Financial Reporting Council

January 2014

Audit Quality Thematic Review

Fraud risks and laws and regulations

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368.
Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.

Financial Reporting Council

Audit Quality Thematic Review

Fraud risks and laws and regulations

1 Background, scope and key messages

1.1 Background and scope

This report sets out the principal findings of the second thematic inspection review undertaken by the Financial Reporting Council's (FRC) Audit Quality Review (AQR) team during 2013. The two themes for this review were the auditor's identification of and response to fraud risks, and the auditor's consideration of laws and regulations.

From 2013 thematic reviews will supplement our annual programme of audit inspections[1] of individual firms. In a thematic review we look at firms' policies and procedures in respect of a specific aspect of auditing, and their application in practice. The reviews are narrow in scope, and the specific aspect may be chosen in order to focus on it in greater depth than is generally possible in our inspections or because our inspection findings have suggested that there is scope for improvement in the area concerned. A thematic review enables us to look at an aspect of auditing in more depth, and to make comparisons between firms with a view to identifying both good practice and areas of common weakness.

The themes for this review were chosen because they are matters of public interest where there are high expectations and common misunderstandings of the auditor's role. They are also areas where sometimes there is no direct relationship to the financial statements, as a result of which there is a risk that the auditor does not place appropriate emphasis on them.

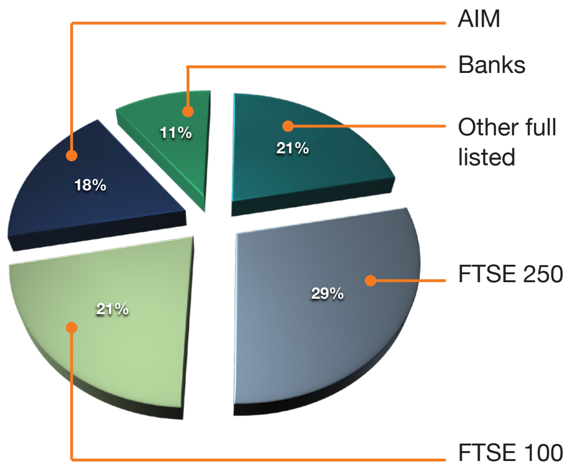
This report should promote a better understanding of the role of auditors in these important areas and should also assist Audit Committees in discharging their oversight responsibilities.

Our findings and recommendations identify some specific areas in which auditors should review and improve their performance with a view to better fulfilling their professional responsibilities. We will expect to see improvements in the areas identified in this report in our future inspections of individual firms.

We visited the six largest audit firms (BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit plc and PricewaterhouseCoopers LLP) to review their audit methodology and guidance and training provided to staff in respect of fraud risks and consideration of laws and regulations.

We also reviewed relevant aspects of the audit procedures performed for 26 entities in the retail, construction, support services, banking and mining industries. These related to audits of financial statements for financial year ends between December 2011 and September 2012. Our reviews focused on the audit team's assessment of fraud risks and risks of non-compliance with laws and regulations and the planned audit procedures to address these risks.

A summary of the entities covered by the audits we reviewed is set out below:



The observations made in this report are based on our review of firms' procedures and guidance and relevant parts of the audits we selected, as identified by the audit teams concerned. We have discussed our findings with each of the audit firms concerned.

1 Audit Quality Inspections Annual Report 2012/13: Section 4 – Summary of activities

1.2 Overview and key messages

This section provides an overview of areas of good practice identified at one or more firms; our principal findings set out in sections 2 and 3; and identifies a number of key messages, of relevance to both audit firms and Audit Committees, arising from the findings of our review.

Good practice observations

Fraud

- Requiring specific audit procedures to be performed for listed entities, including reviewing analysts' reports, to identify fraud risk factors.
- Using forensic specialists in fraud risk discussions and in running computer assisted audit techniques (CAATs) for journal testing.
- Using CAATs on all audits to test journal entries, with exceptions expected to be rare.
- In relation to the risk of management override of controls, requiring completion of a final conclusions document summarising the results of all audit procedures performed and reaching an overall conclusion.
- Requiring audit teams to review the results of audit work performed for all accounting estimates in one place to assess whether there are any indications of management bias.

Laws and regulations

- Using a proforma document identifying the applicable laws and regulations; how they might affect the financial statements; and assessing the design and implementation of relevant controls.
- Providing appropriate training and guidance to audit teams on how they should respond to the UK Bribery Act in conducting audits.

Overview of findings

- All firms' methodologies require audit teams to perform the risk assessment and audit procedures required by auditing standards for fraud and laws and regulations. The matters raised in this report mostly relate to audit teams' application of these requirements in practice. We did not identify any significant deficiencies which would indicate that an inappropriate audit opinion may have been issued. We did, however, identify a number of areas where auditors should improve the quality and effectiveness of the audit procedures performed.
- Although practice is not uniform across all firms and audits, there is a lack of focus on identifying the specific risks in relation to fraud and non-compliance with laws and regulations and there are a number of specific areas requiring improvement. These improvements would better position auditors to detect possible material misstatements due to fraud and non-compliance with laws and regulations.
- The consideration of fraud risks and relevant laws and regulations, and the performance of related audit procedures, tends to be viewed as a compliance exercise rather than as an important and integral part of the audit. Improvements are needed to better focus attention on how these may affect the financial statements. We saw evidence of a presumption by audit teams that issues in these areas were unlikely to occur at the entity they were auditing. This suggests a lack of appropriate professional scepticism.
- More frequent and up to date training would assist audit teams in identifying potential risks in relation to fraud and laws and regulations and in designing appropriate audit procedures to address these risks.

