Developing a quality assurance system

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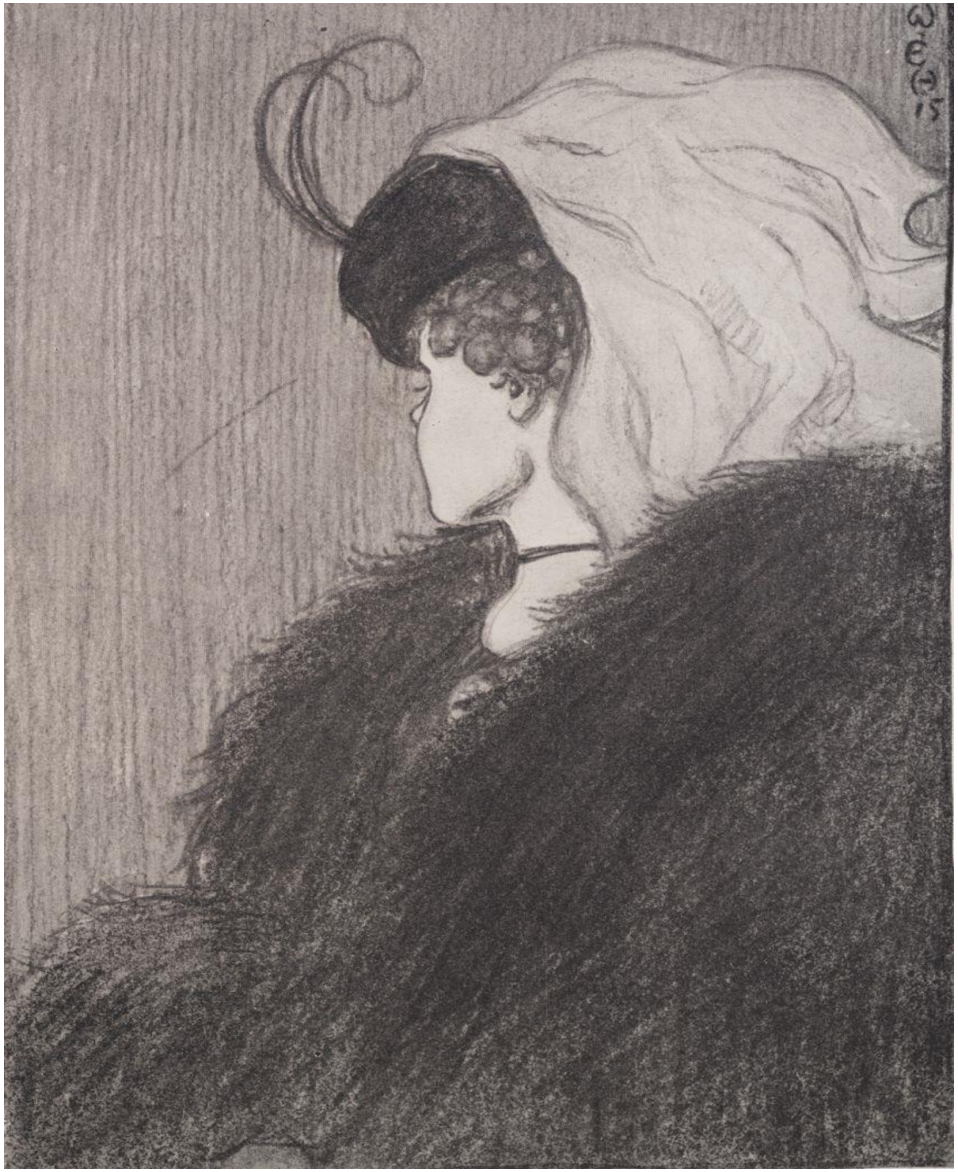
Welche Thiere gleichen einander am meisten?

Kaninchen und Ente.



What's the link?

- What do we really see?
- Auditors can be deceived
- Practical examples

Overview

- What we looked at last time

- Going a little deeper:
  - Real inspection examples
  - Firm-wide procedures
  - Oversight of PAOs
  - Selecting audits
  - The right inspectors

What we looked at last time

- Foundations of quality assurance
- What to inspect
- International support

Examples

- Overseas provision
- Contract revenue

Example 1

Overseas provision

The group inspected was a mining and construction multi-national with global operations (referred to in this example as “ABC plc”). The issue concerned the audit of an environmental provision in an overseas joint venture. The audit firms referred to in the case study were not involved in the audit.

Group turnover was £31bn with audit materiality set at £330m.

The AQR inspection was for the audit of the financial statements for the year ended 30 June 2016.

Example 1

Quando is a joint venture owned by ABC and Ennercis, each with a 50% shareholding. Quando has a single iron ore mine in South America.

In February 2015, a mine dam failed with millions of tonnes of water/mine waste released. 33 people died with extensive damage to the natural environment and local communities.

ABC's 50% interest in Quando is equity accounted. At 30 June 2016, ABC's investment in Quando was impaired to zero.

