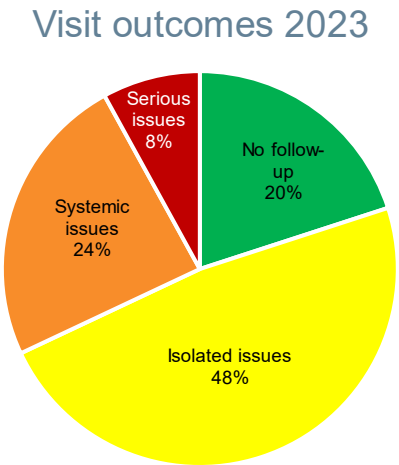
The bulk of the visits undertaken in 2023 were to firms that required a visit under the statutory six-year cycle, with 16 of the visits falling in to that category. The remaining visits were conducted on a shortened cycle basis, informed by the monitoring team's ongoing risk assessment process. The schedule remained somewhat atypical and as a result it may not be easy to make clear comparisons with previous years, but there remain key themes and common findings that all audit registered firms should take into account and learn from.

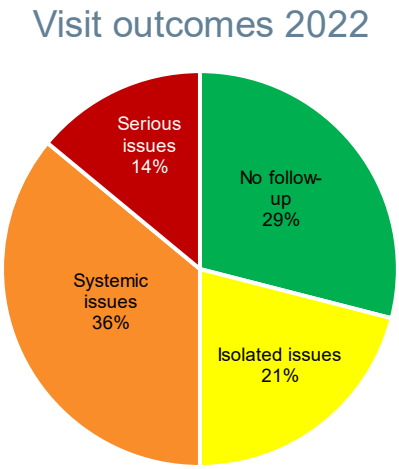
Visit outcomes

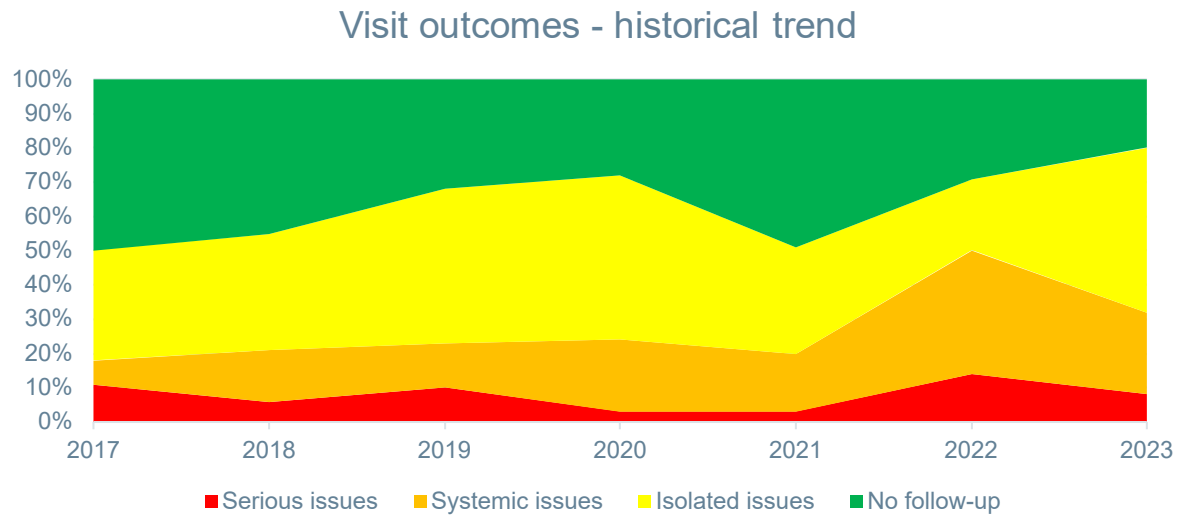
The percentage of visits that presented serious and systemic issues has fallen compared to the previous year. 8% of visits in 2023 presented serious issues (14% in 2022) and 24% of visits presented systemic issues (36% in 2022), which is a positive trend. However, a smaller percentage of visits required no follow-up action in 2023, with only 20% of visits being closed without further submissions or other follow-up actions being required by the Committee (29% in 2022). What is left is an increase in visits presenting isolated issues, which has risen to 48% in 2023 (21% in 2022).

Visits falling in to the 'serious' and 'systemic' categories are always reported to the full Authorisation Committee ('the Committee'), as they are considered to present the most significant findings. In the most serious cases, the Committee has considered whether further regulatory action is required, and that has included stringent follow-up actions and, where appropriate, regulatory penalties.

Where audit file quality has seen a general trend of improvement (as seen in the charts below), the reduction in visits without follow-up action has been impacted by a number of firms having 'whole firm' findings, or due to isolated issues affecting only some audit files, affecting the visit outcome.







