FINANCIAL REPORTING COUNCIL

BULLETIN ON

2014 AUDIT PRACTICE REVIEWS
1.0 Introduction

This bulletin relates to Audit Practice Reviews (APR) conducted by the FRC for the twelve months ending 31 December 2014.

Pursuant to Section 77(1) of the Financial Reporting Act, FRC undertakes audit practice reviews of licensed auditors with the objectives of promoting the highest standards among licensed auditors and improving the quality of audit services provided by the auditors.

For the year 2014 FRC carried out 71 reviews in the following categories and 77 licensed auditors were reviewed.

<table>
<thead>
<tr>
<th>Category of Reviews</th>
<th>No. of Reviews</th>
<th>No. of Licensed Auditors Concerned</th>
<th>No. of Files Reviewed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Reviews</td>
<td>24</td>
<td>24</td>
<td>52</td>
</tr>
<tr>
<td>Follow-up Reviews:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• On-Site</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>• Off-Site</td>
<td>5</td>
<td>5</td>
<td>N/A</td>
</tr>
<tr>
<td>Thematic Reviews</td>
<td>7</td>
<td>13</td>
<td>25</td>
</tr>
<tr>
<td>Off-Site Reviews ISQC1</td>
<td>30</td>
<td>30</td>
<td>N/A</td>
</tr>
<tr>
<td>TOTAL</td>
<td>71</td>
<td>77</td>
<td>82</td>
</tr>
</tbody>
</table>

The review exercise comprised inspection of the firm’s quality system and engagement files, to assess whether the firms/licensed auditors had in place measures to provide an adequate safeguard for audit quality in line with the requirements of:

- International Standards on Quality Control (ISQC 1)
- International Standards on Auditing (ISA)
- Code of Professional Conduct and Ethics issued by IFAC;
- FRC’s Licensing of Auditors Rules 2007; and
- Rules established by FRC on Audit Practice Review
2.0 Engagement File Grading System

During the year 2014, FRC established a grading system to grade the engagement files reviewed during the audit practice review. The grading is in four categories as follows:

(a) Satisfactory (Grade 1)
(b) Acceptable with minor improvements (Grade 2A)
(c) Acceptable with significant improvements (Grade 2B)
(d) Unsatisfactory (Grade 3)

The rationale for the different grades are:
- Grade 1 is assigned when no issue has been raised from the review exercise;
- A grade 2A is assigned when there are minor procedural non-compliances identified in the engagement file;
- A grade 2B is assigned when there are technical issues or a combination of technical and procedural issues identified in the engagement file; and
- A grade 3 is given when the auditor has not complied with the requirements of IASs to perform the audit and yet has given a clean audit report; this is a breach of Section 39(2) of the Financial Reporting Act.

The table below summarizes the grades assigned to the 52 engagement files during the full review exercise for the following categories of entity:

<table>
<thead>
<tr>
<th>Category of Entity</th>
<th>Grading of Engagement Files</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>PIEs</td>
<td>5</td>
</tr>
<tr>
<td>GBC</td>
<td>6</td>
</tr>
<tr>
<td>Private</td>
<td>0</td>
</tr>
<tr>
<td>Non-PIE</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>14</td>
</tr>
<tr>
<td><strong>% of Engagement Files</strong></td>
<td>27%</td>
</tr>
</tbody>
</table>

14 (27%) engagement files were rated grade 1, 15 (29%) were rated grade 2A, 16 (31%) were rated grade 2B and 7 (13%) engagement files were very poor in quality and were rated grade 3.

Compared to previous year’s reviews, FRC noted improvements in the quality of the engagement files reviewed. However, FRC has a rigorous task to do given the 44% of files which require significant improvements. Almost all the engagement files which obtained grade
3 are identified at sole practitioners. Whereas engagement files graded 2B are from both sole practitioners and auditors from medium sized audit firms.

