RUTGERS
UNIVERSITY | NEWARK

**Rutgers Business School**
AIS Department
Continuous Auditing Laboratory
Newark, NJ

https://raw.rutgers.edu/public_interest.html
kevin.moffitt@business.rutgers.edu

# FRC Brief - 2014

### *Audit Quality Inspection of Ernst & Young LLP by Financial Reporting Council (audit quality)*

The Financial Reporting Council (FRC) conducted an audit quality inspection on Ernst & Young LLP (EY) focusing on the year up to March. Key areas evaluated included the firm's internal communications, independence and ethics, performance evaluation, risk assessment, and audit quality monitoring. Certain areas noted for necessary improvements include thorough analysis to enhance audit quality and monitoring the effectiveness of planned actions to manage resource challenges. The report also underlined the need for the firm to sustain auditor independence. The firm's allocation of staff and the impact on audit quality due to resource challenges were raised as concerns, similar to the previous year's inspection. The FRC made these assessments based on reviews of EY's individual audit engagements and their supporting policies and procedures. Furthermore, EY was urged to pay more attention to IT control in their audit quality monitoring. The report was not meant to serve as a comprehensive scorecard, but aimed to highlight areas for improvement to foster better audit quality at EY.

### *The Role of Ethics and Governance in Corporate Profitability (ethics)*

The article discusses how adherence to ethics and governance can improve a company's profitability. The provisions of MiFID do not apply to incidental services provided in the course of regulated professional activities. Having a firm's Code of Ethics positively perceives can increase profitability, aligning the interests of all corporate actors. CEOs can significantly impact a company's ethics, employees' morale, and the risks undertaken by the company. The good practice of 'board processes' can be beneficial. The article highlights the importance of staff training in ethics and conflict of interest management. It discusses the importance of monitoring and ensuring compliance with guidelines and standards for better outcomes. International standard-setting bodies such as the IAASB and IESBA play a crucial role in maintaining dialogue and upholding the principles of auditing and professional ethics. The article indicates the ongoing commitment to improving regulatory systems and processes. Also, the SCWG works on standards and ethics-related topics, emphasizing the sense of shared views and concerns about pronouncements from the IAASB and the IESBA.

### *Audit Compliance Concerns from UK Regulatory Oversight (auditing standards)*

There is evidence of notable discrepancies in audit involvements and procedures within UK firms as seen in various areas such as balance work in group financial statements and group consolidations, which appear to not abide by auditing standards. The lack of involvement of auditors signing the company report in areas such as direction, supervision, and performance is of key concern, posing potential non-compliance with auditing standards and regulations. Of particular concern is the inability to demonstrate the alignment of the current approach with auditing standards, and further, the failure to request audit committees to correct unadjusted misstatements. Furthermore, the firm's methodologies and guidance for the audit of letterbox companies require more involvement to meet auditing standards. The management of fraud risk and the testing of journal entries have also been noted for non-compliance with auditing standards. Compliance with regulations and auditing standards is being closely monitored.

*Enhancements in Corporate Audit Quality Control and Reporting Standards (governance)*

The Financial Reporting Council (FRC) is committed to fostering investments through the promotion of high quality corporate governance and reporting. This is being achieved through the establishment and enforcement of UK Corporate Governance and Stewardship Codes along with standards for accounting, auditing, and actuarial work. Recent improvements to audit inspection activities include the introduction of important additions to the auditor's report for companies that apply the UK Corporate Governance Code. A system for involving the relevant audit committees in key audit reporting processes is also in place. Lastly, the services provided by FRC do not only involve analysis of narrative reporting in annual reports but extends to advisory services such as governance structure reviews and pre-implementation checks of systems and controls. The FRC steadfastly pushes for optimal compliance with the audit firm governance code.

