



Financial Reporting Council

PwC LLP

AUDIT QUALITY INSPECTION

JUNE 2018

The FRC

Our mission is to promote transparency and integrity in business.

transparency



We have responsibility for the public oversight of statutory auditors.

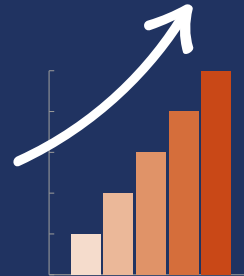
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



AQR

We monitor the quality of UK Public Interest Entity audits.

+1.55	0.20%	+2.27%	-11.48%	POS	-3.2320
+3.02	0.21%	+2.83%	-15.93%	NEG	-3.9993
+3.85	0.14%	+2.42%	-17.67%	POS	-4.2421
+3.39	0.27%	+2.19%	-18.32%	NEG	-4.2083
+3.32	0.27%	+2.28%	-14.73%	NEG	-3.5708
+3.24	0.20%	+2.76%	-20.12%	NEG	-2.8339



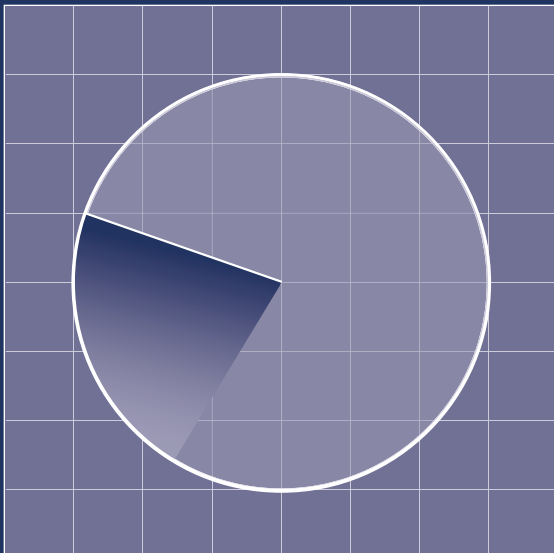
We promote continuous improvement in audit quality.

Our team of over 40 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



The Firm

PwC has 586 audits within the scope of AQR inspection, including 33 FTSE 100 and 65 FTSE 250 audits.



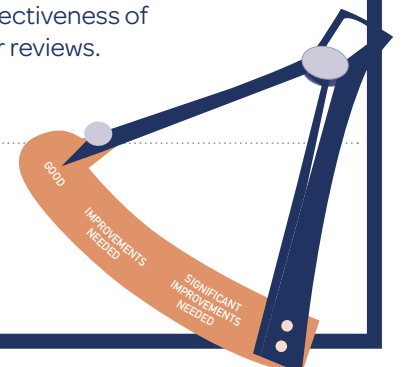
Our inspection process

There are around 2350 audits within the scope of AQR inspection. In total, we inspected 145 individual audits in 2017/18, including 28 at PwC.



We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of the audit work inspected.



Financial Reporting Council

PwC LLP

Audit Quality Inspection

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AQR's objective is to monitor and promote improvements in the quality of auditing.

AQR assesses the quality of audit work and policies and procedures supporting audit quality at firms which audit Public Interest Entities.

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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1 Overview

This report sets out the principal findings arising from the 2017/18 inspection of PricewaterhouseCoopers LLP (“PwC” or “the firm”) carried out by the Audit Quality Review team (“AQR”) of the Financial Reporting Council (“the FRC”). We conducted this inspection in the period from February 2017 to February 2018 (“the time of our inspection”). We inspect PwC, and report publicly on our findings, annually.

Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm’s audit work. Our findings cover matters arising from our reviews of both individual audits and the firm’s policies and procedures which support and promote audit quality, focusing on changes arising from the revised Auditing and Ethical Standards¹.

We plan to implement a new audit firm monitoring approach for the six largest firms from 2018/19². This approach focuses on five key pillars: leadership and governance, firm values and behaviours, business models and financial soundness, risk management, and evidence of audit quality.

We are grateful for the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2017/18 inspection.

Our assessment of the firm’s performance

The overall results of our reviews of the firm’s audits show that 82% were assessed as requiring no more than limited improvements, compared with 93% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 84% as achieving this standard compared with 90% in 2016/17. The FRC’s target is that at least 90% of these audits should meet this standard by 2018/19. We are concerned at the decline in inspection results by comparison with the previous year.