3.0 Full Reviews

For the full review exercise, FRC inspected 24 firms including large firms, 2 partners firms and sole practitioners as follows:

<table>
<thead>
<tr>
<th>Category of Firms</th>
<th>Number of Audit Firms reviewed</th>
<th>Partners Reviewed for first time</th>
<th>Partners Reviewed for second time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Practitioners</td>
<td>10</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>2-Partners Firm</td>
<td>8</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td>Large firm</td>
<td>6</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>24</strong></td>
<td><strong>18</strong></td>
<td><strong>6</strong></td>
</tr>
</tbody>
</table>

The most commonly occurring deficiencies identified from the review exercise concern:

- absence of understanding the entity and its environment (ISA 315),
- lack of auditor’s response to assessed risks (ISA 330),
- documentation of audit evidence regarding revenue (ISA 500), related parties (ISA 550) and going concern (ISA 570),
- consideration of laws and regulations in an audit of financial statements (ISA 250),
- planning procedures (ISA 300),
- Auditor’s responsibilities relating to fraud (ISA 240),
- analytical procedures (ISA 520),
- subsequent events (ISA 560),
• written representations (ISA 580) and
• Audit documentation (ISA 230).

Details of the issues identified are at Annex 1 below.

Directly following from the full review exercise 4 licensed auditors were referred to the Enforcement Panel (EP) by the Audit Practice Review Panel (APRP) whereby 7 of their engagement files were rated grade 3. The EP concluded that these were very poor audits and thus the auditors have not complied with Section 39(2) of the Financial Reporting Act, which states that “No licensed auditor shall, in his report, express an opinion unless he has complied with the auditing standards”.

Consequently the EP recommended to carry out a second full review of three of the 4 licensed auditors in the year 2015, whilst the fourth one has been put in a watch list as he has not renewed his auditor’s licence for the year 2015. The EP also recommended for these auditors not to undertake audit of Public Interest Entities until FRC is satisfied on the quality of audit services provided by them.

4.0 Follow-Up Reviews

Ten follow-up reviews were carried out in 2014 of which 5 were on-site and 5 off-site. On-site follow-up reviews were performed with respect to those practices where major shortcomings were observed during the first review exercise in year 2013. Whilst off-site reviews were done for auditors where certain policies/procedures were found to be missing during the previous reviews and the auditors were requested to provide feedback on the appropriate actions taken.

With respect to on-site follow-up five engagement files which were previously assessed were selected for the exercise. Improvements were noted in 3 engagement files whilst for the other 2 no improvements were noted. The grades allocated to the files were as follows:
### No. of Engagement Files

<table>
<thead>
<tr>
<th>No. of Engagement Files</th>
<th>Movement in the Grade of the Engagement Files</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Grade from First Review</td>
</tr>
<tr>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>1</td>
<td>2A</td>
</tr>
<tr>
<td>1</td>
<td>2B</td>
</tr>
</tbody>
</table>

The two engagement files where the grades worsened from 2A to 2B and from 2B to 3 were referred to the Enforcement Panel for appropriate actions.

#### 4.0 Thematic Review

FRC also conducted Thematic Review on going concern during the year 2014. The engagement files selected for the thematic review were based on the annual reports of those PIEs which had liquidity problems.

The purpose of this review was for the FRC to ascertain that:

(a) The auditor has the appropriate procedures in place to conduct the relevant audit work where risk of ‘going concern’ has been identified; and

(b) The appropriate audit work has been performed and documented by the auditor where the latter has identified going concern risk

For this exercise 25 engagement files from the portfolios of 13 licensed auditors from 7 different audit firms were selected.

22 of the engagement files selected were for 10 licensed auditors from big four audit firms. FRC noted from this review exercise that the audit teams had followed the required audit steps of the firm’s audit methodology on the assessment of going concern, and these were evidenced by the audit work done and same were adequately documented in the performance of the engagement.
5.0 Off-Site ISQC1/Audit Methodology Review

FRC also undertook off-site review for those licensed auditors who had no audit client as at the date of the review. The purpose of this review was to ascertain that these auditors have in place a quality control system as per the requirements of ISQC1 which is one of the licensing condition.

