FRC Financial Reporting Council

Head of audit

8 December 2020

Dear Sir/ Madam

Challenge of Management

Our Audit Quality Review ("AQR") inspection reports and other external regulatory reports, including those from the professional bodies, continue to show that auditors often struggle to challenge the management of audited entities effectively, especially in more judgemental areas such as long-term contracts, goodwill impairment or the valuation of financial instruments.

Effective challenge of management is one of the most critical responses to the requirement across a number of International Standards on Auditing ("ISAs"), particularly ISAs 200 and 540, for the auditor to exercise and demonstrate appropriate professional scepticism. Robust, focused and independent challenge is vital to a high-quality audit, particularly so at a time of prolonged heightened uncertainty, compounded by operational challenges. It should be front of mind for your audit teams as they progress their December 2020 year-end audits.

Since I expressed my concerns in this area following the publication of our November 2019 developments in audit[1], we have been encouraged by the initiatives that some firms are taking to develop and embed a culture of challenge: for example, to emphasise that the management of the audited entity is not the client and the range of culture and quality initiatives being taken within audit practices. My team have also been impressed by the output from the root cause analyses ("RCAs") many audit firms have undertaken.

Nonetheless, our ongoing audit quality review data continues to highlight this area as being a key driver of poor quality audits. More than 80% of the audits we reviewed over the past two years that were assessed as "improvements required" or "significant improvements required" identified ineffective challenge of management as a key driver of our overall assessment of that audit. The initiatives that firms have taken to embed challenge might not yet be reflected in our AQR results, but the prevalence of our findings suggests that further action is needed by firms if greater consistency and quality of challenge is to be achieved.

I thought it would be helpful to share with you the results of our own analysis of the factors which have given rise to both favourable and unfavourable audit review findings, each firms RCA in this critical area and the matters reported in each firms public report on quality in July this year[2]. In the appendices to this letter I have provided some context, a summary of the key results of our analyses and the preliminary conclusions reached by the firms following their root cause analyses, all of which have shaped our thinking on the best next steps we and audit firms should be undertaking to help tackle this issue.

---

[1] https://www.frc.org.uk/auditors/report-on-developments-in-audit

[2] https://www.frc.org.uk/news/july-2020/results-of-frc-audit-inspections

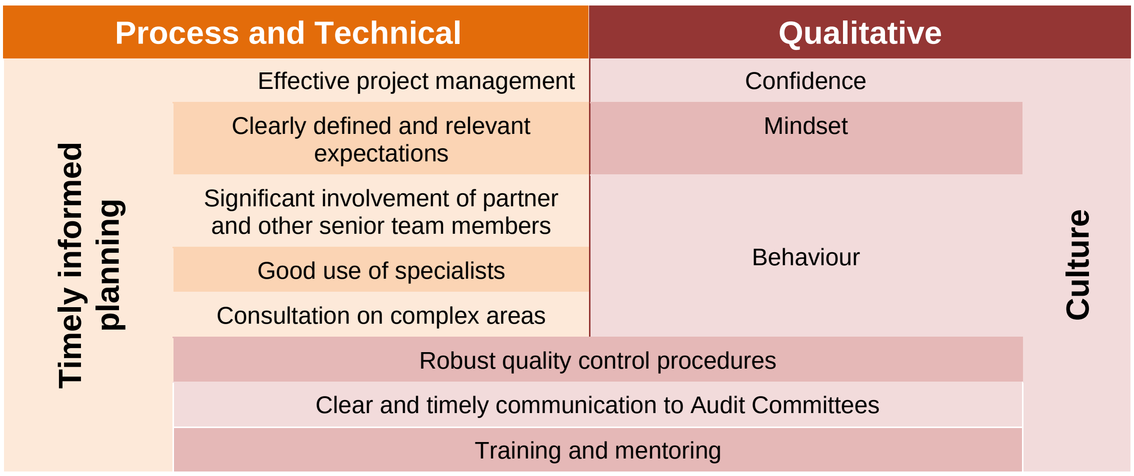
The following table summarises the more significant observations arising from our audit inspections.