Where we identified concerns in our inspections, they related principally to the challenge of management’s estimates and certain aspects of group audits. During the year, the firm has focused on further improving its procedures relating to coaching, supervision and review. We have seen an improvement in relation to most of the key findings we highlighted in last year’s report, although some similar findings remain for this year.

The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement.

¹ The firm was also included within the scope of our thematic review on Audit Firm Culture. The report, published in May 2018, sets out how audit firms are seeking to embed a culture which supports high quality audit: [Audit Culture Thematic Review](#)

² [AFMA Press Notice](#)

Key findings in the current year requiring action

Our key findings in the current year requiring action by the firm are set out below. Further details are given in section 2, together with the firm's actions to address them.

Individual audit reviews

The firm should:

- Further improve the assessment of, and level of challenge regarding, management's estimates and provisions.
- Enhance the involvement of the group audit partner and team members in the direction and supervision of component audits in more unusual circumstances.
- Provide guidance to group audit teams in relation to the approach taken and evidence of work performed on reserves in the extractive industries.
- Require more informative reporting from the firm's internal actuarial experts on the key assumptions underpinning the estimation of company pension scheme liabilities.

Review of firm-wide procedures

- The firm should strengthen its independence systems and procedures relating to personal independence testing, as well as certain other monitoring procedures and non-audit services approval processes.

Assessment of the quality of audits reviewed

The bar charts below show the results of our assessment of the quality of the audits we reviewed in 2017/18, with comparatives for our four previous inspections³. The number of audits within each category in each year is shown at the top of each bar.

The first chart shows the results for all audits reviewed. The second chart shows the results for FTSE 350 reviews only.

³ Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Chart 1: All reviews

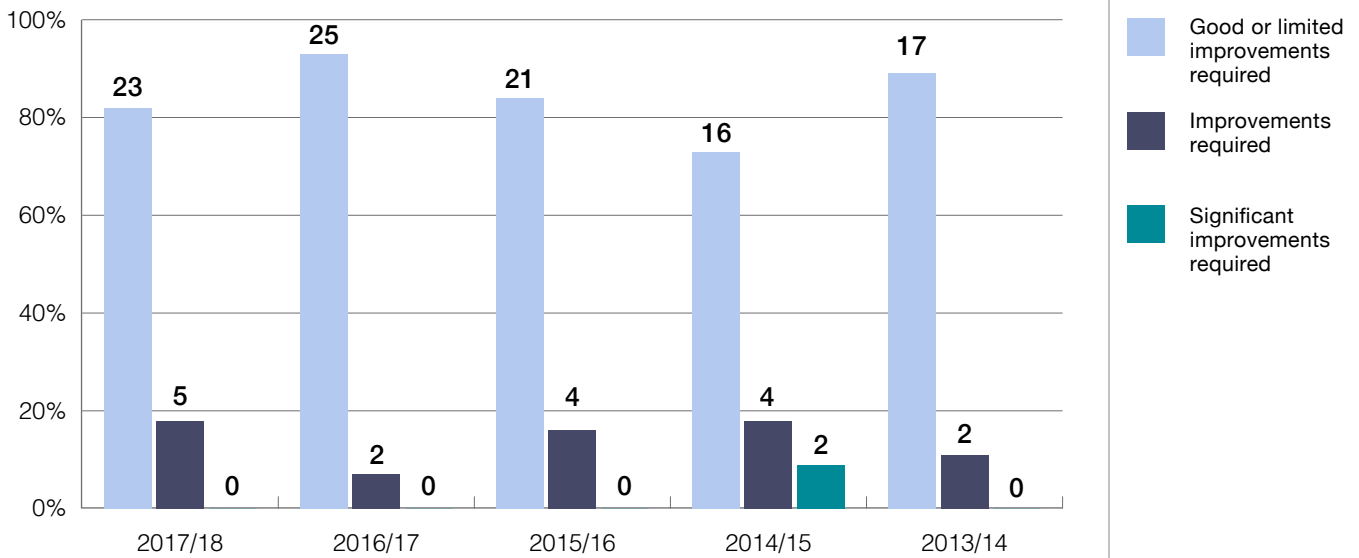
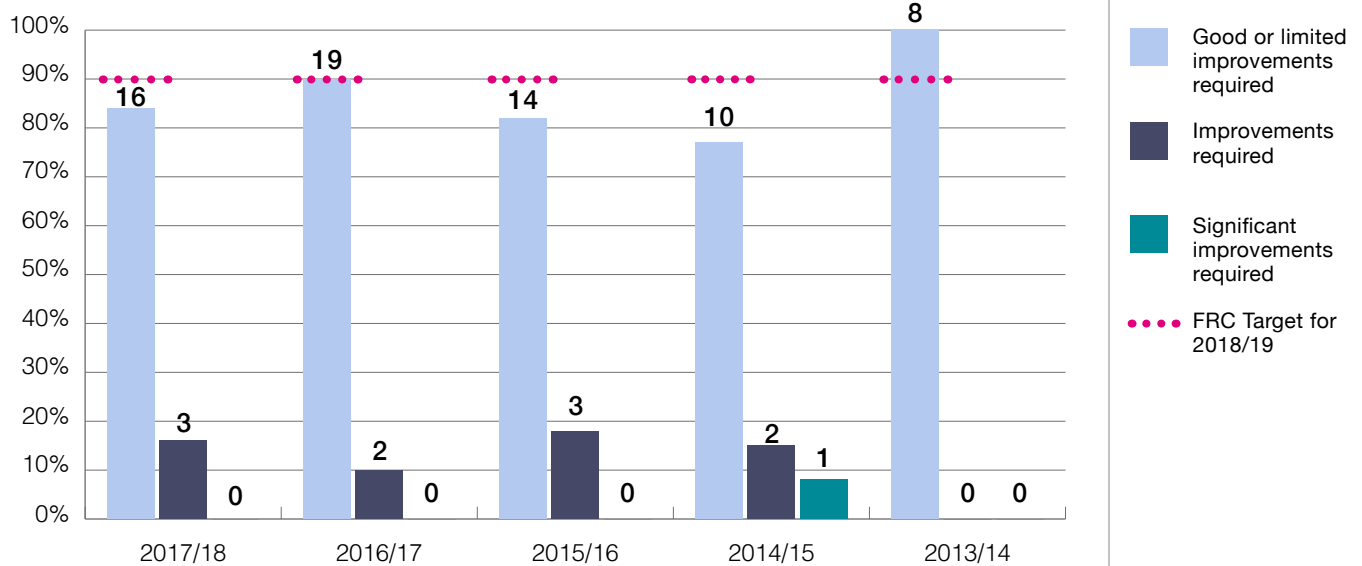