Audit file quality 2023

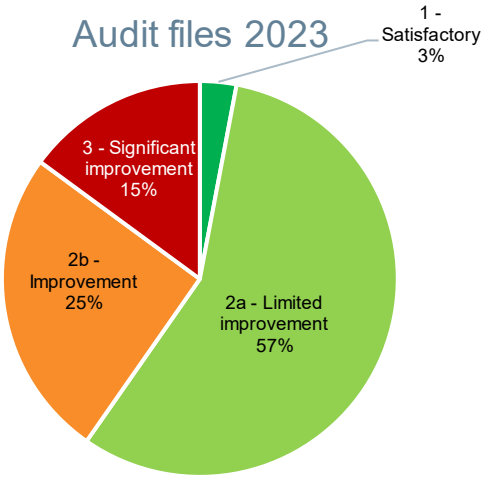
Generally, there was a slight improvement in the level of audit quality seen on the files compared to 2022. The majority of files reviewed in the year (60%) were of a good standard or only required limited improvement, which is a significant improvement on the levels of compliance noted in the previous year, when only 33% of files fell into that category.

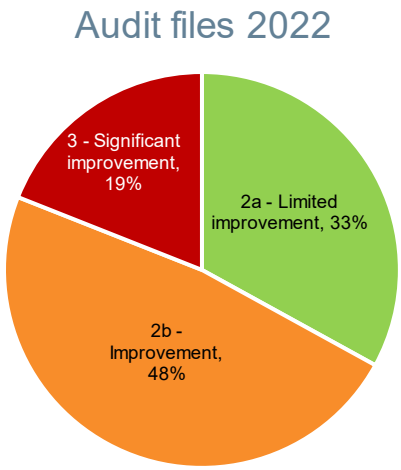
A small number of 1 Grade files were reviewed in 2023, which reflected particularly good levels of compliance. These files presented no areas of concern regarding the sufficiency and quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. Further, there were only limited weaknesses in the documentation of audit work.

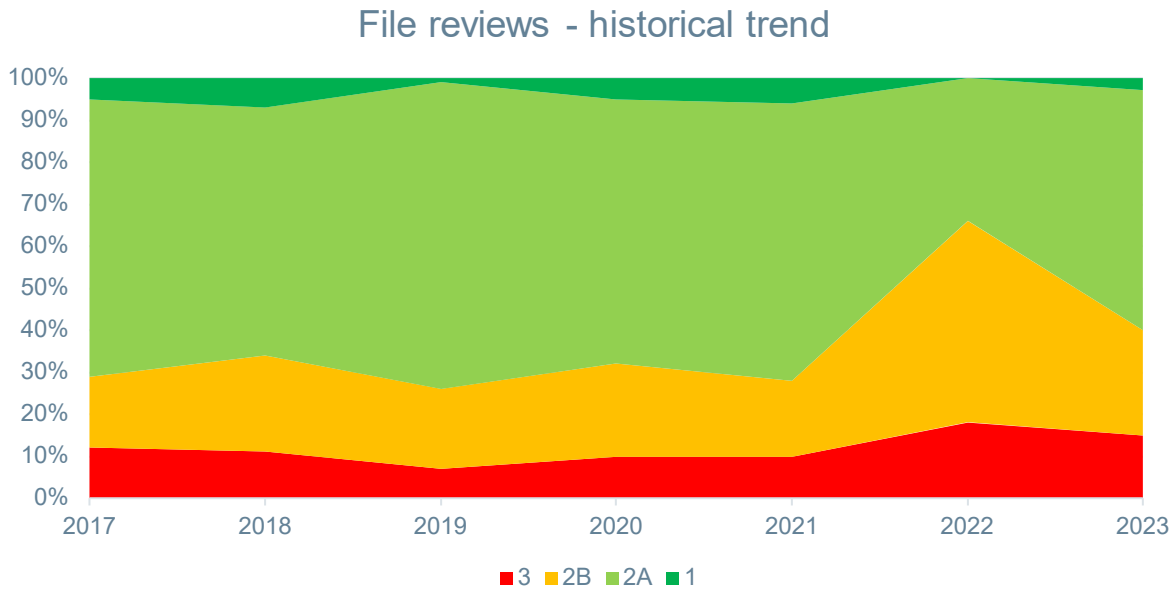
The team also reviewed more files of a 2A standard in 2023, with 57% of the files reviewed reflecting only limited concerns regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed, and where weaknesses in documentation were restricted to a relatively small number of areas. This is a substantial improvement on 2022 when only 33% of the files reviewed were of a 2A standard.

The monitoring team understands the significant challenges that firms face in maintaining audit quality, at a time of increasing regulatory expectations, while at the same time ensuring audits are conducted on a commercial basis. In that context the number of 1 and 2A Grade files is seen as a positive outcome and we hope that this continues into 2024.

The 2023 monitoring year saw fewer files of a 2B and 3 standard, though these still accounted for 40% of the files reviewed. These poorer files, by their nature, present more serious breaches of ISAs and Audit Regulations and also bring the clear potential for further regulatory action to be considered required by the Committee in order to bring standards up to the required level.