When things go wrong:	When things go right:	Firm action plans to improve commonly focus on:
• 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	• Strong risk assessment including an understanding of the risk of management bias • Consultation on complex areas	• Senior team involvement • Understanding of the audited entity's system of internal control • Robustness of management's assessment and evidence

While not identified explicitly from the data analysis, auditors should also report clearly and transparently on critical judgements and explain how the engagement team reached their conclusions.

Changes to audit procedures are likely to be part of the solution. We do not, however, think procedures alone can fix the problem. More processes and templates can also be a distraction, reducing time for and stifling the required critical thinking and robust, evidence-based, judgement that is an essential component of effective challenge. When we aggregate the firms' RCA with those of our own AQR observations we have identified the following processes and attributes which are key features of effective challenge of management:

Aggregation of RCA findings specific to challenge and AQR Review observations



Developing the right ***mind set*** and ***professional behaviour*** 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 the extreme 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 will be encouraged to ask questions and raise concerns; and auditors will be open to new information and challenge from members of the audit team, specialists and peers. In short, through effective continuous professional training (technical and qualitative) and mentoring firms will have ***empowered*** audit teams with the ***right people*** with the ***right knowledge*** doing the ***right procedures*** at the ***right time***. A number of these attributes are set out in the

FRC's Audit Quality Practice Aid[3] and are used by audit committees when they assess the effectiveness of the annual audit.

It was encouraging to note, during our recent going concern review[4] which we published on 24 November, that a number of audit teams were able to demonstrate enhanced challenge of management in respect of the audit of going concern, developed to address the heightened audit risk. We very much hope that the lessons learned and experience gained from this review will allow firms to replicate effective challenge of management consistently on future audits.

The need for a culture of scepticism and challenge was also emphasised in Sir Donald Brydon's Review of the Quality and Effectiveness of Audit. That culture develops and reinforces where the focus of the firm is on the delivery of consistently high-quality work. One of our motivations for operational separation of the audit practice from the rest of the firm is to facilitate a different culture in the audit practice focused above all on delivery of high-quality audits in the public interest.

Given the fundamental importance of these qualitive aspects of challenge, we are planning three initiatives in 2021:

1. ***Ongoing inspection activity, monitoring of root cause analyses and quality plans*** – Through our cycle of audit reviews our AQR team will be alert to examples of good practice as well as identifying continuing issues with challenge of management. Our supervisors will monitor the appropriateness and success of each firm's root cause analysis and their audit quality plans in driving change.
2. ***Debate & thought leadership*** – The FRC will host a conference on the culture of challenge, entitled "Audit firm culture: Challenge. Trust. Transformation." in June 2021 involving academics, other regulators and experts on culture from other sectors. This should provide a strong platform where we can share experience, ideas and good practice.
3. ***Thematic review*** - Given the fundamental importance of culture, I am asking my team to carry out a thematic review on how the firms support effective challenge of management and encourage a culture of challenge and robust professional scepticism. This will draw on the output from the conference, the matters referred to in this letter, our 2018 thematic review of audit culture and our planned work on ISQM 1.

In the meantime, I ask that each firm supports their audit teams to have the confidence to challenge management of audited entities appropriately and constructively. This is particularly important as audit teams progress the audits of December 2020 year ends with the added challenges arising from the continued impact of the Covid-19 pandemic and Brexit uncertainties on businesses and audit teams.