30 licensed auditors/firms were selected for this off-site ISQC1 review. From this exercise the following have been observed:

- 3 auditors did not had a documented quality control system at the time they were called for the review.
- Almost 25% of the auditors had no policies and procedures on the ISQC1 requirement for ‘Monitoring’.
- All the documented audit methodology reviewed during this exercise were developed internally by the auditors.
- Of those who have established the quality control system, the level of mapping of the requirements of ISQC1 were not sufficiently detailed in terms of policies and procedures.
- As most of these auditors are sole practitioners they therefore rely on CPD training courses to update their quality control system and audit methodology.

FRC recommended the auditors to take appropriate actions on the shortcomings identified during the review and these were favourably considered by them.
ANNEX 1

FINDINGS FROM FULL REVIEW EXERCISE

i. Quality System – ISQC1

With respect to ISQC1 the following observations were made:

- 23 of the 24 firms assessed had a documented Quality Control Manual;
- Out of the 23 firms, 20 had implemented the quality control policies and procedures whilst the other 3 did not put into practice their policies and procedures on quality control;
- The quality control manual of 1 firm was not in compliance with all the requirements of ISQC1;
- 4 firms did not have policies and procedures on the requirements for ‘Monitoring’ of the quality control system. Also, 3 firms did not carry any monitoring exercise to ascertain effectiveness of the quality system;
- 1 firm did not have policies and procedures on ‘Human Resources’;
- 2 firms did not have written policy on the completion of the assembly of final engagement files;
- 2 sole practitioners did not declare their independence vis-à-vis their clients, whereas in few other engagement files FRC noted that independence declarations were missing for some staff involved directly in the audits;
- 1 sole practitioner did not follow the procedure for ‘Acceptance & Continuance of Client relationships & specific engagements’;
- 1 auditor did not document the consultations he had on difficult issues encountered during an audit;
ii. Findings on ISA’s

FRC reviewed the engagement files to ascertain whether the licensed auditor had obtained sufficient appropriate audit evidence in order to substantiate his opinion. If the external auditor did not obtain sufficient appropriate audit evidence for any material part, he therefore did not obtain sufficient appropriate audit evidence to justify his opinion regarding the financial statements as a whole.

It can be seen from the table below that from 52 files reviews, 24 and 30 respectively did not comply with ISA 315 and 330 while performing the audit. These ISAs are critical in the sense that good planning of audit will undoubtedly lead to quality audit.

ISA 500 - Audit Evidence Gathering

Audit evidence and conclusions reached on these evidences are necessary to support the auditor’s opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.

The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion. For an audit, the auditor can perform both tests of controls and substantive analytical procedures in order to obtain audit evidence. Tests of controls concentrate on the assessment of the design, existence and operating effectiveness of internal controls of the client. Substantive audit procedures consist of detailed checks of parts of the financial statements and the substantive analytical procedures and balancing checks.

FRC observed that in several engagements the auditor failed to carry out substantive procedures with respect to specific relevant transaction flows, account balances and disclosures. Some of the non-compliances identified were:

- No documentation on the audit procedures used to assess the reasonableness of estimates with respect to impairment of receivables, impairment of investment in subsidiaries, retirement benefit obligations, revaluation reserve, impairment test on property, plant and equipment and improvements to building

- No sufficient appropriate evidence and audit procedures with respect to related party transactions
• No sufficient and appropriate audit procedures with regards to revenue recognition, inventories, taxation, receivables, payables, share capital, expenses, defined benefit plans and related party transactions

In most cases the auditor uses information from summaries, lists and databases of the audit client. FRC noted in several audits that the external auditor had not sufficiently assessed whether these summaries, lists and databases were sufficiently accurate to provide reliable information for his audit.

• No audit procedures to ensure the completeness, valuation and existence of inventories

• No audit work on opening balances

• No audit documentation with regards to retirement benefit obligations, impairment on deferred expenditure,

• No proper documentation of the appropriate legislations pertaining to the financial statements of the entities and the relevant audit procedures in respect of laws and regulations

• No documentation of communications between the auditor and those charged with Governance such as minutes of discussion with those charged with governance

• No documentation of the basis for determining the sample size used

### Adequacy of Presentation and Disclosure

The common area of non-compliance for ISA 330 was with paragraph 24 ‘Adequacy of Presentation and Disclosures’. Shortcomings were noted on IFRS disclosures in 30 of the engagement files inspected during full review. These were however, not detected by the auditors. Some of the important disclosure requirements with respect to IAS 1, IAS 10, IAS 17, IAS 24, IAS 39, and IFRS 7 were missing in the financial statements.

