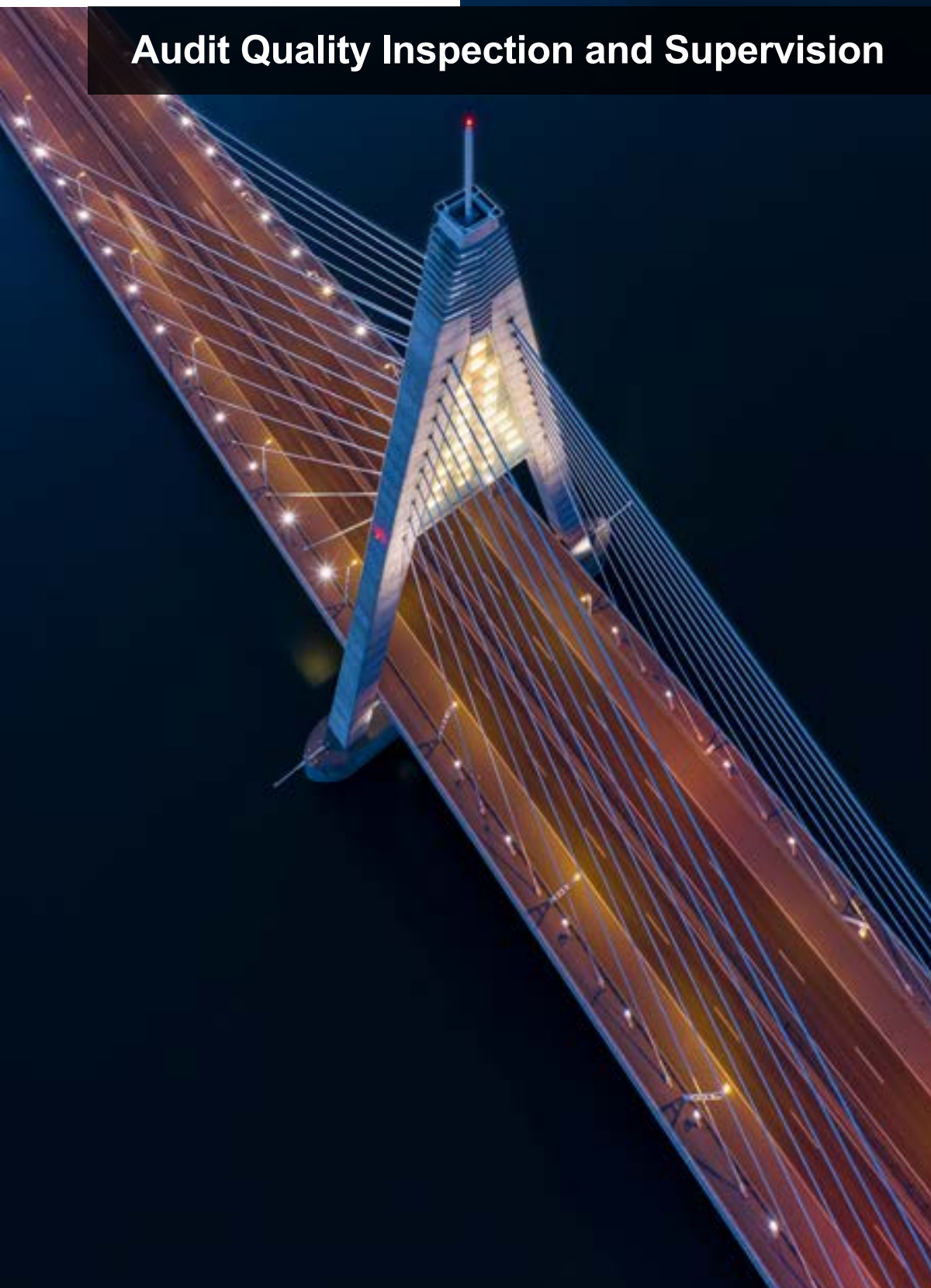




Financial Reporting Council

BDO LLP

Audit Quality Inspection and Supervision



July 2021

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This report sets out the FRC's findings on key matters relevant to audit quality at BDO LLP (BDO or the firm). It is based on inspection and supervision work undertaken in our 2020/21 cycle, primarily our review of a sample of individual audits and our assessment of elements of the firm's systems of quality control.

The FRC's focus is on the audit of public interest entities (PIEs¹). Our selection of individual audits and the areas within those audits for inspection continues to be risk-based focusing, for example, on entities which: are in a high-risk sector; are experiencing financial difficulties; have material account balances with high estimation uncertainty; or, where the auditor has identified governance or internal control weaknesses. The majority of individual audits that we inspect are of PIEs but we also inspect a small number of non-PIE audits on a risk-based basis.

Higher-risk audits are inherently more challenging as they will require audit teams to assess and conclude on complex and often judgemental issues, for example in relation to future cash flows underpinning assessments of impairment and going concern. Rigorous challenge of management and the application of professional scepticism are especially important in such audits.

Our increasing focus on higher risk audits means that our inspection findings may not be representative of audit quality across a firm's entire portfolio of audits or on a year-by-year basis. Our inspection findings cannot therefore be taken as a balanced scorecard of the overall quality of the firm's audit work. However, our forward-looking supervision work now provides us with a holistic picture of the firm's approach to audit quality and the future development of its audit quality improvement initiatives.

As well as risk-based selections, we aim to review all FTSE 350 audits periodically.

To provide a more holistic assessment of audit quality, the report also includes reference to other measures of quality at the firm. The Quality Assurance Department (QAD) of the Institute of Chartered Accountants in England and Wales (ICAEW) inspects a sample of the firm's non-PIE audits, the results of which are summarised on page 8.

The firm also conducts internal quality reviews. A summary of the firm's internal quality review results is included at Appendix 1, together with the actions that the firm is taking in response.

At Appendix 2 are further details of our objectives and approach to audit supervision.

¹ Public interest entity – in the UK, PIEs are defined in the Companies Act 2006 (Section 494A) as: - Entities with a full listing (debt or equity) on the London Stock Exchange (Formally "An issuer whose transferable securities are admitted to trading on a regulated market". In the UK, "issuer" and "regulated market" have the same meaning as in Part 6 of the Financial Services and Markets Act 2000); - Credit institutions (UK banks and building societies, and any other UK credit institutions authorised by the Bank of England); - Insurance undertakings authorised by the Bank of England and required to comply with the Solvency II Directive.