Common areas of non-compliance with the International Standards on Auditing (ISAs) (UK)

Common breaches

The most common ISA' where issues were identified in our monitoring work during 2023 related to:

- ISA 230 – Documentation (80% of visits)
- ISA 240 - Fraud (80% of visits)
- ISA 315 - Risk assessment (76% of visits)
- ISA 500 – Audit evidence (76% of visits)
- ISA 570 – Going concern (60% of visits)
- ISA 530 – Audit sampling (44% of visits)

ISA (UK) 230 – Documentation (80% of visits)

Weaknesses in audit documentation are among the most common findings on the audit files we review. Issues with audit documentation range from: cases where audit work has been undertaken, or supporting evidence obtained, which is not subsequently recorded in the audit file; to more subjective weaknesses where working papers do not clearly set out the nature and extent of audit work undertaken.

Auditors should bear in mind that one of the fundamental objectives of an audit file is to demonstrate that the audit was planned and performed in accordance with the ISAs and applicable legal and regulatory requirements. In visits where audit documentation was found to be of a good standard, working papers were sufficiently clear to enable an experienced auditor, having no previous connection with the audit, to understand:

a) the nature, timing and extent of the audit procedures performed;
b) the results of the audit procedures performed, and the audit evidence obtained; and
c) significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

ISA (UK) 240 – Fraud (80% of visits)

More than half of the monitoring reviews in 2023 found weaknesses in fraud considerations at the planning stage. This is an area where similar issues have been found in previous years.

Weaknesses at the planning stage fell broadly under three categories:

Management's assessment of fraud risk

A number of audit firms had not sufficiently considered and recorded management's assessment of fraud risk.

The review team appreciates that smaller owner managed business may have less-formal arrangements in place with regards fraud assessments. Firms that dealt with this area well, recorded consideration of the following (in addition to discussion with the client about known or suspected frauds):

a. Management's assessment of the risk of material misstatement due to fraud;
b. Management's process for identifying and responding to the risks of fraud;
c. Management's communication, if any, to those charged with governance on its processes; and
d. Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

Auditors may well find that some smaller clients require some support at this stage of proceedings, and planning meetings should provide the opportunity for the auditor to prompt the client to think about how and where frauds could be perpetrated.

Further, where those charged with governance are not involved in managing the entity (e.g. as is often the case in charities) the auditor should make separate inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

Ultimately, as is the case with the risk assessment procedures referred to below, if the auditor's does not understand the client's own assessment of fraud risk there is a real danger that the risk assessment process is fundamentally flawed, and that the appropriate response to audit risks has not been formulated.

Team briefing
The standards require a discussion among the engagement team members, led by the RI, which places particular emphasis on how and where the entity's financial statements (including the disclosures) may be susceptible to material misstatement due to fraud, including how fraud might occur.

Reviewers often find weaknesses in the record of the team briefing meeting. Notes of these team planning meetings are often minimal, sometimes non-existent, and regularly do not demonstrate sufficient professional scepticism as they place too much store in the honesty and integrity of management and those charged with governance.

Presumed significant audit risks
Consideration of presumed significant risks relating to fraud in revenue recognition and from management override, also remains an area for recurring weaknesses. Commonly, this may be because one or both of these risks have been omitted from audit planning, or where the audit approach planned in response does not sufficiently reflect the special status that significant audit risks hold (e.g. where related risk assessments default to 'low' or 'medium' risk without substantial justification).

While the standard recognises that the presumed risk of fraud in revenue recognition may be rebutted in some cases, firms should be aware that such an approach would require clear justification and, given this would be a significant professional judgement in the audit process, sufficient documentation would be required on that process.

The risk of fraud from management override cannot be rebutted and should be recognised as a significant audit risk on every audit file.

Audit Procedures Responsive to Risks Related to Management Override of Control
There also continue to be weaknesses at the fieldwork stage related to the mandatory testing in response to the significant risk of management override of controls.

Again, all auditors should be aware that this significant risk cannot be rebutted. Where audit work was considered good, firms had ensured that an appropriate level of time and (senior) resource was allocated to ensure sufficient appropriate audit testing takes place. This is not an area that should be given to inexperienced members of the audit team, or picked up late in the audit and rushed.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor needs to design and perform audit procedures to test the appropriateness of manual or automated journal entries; review accounting estimates for biases; and evaluate the business rationale for significant transactions that are outside the normal course of business.

In 2023 reviewers continued to regularly find that insufficient substantive testing had been conducted over journals and other adjustments. The best practice in this area included clearly documenting:

- Inquiry of relevant individuals about inappropriate or unusual activity;
- Substantive testing of specific journals and other adjustments at the end of a reporting period (and post-closing entries for those audits under the revised ISA 240), which needs to be recorded sufficiently to meet the ISA 230 requirements set out above; and
- Consideration of the need to test journals and other adjustments throughout the period.

Reviewers have come across a number of cases where journals had been tested, but where the approach was not sufficient or appropriate. Common weaknesses to look out for include:

- Insufficient consideration of whether the population being reviewed is complete –Without this key step, it will not be possible to gain sufficient appropriate audit evidence from the testing. This will include consideration over any listings etc. generated and provided to you by the client (e.g. could they have been altered, and if so how would the auditor identify that?).