*Enhanced Fraud Protection Measures in Financial Markets (fraud)*

The revised MiFID directive highlights numerous fraudulent activities in emission allowance spot secondary markets that can harm overall faith in emission trading schemes. Specific concerns include financial instrument misuse for fraud, misinformation misconduct, crime proceeds handling, terrorism financing, and money laundering. The directive underlines the need for regular checks, accurate record-keeping, and individualistic financial segregation to maintain and promote client trust and market stability. Additional precautions against fraudulent practices include the securities deposit guarantee fund for missing securities and organization-wide measures to reduce client asset loss due to fraud. Harmonized client identification in trading venue records can also aid in detecting potential fraudulent activities. French securities in accounts maintained in France are only likely to come under scrutiny when fraud is suspected.

*Enhancing Audit Quality and Safeguarding Auditor Independence (auditor independence)*

1. Significant attention is needed to improve audit quality, particularly with the rising number of audits requiring improvement. Investigative analysis needs to be conducted to ascertain the reasons behind this trend.
2. Cases have been identified where non-audit services were approved without sufficient evidence that auditor independence would not be compromised. This underlines the need to ensure appropriate safeguards are implemented to protect against potential threats to auditor independence.
3. Instances of partners holding financial interests in audit clients reveal a lack of understanding and compliance with ethical standards prohibiting such arrangements. The firm must reinforce these critical standards amongst partners and staff for preserving auditor independence.
4. In some cases, inadequate consideration is given to the appropriateness of providing non-audit services, particularly when an entity becomes an audit client or subsequently gets listed.
5. Further enhancement of audit quality can be achieved by refining the approach towards auditing collective and individual loan loss provisions in financial service entities.
6. Continuing deficiencies in the performance of analytical review procedures call for a thorough revision of the firm's audit methodology.

*Audit Quality Assessment and Going Concern Evaluation Issues (going concern)*

Four audits required substantial improvements in areas such as group audit considerations, going concern, intangible assets, it controls testing, and the audit of actuarial models and provisions. Particularly, there were deficiencies in the assessment of the "going concern" assumption on eight audits sampled, with issues uncovered in five of them. These issues included insufficient audit team assessment, lack of evidence considering key factors, inconsistencies with management's assumptions, and inadequate financial statement disclosures. There were specific concerns regarding non-renewal of licenses impacting an entity's ability to continue operating. Further issues were seen in the lack of audit evidence on underwriting agreements and inadequate procedures concerning going concern assumption-related disclosures. Such findings were part of a broader Financial Reporting Council (FRC) project scrutinizing the quality of small listed and AIM companies' financial reporting.

*IT Risk and Audit Strategy: The Evolving Role and Requirements of IT Specialists in Complex Environments (environment)*

Audit teams are increasingly required to evaluate the impact of IT on their audit strategies, concurrently considering the complexities of the IT environment on a yearly basis. This task is often undertaken by non-IT experts, which might pose challenges for complex IT ecosystems. A need is emerging for stricter guidelines on collaboration between the audit team and IT specialists for dealing with intricate IT environments to ensure appropriate audit strategy preparation. Auditing firms should also focus on rewarding high-quality audit work to encourage a conducive environment for improvement. Increased regulatory changes are anticipated to drive a considerable surge in future inspection activities with a major focus on the firms such as Baker Tilly UK Audit LLP, Crowe Clark Whitehill LLP and Mazars LLP. Audit teams are required to involve an IT specialist every three years, or sooner if they identify a significant system change or assess the IT environment as complex. This helps determine whether IT specialist involvement in the audit is necessary.

*Internal Audit Control Issues and Subsequent Risk Assessment Procedures (internal controls)*

The audit team's approach to internal controls was found to have issues in three major audits. The current method of item risk assessment does not adequately consider the reliance on internal controls or automated processing. In some instances, even when the risks were classified as low, it was due to the unacknowledged reliance on effective internal controls. Consequently, audit teams primarily engage in substantive audit procedures, including analytical review, indicating an implicit reliance on internal controls. Therefore, the company must reassess its risk measurement procedures, including the supporting evidence required, the weight given to assessments without internal control checks, and whether substantive analytical review is an adequate audit response.

---

*information. Always refer to FRC's original documents for complete and accurate information.*