Key messages for audit firms – Fraud risks

- Auditors should increase their focus on identifying fraud risk factors in both planning and conducting the audit. In achieving this:
  - Auditors should ensure that fraud risk discussions amongst the audit team are led by the engagement partner and are more

focused on identifying fraud risk factors as well as the risks of material misstatement in the financial statements due to fraud. For the larger, more complex entities, including forensic specialists in these discussions would improve the identification of potential fraud risks.

  - Auditors should improve their assessment of fraud risk factors and fraud risks by having more meaningful discussions with management, including internal audit and those outside the finance function. These discussions should focus more on fraud risks rather than any frauds already identified.

- Fraud risk factors may become apparent as the audit progresses. These fraud risk factors should be reassessed at the end of the audit and a conclusion reached as to whether fraud risks have been reduced to an acceptable level.

- Assessment of fraud risks and the audit procedures which are intended to address them should be more tailored to the entity. For example:

  - Auditors should ensure that, in identifying the risk of management override of controls as a significant risk, they also assess the level of risk specific to the audited entity taking into consideration all of the fraud risk factors present.

- As fraud risks should always be considered to be significant risks, auditors should evaluate the design and implementation of the entity's internal controls to detect and prevent fraud, where such risks are identified.

  - Auditors should ensure that journal testing is responsive to the fraud risks identified. More use of computer assisted audit techniques (CAATs) may improve the quality of audit work in this area.

  - Auditors should exercise greater professional scepticism in identifying and addressing the fraud risks that are specific to the audited entity.

- Auditors should ensure that final analytical review procedures are not limited to comparing line items in the current year income statement and balance sheet to the prior year figures. Use of other ratio analysis and inclusion of the cash flow statement in the analysis may improve the quality of work in this area.

- Auditors should draw an overall conclusion relating to the risks of material misstatement due to fraud after considering all relevant audit evidence obtained during the audit.

- More frequent and up to date training is likely to be beneficial in improving audit quality in this area.

Key messages for audit firms - Laws and regulations

- Auditors should improve their identification and assessment of the laws and regulations affecting the audited entity, with a clearer identification of those that may have a direct or indirect impact on the financial statements, including considering the UK Bribery Act 2010.

- Auditors' discussions with management should include management responsible for compliance matters and should place more emphasis on identifying the relevant laws and regulations that may have a direct impact on the financial statements and whether the entity is in compliance with them.

- Auditors should evaluate the design and implementation of the entity's internal controls to monitor compliance with laws and regulations.

- Auditors should exercise greater professional scepticism throughout the audit in relation to possible breaches of laws and regulations that may have a material impact on the financial statements.

- More regular and up to date training is likely to be beneficial in improving audit quality in this area, particularly in relation to the auditor's response to the UK Bribery Act 2010.

Key messages for Audit Committees

Audit Committees play an essential role in ensuring the quality of financial reporting. In particular, their work in discussing with auditors the audit plan, as well as the audit findings, can contribute greatly to audit quality. To assist Audit Committees, we have summarised below those matters which we believe may enhance their oversight of the audit process in relation to fraud risks and laws and regulations and thereby contribute to an overall improvement in audit quality. In some instances these matters are the same as those of relevance to auditors, while in other cases the emphasis differs.

Fraud risks

- Audit Committees should expect to discuss fraud risk factors with their auditors.
- Audit Committees should ensure they have reviewed the key controls in place to mitigate the risk of material misstatement in the financial statements due to fraud and discuss these with their auditors.
- Audit Committees should discuss with their auditors how they have concluded on their audit procedures to respond to the risks of material misstatement due to fraud. In particular:
  - Whether their auditors have had discussions with management (including management from outside the finance function) and internal audit regarding fraud risks.
  - The auditors' assessment of the level of risk of management override of controls.
  - The audit procedures they have performed in response to the risk of management override.
  - The auditors' approach to testing journals and whether computer assisted audit techniques (CAATs) have been used.
- Audit Committees should, when tendering their audit, consider enquiring about the nature and frequency of the fraud training provided by firms to audit staff.

Laws and regulations

- Audit Committees should discuss with their auditors the relevant laws and regulations affecting the business that have, or may have, a material impact on the financial statements.
- Audit Committees should ensure they have reviewed the key controls in place to mitigate the risk of material misstatement due to non-compliance with laws and regulations and discuss these with their auditors.
- Audit Committees should ensure that the entity has appropriate processes and controls in place in response to the UK Bribery Act 2010 and enquire as to the steps that their auditors are taking to address this risk.
- Audit Committees should seek to understand how compliance with relevant laws and regulations has been addressed by their auditors during the audit.
- Audit Committees should, when tendering their audit, consider enquiring about the nature and frequency of laws and regulations training provided by firms to audit staff.