Yours sincerely

David Rule
FRC Executive Director of Supervision

---

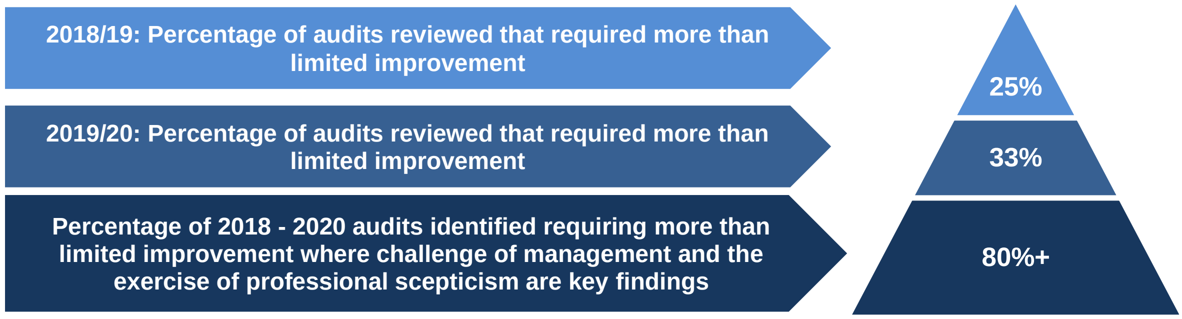
[3] https://www.frc.org.uk/news/december-2019-(1)/frc-updates-aid-to-audit-committees-in-evaluating

[4] https://www.frc.org.uk/news/november-2020/audit-firms-enhance-going-concern-assessments

Appendix 1 – Background information

In this appendix we summarise the results of our analysis arising from our review of the past two year's AQR findings. The results of this review have been overlayed with the results of each firm's root cause analysis ("RCAs") and comments made during various discussions which have taken place over the course of the past year. Before setting out our findings we have provided some context to this key audit area.

Context by numbers - A combination of developments in financial reporting standards and changes in the business models of companies mean that the need to exercise professional scepticism and challenge management constructively has increased in recent years. As can be seen from the following diagram, ineffective challenge of management was a grade driver in more than 80% of our audit files reviews in 2018 - 2020 which had a less than satisfactory grading.



Context by approach - When to challenge information, judgements and estimates made by the management of an audited entity, and the extent of that challenge, are judgements in their own right. It can be the case that even for areas where one would typically expect to see challenge of management, this may not be required. An example of this could be an impairment or fair value review where it is clear to the auditor that management has performed appropriate procedures using inputs and derived outputs which are within an acceptable range framed by the audit team's own independently-sourced and well-rationalised benchmarks, which are free from confirmation bias. For such instances we would still expect to see the audit team recording a well-reasoned explanation of what they have done, how they have reached their conclusion, why further challenge was not required and be alert to the risk of the confirmation bias. We have seen good examples of this, but they are in the minority.

Audit firms need first to identify the issue where there is a requirement to challenge management and then challenge effectively. To identify areas which require challenge the audit team must first develop informed and rationalised expectations which are relevant to the sector and circumstances of the entity being audited. Where the audit team identify variations, trends and other potential anomalies which are outside of their reasonable expectations, those are the areas which should be the focus of the auditor's constructive challenge of management. Basing challenge around informed expectations will also improve engagement with management and those charged with governance.

We see constructive challenge of management as describing a particular kind of group dynamic and interaction between board members, directors, management and the auditor. It involves asking penetrating questions in an effort to clarify positions, reveal potential gaps in either the auditor's or management's understanding of an issue; and, in doing so, obtaining and corroborating information and explanations for transactions, balances, variations, trends, and other potential anomalies which are outside auditor's expectations.

We are aware that some firms are cautious about a perception that they are being encouraged to gain audit evidence through discussion. Audit by discussion alone does not provide sufficient, appropriate and reliable audit evidence. However, discussions are key to challenge, not to obtain evidence, but to understand management's thinking and convey the audit team's challenge. This interaction is essential to understand management's perspective, procedures and data sets. Such interaction is also key to understanding where the data used by management and their outputs sit relative to the audit team's own expectations. Ultimately, this will allow the audit team to rationalise, obtain and evaluate the evidence needed to bridge any expectation gap. Provided the discussion is framed by the auditors own informed expectations, this facilitates better management engagement and reduces the opportunity for confirmation bias. We have seen examples of good practice to support this view which is also supported by some of the RCAs.