- Haphazard, or other, sampling techniques being applied over a pre-assessed number of journals - Firm's should be aware that sampling approaches adopted in other areas of the file will not provide sufficient audit evidence in response to the risk of management override. Review of journals needs to be a bespoke piece of work, and should demonstrate consideration of the potential characteristics of fraudulent journal entries or other adjustments (such as those examples identified in the ISA's application and explanatory material).

ISA (UK) 315 – Risk assessment (76% of visits)

As in previous years, reviewers continue to regularly find areas where risk assessment procedures conducted by auditors have not been sufficient to meet the requirements of this standard. The most common findings in this area continued to be insufficient audit work being conducted at the planning stage in order to understand, and document, the internal control environment relevant to the audit.

Audit teams that demonstrated good levels of compliance with this ISA has ensured that:

- systems work was recorded over all relevant transactions streams (e.g. system notes were held over all key financial systems and identified relevant controls over risk assertions); and
- the auditor had determining whether identified relevant controls had been implemented in the year (e.g. through recording a dedicated 'walkthrough' test, and hadn't relied on inquiry alone).

While poor performance in this area has been somewhat exacerbated by the revisions to ISA 315 that have been effective on some files reviewed in 2023, even the files under the 'old' ISA showed poor levels of compliance with these requirements.

If the audit file does not demonstrate a clear understanding of the entity's control environment, there is a real danger that the risk assessment process is fundamentally flawed, and that the appropriate response to audit risks has not been formulated.

Poor quality planning work at the risk assessment stage has the clear potential to result in insufficient or inappropriate audit work being conducted at the fieldwork stage, and auditor's should ensure that sufficient time and resource is set aside to allow a comprehensive planning process to take place.

ISA (UK) 500 – Audit evidence (76% of visits)

The ISAs require the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure. That requirement stands irrespective of the assessed risks of material misstatement, and there is no justification for omitting to test material classes of transactions or balances on the grounds of a low risk assessment.

Ultimately, obtaining sufficient appropriate audit evidence over the figures in the financial statements is a fundamental component of a compliant audit file, and essential in completing an audit that is considered of a satisfactory quality.

The monitoring team continued to find weaknesses or clear omissions in audit evidence in the majority of visits conducted in the year.

Common issues included:

- Material transaction streams, balances, and/or disclosures not being subject to dedicated substantive audit testing. Note, where completeness is a considered a relevant risk assertion (such as is often the case over revenue or creditors/provisions/liabilities) substantive work may also have to be undertaken on balances that appear to fall below the material level.
- Substantive testing not being appropriately planned, or conducted, in response to the audit risk identified. Examples of this include testing being conducted against the wrong assertion, or assessed samples being split across multiple assertions without clear justification.
- Audit sampling being clearly insufficient, or inappropriate, as is commented upon below.
- Transactions / balances involving significant estimates and judgements being insufficiently considered. Weaknesses here commonly include:

1. The work of a management expert not being subject to sufficient consideration in accordance with ISA 500. Auditors are reminded that the ISA requires:
    i. Evaluation of the competence, capabilities and objectivity of the expert (which might well include that expert's qualifications, etc);
    ii. An understanding of the work of that expert (which may require consideration of their assumptions methods, and data used – and there could be increased risks where an expert is employed by the entity).
    iii. Evaluation of the appropriateness of that expert's work (for which the auditor may have to consider the relevance, completeness, and accuracy of source data used by the expert – which in some cases may have been to them by the entity itself).

2. Significant accounting estimates, such as those over construction contracts, not being considered sufficiently. While the 2018 revisions to ISA 540 have been in place for some time now, reviewers continue to see poor levels of compliance with it, including:
    i. Insufficient understanding of the estimation process at the planning stage of the audit. Often significant areas of estimation are linked to significant audit risks, but relevant controls are not recorded and considered as part of audit planning.
    ii. Failure to review the outcome of previous accounting estimates in the current period. This 'look back' review is a key component of the risk assessment process over significant accounting estimates.
    iii. Insufficient substantive testing being undertaken on significant estimates at fieldwork, due to the likes of overreliance on an internal management expert; and/or insufficient testing of how management made the accounting estimate (e.g. through assessing stages of completion or other significant assumptions).

ISA (UK) 570 – Going concern (60% of visits)

There has been an increase in the number of visits presenting insufficient consideration of going concern in 2023. Given the challenging financial climate in recent years, it is not unexpected that more audited entities face difficult circumstances in this area which along with the 2019 revisions and enhancements to the ISA seem to have caught a number of firms out. Where audit teams had dealt with this challenging area well, the files clearly demonstrated they had obtained sufficient appropriate audit evidence regarding:

- whether a material uncertainty related to going concern exists; and
- the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements

Common weaknesses in going concern considerations include:

- A lack of consideration of going concern at the planning stage, including the required risk assessment procedures over how the entity goes about forming its own going concern assessment. Where management has not yet performed an assessment of the entity's ability to continue as a going concern, the ISA requires the auditor to request one.
- Insufficient evaluation of management's going concern assessment, including the relevance and reliability of the underlying data used and the assumptions on which it is based. Reviewers have seen a number of files in 2023 where going concern was a clear audit risk, but where there was insufficient audit work conducted over the financial projections, and related assumptions, prepared by the audited entity.
- There have also been instances where inappropriate audit report conclusions have been reported, either using the 'old form' audit report wording providing negative assurance over going concern, or where non-standard wording was adopted in the going concern opinion, which significantly increases the risk that the report is not clear and understandable to the users of the accounts. Should the going concern assumption not be appropriate, significant disclosure on the basis of preparation will be required in the accounts disclosures.