1.3 Consideration of fraud risks and laws and regulations in auditing

Auditing standards recognise that both fraud risks and laws and regulations provide particular challenges for auditors.

Fraud risks

A fraud may be perpetrated by or against the audited entity. It may be carried out by customers, suppliers or other third parties, or by employees, management or directors individually or acting together. It may be directed at misstatement of the financial statements, or the misappropriation of assets of the company or others, or to obtain an unfair or improper advantage for the company itself. In general, it will be accompanied by attempts to conceal it, and may be achieved in very sophisticated ways. Directors and senior management, in particular, may be able to conceal fraudulent acts by their ability to override controls, or require employees to act so as to conceal the true nature of activities.

An audit is directed at the truth and fairness of the financial statements, and the auditor is required to obtain reasonable assurance (defined as a high, but not absolute, level) that these are free of material misstatement, whether caused by fraud or error. Auditing standards require the auditor to carry out certain procedures to identify and assess the risks of material misstatement due to fraud. In particular, the auditor is required to consider the presence of fraud risk factors; these are not risks of fraud, as such, but events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to do so. This approach recognises the impracticability of conducting an audit in a forensic manner, and the difficulty in identifying the existence of fraud. Having assessed the risks of material misstatement due to fraud, the auditor is required to design and perform audit procedures that are responsive to these risks.

Laws and regulations

Laws and regulations present different challenges for auditors. The primary difficulty is the wide scope and reach of regulation. The focus again is on the financial statements and, in particular, whether breaches of laws and regulations give rise to actual or potential liabilities. Where there is a breach, material liabilities may arise; but the existence of such a breach may not immediately be identified, or may be evidenced by information and actions outside the financial systems that are the auditor's normal focus.

Auditing standards therefore distinguish between those laws and regulations having a direct effect on material amounts and disclosures in the financial statements (for example, the requirements of accounting standards; tax legislation; pension rules) and those that may have a material effect on the financial statements (for example, compliance with environmental regulations or solvency requirements). Audit evidence is required to be obtained for the former. For the latter, the auditor is required to carry out specified procedures to help identify instances of non-compliance that may have a material effect on the financial statements.

2 Principal findings – fraud risks

The auditor's responsibilities relating to fraud are set out in ISA (UK and Ireland) 240, 'The auditor's responsibilities relating to fraud in an audit of financial statements', (ISA (UK&I) 240). In meeting these responsibilities audit firms should pay particular attention to our principal findings set out below.

The auditor is required to obtain reasonable assurance, defined as a high, but not absolute, level of assurance, that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error (ISA (UK&I) 240 paragraph 5). The ISA explains that the risk of an undetected material misstatement resulting from fraud is higher than the risk of an undetected misstatement due to error. The principal findings we highlight in this report relate to:

- Identification and assessment of fraud risk factors
- Evaluation of the entity's controls in respect of fraud risks
- Fraud risk discussions amongst the audit team
- Fraud risk discussions with management and internal audit
- Assessing the level of risk of management override and planning the audit response
- Journal testing
- Final analytical review
- Concluding on fraud audit procedures
- Fraud training

Our discussions with audit regulators in certain other jurisdictions suggest that our findings in relation to fraud risks are broadly consistent with weaknesses identified by them in this area.

2.1 Identification and assessment of fraud risk factors

- Fraud risk factors were not clearly identified and evaluated in assessing the level of risk associated with management override of controls.
- Audit Committees should expect to discuss fraud risk factors with their auditors.

ISA (UK&I) 240 recognises that while fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. The auditor is required to evaluate whether the information obtained from other risk assessment procedures and related activities indicates that one or more fraud risk factors are present (ISA (UK&I) 240, paragraph 24).

Fraud investigations have shown that a number of fraud risk factors were usually present prior to a fraud being discovered. The identification of fraud risk factors on the audits reviewed required improvement. In most cases, whilst required by the firms' methodologies, there was no clear identification of fraud risk factors or assessment of the level of risk of material misstatement due to fraud arising from these, particularly in relation to management override. We noted the following matters:

(a) On several audits fraud risk factors had been identified on various planning workpapers but these were not collated or their impact assessed.

(b) One firm required specific audit procedures to be performed to identify fraud risk factors for listed entities, including reviewing analysts' reports. However, this was only performed well for two of the four listed entity audits reviewed.

Principal findings – fraud risks

Principal findings – fraud risks

(c) At some firms the identification and assessment of fraud risk factors is embedded in the engagement acceptance and continuance process but these are only considered in the fraud risk assessment if they are identified as high risk. Other fraud risk factors identified, but not assessed as high risk, are therefore not considered for this purpose.

(d) Audit teams' planning discussions and discussions with management focused on how the risk of fraud might arise in the financial statements rather than on identifying fraud risk factors. This suggests some confusion between identifying fraud risks and identifying the existence of fraud risk factors.