Context through Scope - Most of our publications to date have focused on challenge of management in the context of key areas of judgement and estimation such as impairment reviews, provisions, going concern assessments and fair values. This focus has been driven by the incidence of our review findings, but it should not be limited to these areas. Challenge of management is a consideration which cuts across all aspects of audits from understanding the results of substantive and controls testing through to disclosures in the financial statements, including whether narrative reporting is fair, balanced and understandable.

Appendix 2 – AQR review finding themes relating to challenge of management

We have revisited our findings for the most recent two review cycles with a focus on those audits identified as requiring improvement (files assessed as "improvements required" or "significant improvements required") and audit inspection reports that included examples of good practice. The purpose of this review was to identify common themes and examples of good practice. This is not intended to be an exhaustive list of findings in this area.

Where have we seen things go wrong based on our previous reviews?

The tables below set out the key findings over challenge of management, including:

- use of internal specialists or experts
- completeness of evidence considered by audit teams
- overreliance on management inquiry

Use of internal specialists or experts

Of the reviews which were identified to have issues with the level of challenge of management in the audit, over 30% identified the involvement of specialists to be an area where improvement was required.

In order to have the ability and confidence to challenge management's assumptions or judgements, auditors need to have the relevant knowledge and skills. Specialists may be required to provide this input. Financial statement line items where our inspectors have frequently found insufficient use of specialists or experts include impairment of goodwill, uncertain tax positions and valuation of investment property.

Specialists also need to be alert to the risk of management bias and apply sufficient scepticism and challenge in their work.

Findings

The issues identified in previous reviews were wide ranging but included:

1) **A lack of use of specialists** in audit areas subject to a high level of estimation or judgement, without appropriate alternative procedures performed. Specialist involvement may not be required in all instances, for example, when auditing a simple inventory obsolescence calculation.

   Evidence is however often hard to access and assess in certain audit areas and specialist involvement may be required to address this.

2) **Inappropriate response to specialist findings** which could affect the audit team's conclusion. For example, price assumptions or discount rates fell outside a valuation specialist's range, but the impact of this was not assessed and evidenced by the audit team. Audit teams need to evidence appropriately how they responded to the specialist's findings and how management has been challenged as a result of the points raised by the specialist, where applicable.

   In addition, other examples were identified where specialists were unable to determine reasonable ranges which were sufficiently narrow around highly sensitive assumptions. In these instances, audit teams did not appropriately re-consider the risk assessment around these assumptions, the disclosures made in the financial statements, and whether the procedures performed by the specialist were appropriate to support management's specific position in the range.

Good practice

We identified examples where the use of specialists to challenge management was performed particularly well.

- **Using specialists with specific expertise in an area**

  For example, in one audit we reviewed, a tax specialist was used in the audit who had specific knowledge of both the jurisdiction and type of tax being challenged. This enabled the audit team to form a judgement and challenge management appropriately, ultimately leading to a material amendment to the accounts.

  In this instance, the audit team involved the specialist in discussions with management to contribute to the level of challenge.

- **Appropriate evidence of response to specialist findings**

  Good examples were identified where the specialist had thoroughly evidenced the appropriateness of management's assumptions, including external sources used to benchmark. The audit team had then clearly followed up on any findings arising and the resulting conclusions.

3) **Lack of appropriate evidence to support the specialist's work.** This includes evidence of the scope of review by the specialist, the evidence on which the specialist based their conclusion, and how this was understood by the core audit team.	

Completeness of audit evidence assessed

Over 20% of reviews in the data population had review findings identified around the completeness of evidence considered by the audit team. An additional 14% of these reviews had specific issues surrounding the level of audit work over completeness of provisions.

Unconscious or conscious auditor biases may affect the engagement team's professional judgements, including both the design and performance of audit procedures, as well as evaluation of audit evidence. For example, there could be a risk of confirmation bias, whereby information that supports managements assumptions are unconsciously prioritised by audit teams when forming a conclusion. Where the auditor has audited the entity in previous years, 'anchoring' to prior year conclusions is also a risk.