1 Overview

Commentary on our inspection work at the largest audit firms

We completed more audit inspections at the largest seven firms in 2020/21 (103) than in 2019/20 (88). Our overall inspection findings are similar to last year, with 71% of audits (73 out of 103 inspections) requiring no more than limited improvements compared to 67% last year (59 out of 88 inspections).

The number of audits that we have assessed as requiring improvements remains unacceptably high. This year the results varied more between firms and we found inconsistencies, with good practice in some audits but deficiencies in the same areas in other audits at the same firm.

The most common key findings in our public reports are in relation to revenue, impairment of assets and group audit oversight. These are recurring issues but we also identified good practice in these areas in some audits.

We also identified good practice during our 2020/21 thematic review of the audit of going concern, where we found that firms had responded positively to the increased risk arising from Covid-19, by enhancing their procedures in this area².

Four of the largest firms (Deloitte, EY, Grant Thornton and PwC) had a year-on-year improvement in their overall inspection results, with around 80% or more of audits requiring no more than limited improvements. While this is encouraging, these improved results still fall short of our expectations.

Overall inspection results at KPMG did not improve and it is unacceptable that, for the third year running, we found that improvements were required to KPMG's audits of banks and similar entities. In addition, our firm-wide work on KPMG's IFRS 9 procedures and guidance identified that further improvements are required to provide a stronger basis for KPMG's banking audit teams to deliver high quality audits in this area. KPMG has already invested significantly in its banking audit practice and considers that, based on steps it has already taken, it will be able to demonstrate improvements in 2020 year-end audits. In response to our findings this year, the firm's senior leadership has committed to make the further changes necessary to improve audit quality in time for 2021 year-end audits. We will monitor these closely to assess on a timely basis the extent to which they address our findings.

This year, we increased the sample of audits we selected for review at BDO and Mazars, given their growth, with a focus on complex audits. Five of the nine audits that we reviewed at BDO and three of the seven audits that we reviewed at Mazars needed more than limited improvements. These firms have grown the size of their PIE audit practices and have plans to grow further, which will increase competition and choice in the market. Our engagement indicates that these firms are genuinely committed to improving audit quality but they must put in place the necessary building blocks for the consistent execution of high quality audits as they grow.

71%

Overall, the number of inspections requiring no more than limited improvements fell short of our expectations.



This year, results varied more between firms and we found inconsistencies, with good practice in some audits but deficiencies in the same areas in other audits at the same firm.

² <https://www.frc.org.uk/getattachment/953261bc-b4cb-44fa-8566-868be0ff48dc/FRC-going-concern-review-letter.pdf>; and [https://www.frc.org.uk/getattachment/c1ec4c8f-0eb3-44b9-a4c7-5fe5e4c0e0f1/FRC-going-concern-review-letter-\(phase-2\).pdf](https://www.frc.org.uk/getattachment/c1ec4c8f-0eb3-44b9-a4c7-5fe5e4c0e0f1/FRC-going-concern-review-letter-(phase-2).pdf)

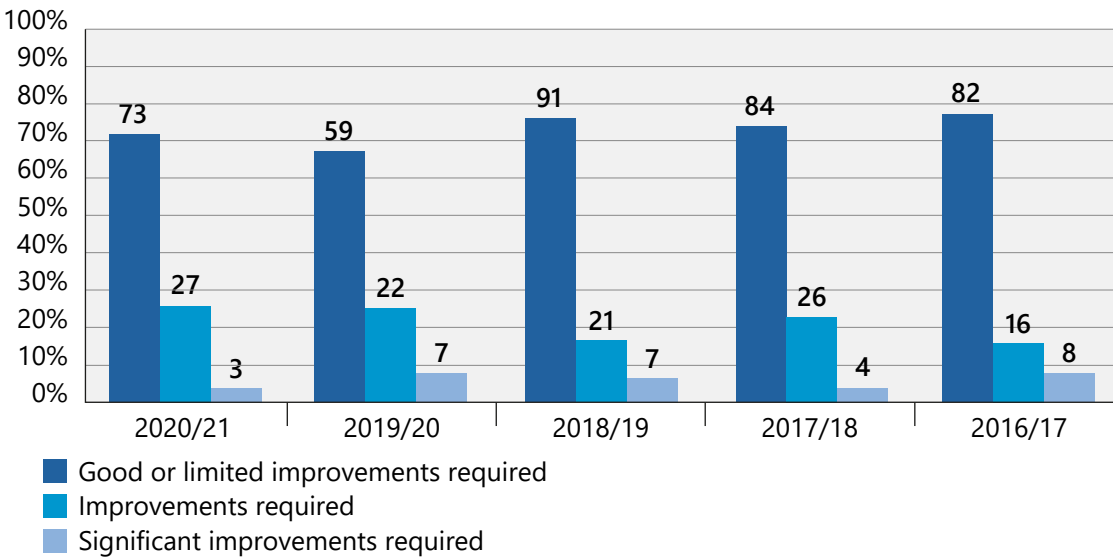
Central to achieving consistent audit quality is a healthy culture within the audit practice that encourages challenge and professional scepticism, as we set out in our letter to Heads of Audit in [December 2020](#). We have a major project underway to examine audit culture, including an international conference held in June this year on the subject. Operational separation of audit practices from the rest of the firm should help the largest firms to focus on developing an appropriate audit culture.

Our supervision teams³ are increasing the range of pro-active and forward-looking work they are carrying out with the largest seven firms in areas such as audit quality plans, root cause analysis, quality control procedures and audit quality indicators with a focus on how firms are responding to recurring findings. We report privately to firms on our findings in these areas, in order to share good practice. In 2021/22 we will continue to focus our inspections on KPMG banking audits and we will increase audit inspections at BDO and Mazars. Our 2021/22 inspections will also focus on and take into account the impact of Covid-19 on audits.