ISA (UK) 530 – Audit sampling (44% of visits)

In most cases, auditors use sampling when designing substantive testing. Sampling is a tried and tested approach to obtain sufficient appropriate audit evidence, and it's rare for a reviewer to conclude that a sampling approach was not appropriate (though auditor's should remain aware that there are cases when sampling may be inappropriate or ineffective).

Non-compliance in sampling became more prevalent in 2023, and there are a number of common areas of fault that firms should look out for:

- Sample sizes being affected by an inappropriate risk assessment (e.g. a significant audit risk area being tested as if 'low' risk).
- Sample sizes being reduced inappropriately due to reliance being placed on analytical procedures that are not considered substantive in nature (in accordance with the four-step process required under ISA 520); and / or reliance being placed on controls being effective without dedicated compliance testing taking place to support that approach.
- Capping of sample sizes without clear and appropriate documentation of the auditor's professional judgement in that regard. While ICAS Audit Monitoring is aware some propriety sample assessment approaches cap sample sizes, that approach is not considered, in isolation, to clearly meet the requirements of the ISAs with regards the application of risk and materiality, and any such approach would require substantial documentation of the auditor's professional judgement sufficient to justify the resulting sample sizes assessed.
- Inappropriate sample selection techniques being adopted, such as those that restrict resulting samples to only parts of the population. Auditors are reminded that the ISA requires each sampling unit in the population to have a chance of selection.
- Inappropriate responses to errors identified in sample testing. The ISA is clear that in the extremely rare circumstances when an auditor considers an error in sampling to be an anomaly (AKA 'isolated'), the auditor must obtain a high degree of certainty that is the case, and that will require additional audit procedures to do so.

Common areas of non-compliance with the Audit Regulations

As may be expected, the most common Audit Regulation breach in 2023 was Audit Regulation 3.10, as it related to compliance with the ISAs. 92% of visits saw issues reported under that regulation, which reflects every visit on which an audit file was reviewed. Commentary is provided above regarding common weaknesses in ISA compliance.

Other than the ISA issues noted above, the most common areas of non-compliance with the Audit Regulations related to:

- Audit Regulation 3.08 – Statutory requirements (40% of visits)
- Audit Regulation 3.02 – Acceptance and reappointment / Ethical compliance (36% of visits)
- Audit Regulation 3.10 – As it relates to compliance with ISQM(UK)1 (32% of visits)
- Audit Regulation 3.20 – Audit compliance review (32% of visits)
- Audit Regulation 3.03 – Acceptance and reappointment (24% of visits)

1. Audit Regulation 3.08 – Statutory requirements (40% of visits)

As part of each audit file review, reviewers consider the quality of the financial statements being audited. Commonly minor areas for enhancement and tailoring are noted, relating to areas like the accounting policies over revenue, contracts, financial instruments, and other disclosures. However, in some cases more significant weaknesses are identified in the Financial Statements and disclosures which warrant a breach of Audit Regulation 3.08. While reviewers are aware that the financial statements remain the responsibility of the audited entity, firms should ensure that appropriate review take place over the financial statement disclosures, and any omissions should be advised to the client and consideration given to potential impact on audit reporting where clear non-compliance remains in the approved accounts. Some examples of more significant issues in this area are provided below:

Significant disclosure issues identified in 2023

2. Audit Regulation 3.02 – Acceptance and reappointment / Ethical considerations (36% of visits)

The Ethical Standard is clear that a fundamental objective of any audit engagement is that the intended users trust and have confidence that the audit opinion is professionally sound and objective. To that end, the Ethical Standards sets out the overarching principles of integrity, objectivity and independence, together with supporting ethical provisions which establish a framework of ethical outcomes that are required to be met by the auditor. Any non-compliance with the Ethical Standards are considered significant matters, and warrant reporting to the full ICAS Authorisation Committee for consideration.

A breach of the fundamental principles set out in the Ethical Standards, and the Code of Ethics issued by Council, would typically result in a regulatory penalty being considered.

Non-compliance with the Ethical standard was identified in 32% of visits undertaken in 2023, with:

- 28% of visits presenting non-compliance with the Ethical requirements relating to the threat of Long Association;
- 4% presenting non-compliance with the Ethical requirements relating to the provision of non-audit services; and
- 4% of visits presenting non-compliance with both of these areas.

Long association

Throughout 2023, reviewers identified issues with firms' identification and safeguarding of long association threats, including where cold file review safeguards were implemented when this is not an appropriate safeguard in the Ethical Standard.