In our view, audit teams' fraud risk assessment process should be improved to focus on the identification and assessment of fraud risk factors.

We also noted a lack of consideration of the key performance indicators reported by management in the front half of the annual report that may be used to determine management remuneration. In some of the industry segments we reviewed these might be:

- Like-for-like sales for retail businesses.
- Forward order book for construction and support services entities.
- Reserves for extractive businesses.

Where there is evidence of management placing particular emphasis on other information of this nature, the risk of manipulation of these figures should be considered in assessing fraud risk factors. There was little evidence that the audit team considered the incentive for management to manipulate other information disclosed in the annual report, outside of the financial statements, to achieve remuneration targets.

2.2 Evaluation of the entity's controls in respect of fraud risks

- There was no evidence, on most audits, that the design and implementation of the entity's controls in respect of fraud risks had been evaluated.
- As part of their review of internal controls, Audit Committees should ensure they have reviewed the key controls in place to mitigate the risk of material misstatement in the financial statements due to fraud[2] and discuss these with their auditors.

The auditor is required to obtain an understanding of internal controls relevant to the audit (ISA (UK&I) 315 paragraph 12). Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor evaluates the design of those controls and determines whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel (ISA (UK&I) 315 paragraph 13).

On a number of audits the entity's policies regarding ethical behaviour and fraud, including whistleblowing policies, were described as controls that mitigated the risk of a material misstatement due to fraud occurring or not being detected by management. However, we noted that there was a lack of assessment of the design and implementation of these controls. For example, for the 16 entities for whom the annual report or the audit file referred to a whistleblowing log, the log was only obtained and reviewed on four audits we reviewed.

Controls that mitigate the risk of material misstatement due to fraud are relevant to the audit and therefore further audit procedures to assess the design and implementation of these controls should be performed.

2 The UK Corporate Governance Code 2012 states that the responsibilities of the audit committee should include reviewing the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, reviewing the company's internal control and risk management systems.

2.3 Fraud risk discussions amongst the audit team

- Fraud risk discussions amongst the audit team should be led by the engagement partner and place more emphasis on discussing fraud risk factors, identifying potential risks of material misstatement due to fraud and the planned audit approach in response to the risks identified.

A discussion is required among key engagement team members, led by the engagement partner, to discuss the susceptibility of the entity's financial statements to material misstatement (ISA (UK&I) 315 paragraph 10). This discussion places particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion occurs setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity (ISA (UK&I) 240 paragraph 15).

It was only clear in 12 of the 26 audits that this discussion was led by the engagement partner. For the remaining audits:

- In three audits there was no record of who attended this meeting.
- In two audits the engagement partner had met senior audit team members separately who then led the discussions with the rest of the audit team when the engagement partner was not present. In both cases there was no record of the matters discussed at the meeting with the engagement partner.
- In nine audits the engagement partner was noted as attending the meeting but there was no record of either who led or who contributed to the fraud risk discussion.

The discussion is required by ISA (UK&I) 240 to consider both the risk of misappropriation of assets and the risk of fraudulent financial reporting. There were four audits where there was a lack of evidence of discussion of the potential risks of fraudulent financial reporting. There were six audits where there was a lack of evidence of discussion of the potential risks of misappropriation of assets. Audit teams should ensure that their discussions cover both of these risks.

In a number of audits the discussions focused on immaterial frauds reported by management. Audit teams should ensure that this does not distract them from discussing the risk of material fraud not detected by, or concealed by, management.

In most audits the records of the discussions were at a high level and were more akin to a briefing for the audit team of the identified fraud risks rather than a discussion amongst the team of the potential fraud risks. In particular, there was little evidence of a discussion of the existence of fraud risk factors or the audit team's approach to journal testing and how it addressed the fraud risks identified, although this is required by the methodology of some firms.

Specialists from outside of the audit team, such as tax, valuations and IT specialists, were involved in approximately half of the fraud risk discussions; a forensic specialist was included in this discussion on only one audit. This discussion is an opportunity for an exchange of views amongst all members of the team which may identify fraud risks that had not been previously considered. More importance should therefore be placed on encouraging this discussion and including non-audit team members.

2.4 Fraud risk discussions with management and internal audit

- Fraud risk discussions were generally held with management within the finance function and did not always include internal audit. These discussions did not adequately cover consideration of the risks of material misstatement due to fraud.

- Audit Committees should enquire whether their auditors have had discussions with management (including management from outside the finance function) and internal audit regarding fraud risks.

The auditor is required to make inquiries of management and internal audit regarding their assessment of the risk that the financial statements may be materially misstated due to fraud, management's processes to mitigate the risks, management's communications to employees and those charged with governance and whether they have any knowledge of any actual or suspected frauds (ISA (UK&I) 240 paragraphs 17-19).

Fraud risk discussions with management

In all audits there was evidence of discussions with finance team management. For ten audits, discussions with management were also held with individuals from outside the finance team, such as operational management, head of legal, head of risk or the company secretary. Discussions regarding fraud risks with individuals from outside the finance team may be more useful, in particular, in identifying the risk of management override. Given the complexity and size of the entities reviewed, we would have expected more fraud risk discussions with non-financial management.