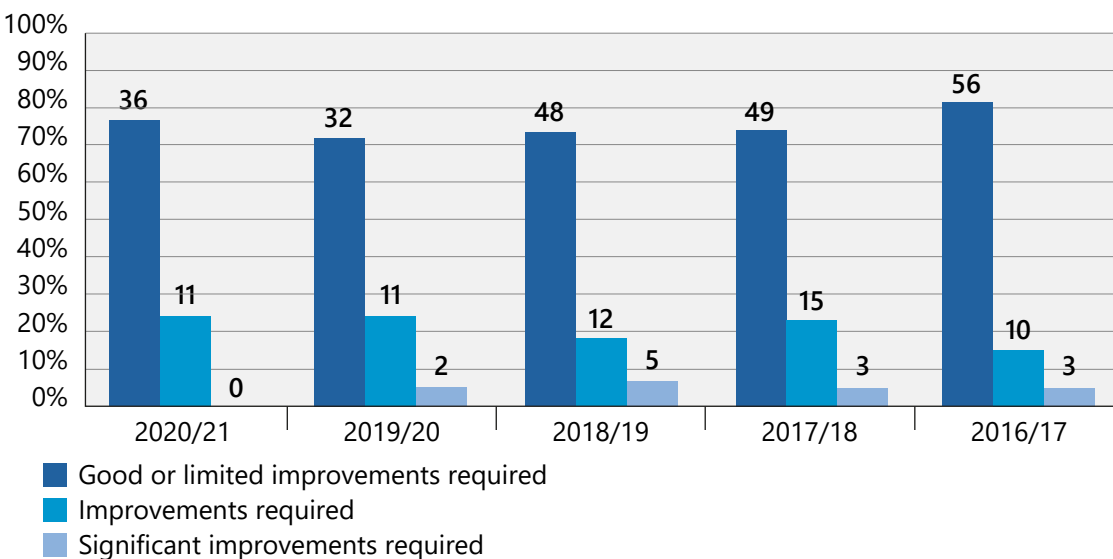
Our supervision teams are increasing the range of pro-active and forward-looking work.

All reviews



In 2021/22 we will continue to focus our inspections on KPMG banking audits and we will increase audit inspections at BDO and Mazars.

FTSE 350



³ Our approach to supervision is set out in the March 2021 publication, <https://www.frc.org.uk/getattachment/db4ef2e0-72f6-4449-bda0-c8679137d1b1/FRC-Approach-to-Audit-Supervision-FINAL.pdf>

BDO overall assessment

We reviewed nine individual audits this year and assessed only four (44%) as requiring no more than limited improvements. There has been a continuing decline in the number of audits requiring no more than limited improvements in the year, which is unacceptable.

In the 2020 public report, we concluded that we would monitor closely and assess the promptness and effectiveness of the firm's actions to address the findings raised in that year. As there have been recurrent key findings, the firm's actions do not appear to have adequately addressed our concerns and therefore we will take further action, including:

- Increasing the number of audits inspected.
- Requiring the firm to ensure that the actions taken under its Audit Quality Plan have sufficient focus on the audit of revenue and the audit of long-term contracts.
- Ensuring that risk-based selections within the firm's Internal Quality Monitoring review process have a sufficient emphasis on sectors where we have identified weaknesses, and that the reviews are of sufficient depth to support audit quality.

The recurring findings that contributed most to our results related to the effectiveness of the audit of revenue and the audit of long-term contracts. On four audits, this contributed to our assessment of the audits requiring more than limited improvements.

The firm has taken some steps to address the firm-wide findings raised in the prior year in relation to partner and staff appraisals. The firm has also made some progress in the areas of acceptance and continuance.

Similar to the prior year, we identified findings in all of the firm-wide areas reviewed in the current year which the firm needs to address. In response to the poor audit inspection results identified in our 2020 public report, the firm continued to develop its audit quality initiatives and enhanced its Audit Quality Plan (AQP or the plan) in March 2021 with actions addressing key 2020 findings, including focused training, enhanced audit guidance and investment in the number of experts available to audit teams.

In addition, the firm's current AQP has been strengthened to identify the key audit quality risk areas that pose the most significant threat of corporate failure and reputational damage to BDO. Despite the enhancements to date, the AQP needs to be further developed to cover improved risk assessment and, there should be more clarity on the independent oversight of the AQP. The responses to certain key findings identified in the prior year public report also need continued focus.

The firm's actions in response to last year's Root Cause Analysis (RCA) findings have not been fully implemented. In particular, RCA reviews have not yet been performed on all internal reviews that have significant findings. The firm needs to continue to develop its RCA analysis so that there is sufficient depth of information and analysis to identify the risk drivers. There needs to be clear quality control, accountability for, and oversight of the findings.

The evolution of the AQP and the ability of RCA to drive continuous improvement are important foundations for BDO's strategic growth ambition, including undertaking increasingly complex audits. BDO must ensure both these areas have sufficient focus. In addition, the firm needs to ensure that the resourcing in its central functions that support high quality audit (including technical teams, internal quality monitoring, the RCA function and hot review teams) is strengthened.

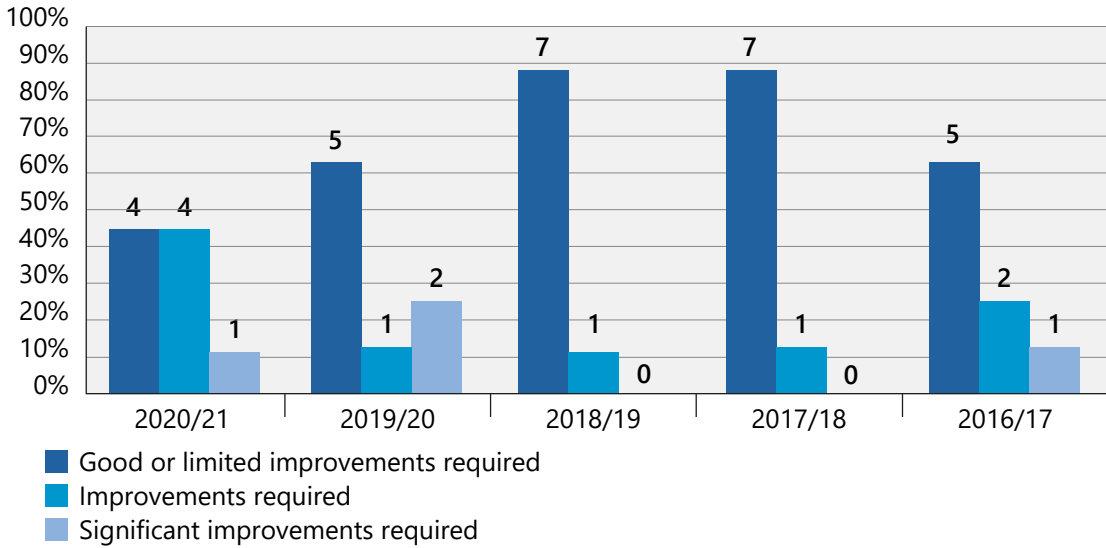
Nonetheless, we have identified some improvements, for example, in the use of and work performed by internal / external experts and specialists and substantive analytical review procedures used to