A special feature was included in the *Winter 2023* edition of Audit News and firms are reminded that the standard requires one of the following safeguards:

- Appointing another Responsible Individual ('RI') to lead the audit (something that may not be possible in smaller audit firms);
- Involving an additional partner, who is not and has not recently been a member of the engagement team, to review the work done by the partners and the other senior members of the engagement team (some smaller firms may not have another partner, independent of the audit team, with sufficient recent audit experience to conduct a review of this nature); or
- Arranging an Engagement Quality Review (EQR) of the engagement in question (which may well require an external reviewer to be engaged if a firm only has one RI) – otherwise known as a 'hot' file review.

While there were some revisions to the requirements of the Ethical Standard in 2019, these have been effective for all engagements relating to periods commencing after 15 March 2020 and as such any reference to older approaches, as is occasionally still seen on visits, is now well out of date. Now that audit firms have been reminded in the Winter 2023 Audit News it is expected that firms failing to meet the standard are at risk of regulatory action from the Authorisation Committee.

Reviewers also came across instances where an internal hot file review process had been conducted, but where the individual involved did not appear to meet the requirement in the Standard for a 2nd partner review, or appear to hold the required authority to qualify as an EQR reviewer.

Where firms are implementing an internal EQR process, they should be careful to ensure the individual involved has not only the appropriate competence and capabilities to conduct the role, but also holds sufficient authority in the firm to challenge the RI's judgements and conclusions.

Non-audit services

In two cases during the year, reviewers identified non-compliance with section 5 of the Ethical Standard which relates to non-audit services. It is common for ICAS audit firms to deliver a range of services to their audit clients, but it is essential that any such non-audit services are identified and fully considered in line with the requirements of the Ethical Standard. In some cases, the delivery of specific services is expressly prohibited by the Standard, and in other cases, carefully consideration must be given (and recorded) to demonstrate that related ethical threats have been appropriate safeguarded.

The principal threats to the integrity, objectivity and independence of the audit firm relating to non-audit services are: self-interest; self-review; management; advocacy; familiarity; and intimidation, with self-review and management arising in almost all file reviews where non-audit services are delivered. The identification and appropriate safeguarding of these threats is absolutely essential, and in cases of good practice a clear record had been retained on the audit file of the considerations that had taken place at the outset of the audit in this regard. Failure to identify and safeguard these threats could result in Committee consideration of regulatory action as a result. Firm's should pay particular attention to services which raise the Management threat, as this has been an area which has not been well considered in recent visits.

Particular weaknesses have been noted in the consideration of the management threat with regards accounting services delivered to clients (which can range from accounts preparation work through to the likes of bookkeeping services). The significance of the related ethical threats depends on the nature and extent of the accounting services in question, but all firms must be clear that the Ethical Standard states that an audit firm cannot provide accounting services to an audit client where those services would involve the firm undertaking part of the role of management or initiating transactions; or where the services are anything other than of a routine or mechanical nature, requiring little or no professional judgement.

Services like bookkeeping involve interaction with the accounting records and firms should be mindful that the maintenance of the accounting records (and indeed the preparation of the financial statements) is the responsibility of management. Good practice in this area would involve firms recording consideration of each service clearly, and demonstrating at the outset that the firm had not initiated any transactions or taken any decisions or mad any judgments, which are properly the responsibility of the management, such as:

- authorising or approving transactions;
- preparing originating data (including valuation assumptions);
- determining or changing journal entries, or the classifications for accounts or transactions, or other accounting records without clear management approval.

While the Provisions Available for Audits of Small Entities (PAASE), in Section 6 of the Ethical Standard, include an exemption relating to the Management threat arising from non-audit services delivered to small companies (and other qualifying entities), reviewers have encountered a number of cases where the PAASE exemption could have been applied but was not. If an audit client does not qualify for the exemptions in the PAASE, or where PAASE exemptions are available but have not been taken, great care must be taken when delivering any non-audit service where the Management threat arises.

3. Audit Regulation 3.10 - Compliance with ISQM(UK)1 (32% of visits)

International Standard on Quality Management (UK) 1 became effective on 15 December 2022, and the standard required all audit firms to implement a system of quality management (SOQM) from that date.

Most firms made a good effort at complying with this new standard. In many cases, firms had used off-the-shelf packages to help them record their SOQMs, and link their existing policies and procedures in to the new framework required by the standard.

In a small number of cases, firms had begun with a blank sheet of paper, and from direct reference to the standard had set out a bespoke tailored record of the firm's Quality Objectives, Quality Risks and Quality Responses covering the required components:

- The risk assessment process.
- Governance and leadership.
- Relevant ethical requirements.
- Acceptance and continuance of client relationships.
- Engagement performance.
- Resources.
- Information and communication.

A small number of firms visited had not established their SOQM and these firms were required by the Committee to submit evidence of their SOQM following their monitoring visit. While some areas for general tailoring and enhancement were identified in many cases, the most significant weaknesses in compliance with ISQM1 were varied in the year, ranging as follows:

As time moves on, non-compliance with ISQM1 is likely to be considered progressively more significant, and while no regulatory penalties were raised in 2023 as a result of failings in SOQM arrangements, that may not always be the case.