There was evidence that the discussions with management did not always cover the two types of risks of material misstatement due to fraud. In 16 audits there was no evidence that the discussions included the risk of misappropriation of assets, although in some of these cases immaterial actual misappropriation frauds were discussed. In 18 audits there was no evidence that the risk of fraudulent financial reporting had been discussed. Where an agenda for the meeting was included on the audit file, in many cases fraud risks were not included as an agenda item.

Where management discusses frauds already identified, audit teams should ensure that this does not distract them from discussing other potential fraud risks.

One firm requires management to complete a fraud questionnaire identifying whether there are any fraud risk factors present. For one of the five audits reviewed at this firm, we saw no evidence that the fraud risk factors identified were subsequently discussed with management.

Fraud risk discussions with internal audit

For six of the 26 audits reviewed there was a discussion with internal audit of their assessment of fraud risks. For a further eleven entities with an internal audit function, there was either no evidence that a discussion was held with internal audit or that it had included a discussion of fraud risks (in addition to actual frauds).

Six of the entities reviewed had an outsourced internal audit function. For five of these entities, no discussion of fraud risks was held with internal audit.

Where there is an internal audit function, including where this is outsourced, the audit team should meet with them to discuss the risks of material misstatement due to fraud at the entity.

2.5 Assessing the level of risk of management override and planning the audit response

- While the risk of management override of controls was identified as a significant risk, the level of risk specific to the audited entity was not assessed. The response to the risk of management override did not extend beyond the minimum audit procedures required by the ISA and was therefore not responsive to the level of risk identified for the entity.

- Audit Committees should request information from their auditor regarding their assessment of the level of risk of management override of controls and the audit procedures they have performed in response to this risk.

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk will vary from entity to entity, the risk is nevertheless present in all entities (ISA (UK&I) 240 paragraph 3).

ISA (UK&I) 240 paragraph 32 sets out some specific audit procedures to address the risk of management override that must be performed on all audits. Paragraph 33 states that the auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to.

At all firms the audit procedures required by ISA (UK&I) 240 to respond to the risk of management override of controls (management override) are embedded into their audit methodology and are therefore required to be completed by all audit teams.

ISA (UK&I) 240 requires management override to be identified as a significant risk, while recognising that the level of risk will vary from entity to entity. The identification and assessment of fraud risk factors assists the auditor in assessing the level of risk of management override and in planning an appropriate audit approach. On all audits reviewed there was no assessment of the level of risk of management override that was present. Two firms do not specifically identify management override as a significant risk on their audit files on the basis that the audit procedures required by ISA (UK&I) 240 to address this risk are included in the various audit work programmes.

There appeared to be an assumption that, as management override is a presumed significant risk, the minimum procedures mandated by ISA (UK&I) 240 would be sufficient to address this risk. In most of the audits reviewed, the audit procedures to address management override did not extend beyond those specifically required by ISA (UK&I) 240 (test the appropriateness of journal entries, review management's accounting estimates for bias and evaluate the business rationale for significant, unusual transactions). ISA (UK&I) 240 also requires the auditor to consider whether other audit procedures should be performed. Only at one firm, which requires audit teams to identify and perform at least two "unpredictable" audit procedures, were any further audit procedures performed.

There were no audits where computer assisted audit techniques (CAATs) were planned to be used as a fraud risk audit procedure for anything other than journal testing (eg duplicate sales invoices, matching supplier and employee bank account details). Where fraud risks have been identified, testing of this type can be useful in detecting previously unidentified frauds, particularly in relation to larger, more complex entities.

As the audit approach to management override was similar for all of the audits reviewed, there was little evidence that the audit approach was tailored in response to fraud risk factors identified. Audit teams need to assess the level of risk of management override that is present and ensure that the planned audit procedures are responsive to the particular risks identified.

2.6 Journal testing

- It was not always clear that the journal testing planned was responsive to the fraud risks identified and the use of CAATs to test journal entries was limited.

To respond to the risk of management override, paragraph 32 of ISA (UK&I) 240 requires the auditor to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

Principal findings – fraud risks

Identifying journals with fraud characteristics

Audit teams use a number of criteria to identify journals with fraud characteristics which should be selected for testing. Most firms require the discussion among the audit team to consider the approach to journal testing and the criteria for selecting journals to test. However, as noted earlier, in the majority of audits reviewed there was no evidence that this discussion had taken place.

We note that only one firm requires computer assisted audit techniques (CAATs) to be used on all audits (with exceptions to this expected to be rare) to identify journals with fraud characteristics for testing. Most other firms leave it to the audit team's judgment as to whether CAATs should be used. Of the 26 audits we reviewed, seven audits used manual identification, nine used CAATs run by the audit team and four used specialists (three IT and one forensic) to run the CAATs. Given the nature of the audits included in our sample (ie the larger, more complex entities), we expected to see CAATs and specialists (in particular, forensic specialists) being used more widely.