In March 2016, ABC, Quando and Ennercis agreed with local authorities to compensate for the damage caused by the dam failure. The Agreement established that, if necessary, ABC and Ennercis would fund Quando to meet the obligations under the Agreement.

The audit procedures to assess the financial statement impact of the dam failure focused on assessing the:

- Appropriateness of the relevant ABC accounting policies;
- Existence of any legal or constructive obligations; and
- Completeness of the disclosures relating to contingent liabilities.

The Group audit team concurred with ABC management that the only provision required related to the potential obligations under the Agreement.

As at 30 June 2016, Quando calculated the expected cost of meeting the obligations under the Agreement to be US$2.4 billion, including a fixed amount of compensation and an estimated cost of remediation. The estimate was audited by KPMG Argentina as a component auditor for the ABC Group audit. The estimate was highly judgemental and KPMG reported an emphasis of matter to EY highlighting the uncertainty.

The Group audit team engaged EY Brazil to review the sufficiency and appropriateness of the KPMG audit. There was no evidence that the group team issued instructions to EY Brazil on the scope of their review.

EY Brazil concluded that KPMG's audit procedures were sufficient (in a brief memo to the Group audit team). The Group audit team also held a number of calls directly with KPMG. These discussions were not minuted.

Example 1 – actual report

The determination of the amount of a provision is highly judgemental and may be subject to conscious or unconscious management bias. Given the significant risk identified, the group team should exercise rigorous and detailed oversight of the component team's work or perform procedures of their own to evaluate the appropriateness of the amount provided.

The Group team obtained insufficient evidence to support the estimated cost of remediation and, therefore, the Quando provision for a potential funding obligation. In particular the Group team did not:

- Obtain sufficiently detailed reporting from KPMG to evaluate the key assumptions used by Quando in its cash flow forecasts or assess the quality of evidence obtained by KPMG;
- Provide instructions to EY Brazil to ensure their review of the procedures performed by KPMG was sufficient and appropriate. In addition, the EY Brazil reporting was too high level in relation to the appropriateness of the amount provided; or
- Perform appropriate testing of ABC's controls over the cost estimation process, or the underlying cash flow estimates and assumptions used to measure the expected cost of the remediation work.

Example 2

Loss-making contract

The company provides telecommunication solutions, including installation of bespoke software, and recorded revenue of £331 million. The audit team took a fully substantive audit approach, including the use of revenue CAATs.

Audit materiality was £1.9m.

The AQR inspection was for the audit of the financial statements for the year ended 31 March 2017.

Example 2

Loss making contract - RDG

The RDG contracts involved multiple elements with a total contract value of £9.7 million over five years (Financial Year 2017 revenue of £3.4 million). Significant delays and unexpected costs were incurred and RDG requested significant contract revisions in November 2016. Management estimated that an additional provision of £1 million was required. This took total losses for these contracts for the year to £3.6 million.

RDG required the contract revisions to be completed by March 2017.

The audit team made enquiries of the key personnel managing the RDG contract, including the project manager and the Director of Projects. The audit team obtained copies of the forecasts used to calculate the loss provision from the project team and discussed in detail to understand the process undertaken to derive the forecasts and the status of the project.

The audit team validated the rates used for a sample of employees and contractors in the forecasts prepared and compared actual hours incurred in April 2017 to the forecasts. Explanations were obtained for variances.

The required change to the contract plans had not been submitted at the date of the audit report (June 2017).

Example 2 – actual report

The audit team did not obtain sufficient appropriate evidence regarding the completeness of the forecast costs to complete for the RDG contract. In particular, the audit team did not obtain any external corroborative evidence, such as copies of correspondence between the company and RDG regarding the progress and status of the contract.

In addition, the audit team did not sufficiently evidence:

- The detail of the discussions held with the project team and other key management personnel;
- How the procedures performed provided sufficient assurance that the forecasts for the remaining contract deliverables were reasonable; and
- Their consideration of whether the delay in providing the revised milestone and project plans had implications for the completeness of the forecast costs to complete.

Learning points

- Example 1
  - Starting in the wrong place
  - Proper oversight
  - Corroboration of judgements

- Example 2
  - Dangers of familiarity
  - Audit by discussion
  - Common sense

Firm-wide procedures

- ISQC 1

- What we assess:
  - Tone at the top
  - Ethics and independence
  - Quality control
  - Partner appraisals
  - Client acceptance

Thematic reviews

- Wide-ranging review across firms

- Recent reports:
  - Materiality
  - Root cause analysis
  - Planning
  - Data analytics

- Firm-wide comparison

Overseeing PAOs

- FRC oversight of professional bodies:
  - Education and training
  - Audit monitoring
  - Enforcement

Getting the selection right

- Factors to consider:
  - Listed?
  - Change of audit firm?
  - Profit warnings?
  - Poor previous inspection?
  - Poor media coverage?

The right audit areas

- Difficult to audit?
  - Areas of judgement
- Material?
- Recurring problem area?
- Specific to a business sector?