All monitoring visits seek to consider firms' arrangements in the context of the firm's own circumstances and reviewers recognise that a tailored approach will take into consideration the scale and complexity of the firm's activities. In cases where good practice was identified, and a compliant SOQM was in place, firms had:

- Assigned ultimate and operational responsibility for the SOQM to appropriate individuals;
- Identified quality objectives, risks and responses for each component utilising clear documentation to record consideration.
- Reviewed current policies and aligned them to the quality risks that they had identified.
- Completed the first annual review of the SOQM (by 14 December 2023).

4. Audit Regulation 3.20 – Audit compliance review (32% of visits)

Weaknesses in relation to Audit Regulation 3.20 are now intrinsically linked to weaknesses in a firm's SOQM, however there are specific requirements under Audit Regulation 3.20 that mean that separate reporting of issues is considered beneficial. The two key failings under this regulation were: a firm's review of its compliance with the Audit Regulations; and a firm's cycle of internal cold file review processes.

Cold file review processes

The most common underlying issue with a breach of this regulation was due to the lack of an effective cold file review process. In most cases, this resulted from a complete lack of a cold file review process in the year of the monitoring visit, and that preceding it.

An effective cold file review process is an essential component of a firm's SOQM, and firms with good quality audit files tend to have an effective cold file review process in place more often than not. ISQM(UK)1 in looking for a more proactive approach to quality management anticipates that firms should be conducting monitoring on a frequent basis to obtain real-time feedback on the effectiveness of the SOQM, however there are no laid down requirements in this standard.

However, the Audit Regulations are more prescriptive. All audit firm's should ensure that at least one cold file review process is conducted annually, and firm's should be careful to ensure sufficient coverage across all RIs and client types in a reasonable cycle. When it comes to considering how many cold file reviews to conduct, the Audit Regulations note:

> *"One approach to the question of frequency is simply to decide that the work of each responsible individual should be reviewed each year. Completed audit files would be selected and reviewed to make sure that the auditing standards and the firm's procedures had been followed. For many firms this may be the easiest procedure to adopt. In deciding how often to review someone's work, firms will consider factors similar to those used when deciding which files to review. Indeed, there may be particular reasons where the work of a particular responsible individual is reviewed more frequently."*

Most cases where a cold file review process had not been conducted involve smaller firms, and it is acknowledged that sole RI practices can find it especially challenging. ISQM1 does not normally permit an RI to undertake a cold file review on their own file, however if it is not possible to otherwise find a suitable reviewer within the firm the guidance within the Audit Regulations states that a sole RI can conduct their own cold file review so long as an external reviewer is engaged at least once every three years.

Smaller firms may also want to consider whether there is any another individual in the firm who, although not a responsible individual, is very experienced in current auditing requirements and might be able to undertake an effective review. If so, assuming that the individual did not take part in the audit, the firm may decide this individual would be a suitable person to conduct the required cold file review.

Reviewers also came across some instances in the year where a cold file review had been conducted as required, but where the findings of the process were inconsistent with the findings of ICAS Audit Monitoring. This is most often the case where an internal review did not raise many queries, or did not identify significant issues that were identified in the monitoring visit. Firms should ensure that any cold file review process is robust and conducted by individuals with sufficient capability and experience.

Audit regulation compliance review

There were a small number of cases in the year where a firm had not conducted an effective compliance review against the audit regulations. In one case an Audit Regulation compliance review had not been conducted which was a clear breach of requirements. In another case a review had been conducted, but had not identified a significant eligibility issue, and as a result had not been considered effective.

5. Audit Regulation 3.03 – Acceptance and reappointment (24% of visits)

Reviewers also found a number of issues relating to acceptance procedures during 2023. The most common weaknesses identified related to firm's Anti-Money Laundering (AML) arrangements, which affected 20% of the 2023 visits. Issues regarding AML compliance identified this year included:

- In two visits, the auditor had recorded ownership of an audit client lay with a foreign incorporated entity, but had not demonstrated sufficient work had been conducted in order to gain assurance over the ultimate beneficial ownership of the foreign parent itself.
- On one visit, the existence of the company being audited had been confirmed and documented, however the required Client Due Diligence over directors had not taken place.
- On one visit, AML considerations were not recorded covering two entities at the outset of the engagement, as there was no AML risk assessment; verification of ID for relevant trustees; and no evidence of ongoing review of the above.

- On one visit, historical records had been destroyed when the firm went 'paperless' and the existing files did not sufficiently record the required verification of identity for beneficial owners had taken place.

As part of its commitment to be an effective supervisory body for AML, ICAS will take regulatory action where there is sufficient evidence of a failure by its supervised entities and individuals to adequately meet their AML obligations and requirements.

Firms that had approached this area well had ensured that appropriate AML considerations were recorded for all audit clients, and where ownership sat with foreign entities the records had shown a clear understanding, and where relevant verification of identity, over the ownership structure including the ultimate beneficial owners.