Chart 2: FTSE 350



Good practice identified

Examples of good practice we identified in the course of our work include the following:

Individual audit reviews

- Effective use of data analytic techniques in the audit of revenue and journals.
- The quality of the firm’s summaries of audit responses to significant risks and related findings.
- The use of, and interaction with, the firm’s internal specialists and experts.

Firm-wide procedures

- The response to the revised Ethical Standard requirements and certain independence related procedures, including the central independence team's involvement in acceptance and continuance procedures and the guidance issued for gifts and hospitality.
- The response to the revised Auditing Standard requirements, including the training provided in this area.

Further details and examples are set out in section 3.

Issues driving lower audit quality assessments

All of the issues driving these lower audit quality assessments are included in our key findings in section 2.

Root cause analysis

Thorough and robust root cause analysis ("RCA") is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

Our report on Audit Firm Culture stated that, based on RCA undertaken through 2017, all firms covered by that review had improved their RCA since our 2016 thematic review. We also reported that firms should seek to develop their RCA techniques "to identify the behavioural or cultural factors that contributed to either good or poor quality outcomes".

The firm has performed RCA in respect of our key findings and considered the outcome in developing the actions included in this report. We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques further.

Firm's overall response and actions:

We set high standards for our audits, and are committed to continual improvement in audit quality. We have reflected at length on the results of this year's inspection findings. Whilst we are naturally disappointed that the AQR has assessed there to be a reduction in the proportion of audits requiring no more than limited improvements, their assessment over a longer timeframe (the last five years) shows a consistently high level of audit quality. That broader picture is also consistent with both our own internal review findings as well as with the findings from inspection of our work by other regulators.

The AQR has identified a wide range of good practices from their audit inspections, as well as from recent thematic reviews. It is important that we continue to leverage these strengths. Nevertheless, we also recognise there is more that can be done to continue to improve our work.