In areas of high estimation uncertainty or judgement, the auditor may need to draw on information from sources independent of the entity. This includes, but is not limited to, market data, analyst reports, historical performance and forecasting accuracy.

Findings	Good practice
1) Challenge of forecast assumptions We have found examples where audit teams were not considering all available evidence when assessing management assumptions, particularly in areas where forecasts are used. Historical performance of the business and other readily available industry data was not considered by the audit team, despite these providing contradictory evidence. In addition, when assessing long-term forecasts, the audit team's consideration of forecasting accuracy was often limited to one year of historical results. Management's ability to forecast accurately beyond a 12-month period should be considered by audit teams where relevant. Furthermore, examples were seen of over-reliance or bias towards only one source of information when corroborating assumptions, without appropriate justification for why this evidence was reliable and sufficient to warrant no further audit procedures. **2) Completeness of provisions** Completeness of provisions was a recurring theme in relation to long-term contracts, leases and inventory. Audit teams did not evidence sufficient professional scepticism or challenge in these highly judgemental areas. A history of under-provisioning can be a strong indicator of potential issues with completeness of provisions and was frequently a risk factor which was not responded to appropriately. **3) Completeness of disclosures** Challenges over completeness is not limited to financial statement balances but also disclosures. Incomplete or insufficient disclosures and a lack of challenge of management in these cases has been a recurring theme in our inspections.	Good practice examples had the following common themes: • **Undertaking external research** to compare to management's information and to enable the audit team to form their own conclusion over areas such as impairment. An example included identification of a plausible range for revenue growth based on external market data. • Assessment of key assumptions across **various sources** including historical experience and third-party evidence. • Challenging management to review and revise their forecasts where assumptions were **not supportable based on historical performance.** This has, in some instances, led to material changes in financial statement balances. • **Clear evidence of discussions with management** on the impact of any findings from the above and follow-up of how this affected any assumptions in the final models**.**

Over-reliance on management	
Over 20% of reviews assessed as improvements required or significant improvements required identified issues with overreliance on management explanation without supporting corroboration. Management may be biased or lack neutrality towards outcomes or assumptions, whether consciously or not. The auditor is unable to respond to such risks if their audit process is limited to inquiry.	
Findings	**Good practice**
The work performed by the audit team was **limited to management inquiry alone** with insufficient challenge of management responses. Examples of overreliance on inquiries of management included: • explanations for significant variances when performing analytical procedures. • going concern assessments. • estimates in long-term contracts. This was not limited to verbal inquiries but also where **overreliance was placed on management representation letters** without further audit procedures being performed. Furthermore, examples have been seen where management information has been given a higher weighting than other external data when concluding on assumptions. In many instances, management may have access to better information, such as industry data and resources, than the auditor. Where this is the case, the audit team should evidence the source, the relevance and the reliability of the data utilised. Examples were also seen where the audit team placed reliance on management experts without sufficient assessment of the scope and objectivity of the expert's work.	For higher risk or significant risk areas, the evidence provided needs to be more persuasive than in a lower risk area. We have found examples of good practice where auditors used a variety of information from sources independent of the entity such as analyst reports to support assumptions with a high risk of material misstatement. In some instances, information from sources independent of the entity may not be available to provide corroboration. For example, in one audit that we reviewed, cost savings were built into management's forecasts. The audit team obtained detailed supporting papers from management on how these cost savings will be achieved. The auditor verified that the company had achieved cost savings historically in another area of a similar nature.

Where have we seen things go right based on our previous reviews?

We have also analysed those audits where challenge of management was identified as an area of good practice. This analysis identified examples which included:

- strong risk assessment
- consultation on complex areas

Risk assessment
Background Risk assessment is a fundamental and continuous part of the audit process. In areas of high complexity or judgement, the risk assessment should be thorough and sufficiently granular to design an appropriate response to the audit risk.

