



## Article topic: Financial Reporting

### Audit Failures on the Increase

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The Financial Reporting Council (FRC) has heavily criticised small audit firms for failing to conduct their audits to a satisfactory level. In particular, the FRC notes that a 'high proportion' of small firms are failing to gather sufficient and appropriate evidence to support the material areas of the financial statements.

The FRC has also reported that smaller firms of auditors are undertaking audits of listed and major public interest entities, but their work requires 'significant improvement'. In some extreme cases, smaller audit firms have been prevented from taking on listed clients because of their poor quality audit work.

So why are some smaller firms producing substandard work? Is it down to 'regulation overload', or a total failure to understand regulatory requirements.

#### New standards

Talking to practitioners, it would seem that regulation overload is a major contributing factor to standards falling short of the mark.

In recent years we have seen the UK switch from Statements of Auditing Standards (SASs) to International Standards on Auditing (ISAs) – which was a very painful switchover with many firms failing to understand and subsequently implement relevant ISAs.

We have also seen the implementation of International Financial Reporting Standards (IFRSs) introduced for quoted and AIM-listed companies, which has not been without problems. The new Companies Act 2006 was phased in and this is the largest legislation the UK has ever seen; then we have our complex taxation system in the UK which sees frequent changes, with some changes being more welcome than others. I covered much of these issues in a 'regulation overload' article, and certainly talking to practitioners, it would seem regulation overload is a major contributing factor to standards falling short of the mark.

In some more worrying cases, however, the competitive nature of the profession (more so nowadays) mean some firms are taking on work which they are simply not technically competent to undertake, nor do they have the resources available in order to complete the work to a certain

standard. This is one of the reasons cited in the Audit Inspection Unit's report and makes reference to smaller firms who audit large companies.

### More change on the way

Auditing in the UK is about to undergo a further fundamental change with the introduction of the Clarity ISAs for accounting periods commencing on or after 15 December 2010 and, yet again, practising firms will have to revise their audit methodologies and make sure they are aware of the new standards. Auditors will have to read (and understand) the Clarified ISAs because there is no other substitute to gaining an understanding of the revised requirements.

The Clarity ISAs have been the subject of some criticism within the profession because some critics consider the clarified ISAs as removing professional judgement from auditors (for example replacing the word 'should' with 'shall'). Notwithstanding the onerous regulatory requirements of today's modern accountancy profession, by talking to auditors and accountants in the profession through lectures, I am of the opinion that the problem is twofold.

Firstly, today's modern auditing standards place much more responsibility on the part of the auditor than the old SASs did. They require more thorough planning and a lot more documentation. When the ISAs were first introduced, audit firms saw a significant increase in the size of their audit files. One professional I was talking to recently said "we are being told to write with the right hand and document why we have not used the left!" This, I thought was a fair point, and is probably one of the main reasons why smaller firms of auditors are coming under fire from the regulators. In a number of cases, it seems practitioners are not doing enough work on audit planning and thus developing an adequate audit strategy. This seems to be happening because of fee pressure (clients view the audit as a cost with no benefit attached to it) as well as some practitioners not fully understanding the requirements of the ISAs.

Secondly are the inherent problems with audit programmes. An audit programme (and indeed the ISAs for that matter) will not make a good auditor or a good audit firm. The way we audit fixed assets, trade debtors, trade creditors, bank etc. is still a straight forward process for any experienced auditor, and has not changed significantly, even from the old SASs onto the new ISAs. The problem with the audit programmes in a lot of cases is that they encourage a 'tick box' style audit, without any thought going into the sufficiency and appropriateness of the audit evidence being gathered. Practitioners often think the steps in the audit programme are 'gospel' and if they follow each and every step throughout the audit programme, this will produce a high standard audit. This is not necessarily the case and firms need to understand that in a lot of cases, programmes will need to be tailored to be client-specific.

The standard-setters are keen to ensure that the work of professional accountants is completed to a high standard. However, the auditors are generally the ones in the firing line following a corporate scandal and as I have frequently suggested, a significant risk within the auditing profession is the fact that a material fraud could well go undetected by the auditors even where a degree of professional scepticism is adopted, the audit procedures adopted have been responsive to the levels of risk and the audit evidence gathered is sufficient and appropriate. This risk is present in all audits, large and small, because of the inherent limitations in auditing. Standard-setters can introduce new, or amend existing standards, but no standard, regardless of how much responsibility it places on an auditor, will ever stop fraudulent activity at client level.

### Sufficient and appropriate audit evidence

The whole objective of the audit is for the auditor to gather 'sufficient' and 'appropriate' audit evidence to give reasonable (not absolute) assurance that the financial statements are free from material misstatement. The fact that some smaller firms are not obtaining sufficient and appropriate audit evidence is one of the key reasons the FRC have launched a scathing attack on smaller audit firms. ISA 500 'Audit Evidence' (UK & Ireland) recognises 'sufficiency' as the measure of the quantity of audit evidence. 'Appropriateness' is the measure of the quality of the audit evidence gathered. ISA 500 (UK & Ireland) goes on to say that regard should be made to the relevance and reliability of evidence in providing support for, or detecting misstatements in, the classes of transactions, account balances, disclosures and related assertions.