We have, as in prior years, evolved our root cause analysis (RCA) activity, leveraging our global RCA programme whilst also responding to the FRC's RCA thematic review. This analysis has enabled us to focus on the following, more behavioural, causal factors which have been identified this year:

Firm's overall response and actions:

- Positive team behaviours, that reflect our values, directly contribute to our most successful audits. Conversely, where improvements are identified those behaviours are less consistently demonstrated. For some time we have focused on the importance of coaching, supervision and review (CSR) activities within our engagement teams. The positive impact of this programme, combined with teams embracing new ways of working, is clearly evident on engagements requiring no more than limited improvements. Therefore, in the coming year we will use various mechanisms to communicate to the practice consistent and positive messages around team behaviours, including CSR. These expected behaviours, which both leverage and reinforce PwC's Values, are the basis for our first classroom based learning session, in which all partners and qualified staff participate, to be delivered over the summer. The sessions will be used to directly link these behaviours to quality findings and generate innovative ideas to address challenges. Such challenges can also include general resourcing pressures which don't help teams prioritise good practice team behaviours. We are therefore also focusing efforts on recruitment and retention activities.
- Our RCA shows us that timely engagement leader led audit planning has a positive impact on quality and that lack thereof has a detrimental impact. Planning decisions should be continuously reconsidered throughout the audit, enabling the audit team to respond on a timely basis to changing risks, client actions and audit findings. Furthermore, on group audits, clarity at the planning stage is paramount to ensuring appropriate interaction, challenge and discussion activities between group and component audit teams are undertaken and documented appropriately. Alongside broader audit planning initiatives, which are currently in development, we will share positive planning behaviours and activities identified in higher rated engagements, through a discussion based webcast.
- In the past we have focused our engagement teams on ensuring the audit documentation 'tells the story of the audit'. Our RCA has identified this has sometimes been interpreted as describing the audit processes, rather than articulating conclusions based on evidence obtained. Our teams continue to try to balance the need for clarity within the audit file with an increasing expectation of granular detail and narrative. We will therefore ensure our teams focus on telling the 'story of the judgments' (i.e. why we have concluded in the way we have) rather than just the audit process. This updated focus will continue to be reinforced with engagement teams through our pre-issuance review programme, and will be embedded throughout the classroom and remote learning technical program completed by all audit staff.

As we have done in previous years, we will share these inspection results, and the AQR's areas of focus with partners and qualified staff in our annual regulatory findings webcast in June. Our RCA shows that where our engagement teams have a good awareness of the activities and focus of the regulator they better engage with quality initiatives.

We are confident that these activities, together with the detailed actions in response to the key findings set out in section 2 of this report, will continue our focus on delivering audits of the highest quality.

2 Key findings requiring action and the firm's response

We set out below the key areas where we believe improvements are required to enhance audit quality and safeguard auditor independence. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Further improve the assessment of, and level of challenge regarding, management's estimates and provisions

Estimates and provisions in financial statements are inherently subjective and can be sensitive to changes in management's key assumptions. Audit teams should ensure they provide an appropriate level of challenge and adequately test management's key assumptions and related processes.

Findings

Given the level of audit risk and the potential impact on the financial statements, we reviewed the audit of management's estimates and provisions on the majority of the audits that we inspected. The audit work was often performed to a good standard. We did, however, identify findings relating to the evidence of appropriate consideration or challenge of estimates or provisions on one or more audits, including the following:

- In relation to estimating future contract costs that impacted current profits, insufficient evidence of adequate audit procedures to ensure that costs to complete and margins had been appropriately estimated, including the testing of forecasting and monitoring controls (two audits).
- In relation to estimating the fair value split of multiple element contracts that impacted the amount of revenue recognised, insufficient evidence of the audit team's consideration and challenge relating to the fair value of the separate contract components.
- For maintenance provisions, insufficient analysis of the different elements of the provision for risk assessment purposes and insufficient corroboration of certain cost assumptions.
- For loan loss provisions, insufficient audit procedures regarding the models used to calculate the provisions for certain loans.
- For bad debt provisions, insufficient evidence that the audit team adequately challenged management's assumptions for the extent of recoverability of trade receivables.
- For tax provisions, insufficient audit evidence supporting the conclusions relating to the level of certain tax provisions (three audits).

Firm's actions:

Given the inherent subjectivity often involved, our teams endeavour to adopt a “challenge”, rather than “validate”, mindset when auditing estimates and provisions. Continuously applying professional scepticism is key to ensuring this challenge is appropriate on a consistent basis. This can be more difficult when no external data sources are available or relevant. Concluding on the sufficiency of evidence obtained in these circumstances requires substantial judgement in determining whether the risk has been addressed. The clarity of the rationale supporting the ultimate judgment reached is therefore critical.