Specific insight to good practice examples

- High quality analysis of the risk factors and key assumptions included in group instructions issued to component teams to ensure clarity of communication of risks identified at a group level.
- Thorough understanding of management's models to identify areas of risk in the process and design an appropriate audit response to address this.
- Clear memoranda maintained on the audit file which explained the risk and uncertainties associated with a financial statement balance at a granular level. The audit risks had a clear link with the procedures performed to address the level of risk.

Consultation on complex areas

Background

In areas which are highly contentious, judgemental or complex, audit teams need to consider whether consultation with internal technical specialists or other individuals within the firm is necessary. Consultations can be beneficial to provide a further independent perspective and also knowledge on a specific accounting or audit issue from previous consultations within the firm.

Specific insight to good practice examples

Examples were identified where consultation with technical specialists led to further challenge of management. Good practice was seen where the challenges arising from the consultation and their resolution were clearly summarised on the audit file.

Appendix 3 – What are audit firms telling us?

As part of each AQR inspection, audit teams are required to prepare action plans to address issues raised, including those related to challenge of management. Audit firms also perform root cause analysis ("RCA") and identify firmwide actions, including audit quality plans by the firms, which incorporate matters to improve challenge of management.

We have analysed these plans to understand where individual audit teams have observed deficiencies in the audit process. Common themes included:

- Insufficient senior team involvement
- Lack of understanding of the audited entity's system of internal control
- Robustness of management's assessment and evidence

Senior team involvement

Background

The need to involve more senior team member in the audit work over significant estimates and judgements was a recurring point in the action plans prepared by audit teams.

Areas of focus for audit teams

- Involving the **right people** with the **right knowledge** at **the right time** is key. A greater level of involvement of senior team members may be required to make informed expectations and appropriately challenge management in contentious or high-risk areas.
- Strong quality control processes need to be performed by the engagement partner and the engagement quality control reviewer to ensure that there is sufficient challenge of management and appropriate evidence of this challenge.
- The senior team is responsible for embedding a culture of challenge within their audit teams and to ensure the audit is approached with sufficient professional scepticism.

Understanding the audited entity's system of internal control

Background

A robust audit starts with a thorough understanding of the audited entity's system of internal control. Even when control reliance is not expected, an understanding of the risk points in a process can aid in risk assessment and have an impact on the level of substantive testing required.

Areas of focus for audit teams

- Complex accounting estimates often inherently have complex accounting models behind them. The entity's internal controls as they related to accounting estimates should be understood by the audit team when determining audit risk and audit approach.
- Management review controls are common in areas of estimation or judgement. In some instances, audit teams have indicated they will attend management meetings to obtain a more thorough understanding of management's review process.

Robustness of management's assessment

Background

Audit teams indicated that in order to enable them to improve the robustness of challenge of management in the audit, they will need to request management to 'do more' in this area.

This may be requesting more robust or sophisticated models, improvements to be made in the financial reporting processes and control environment or higher quality evidence to corroborate assumptions.

Areas of focus for audit teams

- The quality of information provided by management does have a direct impact on audit approach.

- Audit teams should be engaging with management at an early stage on what is expected and will be required in the audit.
- Where information provided by management is not sufficient to meet audit purposes, this should be communicated to those charged with governance (usually the audit committee) on a timely basis. The key challenges identified in the audit should be communicated as part of the formal reporting.

We have also reviewed the RCAs of the seven largest audit firms. In addition to seeking lessons from audits which received a less-than-satisfactory review, some firms looked at audits which received good or limited-improvement-required assessments to see if good practices could be identified. Some firms also aggregated data from their own internal quality monitoring reviews and reviews performed by the professional body for non-public interest audits. The results were highly consistent across firms.

These firm's RCAs understandably identified similar shortcomings to our own, but also identified more qualitative factors such as behaviour, critical thinking, confidence and most significantly culture. Various training and mentoring initiatives are being developed to address these issues.