In general, where journals were identified for testing manually, fewer criteria were used to identify journals exhibiting fraud characteristics, tending to focus on journals that were for large or round sum amounts or posted outside normal working hours. These may not be the only or most appropriate fraud risk characteristics to use to select journals for testing.

Where CAATs were used, additional criteria were used to identify journals with fraud characteristics, including analysing journals by user, journals targeted at specific balances (in particular revenue) and searching for key words. This testing was more targeted to the fraud risks identified for the entity. There could, however, be better linkage from the fraud risk factors and fraud risks to the fraud characteristics selected to identify journals to be tested.

Journal testing

The sample sizes for journal testing varied significantly and the rationale for the sample size used was generally not clear. It was also not clear how the sample selection criteria linked to the fraud risks identified.

The use of CAATs often identified large numbers of journals exhibiting fraud risk characteristics using the criteria selected by the audit team. In some of these cases only a sample of these were selected for testing. The rationale for only testing a sample of journals identified as having fraud characteristics and the sample sizes used were not well-explained. Where very large samples are identified through the use of CAATs, the audit team should evaluate whether the criteria used are appropriate for the circumstances of the entity and consider refining them to identify a smaller population for testing.

In 11 audits we saw evidence that journals selected for testing were agreed to supporting documentation and/or discussed with management. However, it was not always clear that the purpose and appropriateness of the journal was considered. We also noted examples where journals were discussed with management but were not tested. Discussion with management, without obtaining any corroborating evidence, is not a sufficient audit response to address the risk of fraud, particularly in relation to the risk of management override.

Journal testing not performed

We identified four audits where there was no evidence that journal testing had been performed. In three of these audits, the substantive audit procedures performed in relation to financial statement line items were stated to have provided sufficient evidence such that no further testing was required.

However, whilst the substantive audit work on specific balances may identify certain journals posted to these accounts it may not identify all journals with fraud characteristics because:

- Substantive analytical review procedures are unlikely to identify journals that have been posted by management to manipulate the amounts reported in order to meet expectations.

- Substantive audit testing is only required for material financial statement line items. Journals may be posted to accounts with immaterial or nil balance and these should also be considered for testing.

It is therefore not appropriate to rely on these audit procedures, as an alternative to journal testing, for the purpose of addressing the risk of management override.

2.7 Final analytical review

- In the majority of audits final analytical review procedures were limited to comparing line items in the current year income statement and balance sheet to the prior year figures. There was limited use of other ratio analysis or inclusion of the cash flow statement in the analysis.

The auditor is required to evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity, indicate a previously unrecognised risk of material misstatement due to fraud (ISA (UK&I) 240 paragraph 34).

All firms' guidance, except one, required audit teams to perform an analysis beyond comparing this year's balance sheet and income statement to the prior year. Despite this, on most audits, the audit procedures performed did not extend beyond this. Of particular note was that the cash flow statement was not included within this final analysis and there was little use of ratio analysis.

We also noted that these procedures were not specifically designed to address the identified risks of fraudulent financial reporting.

2.8 Concluding on fraud audit procedures

- In most cases auditors reached conclusions on each of the fraud audit procedures performed. There was little evidence of an overall conclusion relating to the risks of material misstatement due to fraud, considering all the audit evidence obtained during the audit, or an assessment as to whether new fraud risk factors had been identified during the audit.

- Audit Committees should discuss with their auditors how they have concluded on their audit procedures to respond to the risks of material misstatement due to fraud.

The auditor is required to evaluate whether sufficient appropriate audit evidence as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, has been obtained (ISA (UK&I) 700 paragraph 8).

ISA (UK&I) 240 requires the auditor to perform a number of audit procedures to respond to the risks of fraud including:

- Testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements;

- Performing procedures to respond to the risk of fraud in revenue recognition;

- Evaluating whether the selection and application of accounting policies by the entity may be indicative of fraudulent financial reporting;

- Reviewing accounting estimates for biases;

- Considering the business rationale for significant transactions (including with related parties);

- Evaluating unadjusted misstatements for indicators of fraud; and

- Performing final analytical procedures at or near the end of the audit.

The audit procedures to address the risk of fraud are, therefore, likely to be performed in different areas of the audit file and by different members of the audit team. Within each of these audit procedures the auditor may have identified fraud risk factors/ indicators and reached a conclusion individually that the risk had been satisfactorily addressed. The fraud risk factors identified in the appendix to ISA (UK&I) 240 may therefore only become apparent as the audit progresses. Whilst the ISA does not specifically require fraud risk factors to be collated during the audit process to reassess the risk at the completion stage, this reassessment of risk is required by other ISAs. If these individual fraud risk factors were assessed collectively, the auditor may have reached a conclusion that the risk of material misstatement due to fraud was higher than originally expected. In these circumstances, further audit work may be required to reduce this increased risk to an acceptable level.

One firm requires a concluding document to be prepared for each significant risk, including revenue recognition and management override, and a further document to demonstrate how professional scepticism has been applied. Where these documents were prepared, there was better evidence of the link between the fraud risk assessment, the audit evidence obtained and the conclusions reached.

Another firm requires the audit team to consider the overall results of the audit procedures performed in relation to all accounting estimates and this facilitates a more informed assessment of whether there are any indicators of management bias.