Where the consequence of our challenge is a change to management's estimate, this can be relatively simple to evidence within our working papers. However, this challenge may have taken place over a number of reporting periods, involved the views of experts, multiple interactions with various team members and client staff, and/or many iterations of forecasts or data. Where this is the case, the engagement team needs to clearly and effectively capture this challenge, including, for example, when evaluating the data sources and key inputs in complex models. Reflecting on how a third party reviewer of the evidence might assess its adequacy would assist the team in providing sufficient clarity of thought when describing inputs, process, judgement, challenge and conclusions.

To address these ongoing challenges, we are taking a number of new steps this year, focusing in particular on 'how' we deliver additional support to the practice, not just what. For example, we are taking a deliberate and innovative approach when delivering our training for all qualified staff this summer. By positioning lessons learned alongside classroom technical training and reinforcing using a simulation-based interactive online training module we aim to challenge the mindset of our teams when approaching the audit of provisions and estimates. Further, and using examples from recent reviews, we will reiterate the need to actively seek and document third party sources of available information and record judgments taken, as well as promote the more consistent use of PwC's 12-step practice aid to auditing estimates. Finally, new interactive audit working paper tools have been developed to assist teams in this area.

Enhance the involvement of the group audit partner and team members in the direction and supervision of component audits in more unusual circumstances

The group audit partner, supported by the audit team, is responsible for the direction and supervision of the group audit and therefore needs to demonstrate sufficient involvement throughout the audit process.

Findings

For all group audits, we reviewed the level of involvement of the group audit partner and other group audit team members in the direction, supervision and review of the component audits. The audit work was usually performed to a good standard, and we have noted specific examples of good practice in this report. On two audits with more unusual circumstances, however, improvements were required in respect of the group audit team's direction and supervision of the group audit as follows:

- On one audit, the group's head office was based overseas and there was a combined group audit team with members of an overseas PwC member firm. While the UK based group partner and senior staff members visited the overseas head office and certain significant component audit teams prior to the year end, they did not visit these or review the component audit working papers after the year end.
- On the second audit, there were restrictions as to who could perform the audit and have access to audit work papers for certain components. Additional procedures which could have been performed by the group audit team to address this situation include visits to the component auditors after the year end, or enhanced review procedures and reporting requirements.

Firm's actions:

Whilst both audits referred to had 'unusual circumstances' which led to particular findings, we note that on the whole, our work on group audits is good. We will leverage that good practice with our teams to ensure they continue to undertake group audit work to a consistently high level.

Evidencing the direction in particular, but also the supervision, of component teams on a group audit file requires rigorous process to ensure it is fulsomely recorded. The implementation of ISA (UK) 600, relevant for more recent audits, helps us to address some of these challenges given its more prescriptive requirements.

During 2017, we provided updated work programs and more detailed guidance to teams to help them in these areas. These both required teams to provide further clarity as to the nature, timing and extent of the component team audit procedures on the group audit file and to provide better rationale as to why certain procedures were undertaken and others not. We will continue to build on these tools by sharing experience of year one of implementing the new standard and identified good practice with partners and staff. This will include particular emphasis on the identified unusual situations.

Provide guidance to group audit teams in relation to the approach taken and evidence of work performed on reserves in the extractive industries

While mining and oil and gas reserves are not recognised on the balance sheet, they can have a pervasive impact on the financial statements, including asset impairment, depreciation and decommissioning provisions. Audit teams therefore need to assess the related risks of a material misstatement of the financial statements arising and respond appropriately to these risks.

Findings

We reviewed three group audits where there were significant mining or oil and gas operations overseas.

For two of these audits, the audit procedures on the mining reserves were undertaken by local component teams. The group audit team did not adequately explain on file why reserves (or aspects thereof) was not considered to give rise to a significant or elevated risk. In addition, the group audit team should have clearly set out the nature and extent of the procedures to be performed and evidence obtained by the component audit teams.

On the third audit, the group audit team did not perform sufficient procedures to demonstrate that they had understood and evaluated the work undertaken in respect of oil and gas reserves by an expert engaged by management. In particular, their procedures did not include meeting with management's expert to understand and challenge the appropriateness of their work in estimating the level of reserves, including the key assumptions and source data used.