Other less common audit regulation breaches

Audit Regulation 3.17 & 3.17a 16% - Maintaining competence (16% of visits)

These two audit regulations relate to maintaining competence, and are reported against when the monitoring team finds weaknesses in a firm or RIs arrangements for training and continuing professional development (CPD). Breaches of these regulations are often closely linked to other significant, or widespread, issues with audit quality or compliance.

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*3.17 **A Registered Auditor** must make arrangements so that all principals and employees doing audit work are, and continue to be, competent to carry out the audits for which they are responsible or employed.*

*3.17A **A responsible individual** must take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values, including, in particular, in relation to auditing, with content that is relevant to their role and responsibilities*

Half of the visits with issues report under Regulations 3.17 & 3.17A related to cases where insufficient or ineffective CPD was considered to have been an underlying factor in poor audit quality (where the RIs files were found to require significant improvement).

The other half of the cases in 2023 related to instances where RI's CPD records were poor, and did not demonstrate sufficient consideration of the requirements of International Education Standard 8 (IES8). IES8 requires each Audit Engagement Partner (i.e. RI) to develop and maintain the necessary competencies to perform the role effectively but the monitoring team often find weaknesses in how RIs demonstrate their maintenance of those competencies.

The "ICAS Guidance on IES8 Competencies & Learning Outcomes" provides assistance on the requirements of IES8 and how these can be applied practically to audit engagement partners, and more specifically to RIs in ICAS audit firms

Further, the ICAS website holds example CPD records, including one for an experienced Audit Engagement Partner which may provide useful reference. All RIs should ensure that they take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values, including, in particular, in relation to auditing, and their CPD records should demonstrate consideration of the requirements of IES8 as part of their CPD process.

Audit Regulation 3.16 - Audit reports (breached in 12% of visits)

This regulation sets out the requirement for an audit report for a UK entity to:

- state the name of the firm as it appears in the Public Audit Register;
- include the words 'Statutory Auditor' or 'Statutory Auditors' after the name of the firm; and
- if required by law (e.g. in the case of a limited company), state the name of the responsible individual and include the words 'Senior Statutory Auditor' after the name.

The most common issues found on monitoring visits in relation to this regulation are show below, and firms should be careful to check they do not arise:

- The name of the RI, or firm, used on the audit report does not match that recorded on the Public Audit Register.
- The required references under the Companies Act, such as the name of the Senior Statutory Auditor, are omitted. A practical example of this was where an incorrect (unincorporated) audit report template was applied to an incorporated charity.
- An audit report is signed in the name of the firm, when it is required to state the name of the responsible individual.
- The required references to Statutory Auditor (firm) and/or Senior Statutory Auditor (RI) are omitted.

Audit Regulation 2.03 - Audit eligibility (8% of visits)

While breaches of eligibility are relatively rare, they are among the most significant issues identified on audit monitoring visits. A breach of this Regulation would always warrant consideration by the full Committee and will carry the potential for regulatory action to be taken, including the likes of regulatory penalty (with associated public notice), or potentially worse, depending on the circumstances surrounding the breach.

Issues with eligibility most often arise where there have been changes in the structure of a firm, or where principals have changed, without sufficient notification being made to ICAS and consideration of the potential impact of the changes with regards compliance with the Audit Regulations. Audit Regulation 2.11 requires audit registered firms to inform ICAS in writing, as soon as practicable, of any changes which might affect a firm's eligibility. Notification of such changes should be timely and not later than ten business days after the event.

A summary of previous findings in this area is provided below for firms' reference, and all firms are reminded to keep ICAS Regulatory Authorisations aware of changes within the practice on a timely basis.

- Principals in an audit firm who are not members of ICAS, ICAEW, ICAI, or ACCA will likely require an Audit Affiliate application to be submitted. If there are changes in a firm's principals it will be important to ensure the requirements in the Regulations are checked, changes notified within 10 days, and any required affiliate applications made. In the past firms have been tripped up where internal promotions, or external appointments, of non-qualified individuals has resulted in eligibility issues that could have been easily addressed at the time of appointment.
- Individuals with the audit qualification must hold sufficient rights to direct an audit firm's overall policy or alter its constitution (i.e. hold at least a majority control). Again, the monitoring team has come across issues where new appointments, or retirals of existing principals, has led to a firm ceasing to be eligible for audit registration as individuals with the audit qualification no longer hold sufficient control of the firm. Not all CAs have the Audit Qualification, so care should be taken to keep track of changes in Audit Qualified principals and voting rights.
- Following on from the above, it is worthwhile to note that if a firm is constituted as an LLP or a Partnership and does not have a formal partnership agreement in place, all members/partners will be considered to have equal voting rights.

- Where an audit firm is constituted as a corporate practice (i.e. a limited company), there are various requirements that must be met in the entity's articles of association. These include a requirement for shareholders to notify the firm of any changes in shareholding, and a requirement that the firm's directors must approve any transfer of shares resulting in a shareholder holding more than 3% of the firm's share capital.
- In the unusual circumstances where the Audit Compliance Principal (ACP) is not a principal in the firm, the regulations require the ACP to be a member of a management board which administers or manages the firm.

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