44%

At BDO, there has been a continuing decline in the number of audits requiring no more than limited improvements, which is unacceptable.

test revenue, key findings last year. In addition, we identified good practice in some areas of the audits we reviewed (including group audit team oversight and assessment of going concern and viability) and in the firm-wide procedures (including mandating the use of experts when auditing multiple economic scenarios on banking audits).

Our assessment of the quality of audits reviewed: BDO LLP



The audits inspected in the 2020/21 cycle included above had year ends ranging from 31 August 2019 to 31 March 2020.

Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our inspections are also informed by the priority sectors and areas of focus as set out in Appendix 2. For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm’s performance and are not necessarily indicative of any overall change in audit quality at the firm.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.



Monitoring review by the Quality Assurance Department of ICAEW

The firm is subject to independent monitoring by ICAEW, which undertakes its reviews under delegation from the FRC as the Competent Authority. ICAEW reviews audits outside the FRC's population of retained audits, and accordingly its work covers private companies, smaller AIM listed companies, charities and pension schemes. ICAEW does not undertake work on the firm-wide controls as it places reliance on the work performed by the FRC.

ICAEW reviews are designed to form an overall view of the quality of the audit. ICAEW assesses these audits as 'satisfactory', 'generally acceptable', 'improvement required' or 'significant improvement required'. Audits are selected to cover a broad cross-section of entities audited by the firm and the selection is weighted towards higher-risk and potentially complex audits within the scope of ICAEW review.

ICAEW has completed its 2020 monitoring review and the report summarising the audit file review findings and any follow up action proposed by the firm will be considered by ICAEW's Audit Registration Committee in September 2021.

Summary

Overall, the audit work continues to be of a generally good standard. Of the ten reviews, eight were either satisfactory or generally acceptable. Two audits required improvement. These results are not quite as good as the 2018 reviews when ICAEW graded ten files satisfactory or generally acceptable, and one file required improvement.

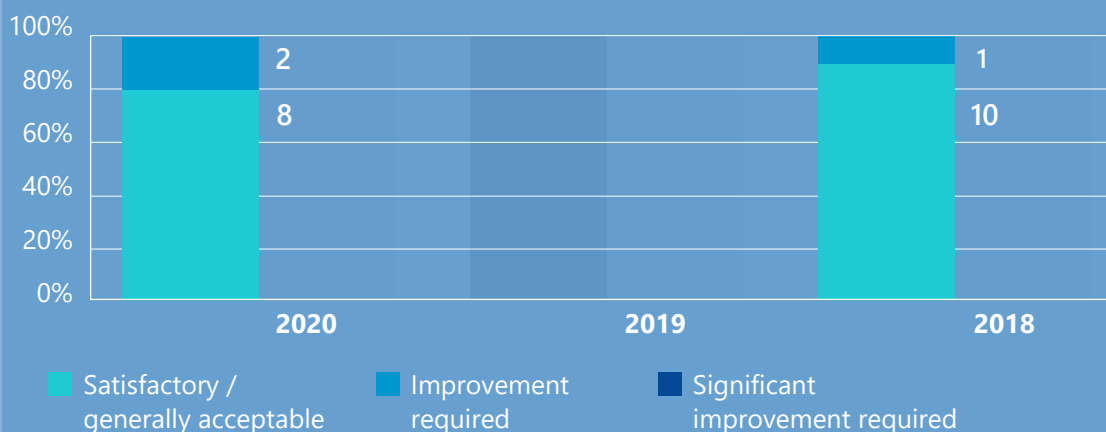
The audit work on key judgements and estimates in contract accounting required improvement on one audit. This was a new appointment, which is a feature common to the audit that required improvement at the 2018 visit. On the other audit that required improvement, the audit team did not adequately challenge management's assumptions in three key areas of judgement relating to the valuation of goodwill, going concern and provisions.

On the audits assessed as generally acceptable, there were some gaps in audit work over the completeness of income, capitalised development costs, restricted funds in deficit and the use of service organisations. There were also isolated areas where documentation needed improvement.

ICAEW identified and shared examples of good practice on some of the reviews.

Results

Results of ICAEW's reviews for the last three years are set out below.



Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of a firm's performance or overall change in audit quality.

80%

Of the ten ICAEW reviews, eight were either satisfactory or generally acceptable

Review of individual audits

Our key findings related primarily to the need to:

- Urgently improve the quality of the firm's audit of revenue.
- Improve the audit teams' understanding and assessment of significant and presumed fraud risks, together with the required audit response.
- Improve, as a matter of urgency, the challenge and testing of estimates and assumptions in key areas of judgement.
- Strengthen the audit work over the existence and valuation of assets within defined benefit pension schemes.
- Implement enhancements to improve audit quality in response to other issues driving lower quality assessments.

Good practice observations



We identified examples of good practice in the audits we reviewed, including the following:

- Group audit oversight.
- Going concern.

Review of firm-wide procedures

This year, our firm-wide work focused primarily on the following areas:

- Audit quality initiatives.
- RCA process.
- Audit methodology and training.

The reason for the focus on RCA and audit quality initiatives is the importance of taking effective action to address recurring inspection findings. On both of these areas we have assessed the firm's progress on the findings set out in last year's public report and re-assessed overall progress.