The firm uses audit teams with experience in conducting audits in the mining and oil and gas sectors and provides industry related training to them. The firm should also provide guidance to group audit teams to assist them in providing direction to component audit teams in this area.

Firm's actions:

Our risk assessment on extractive industry clients is performed at both the group and the component level and is focused on identifying those risks of material misstatement at a financial statement line item (FSLI) level. Reserves and resources are typically not a separately identified risk, but instead they may be a key input to one or more of the risks identified. Whilst our industry practitioners are well aware of this approach, the clarity with which this was articulated on the audits reviewed, varied. We will therefore provide guidance to the industry group to ensure this approach, and our rationale, is clearly evidenced in a more consistent way.

We are also in the process of standardising the competent person evaluation template within our methodology to ensure consistency between teams when evaluating management's experts, particularly in overseas reporting components. Furthermore, the audit principles when using the work of management's experts within a component will be reiterated to the industry group.

Our guidance and training in respect of group audits referred to above, and in particular the requirements to evidence direction to component teams, is also relevant to the group work performed in the extractive industries.

Require more informative reporting from the firm's actuarial experts on the key assumptions underpinning the estimation of company pension scheme liabilities

Defined benefit pension liabilities are included on company balance sheets, offsetting pension assets. The estimation of the level of these liabilities often involves complex actuarial calculations supported by a number of significant assumptions. Internal actuarial experts usually assist auditors, when concluding on liability valuation, given the specialised nature of the calculations and assumptions. Auditors should understand the basis of the assumptions and methodologies used, to support their assessment of whether the liabilities are appropriately valued.

Findings

The audit of pension scheme liabilities was an area of focus for our 2017/18 inspection. We reviewed the audit work performed, drawing on the expertise of FRC actuaries in our review process. We generally found a good level of involvement from the firm's actuarial experts. The experts reported on their work to the audit team in a standard format recommended by the firm. We found a common theme of insufficient evidence and information provided in relation to aspects of the judgements, assumptions and methodologies for the valuation of pension liabilities.

Firm's actions:

Our internal actuarial experts have for some time used a standard template to provide reporting to our engagement teams. This standardisation enables audit teams to consistently and clearly understand the work performed by the experts, the conclusions drawn and perform follow up procedures as required.

The standard report did not require the expert to include the basis for the client using the roll-forward methodology and the limitations of that approach. It also did not set out the methodology used by our actuaries to determine quarterly independent expectations for reasonable ranges using broad market data. The engagement teams did not request this level of detail from their experts, as our standard audit work programmes did not require them to include this level of detail.

We have enhanced both the standard reporting template from our actuarial experts as well as the relevant working papers within our audit files to include further details underpinning key assumptions and to ensure the audit team is prompted to understand and record clearly the relevant supporting detail utilised by the expert.

Strengthen the firm's independence systems and procedures relating to personal independence testing, as well as certain other monitoring procedures and non-audit services approval processes

A revised Ethical Standard ("ES") became effective during the year with enhanced requirements and stricter prohibitions. The firm therefore needed to ensure its policies and procedures complied with these requirements.

Given the importance of auditor independence and the impact of the revised ES, in March 2017 we reviewed the arrangements for independence and ethics at the six largest firms. This approach allowed us to benchmark arrangements across the firms and share good practice. Our review focused on how the firm's policies and procedures address the revised ES requirements. We have also reviewed compliance with the previous Ethical Standards as part of our inspections of individual audits.

Findings

The firm has revised its policies and procedures in response to the revised ES. We have identified some examples of good practice, as well as certain areas for improvement. We identified the following concerns:

- The firm’s testing of compliance with personal independence requirements (for example, holding prohibited investments) does not ensure that all partners and staff are subject to periodic testing. The percentage of partners tested annually should be increased and testing extended to include those captured by the expanded ES definition of a partner. In addition, the firm has only recently started to test staff’s financial interests. Notwithstanding these findings, the firm’s testing of personal independence covers the past 12 months of transactions, as opposed to testing a point in time, representing good practice.
- The firm’s systems relating to non-audit services do not require audit engagement partner approval before personnel obtain time codes for non-audit engagements. These systems also do not incorporate the ES changes or functionality to help engagement teams identify non-permitted services. There is also no central monitoring of the delegation of the audit engagement partner’s responsibility for approving non-audit services.
- The firm had not been centrally monitoring compliance with audit firm rotation requirements for all of its PIE audits.
- The firm does not centrally monitor the communication of ethical and independence breaches to audit committees.