Appendix 4 - Aggregation of AQR and RCA Observations

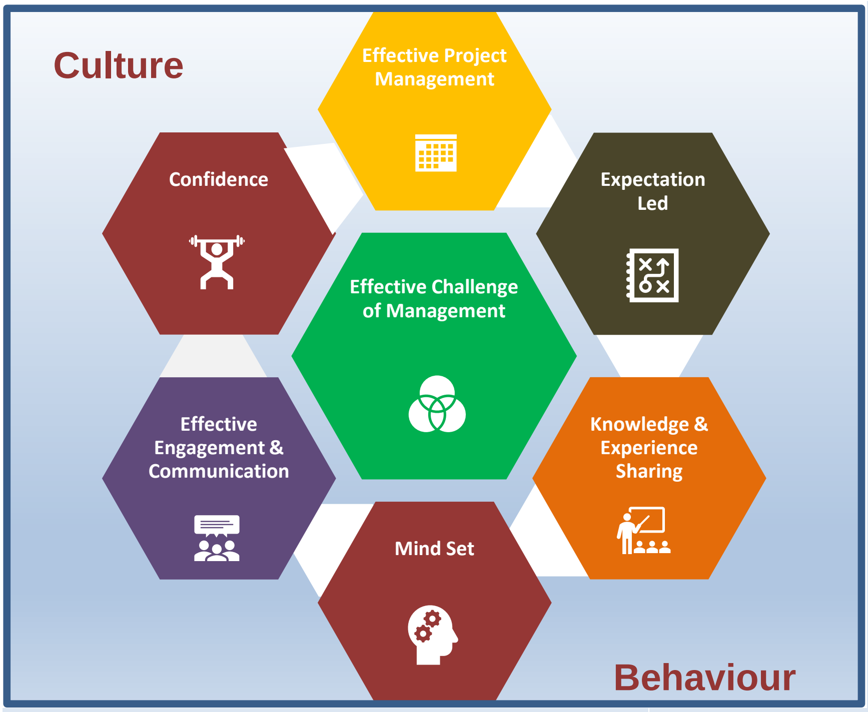
The key findings from our review activities and our observations on the firms' RCAs are summarised in the following table divided, where possible, into "process and technical" and "qualitative":

Figure 1 - Aggregation of RCA findings specific to challenge and AQR Review Observations

Process and Technical		Qualitative	
Timely informed planning	Effective project management	Confidence	Culture
	Clearly defined and relevant expectations	Mindset	
	Significant involvement of partner and other senior team members	Behaviour	
	Good use of specialists		
	Consultation on complex areas		
	Robust quality control procedures		
	Clear and timely communication to Audit Committees		
	Training and mentoring		

Many RCAs refer to the importance of the qualitative aspects enhancing challenge and how these interact with established and developing processes. Based on our initial analysis of the RCA and AQR observations, we believe the interaction of the qualitative and process aspects of challenge can be illustrated in the following diagram. We are keen to discuss in detail with audit firms and other stakeholders whether this summary and interaction encapsulates the various qualitative influences on challenge and what further actions firms are taking or planning in these areas.

Figure 2 – Interaction of process and qualitative aspects of challenge of management



Effective project management – Issues raised late are less likely to be resolved effectively. Project management is key to making sure management and the audit team have time to work through an issue.

Expectation led – Without an informed expectation it is difficult for an auditor to be sceptical and identify the need for challenge. The absence of scepticism increases the risk of confirmation bias.

Knowledge & experience sharing – It is essential that the more experienced members of the team share their experience with the more junior team members who are closer to the issue.

Mind set – This is a key behaviour attribute which defines the enquiring mind of a suitably sceptical auditor.

Effective engagement & Communication – Challenge of management should be a constructive process where each party can understand the others' perspective so that the right answer becomes clear. Such an environment is enhanced through clarity of communication and a strong professional relationship.

Confidence – RCAs identified confidence as key to achieving successful challenge of management. Confidence is a qualitative trait shaped by mind set, experience and the culture of the firm, including support from senior management.