Audit quality initiatives

Our key findings in these areas related primarily to the need to:

- Ensure effective implementation of the AQP is supported by accountability and effective oversight.
- Ensure that incentives, recognition and promotion are aligned to achieving audit quality.
- Enhance clarity on AQP priorities and milestones.

RCA process

Our key findings in these areas related primarily to the need to:

- Expand the scope and coverage of the RCA process.
- Improve the analysis and articulation of root causes.
- Ensure there is appropriate ownership and oversight of RCA findings.
- Ensure that the range of actions the firm seeks to take in relation to challenge of management and scepticism are sufficiently focused on achieving desired behaviours.

Audit methodology and training

Our key findings in these areas related primarily to the need to:

- Ensure audit practitioners complete their mandatory training on a timely basis.
- Improve the guidance to audit teams in relation to the auditing lease accounting in accordance with IFRS 16.
- Improve the quality and extent of IFRS 9 methodology and guidance relating to banking audits.

Good practice observations



We identified examples of good practice in our review of firm-wide areas, including the following:

- **Audit quality initiatives** – restructuring of its management oversight bodies in response to changes in scale and complexity of the business.
- **RCA process** – additional sector-wide, or thematic, RCA are performed where there are a number of quality occurrences in an area.
- **Audit methodology and training** – mandating the use of experts when auditing multiple economic scenarios on banking audits.

Firm's overall response and actions



We are obviously disappointed with the results of the FRC review this inspection year and acknowledge the need to act quickly and effectively to identify causes and implement actions to return the firm to the results achieved in previous years. As noted below, the firm has already developed an enhanced action plan to build on the work that was in progress following previous inspection findings.

We are focused on the need to ensure the firm's strategic growth plans, which are important to audit market reform and increased competition, are built on high audit quality and that growth is both sustainable and controlled.

We have made widespread changes to the Audit Quality Plan which are supported by the Audit Executive and have been subject to review and subsequent approval by the Leadership Team, Quality and Risk Management Committee and Public Interest Committee. The Audit Quality Plan was communicated to the Audit Stream in March 2021 and the focus on the four key areas of the plan: Audit of Revenue, Going Concern, Detecting Material Fraud and Challenge of Management are key themes in ongoing communications as further actions in these areas are undertaken.

In relation to the audit of revenue we would note that specific actions were put in place following last year's findings which included five modules at our Summer School in July 2020 covering subjects such as understanding the revenue cycle and designing a revenue audit strategy. We also introduced consultation with a central team to assist engagement teams in understanding revenue systems and processes. These actions potentially take time to flow through into audits and, due to timing, we consider that some of these benefits have not yet been seen in the files reviewed this inspection cycle. However, we acknowledge the urgent need to take further action in this area. In addition to the Summer School 2021 training already planned on revenue:

- We will run a full day dedicated training session for the Audit Stream in the Autumn, focussed on designing and executing the most effective audit strategy.
- We will issue clear requirements for audit teams on the approach to the audit of revenue focused on detailed end to end understanding of revenue streams and the use of 'What could go wrong' analysis. This will be supported by revised work paper templates to drive consistency.
- We will undertake a central risk assessment to identify entities with more complex or subjective revenue cycles. These audits will be subject to support from a central team enhancing the current central revenue systems reviews to drive detailed assessment of the revenue cycle, formal approval of testing strategies and any revisions to the strategy required as the audit progresses. We will invest in and expand the central team, which will involve external recruitment, to increase the depth and scale of support provided to audit teams in respect of revenue. This will enable increased central involvement in the understanding of revenue streams and designing audit tests for a larger population of audit engagements.

In order to deliver the ambitions of the firm included within the Audit Quality Plan, the firm has appointed partners as Head of Audit Quality and Head of Resourcing who both sit on the Audit Executive. The Head of Audit Quality has a specific objective of delivering the Audit Quality Plan which should lead to an improvement in the firm's quality scores. The Audit Executive has approved the National Audit People and Culture Programme which is aligned to the firm's Strategic Plan and the Audit Quality Plan. Coupled with this, we have increased and will continue to increase the size and capability of our central support functions in a number of other areas, including the aforementioned appointments and more resources within the technical team and the central support functions.

Later in the report we detail the specific actions taken in relation to the findings. However, we have already undertaken a number of actions:

- In 2020, we introduced a mandatory 3-day Summer School for qualified members of the audit team. The focus of the Summer School was the audit of revenue, challenge of management, going concern, COVID-19 and working with experts and specialists. We are pleased to note that improvements in relation to experts and specialists are already beginning to filter down into the files being reviewed and are hopeful that this will continue
- Identified 4 key audit quality risk areas within the Audit Quality Plan that need specific focus by audit teams: audit of revenue, challenge of management, going concern and the detection of material fraud. The 4 areas form the focus of regular communications, additional guidance, and the curriculum for Summer School 2021.

- Continued to expand our RCA process from file reviews to identify common areas across the sectors and streams within the firm that have caused issues in relation to audit quality to then perform further RCA at this level. The firm is currently working through RCAs on two areas, with the assistance of an external RCA facilitator including the auditing of long-term contracts and the relationship between the audit team and IT auditors.
- Further developed our RCA process by the appointment of a dedicated central resource who will allow us to undertake a larger number of RCA investigations and further develop the reporting of findings. We have started to undertake RCAs on more internal file reviews with any significant findings as well as the files receiving the lowest grades. In the future, we will undertake RCA on all external file reviews. Potential actions identified as part of the RCA process will then be analysed by the Quality Steering Committee (on which the Head of Audit Quality sits) and, when approved, added to the Audit Quality Plan detailed action plans. The QSC undertakes monthly oversight of the action plans, the status of which are reported to the Audit Executive, Leadership Team and Quality and Risk Management Committee on a quarterly basis.
- We are developing our Audit Quality Indicators and Audit Milestone Program to focus on threats to audit quality during the audit process as opposed to after the event to allow us to act quickly to prevent issues arising down the line.

The firm has made an unequivocal commitment to improve audit quality which will support our growing audit practice. This is evidenced in our investment in resourcing and the Audit Quality Plan.

Our supervisory approach

The AFS, AMS and AQR teams in the FRC's Supervision Division work closely together to develop an overall view of the key issues for each firm to improve audit quality. We also collaborate to develop our plans for future supervision work.



