

FRC Brief - 2015

Inspection of Ernst & Young LLP's Audit Quality by the Financial Reporting Council (audit quality)

The Financial Reporting Council (FRC) has conducted an audit quality inspection of Ernst & Young LLP (EY). This inspection involved reviews of individual audit engagements and EY's supporting audit policies and procedures, with a focus on areas such as internal communications, risk assessment, performance evaluation, and audit quality monitoring among others. The goal of these inspections is to enhance audit quality and adherence to the firm's independence processes. Attention was also given to ensure that EY's audit reports accurately describe performed audit procedures. The FRC has taken note of improvements made by EY in response to last year's inspection, notably increased focus on audit quality and the establishment of an audit quality board. The report highlighted areas where EY needed improvement, such as the evidence supporting certain audit decisions. Improvements included the appointment of the audit quality leader and board, and strengthening of the quality support team. EY has also implemented measures to address previous inspection findings.

Audit Quality Inspections and Corporate Governance Standards (governance)

Ernst & Young LLP, Grant Thornton UK LLP, Deloitte LLP, and BDO LLP have participated in audit quality inspections carried out by the Financial Reporting Council (FRC). The FRC aims to uphold high standards of corporate governance and reporting to encourage investment, setting the UK's corporate governance and stewardship codes, as well as the country's standards for accounting, auditing, and actuarial work.

A senior EY audit partner, acting as the audit quality leader, provides essential feedback and proposes changes to the audit practice's governance and control as needed. The FRC also introduced a revised, expanded auditing standard on auditor reporting, which came into effect in October, mandating significant additions to the audit report.

In April, potential updates to the UK Corporate Governance Code were deliberated, with the key focus on improving communication with audit committees, mainly regarding planning the audit approach or resolving arising issues. All inspected firms are generally covered by the audit firm governance code, which means their findings are directly sent to the respective audit committees or individual responsible for the firm's governance.

These inspections are crucial to ensure transparency and accountability in corporate governance, notably in compliance with London Stock Exchange listing rules and their application in firms' audit reports. The goal remains to ensure optimal communication of audit findings to both the auditor and those charged with governance.

Ethical Standards and Corporate Governance in Pakistani Securities Markets (ethics)

Arguments against aggregation include the potential for confusion in the producer's actual position and conflicts with existing principles of employment law. However, current recommendations should be free of such conflicts, as already mandated by applicable ethical codes. These ethics, which prioritize due diligence and independence in the issuance of investment recommendations, are integral in shaping the direction of boards within Pakistan's

securities market.

Quality and performance of external audits are guaranteed by guidance provided in the Code of Corporate Governance (Code), which also outlines regulations for appointing external auditors. Furthermore, ICAP's adoption of the International Ethics Standards Board's Code of Ethics fortifies the regulatory framework that facilitates compliance and quality control within the auditing profession. This Ethics Code, adoptive of IFAC's guidelines, defines principles like integrity, objectivity, professional competence, and confidentiality for all associated parties. Failure to comply with the Ethics Code results in disciplinary action by the ICAP council, after an investigation. Auditing standards in Pakistan align with International Standards on Auditing (ISA), the International Code of Ethics, and the International Standard on Quality Control, guaranteeing independence and other aspects of professional ethics. The Ethics Code covers assurance engagements, delineates 'conflicts of interest,' and addresses independence requirements for audits and reviews. Non-compliance results in termination of relevant engagement, thus ensuring and enforcing ethical standards.

Compliance Issues in Auditing Practices and Standards (auditing standards)

The report highlights several instances of non-compliance with auditing practices and standards. This includes unsupported conclusions regarding certain revenue streams posing no significant risks, neglect of full scope audits on significant components, and issues with the usage of extended auditor's reports. Incorrect auditing standards were utilized where an extended auditor's report was not necessary. The report underscores the importance of adhering to auditing standards, ethical standards, quality control standards, and audit regulations issued by professional bodies, especially in light of new requirements introduced by the UK auditing standards. The report also notes instances where certain risks were not separately highlighted as 'significant risks'. Further, there were instances where the audit team failed to conclusively determine their stance on the group's application of accounting standards, impacting the expression of a clear audit opinion.

Enhancing Audit Quality and Safeguarding Auditor Independence (auditor independence)

The firm needs to focus on rectifying deficiencies in their independence processes, ensuring resources are efficiently utilized to identify and respond promptly. The perceived threats to auditor independence need to be properly identified, paired with the corresponding safeguards, and communicated adequately to audit committees. The firm must also introspect the ongoing deficiencies in their audit performance. Auditor rotation may be needed to safeguard independence, especially as the threat increases with the audit engagement partner's prolonged involvement. Clarification is needed in tender documents emphasizing the necessity to maintain auditor independence. Lastly, the firm should foster a culture promoting professional skepticism and management challenges to enhance audit quality and safeguard auditor independence.

Audit of Loan Losses, Impairments and Internal Control Testing (internal controls)

The primary focus of interest revolves around the audit of loan losses and impairments, backed by the FRC's thematic inspection. There is a significant concern about the lack of internal control testing, resulting in inadequate audit evidence regarding inventory existence and conditions at unvisited sites. In several audits reviewed, auditors tended to rely on internal controls for certain financial statement areas and actively tested these controls' operational effectiveness.

However, this method, which doesn't rely on internal controls, may not be extensively efficient in certain protocols. Therefore, attention is drawn to the auditor's perception on critical accounting policies, effectiveness of internal controls, and other annual report-related aspects.

Understanding Fraud Risk and Audit Approaches in Financial Inspection Findings (fraud)

There's an intrinsic need to enhance the audit approach concerning the testing of journals, including the selection based on fraud risk characteristics. In several audits, there were lapses in rightly identifying the fraud risk in revenue recognition, leading to ambiguity in the audit process. Generic risk criteria were typically used to select journals for testing, often overlooking specific fraud risks related to the audit. The most common issues reported were regarding fair value and value in use measurements. Despite improvements in using computer-assisted techniques for identifying journals with fraud risk characteristics, some audits focused too narrowly on specific fraud risks, failing to adequately consider journals presenting multiple fraud risk characteristics.

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