2.9 Fraud training

- The nature, frequency and level of training in respect of fraud risks varied significantly across the firms.

- When tendering their audit, Audit Committees should consider enquiring about the nature and frequency of the fraud training provided by firms to audit staff.

The level of fraud training varied significantly across the firms. There were some good examples of fraud "war stories", particularly where the training was delivered by forensic specialists, and this type of training is important. When an audit team has more knowledge as to the potential ways that frauds can be perpetrated, they are more able to identify potential fraud risk factors during the audit and tailor the audit response more effectively. However, some of the training material used was not very recent. New types of frauds become apparent regularly, so more frequent and up to date training is likely to be beneficial in improving audit quality in this area.

One firm's training included sessions to help teams assess when risks of irregular financial reporting can be categorised as aggressive earnings management rather than being potentially fraudulent in nature. This type of distinction may convey the wrong messages to audit teams. Aggressive earnings management is a fraud risk indicator and any judgments of this nature should be reached by the audit engagement partner.

3 Principal findings – laws and regulations

The auditor's responsibilities in respect of laws and regulations are set out in ISA (UK and Ireland) 250 Section A, "Consideration of Laws and Regulations in an Audit of Financial Statements", (ISA (UK&I) 250). This states that the auditor's objectives are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

In meeting these responsibilities audit firms should pay particular attention to our principal findings set out below. These relate to:

- Identification of the laws and regulations relevant to the business
- Discussions with management regarding compliance with laws and regulations
- Evaluation of the entity's controls regarding compliance with laws and regulations
- Audit procedures performed in relation to laws and regulations having an indirect impact on the financial statements
- Audit response to the UK Bribery Act 2010
- Laws and regulations training

3.1 Identification of laws and regulations relevant to the business

- On the audits reviewed, not all relevant laws and regulations specific to the audited entity were identified and evaluated in assessing the potential impact of non-compliance on the financial statements.
- Audit Committees should discuss with their auditors the relevant laws and regulations affecting the business that have, or may have, a material impact on the financial statements.

The auditor is required to obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry in which it operates and how the entity is complying with that framework (ISA (UK&I) 250 paragraph 12).

The laws and regulations relevant to the audit identified by teams varied and some laws and regulations which were relevant to the entity were not identified by them. In particular:

- The laws and regulations identified on the audit file were often not consistent with those referred to in the Annual Report. In particular, some laws and regulations noted within the principal risks and uncertainties facing the business were not identified by the audit team (for example, the UK Bribery Act 2010, compliance with operating permits, health, safety, environmental and security risks, infringement of intellectual property of others).
- Where legal cases discussed with an entity's legal counsel highlighted that it may not have complied with certain laws and regulations, there was no check that these had been identified as relevant laws and regulations affecting the business and that the planned audit approach was appropriate.

Audit teams at one firm utilised an effective summary table which identified the applicable laws or regulations, summarised the entity's policies and procedures, described the potential impact on the financial statements and set out the planned audit procedures.

In a number of audits there was no analysis as to which laws and regulations were considered to have a direct material effect on the amounts and disclosures in the financial statements (direct impact) and those which may have a material effect on the financial statements (indirect impact). A different audit response is required depending on this assessment.

3.2 Discussions with management regarding compliance with laws and regulations

- Audit teams' discussions with management should include management responsible for compliance matters and should place more emphasis on identifying the relevant laws and regulations that may have a direct impact on the financial statements and whether the entity is in compliance with them.
- Audit Committees should seek to understand how compliance with relevant laws and regulations has been addressed by their auditors during the audit.

The auditor is required to make inquiries of management as to whether the entity is in compliance with laws and regulations that may have a material impact on the financial statements (ISA (UK&I) 250 paragraph 14(a)).

In obtaining an understanding of the legal and regulatory framework the audit team may make inquiries of management as to the other laws and regulations that may have a fundamental impact on the operations of the entity and the policies and procedures in place in respect of these (ISA (UK&I) 250 paragraph A7).

We found little evidence that discussions held with management included the identification of laws and regulations that may have a material impact on the financial statements. In some audits, there was no evidence of any discussions with management regarding compliance with laws and regulations despite this being a required audit procedure.

We would expect audit teams to hold discussions with management to identify the relevant laws and regulations and its processes for monitoring compliance with them. Where appropriate, inquiries should include the entity's head of legal and/or other management with responsibility for compliance matters.

In nearly all of the audits reviewed, inquiries regarding known breaches were made of the entity's head of legal. It is likely that this reflects the size of the audited entities concerned (larger entities are more likely to have this resource).

3.3 Evaluation of the entity's controls regarding compliance with laws and regulations

- There was no evidence on most of the audits reviewed that the design and implementation of the entity's controls in respect of the risk of non-compliance with laws and regulations had been evaluated.
- Audit Committees should ensure that they have reviewed the key controls in place to mitigate the risk of material misstatement due to non-compliance with laws and regulations[3] and that they have discussed these with their auditor.

