



LEGAL- LETTERBOX

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The brass plates on anonymous buildings may look harmless, but letterbox companies have hidden pitfalls for auditors, reports **Philip Smith**

Earlier this year, audit quality watchdogs spent time examining the work of senior auditors engaged at so-called 'letterbox' companies. The move had not come without plenty of warning. The Audit Quality Review Team of the Financial Reporting Council (FRC) had flagged its intention to investigate the letterbox companies 12 months previously following a round of inspections that identified 'serious issues' with a number of audits it had just reviewed.

But nevertheless, in its latest round of inspection reports, the AQRT found plenty to criticise, raising questions about the over-reliance on other auditors' work. Such criticism has stung the audit firms into action, with procedure updates and guidance improvements landing in the inboxes of those engagement partners directly responsible for letterbox company audits.

And this is not just in the UK – standard setters around the world have also called for further action in this area, amid growing concerns that such structures are ripe for abuse.

So why is the AQRT so interested in these types of companies, what are the risks for auditors and how does this tie in with a global

push to improve governance and transparency? Letterbox companies are companies or groups of companies where the general and financial management and the company's operations are located in a different jurisdiction to that of the company's legal registration. The location of legal registration is important, because this is where the auditor who signs the group audit report is usually based.

So in essence, there is next to nothing to show physically that the company is present in the jurisdiction of its legal registration, bar a brass plate on an office block wall. No board of directors, no head office functions, no business operations, just a letterbox.

According to Steve Snook, a partner at PwC, a true letterbox company in the UK will be one that is registered in the UK to be used as a 'top co' for an overseas group to access UK capital markets. If a group wants to raise money, it can choose to do so wherever is appropriate, whether that is to diversify the shareholder base or to focus on particular regions or industries. Such groups can come to London, place a UK-registered holding company on top of its structure and list on one of the city's exchanges.

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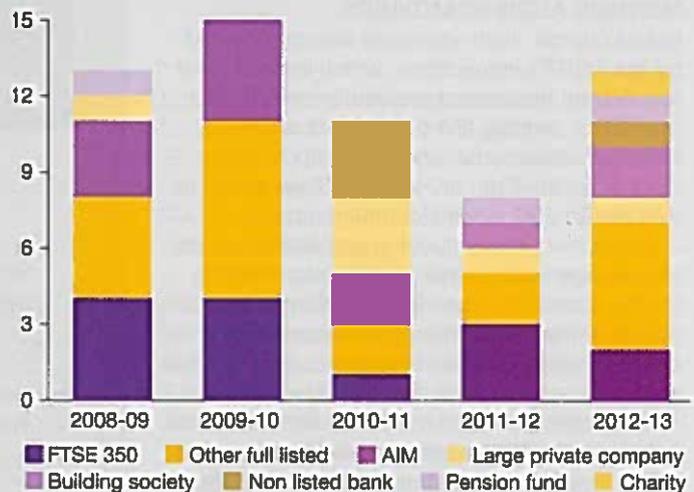
AQR AUDIT REVIEWS REQUIRING SIGNIFICANT IMPROVEMENTS

The graph below provides an analysis of audits (excluding public sector and follow-up reviews) assessed each year as requiring significant improvements (grade 3) by type of entity.

The number of grade 3 audits fluctuates from year to year with a range of 10% to 17% of the audits inspected. The decline in numbers in 2010/11 and 2011/12 did not continue in 2012/13 partly as a result of issues relating to the audit of letterbox companies – those groups or companies that have little more than a registered office in their country of registration, with management and activities based elsewhere.

The number of FTSE 350 grade 3 audits is relatively low and has decreased over the years, down to 8% in 2013/14.

Source: Audit Quality Inspections Annual Report 2012/13, FRC



focus on letterbox companies because there are certain risks,' Snook says. 'The challenges stem from relatively simple reasons; you have an audit partner here in the UK, but all the key management, operations and functions are not here. It is the tyranny of distance. There may also be different styles, cultures and ways of doing things.'

Having the auditor so far away from the senior management team presents one of the key risks. As Snook says: 'If you have a client based here in London and an issue arises, you can just pop round to the company and resolve it. It's not quite the same if you have to jump on a plane and travel for 24 hours.'

LACK OF OVERSIGHT

This 'tyranny of distance' was one of the main reasons why the FRC, through the AQR, chose to make letterbox companies a priority for its inspections. As Andrew Jones, director of the AQR said when he wrote to the major firms last year: 'There is, therefore, often very limited or no oversight of those overseas operations from the country of registration. This can make it more difficult for the auditor in the country of registration to maintain a dialogue with

the entity's management, or gain a proper understanding of the business risks and the risks associated with the audit, and may limit the extent to which the audit approach can place reliance on financial and operational controls.'

'It may,' he continued, 'result in these auditors performing little of the underlying audit work themselves.'

Despite this warning shot, the Big Four firms – PwC, Deloitte, KPMG and EY – subsequently found themselves on the receiving end of less than favourable reports when this year's inspection results were published in May.