The audit evidence gathered must be able to support the opinion expressed in the financial statements. If an audit firm cannot corroborate the opinion they have expressed in their auditor's report, they can expect to receive appropriate criticism from the regulators. But how much is 'sufficient' audit evidence? There is no benchmark in the UK & Ireland ISA as to what would be considered sufficient evidence; professional judgement needs to be used, but consider a manufacturing company who is very plant intensive. One of the material areas of their balance sheet will be the fixed assets and an immaterial area could well be petty cash. If the audit firm has spent hours producing reams of audit work and undertaken every possible audit procedure on petty cash (i.e. 'over-auditing'), but hardly focussed on fixed assets then clearly the auditor has not gathered 'sufficient' evidence to support a material area. Where audit sampling is used as an audit procedure, as long as the auditor ensures the sample is representative of the population then sufficient audit evidence can be gathered – problems arise in terms of sufficiency when these samples are not representative of the population from which they are extracted and I suspect many smaller firms are guilty of this.

### Documentation

One of the main areas that practitioners seem to struggle on is documenting the audit work. Regulators from the various professional bodies will expect to see documentation on file if you have a conversation with a client (say). 'Inquiry' is a procedure under ISA 500 'Audit Evidence' (UK & Ireland), and the standard recognises that inquiry alone will not provide sufficient audit evidence to detect material misstatements at the assertion level, but is complimentary to other audit procedures and is used quite vastly during the course of the audit. However, in order for inquiry to be used as audit evidence, it has to be documented.

Practitioners often ask what benefit there is to documenting all these issues. There is a whole standard devoted to audit documentation (ISA 230 (revised) UK & Ireland) and a key point in this UK & Ireland ISA is that audit documentation should be prepared to allow another experienced auditor, with no previous connection to the audit to be able to understand:

- The nature, timing and extent of audit procedures.
- The results of the audit procedures and the audit evidence gathered.
- Any significant matters arising during the course of the audit and the conclusions reached.

Unless you document discussions with the client or the audit procedures you have adopted, there is no way of knowing that the auditor has undertaken a procedure. I have heard practitioners who have been subjected to a visit from a regulator say that the abbreviation 'N/A' is deemed by some regulators to stand for 'not attempted'. In some audits, auditors will have undertaken the required audit procedures to satisfy themselves that there are no material misstatements within the financial statements, but in many cases these have not been documented – this is where regulators, such as the FRC, will complain about audit evidence not being sufficient.

### Documentation for smaller audits

It is fair to say that the use of an audit programme is critical in many audits. Unless you have extensive knowledge of the requirements of every single applicable UK & Ireland ISA pertinent to an audit client, you will need an audit programme. As mentioned above, the problem with audit programmes are that firms' often place complete reliance on them, forgetting that they should be tailored to become 'client-specific'.

This article has primarily focussed on smaller audit firms auditing large multi-nationals, but in general smaller firms will audit smaller companies. Many auditors forget about Practice Note 26 'Guidance on Smaller Entity Audit Documentation'. Practice Note 26 is specific to smaller audits and is an excellent resource for firms who conduct smaller audits. It is important to emphasise that the objective of Practice Note 26 is not to override the requirements of the ISAs, but instead to offer guidance on the form and content smaller audit documentation might take. A notable feature of this Practice Note is the fact that it contains illustrative examples of how audit documentation could be prepared for a smaller audit.

### Potential solution

The Audit Inspection Unit of the FRC is considering whether special tests should be set to consider whether a smaller firm of auditors can undertake an audit of a multi-national company. This could be given more prominence in the future as smaller firms are hoping audit competition will be expanded from the large firms of accountants (who have also recently been criticised by the Professional Oversight Board).

Of course, any audit firm, large or small, who produces substandard audit work, will receive criticism from regulators and the FRC have said that the number of smaller firms assessed by them as requiring significant improvement is a concern. However, having said that, let's not forget the well-publicised corporate disasters such as Enron, Parmalat and more recently, Lehman's and the recent shenanigans in the banking industry which involved larger firms. Should the FRC not devise a test for the larger firms as well? However, firms cannot blame regulation or legislation entirely. Professional accountants have a duty of care to their client and must only take on work which they are technically competent to undertake and also have the resources available to service the assignment. It would be reckless for a practising firm to take on work which it simply cannot complete to a required standard simply for the fee.

I think many practitioners may well welcome much less onerous legislation being bestowed upon the profession and a more 'user-friendly' approach to regulatory and legislative issues, certainly for clients at the smaller end of the spectrum, or is this being too optimistic?

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