3 The UK Corporate Governance Code 2012 states that the responsibilities of the audit committee should include reviewing the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, reviewing the company's internal control and risk management systems.

The auditor is required to obtain an understanding of internal controls relevant to the audit (ISA (UK&I) 315 paragraph 12). Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor evaluates the design of those controls and determines whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel (ISA (UK&I) 315 paragraph 13).

There was evidence in some audits that audit teams, through their discussions with management, had obtained an understanding of the actions taken and controls put in place by the entity relating to compliance with laws and regulations. However, there was a lack of assessment of the design and implementation of controls regarding the entity's policies relating to compliance with laws and regulations, ethical behaviour and whistleblowing hotlines. The whistleblowing log was only obtained and reviewed on four audits reviewed.

Controls that mitigate the risk of material misstatement due to non-compliance with laws and regulations are relevant to the audit and further audit procedures to assess the design and implementation of these controls should therefore be performed.

3.4 Audit procedures performed in relation to laws and regulations having an indirect impact on the financial statements

- In performing other audit procedures there was limited evidence, in most audits, that the team were alert to identifying possible breaches of laws and regulations that may have a material impact on the financial statements.

During the audit, the auditor is required to remain alert to the possibility that other audit procedures may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention (ISA (UK&I) 250 paragraph 15).

These other audit procedures may include reading minutes of board meetings, making inquiries of management and legal counsel and substantive audit procedures.

While board minutes were generally reviewed, it was not always clear whether matters relating to relevant laws and regulations had been identified or how their impact on the audit procedures that needed to be performed had been assessed.

Similarly, we noted instances where minutes of inquiries with management and legal counsel highlighted potential breaches of laws or regulations that had not been identified at planning by the audit team. It was not clear how these potential breaches had been assessed and what audit procedures were then planned in response to them.

3.5 Audit response to the UK Bribery Act 2010

- In most audits the UK Bribery Act 2010 was not identified as a relevant law that may have either a direct or indirect impact on the financial statements.

- Audit Committees should ensure that the entity has appropriate processes and controls in place in response to the UK Bribery Act 2010 and enquire as to the steps that their auditors are taking to address this risk.

The UK Bribery Act 2010 came into effect in July 2011 and brought in a new offence of 'failure by a commercial organisation to prevent bribery'. Where an entity has received a financial benefit as a result of a bribe, that financial benefit may be considered to be a proceed of crime requiring a report under the Proceeds of Crime Act and a restatement of the financial statements.

According to Transparency International's 2013 Global Corruption Barometer (surveying 107 countries and 114,000 people), 27% of respondents said they had paid a bribe when accessing public services and institutions in the last year and more than half of those surveyed believe corruption has worsened in the last two years. Entities are facing real risks in respect of bribery and corruption.

Auditors should be considering whether there is a risk of the financial statements being materially misstated as a result of the audited entity making questionable payments which might be deemed to be bribes. Any resulting financial asset or other benefit obtained by the entity may not meet the recognition criteria for inclusion in the financial statements.

The annual report of 15 entities identified compliance with the UK Bribery Act 2010 (Bribery Act) as a key risk facing their business and described the processes and controls they had put in place to mitigate this risk. However, the Bribery Act was only identified as a relevant law by the audit team in eight of these cases. In one case, the audit team did identify the Bribery Act as a relevant law for a mining entity even though it was not identified in the entity's annual report as a key risk facing the business. In the remaining 10 audits, the Bribery Act was neither mentioned in the annual report nor identified by the audit team as a relevant law requiring consideration.

The Bribery Act was not identified as a relevant law in either the annual report or by the audit team for three of the seven mining entities reviewed. In all three cases, the main business operations were in countries which feature highly on Transparency International's perceived corruption index. For these entities the Bribery Act should have been identified as a relevant law that may have a direct impact on the financial statements.

Our review did not cover how the group auditors had ensured that component auditors had adequately addressed the risks arising from non-compliance with the Bribery Act in the audit of overseas subsidiaries or divisions. Firms need to ensure that this aspect is adequately considered on group audits.

Audit firms have responded to the Bribery Act in different ways. Some firms have issued clear guidance to audit teams on how this should be addressed on the audit and others have provided teams with relevant training. At other firms, however, little training or guidance has been given to teams and this has focused on the impact for organisations and the firm rather than the impact for the audit. The number of audits where the Bribery Act was identified as a relevant law that may affect the financial statements was higher at those firms where comprehensive training and/or guidance had been provided to audit teams.

3.6 Laws and regulations training

- Firms should ensure that they provide sufficient up to date guidance and training to audit teams relating to relevant laws and regulations, such as the UK Bribery Act 2010.
- When tendering their audit, Audit Committees should consider enquiring about the nature and frequency of laws and regulations training provided by firms to audit staff.

The level of training relating to laws and regulations varied across the firms. Other than in relation to financial reporting and specialist areas such as banking and finance, there was limited regular training provided. As regulators now appear to be more willing to investigate and fine companies for breaches of legislation across a number of industries, more frequent and up to date training is required to assist audit teams to identify the potential risks arising.

Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

+44 (0)20 7492 2300

www.frc.org.uk