The supervisory staff producing our reports

The AFS, AMS and AQR teams comprise over 70 experienced professional and support staff assessing the risks to audit quality and resilience at each firm and the actions needed to address those risks.

70+



BDO⁴

RIs
152

Offices
18



5421
Professional Staff

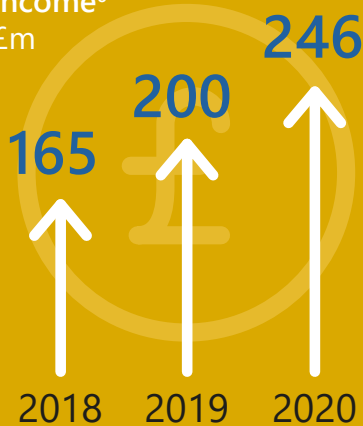
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Audits within the FRC's inspection scope

Inspection Cycle ⁵	FTSE 100 audits	FTSE 250 audits	Total audits in FRC scope
2021-22	0	15	238
2020-21	0	7	186
2019-20	0	4	139

BDO

Audit fee income⁶
£m



BDO

Audits inspected by the FRC⁷



BDO

Local audits⁸



4 Source – the ICAEW's 2021 QAD report on the firm.

5 Based on data compiled by the FRC, dated 31 December 2020, 2019 and 2018 respectively and used to select audits for inspection in the relevant inspection cycle.

6 Source – the FRC's 2019, 2020 and 2021 editions of Key Facts and Trends in the Accountancy Profession.

7 Excludes the inspection of local audits.

8 The FRC's inspection of Major Local Audits are published in a separate annual report to be issued later in 2021. The October 2020 report can be found [here](#).

2 Review of individual audits

We set out below the key areas where we believe improvements in audit quality are required. As well as findings on audits assessed as requiring improvements or significant improvements, where applicable, the key findings can include those on individual audits assessed as requiring limited improvements but are considered a key finding in this report due to the extent of occurrence across the audits we inspected. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Urgently improve the quality of the firm's audit of revenue

Revenue is a key driver of operating results for many entities and is often identified as a key performance indicator for investors and other users of the financial statements. Accounting for revenue recognition, including long-term contracts, may be susceptible to management bias or error. Auditors should therefore evaluate and address the related risks and obtain sufficient appropriate audit evidence over revenue recognised.

We have identified key findings in relation to the audit of revenue in our previous two inspection cycles. Two years ago, we reported that the firm needed to strengthen audit procedures relating to the timing of revenue recognition. Last year we identified issues covering the work on revenue. We reported that the firm should take prompt action to reassess the root causes of its revenue deficiencies, and monitor audit quality in this area through the firm's hot review process.

Key findings



We have continued to review the audit of revenue on the majority of audits inspected and we identified key findings relating to revenue on four audits. All of these findings resulted in ratings of more than limited improvement and covered aspects of risks associated with revenue, including:

- We reviewed two audits which involved long-term contracts. In one case, the audit team did not adequately challenge the significant judgements and accounting treatments arising on contracts, to support the revenue and profit recognised. Insufficient audit evidence was obtained on the other audit to confirm that the terms, conditions and performance obligations of significant contracts had been considered, including rolling forward contract assessments from previous audits, where continuing contract revenue was material.
- On one audit, the audit procedures failed to ensure that sufficient, appropriate evidence was obtained to corroborate and conclude on the occurrence of revenue. Furthermore, the audit team did not sufficiently challenge the revenue process and whether there were alternative methods to record revenue and whether the scope and extent of controls testing relied upon were adequate.
- On another audit, the audit team did not demonstrate sufficient challenge of management over adjustments to revenue for agency arrangements, including an assessment of the completeness of agency revenues.
- On one of the audits above, substantive procedures performed did not adequately address the risks identified in relation to accuracy and occurrence and whether revenue was recorded in the correct accounting period. In addition, there was insufficient evidence of IT controls testing over access to restricted systems used to recognise revenue.

We have identified findings in relation to the audit of revenue for the last three inspection cycles.

- On another of the audits above, the entity's revenue was highly dependent on the accurate reconciliation of cash. The audit team performed insufficient procedures over the period-end bank reconciliation, in particular the composition of net reconciling items identified as requiring investigation.

The issues outlined above covered a wide range of aspects of the audit work over revenue, and the relevant risks arising over accuracy, occurrence, completeness and cut-off. Given that key findings have been reported over the audit of revenue for the last three inspection cycles, the firm should take urgent and robust action to address these concerns and understand their root causes. Resulting actions need to be given the highest priority. The firm needs to monitor the progress of changes made to address these findings, through the AQP and hot and cold review monitoring processes.

Firm's actions:



The findings over revenue include varied individual matters. However, the findings fall into two broad categories: the audit of revenue in high volume transaction environments and judgments in respect of long-term contracts.

In response to the previous comments raised in relation to the audit of revenue we have implemented a number of actions in the past 12 months:

- As noted above, in contrast to the prior period, we have involved an external root cause analysis expert to assist us with two investigations in areas identified as fundamental to driving improvements in the audit of revenue. These include the approach to audit of long-term contracts and the relationship between the members of the audit team working on the financial audit and IT elements of the work. We acknowledge that the integration of IT general controls and systems is key to many of the entities we audit and therefore our audit approach in these areas is fundamental.
- The Audit Quality Plan includes the audit of revenue as one of the four key audit risk areas of focus that need to be addressed in order to fulfil the need for immediate action in relation to audit quality in this area.
- The firm has made a substantial investment in our IT audit department including the recent appointment of two new partners and the approval by the Audit Executive to significantly increase resources further. The firm is proposing to appoint a new partner with specialist expertise working with entities who have long-term contracts who will work with the current sector team to improve guidance on auditing long-term contracts.
- The Summer School 2020 3-day training event included 5 sessions related to revenue which addressed points arising including completeness and existence of revenue using real life examples. Further focus on revenue will be covered in Summer School 2021 as part of the continuing focus on this theme to reinforce messages and continue to build on prior learning.
- The audit of cash and its importance has been the feature of a number of communications to the stream and will be a focus for Summer School in summer 2021.