As per the requirement of ISA 330 paragraph 24, the auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. This relates to whether the individual financial statements are presented in a manner that reflects the
appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

In 24 engagement files FRC observed that there was a lack of documentation on understanding the entity and its environment and risk assessment. The procedures were not carried out adequately in relevant areas, and the auditor was therefore not able to obtain sufficient appropriate audit evidence to ascertain that they have obtained a good understanding of the entity and the risks associated to it. The auditor in fact failed to do the following:

- Understand the entity’s objectives and strategies
- Analyse the relevant industry factors (such as the competitive environment, supplier and customer relationships, and technological developments)
- Carry out preliminary analytical procedures at planning stage
- Address matters such as susceptibility of the entity’s financial statements to material misstatement and risks of fraud with the engagement team
- Obtain an understanding of the entity’s selection and application of accounting policies

Other Observations

FRC also made the following observations in certain engagement files with respect to:

Preliminary Engagement Activities
- Letters of engagement were not dated (ISA 210).
- No proper documentation of the procedure for acceptance/continuance of the engagement (ISA 220).
- No independence declaration (ISA 220).

Planning and Risk Assessment
- No sufficient and appropriate procedures for assessing fraud risks (ISA 240).
- No proper documentation of planning meeting with clients and management (ISA 300).
- No sufficient and appropriate documentation with regards to the audit work performed on Planning and Risk Assessment (ISA 315).

Audit Finalisation
- No analytical review performed at the end of the audit (ISA 520).
• No proper consideration of evidence gathering on subsequent events (ISA 560).
• No sufficient and appropriate documentation with regards to assessment of going concern assumption (ISA 570).
• Inappropriate documentation with respect to written representations (ISA 580).

The table below provide a summary of the areas where non-compliances were identified in the engagement file

<table>
<thead>
<tr>
<th>Respective Audit Areas</th>
<th>No of Engagement Files where shortcomings were identified</th>
</tr>
</thead>
<tbody>
<tr>
<td>o ISA 220, Quality Control for an Audit of Financial Statements</td>
<td>12</td>
</tr>
<tr>
<td>o ISA 230, Audit Documentation</td>
<td>10</td>
</tr>
<tr>
<td>o ISA 240, The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements</td>
<td>14</td>
</tr>
<tr>
<td>o ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements</td>
<td>16</td>
</tr>
<tr>
<td>o ISA 300, Planning an Audit of Financial Statements</td>
<td>16</td>
</tr>
<tr>
<td>o ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</td>
<td>24</td>
</tr>
<tr>
<td>o ISA 320, Materiality in Planning and Performing an Audit</td>
<td>8</td>
</tr>
<tr>
<td>o ISA 330, The Auditor’s Responses to Assessed Risks</td>
<td>30</td>
</tr>
<tr>
<td>o ISA 350, Audit Evidence</td>
<td>18</td>
</tr>
<tr>
<td>o ISA 501, Audit Evidence-Specific Considerations for Selected Items</td>
<td>8</td>
</tr>
<tr>
<td>o ISA 520, Analytical Procedures</td>
<td>14</td>
</tr>
<tr>
<td>o ISA 530, Audit Sampling</td>
<td>10</td>
</tr>
<tr>
<td>o ISA 550, Related Parties</td>
<td>18</td>
</tr>
<tr>
<td>o ISA 570, Going Concern</td>
<td>18</td>
</tr>
<tr>
<td>o ISA 560, Subsequent Events</td>
<td>14</td>
</tr>
<tr>
<td>o ISA 580, Written Representations</td>
<td>12</td>
</tr>
<tr>
<td>o ISA 700, Forming an Opinion and Reporting on Financial Statements</td>
<td>8</td>
</tr>
</tbody>
</table>

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