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Independent challenge is vital to high-quality audit - industry regulator report

Advocate Raymond Ashton offers his analysis of the Financial Reporting Council's report on the challenges faced by auditors



Auditors should report clearly and transparently on critical judgements and explain how the engagement team reached their conclusions, a conclusion frequently stated in evaluation reports. (29090763)

OF all the financial journals outside the specialist papers, the Financial Times is the paper which takes the most interest in developments in auditing.

One of the problems in audit practice is that the auditors often view the management of the company they audit as the client. The Financial Reporting Council [the regulator for auditors, accountants and actuaries] has issued a report on the challenges faced by auditors in discussions with management and particularly judgmental areas such as long-term contracts, goodwill impairment or the valuation of financial instruments.

This article looks at the findings of this report which were reported by the FT.

Effective challenges to manage-

'The audit function should be seen as an effective tool of management which can be justified on its own terms and result in better decisions and more cost effective decision-making'

ment is one of the most critical responses across a number of International Standards on Auditing, for the auditor to exercise and demonstrate appropriate professional scepticism.

Independent challenge is vital to a high-quality audit, particularly at a time of prolonged heightened uncertainty as at the moment which is compounded by operational challenges.

It should be at the forefront of auditors' minds also as they progress their December 2020 year-end audits thereafter.

It appears the FRC have been encouraged by the initiatives that some firms are taking to develop and embed a culture of challenge; for example, to emphasise (as stat-

ed above) that the management of the audited entity is not the client (see above reference) and the range of culture and quality initiatives being taken within audit practices. It seems that the FRC have been impressed by the output from the root cause analyses many audit firms have undertaken.

Despite this, the audit quality review data continues to highlight this area (the interaction with management) as being a key determinant of poor quality audits.

More than 80% of the audits that were reviewed over the past two years were identified as 'improvements required' or 'significant improvements required'. The ineffective challenge of management was a key driver of the overall

assessment of the audit work. Whilst the initiatives that firms have taken might not be reflected in the current Audit Quality Results (AQR) results, the prevalence of their findings suggests that further action is needed by firms if greater consistency and quality of challenge is to be achieved.

The table below left summarises the more significant observations arising from the audit inspections.

Auditors should report clearly and transparently on critical judgements and explain how the engagement team reached their conclusions, a conclusion frequently stated in evaluation reports.

Changes to audit procedures are likely to be part of the solution; procedures alone cannot fix the problem. More processes and templates can be distractions that stifle the required critical thinking and robust, evidence-based, judgement is an essential component of an effective challenge.

Developing the right mindset and professional culture is critical. Both of these attributes are heavily influenced and reinforced by a strong audit culture of scepticism and challenge.

In such a culture, auditors will feel confident that they have the support of senior management of the firm when they challenge management, even if it might in certain circumstances lead to delays or modifications of audit reports, or a breakdown in the relationship with the management of the audited entity.

Members of audit teams should be encouraged to ask questions and raise concerns; and auditors should be open to new information and challenge from members of the audit teams, specialists and peers.

Conclusions

As an example of an improvement, the FRC noted during their recent going concern review that a number of audit teams were able to demonstrate enhanced challenge of management in respect of the audit of going concern which was developed to address the additional audit risk.

It is hoped that the lessons learned and experience gained from this review will allow firms to replicate effective challenge of management consistently on future audits.

These innovative developments should be encouraged.

Quite independently of this development, management can expect auditors to challenge them more robustly both in the immediate future and subsequently.

However, it is important that whilst auditors should develop and enhance the measures to challenge management they should at the same time demonstrate that the measures can be justified on a cost benefit basis.

The audit function should be seen as an effective tool of management which can be justified on its own terms and result in better decisions and more cost effective decision-making.

When things go wrong:	When things go right:	Firm action plans to improve commonly focus on:
<ul style="list-style-type: none"> Insufficient use of internal specialists or experts Issues relating to completeness of evidence, including too much focus on gathering corroborative evidence and not being sufficiently alert to contradictory evidence Overreliance on management inquiry 	<ul style="list-style-type: none"> Strong risk management including an understanding of the risk of management bias Consultation on complex areas 	<ul style="list-style-type: none"> Senior team involvement Understanding of the audited entity's system of internal control Robustness of management's assessment and evidence