Notwithstanding these actions, we recognise the need for further and accelerated action in this area and we will implement the following four pillar response:

- Issue clear requirements for audit teams on the approach to the audit of revenue, together with revised work paper templates to drive consistency.

- All members of the audit stream will attend a dedicated full day training event on the audit of revenue and embed the enhanced approach to revenue testing.
- As noted above, we will undertake a central risk assessment to identify entities with more complex or judgemental revenue cycles. These audits will be subject to support from a central team to drive detailed assessment of the revenue cycle, formal approval of testing strategies and any revisions to the strategy required as the audit progresses. We will invest and begin to build a centre of excellence for revenue within the central team to increase the depth and scale of support provided to audit teams in respect of revenue.
- Audit of revenue will be a specific focus of the internal quality monitoring programme alongside detecting material fraud, going concern and challenge of management.

Improve audit teams' understanding and assessment of significant and presumed fraud risks, together with the required audit response

Auditors are required to perform procedures that are responsive to identified risks, including those determined to be significant and presumed fraud risks. These procedures should be tailored to ensure that sufficient and appropriate audit evidence is obtained to reduce the risk of a material misstatement in each risk area to an acceptably low level.

Key findings



We identified issues on four audits where the audit approach did not sufficiently address and fully respond to the identified significant risks or presumed fraud risk:

Significant risk

Auditors should obtain sufficient and appropriate audit evidence regarding possible material misstatement arising from significant risks, through designing and implementing appropriate responses to those risks. Without a clear understanding of the entity and its internal control environment, the auditor cannot design an appropriate audit response to address the arising risk of misstatement and provide assurance over the financial statements.

- On one audit, the audit team did not demonstrate a sufficient understanding of the entity and the underlying controls in place to minimise the inherent risks. This resulted in an audit approach which failed to address the risks arising over certain key processes.
- On one audit of a group operating in a highly regulated industry, the audit team recognised that compliance with laws and regulations was a significant risk and that non-compliance could result in regulatory sanctions and adversely affect the group's operations. However, the audit team did not perform appropriate procedures to respond to this risk. The team failed to obtain a sufficient understanding of the operation of relevant controls across all jurisdictions and did not challenge management on the impact of issues in one jurisdiction and why these were not relevant to other locations.
- The audit team's approach on one audit did not provide adequate assurance over the valuation of inventory. The team performed its net realisable value testing on a population not reflected in the period-end inventory balance and the evaluation of the rebate provision was based on unrealistic assumptions and unexplained exclusions of inventory categories.

We identified issues where the audit approach did not fully respond to fraud risks.

Presumed fraud risk

The testing of journals is one of the key audit procedures to respond to the risk of management override of controls. Auditors should therefore perform appropriate testing of journals in response to the risk of management override. We reviewed the testing of journals on most of the audits we inspected and raised the following findings, relating to the audit teams' response to this risk:

- On two audits, the audit teams concluded that manual journals selected for testing were not 'unusual' and therefore failed to perform any substantive testing to address the presumed fraud risk identified.
- In its approach to the testing of manual journals on another audit, the audit team performed insufficient procedures to identify and then corroborate manual journals. Further, the audit approach did not sufficiently justify the rationale not to test automated journals.

Firm's actions:



Significant risks

We have shared the learning points from the findings on the audits noted above with audit teams to demonstrate the importance of clear understanding of relevant risks and specific and focused risk assessment to ensure the creation of an effective audit strategy.

As part of this, we launched our Professional Judgement Framework at Summer School 2020 and will be undertaking a programme to further embed the framework which focuses on establishing a clear understanding of the entity and the application of professional scepticism.

In order to enhance our approach to the audit of inventory, the central team review of the approach to revenue of new PIE engagements will extend to inventory where it is material.

Other aspects in relation to these issues have been picked up elsewhere and fed into our RCA findings.

Presumed Fraud Risks

The identification of material fraud is another of the four key audit risk areas within the updated Audit Quality Plan. Focus on this topic included Summer School 2020, training sessions for individuals working on PIE engagements, aide memoires released to assist with identification of fraud risks and specific audit file templates to document considerations.

Summer School 2021 will include significant input from members of our forensics and IT audit teams with sessions including a focus on the importance and nature of journal testing and strengthening the linkage between identified fraud risks and the resulting audit strategy response. The sessions run by IT audit will include consideration of fraud risk factors in relation to Information Technology general controls (ITGCs) and responses to address these risks. This will build on recent sessions that have been delivered to all Responsible Individuals by the IT audit team.

Additional guidance around the audit of journals and specific considerations in relation to automated journals is also being produced.

Further to this a central fraud risk register has been created which will be shared quarterly with the stream using real life examples to demonstrate the importance of properly identifying fraud risk factors.

The firm is running a pilot with a small group of audit teams working on high risk engagements to involve the forensics experts at the outset to assist with the identification of fraud risk factors and responses. Learning points from the pilot will be shared with other audit teams.

Improve, as a matter of urgency, the challenge and testing of estimates and assumptions in key areas of judgement

Estimates and assumptions in key areas of judgement are inherently subjective, being both susceptible to management bias and highly sensitive to change. In evaluating management judgements, audit teams should apply an appropriate challenge, test the assumptions applied and consider the sensitivity of those assumptions.

Last year we reported that the firm should take action to address our findings relating to the audit of estimates and provisions, specifically for long-term contracts and insurance technical liability provisions. The firm implemented actions in these areas, including the introduction of consultations with the firm's central technical and quality teams. We continue, however, to identify weaknesses in the firm's testing of key estimates and judgements:

Key findings



We have reviewed the challenge and testing of estimates and assumptions in key areas of judgement on all of the audits inspected and we identified key findings on six audits.

- On one audit, the audit team's lack of professional scepticism and challenge of management contributed to significant deficiencies in the audit of long-term contracts. We identified insufficient audit procedures to assess, corroborate and challenge costs (both incurred and forecast) and whether additional provisions were required for loss-making contracts. The audit team did not adequately consider the validity and appropriateness of unagreed variations and claims and the impact they could have on profit recognised.
- On another audit, where the audit team identified uncertain tax provisions as a significant risk, the audit team did not sufficiently challenge and evaluate whether a further tax liability was only a remote possibility, given potentially contradictory evidence.
- On another audit, there was insufficient justification or explanation for the assumption to exclude certain categories of inventory from the calculation of an inventory cost rebate provision.
- On four audits, the audit teams did not sufficiently challenge certain assumptions in management's cash flow forecasts to assess going concern or potential impairment. On one audit, the audit team did not obtain sufficient appropriate evidence to corroborate the availability of intra-group financial support.