Firm’s actions:

The changes to the independence requirements, particularly personal independence, are nuanced and have evolved since implementation of the Ethical Standard. Even in a fully restricted model, and with detailed training, it has been challenging for individual practitioners to be aware of developments on a continual basis.

The approach adopted for compliance testing was in accordance with PwC global policy and based on the definition of partners within the global independence policy. In response to the findings we have increased the frequency of testing for partners, and refined the scoping methodology for staff testing to include a higher proportion of staff with signing rights.

The firm’s systems cannot currently be configured to prevent finance codes being created for non audit services where approval is yet to be received from the audit engagement leader. Approval of non-audit services to audit clients requires a behavioural refocus in our non-audit delivery teams and we are addressing this through additional communications and potential consequences of non-compliance.

Rotation monitoring has historically been performed at a business unit level, with no instance of non-compliance with firm rotation requirements. Nevertheless, we have made updates to our rotation tracking database and implemented formal notification confirmations to enable a centralised annual monitoring control over audit firm rotation to be implemented.

Ethical breaches are only one of many matters which are required to be reported to Audit Committees by engagement teams. The Ethical Standard is also clear this is the engagement leader’s responsibility. We have recently introduced an annual confirmation process requiring engagement leaders to confirm that required communications with Audit Committees have been made.

3 Good practice examples and developments in the year

Good practice

We set out below the key areas where we noted good practice, either in audit work on individual engagements or firm-wide procedures.

Individual audit reviews

Effective use of data analytic techniques in the audit of revenue and journals.

The effective use of data analytic techniques in the audit of revenue and journals enhanced the quality of audit work in those areas in a number of cases.

The quality of the firm's 'significant matter' summaries

Significant matter summaries are prepared by the audit team to provide an overview of the audit responses to significant risks and related findings. These are required to be reviewed by the audit partner and engagement control quality reviewer. The significant matter summaries prepared for most audits we reviewed were of a good standard.

The use of and interaction with the firm's internal specialists and experts

Audit teams often use the firm's specialists (who work as part of the audit team) or experts (who report to the audit team) in areas such as tax and IT. Examples of good practice included their involvement in determining a reasonable range for certain estimates and in the benchmarking of key assumptions.

The extent of involvement by the group auditors in the review of the work of component auditors

On certain group audits, we identified good examples of the extent of involvement by the group audit team in the direction and review of the work of component auditors and the evidence of that involvement. This included obtaining the component audit teams' 'significant matter' summaries of the audit procedures performed and findings on the significant risks. On one audit, a group audit team member was seconded to the largest component audit team, and another followed a rotation plan for members of the component audit teams to join the group team which provided a greater understanding of the component audits by the group audit team.

Responses to IT control and other control deficiencies

On certain audits with IT control deficiencies, we saw good examples of the audit responses to this, including the consideration of the deficiencies, testing of compensating controls and performing additional procedures.

Firm-wide procedures

Independence procedures and the response to the revised ES requirements

We note the following areas of good practice:

- Firms are required to assess whether they comply with the ES requirements before accepting or continuing an engagement. The central independence team performs this assessment for public interest entities (“PIEs”), overseas entities or any entity deemed to be complex.
- The revised ES has substantially reduced the level of gifts and hospitality that can be accepted from or provided to audited entities. The firm’s guidance as to what is permissible is clear and informative.

Revised Auditing Standards

The firm has made good progress in addressing the new requirements of the revised Auditing Standards, including updating the firm’s policies and procedures. We note the following areas of good practice.

- Training – The firm has provided training on the revised Auditing Standards for those internal specialists involved in audits.
- Communication with regulators – The firm requires internal consultation in any circumstances which could give rise to a duty to report to the relevant regulator.

Developments in the year

Following actions from the firm, we have seen an improvement in relation to most of the key findings we highlighted in last year’s report.

The firm has enhanced its policies and procedures during the year in a number of areas, including the following:

- Guidance and training: there have been updates to the firm’s guidance and training in a number of areas, including guidance on how to approach the audit of provisions and estimates.
- Effective coaching, supervision and review procedures: there has been continued focus on how audit teams embed effective coaching in the audit.
- Project management: a review of engagement project management skills and behaviours has been undertaken to identify potential enhancements to the quality of audits undertaken.

Audit Quality Review

FRC Audit and Actuarial Regulation Division

June 2018

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