'We were not passing judgment on the structure [of these companies], but on how they are being audited,' says Paul George, the FRC's executive director for conduct. He adds that the AQR thought long and hard about whether to actually use the term 'letterbox company' when describing these structures as it can be construed as a pejorative term.

And this adds to the reasons why there has been interest in this area – a brass plate with no substance behind immediately raises suspicions. For instance, it is an issue the Netherlands is grappling with amid accusations of tax avoidance.



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Andrew Jones, director, audit quality review team, FRC

RICHARD ADDISON

partner, EY

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MEETING AUDIT STANDARDS

But of course, such scenarios are not covered by the AQRT's inspections, which instead have focused on the correct application of auditing standards, notably ISA 600, *Audits of Group Financial Statements*, and ISA 200, *Quality Control for an Audit of Financial Statements*, as well as ISA 230, *Audit Documentation*.

Combined, these auditing standards require the engagement partner to take responsibility for the direction, supervision, performance and review of the engagement, with appropriate backing documentation setting out exactly what was done, when it was done, and by whom.

'Our concerns were that audit firms were not following ISA 600,' says George. 'If you are the group engagement partner, you have to take responsibility for the group audit. Our [2014] report highlighted examples where firms were relying on sign-offs from other auditors. The reason why the audit came within our scope was because of the place of incorporation, but the reality was that the audit was being conducted elsewhere.'

George adds that his inspectors also found that some of the firms' methodology did not make clear that engagement partners of letterbox companies had overall responsibility for the group audit. 'It could have been concluded that the guidance promoted an approach for the reliance upon other auditors to do the work,' he says.

Put bluntly, the AQRT felt that group audit engagement partners needed to be far more involved in the actual audits. And to be seen to be doing so as well; the nature of these audits is such that every action needs to be documented to a higher degree than might normally be expected.

Deloitte director, national accounting and audit, Robert Stenhouse says: 'The challenge is to do a good job, and show that you have done a good job. When you do this kind of work out on location, you need to put down some basic detail that you might take for granted when you are in a UK situation.'

Much reliance will still be placed on the work of other auditors, even if they are within the

STEVE SNOOK

partner, PwC

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same international network. As Snook explains: 'We have to get comfortable with the work of others. The ISAs for UK and Ireland require us to do certain things to do that, but at the end of the day it is about directing, supervising and reviewing the work of other auditors.'

On a practical level, this can mean that the management of the group behind a letterbox company, who might have been used to dealing with a local audit team, now comes under the watchful eye of a London partner. As EY partner Richard Addison says: 'You need to integrate the audit team across borders, with the London partner taking control. But the logistics can be challenging and there may be language and other difficulties.'

Senior auditors acknowledge that the very nature of a letterbox company's main business operations and locations could pose risks in



VIEWPOINT

ROBERT STENHOUSE

director, national accounting and audit, Deloitte

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topped the list of concerns expressed by the European Audit Inspection Group of 21 European audit regulators that includes the UK's FRC, who have called on Arnold Schilder, the IAASB chairman, for an earlier start on the ISA 600 revision project.

The FRC is not alone. Other organisations, such as the International Organisation of Securities Commissions (IOSCO) and the European Securities and Markets Authority (ESMA), have joined this particular chorus. Indeed, KPMG complained to the IAASB in April (2014) that a failure to address the shortcomings of ISA 600 had resulted in the audit firms adapting the standard to accommodate what it called 'cross-border structures to facilitate financing and/or minimise taxes'. The firm said: 'These adaptations have resulted in inconsistencies in practice and in criticisms... from audit oversight regulators.'

Currently, the IAASB is proposing that this should be a priority project 'in the future', suggesting 2017 as a suitable starting point following initial information gathering in 2015 and 2016. The board is due to give its response to these concerns towards the end of this year, but as Stenhouse says: 'The IAASB can only do so much, but there is regulatory pressure to deal with ISA 600.'

Of course, there is also a wider dimension to the use of letterbox companies in multinational group structures, notably to reduce overall tax liabilities, which has been the subject of heated debate for some time.

George, however, says that the FRC's focus through the AQRT was not carried out as 'part of a concerted effort' in this wider argument. 'But,' he says, 'it does contribute to other activities and other considerations that people might have in this area. We didn't do this because someone else was shining a light on it; we did it because we had identified some issues that we thought might be more systemic than isolated. But if that has wider benefit, then so much the better.'

the most normal of circumstances. Emerging markets and extractive industries are frequently mentioned in this context. And there can be confidentiality issues as well, where some jurisdictions do not allow audit papers to cross national borders.

INTERNATIONAL ACTION

So it is not surprising that there is an international push to get the issue higher up on the audit agenda. Many regulators have urged the International Auditing and Assurance Standards Board (IAASB) to bring forward a project looking specifically at the issue as part of its proposed work programme for 2015-2016. Indeed, the issue of letterbox company audits