Whilst the firm has taken certain actions in response to our findings on long-term contracts raised last year, it should urgently develop further actions to address continuing deficiencies. This could include assistance from the firm's internal experts and updating its methodology and guidance in relation to the controls and substantive testing expected in the audit of long-term contracts.

We continue to identify weaknesses in the firm's testing of key estimates and judgements.

Firm's actions:



Challenge of management is another of the four key audit quality risk areas in the updated Audit Quality Plan. A culture of challenge is also one of seven building blocks to audit quality within the Audit Quality Plan which are critical to achieving the firm's ambitions in relation to audit quality.

The firm acknowledges that the main drivers for this particular area are behavioural and the answer cannot solely rely on the creation of documentation or checklists.

Summer School 2021 will build on the initial understanding from Summer School 2020 of the BDO Professional Judgement Framework and how to apply this to a wide spectrum of issues in relation to the audit.

Stage one of this implementation was to establish an understanding of the framework through Summer School 2020 and enhance our documentation to support the application. Stage two will focus on a roll out programme of embedding the Professional Judgement Framework in all standard documents and how to apply it in real life scenarios which will use case studies to aid understanding and drive consistent effective challenge of management.

In relation to the audit of long-term contracts, we noted above our actions being taken in this area under our response to the audit of revenue findings.

Strengthen the audit work performed over the existence and valuation of assets within defined benefit pension balances

Auditors should obtain an understanding of defined benefit schemes, including the type of assets held, to assess the related risks and then develop an appropriate audit strategy.

Assets included in defined benefit schemes often include pooled investment vehicles (PIVs), which can be harder to value. Validating the existence of these scheme assets can present audit challenges, as can the management of pension funds by custodians separate to the entity. Auditors should focus on testing the valuation and existence of these investments to be able to identify potentially material misstatements of net defined benefit scheme balances.

Key findings



We identified findings on the two audits where we reviewed the work performed relating to defined benefit pension scheme asset balances. In both cases, audit teams obtained insufficient assurance over the valuation and existence of the scheme assets:

- On both audits, insufficient substantive audit procedures were performed over the valuation of pension scheme assets, in particular over unquoted assets, including equities and bonds, property and assets held in PIVs.
- On one of these audits, the audit team did not assess investment manager control reports and therefore obtained inadequate evidence of appropriate controls over pension scheme asset existence and valuation. On the other audit, the audit team inappropriately relied on a controls report as there was no evidence that any relevant controls were identified that addressed the valuation of pension scheme assets
- On one of these audits, insufficient procedures were performed to verify and test the classification of quoted and unquoted pension scheme assets disclosed in the financial statements.

In two cases, audit teams obtained insufficient assurance over the valuation and existence of defined benefit pension scheme asset balances.

- On one of these audits, the audit team did not obtain independent asset confirmations to verify asset existence.

The firm should take action in response to these findings, including updating its pensions methodology and guidance for audit teams. This should address the required procedures covering asset existence and valuation and consider the use of internal pensions specialists.

Firm's actions:



The firm has taken immediate action in relation to the audit of defined benefit pension schemes to ensure that the methodology in this area is clearly understood and consistently applied notwithstanding the challenges posed by the structural issues in the pensions industry to audit of such balances. This included:

- The central technical team undertook a rapid response 'in flight' consultation with all audit teams who were in the process of auditing material balances in this area to focus on the strategy.
- A revision of the defined benefit pension scheme guidance in areas such as identifying harder to value pension assets and the relevant audit response.
- A case study based training session for audit teams who need to audit defined benefit pensions schemes to build on from the training session delivered to all audit teams working on PIE engagements.

Implement enhancements to improve audit quality in response to other issues driving lower audit quality assessments

We identified the following other key findings driving a lower audit quality assessment on individual audits:

- **Quality control and Engagement Quality Control Review procedures:** Auditing Standards require the appointment of an audit partner and an Engagement Quality Control Reviewer (EQCR). The audit partner is responsible for the overall quality of the audit, including direction, supervision and review of the audit work performed by the audit team. The EQCR is a suitably qualified person, with sufficient and appropriate experience and authority to evaluate objectively the significant judgements made and the conclusions reached in formulating the auditor's report. Deficiencies in audit evidence should be detected by these quality control procedures, so that they can be remedied before the audit report is signed.

On one audit, several key findings were identified, indicating that the audit partner and EQCR's quality control and review procedures were not effective in ensuring that the audit work was sufficient or fully supported the conclusions reached.

- **Independence considerations:** On one audit, the firm was engaged to provide services to the audited entity in respect of an acquisition. The audit team did not adequately consider the perceived self-interest threat arising from the provision of non-audit services and whether independence safeguards were necessary to mitigate the threats to independence.

The firm should consider what further action is needed in these areas to promote improvements to audit quality.

Firm's actions:



The importance of review procedures as key to audit quality was raised as a root cause on a number of audits where issues arose.

A number of real-life examples are being used to create a session for each Local Head of Audit to run in their office. This will clarify and reinforce the roles and responsibilities of all team members within the review process.

The firm is in the process of implementing a programme of audit milestones that will be monitored centrally and allow early notification of potential issues that may impact audit quality. This is being piloted for June 2021 year ends and will be rolled out to all PIE audits for December 2021 year ends. This will focus on various touch points and timing of expected events in the audit file, including data on the timely involvement of both the RI and EQCR at certain key points in the audit.

The firm has been rolling out project management training to senior managers in each sector to help address the project management demands of large public interest audits. This will help ensure the right people are doing the right work at the right time across the audit process.

In relation to independence, a new consultation memo has been created for use when consulting with the ethics team on non-audit services in relation to PIEs and OEPIs. This should improve consistency and ensure the specific documentation of threats and safeguards to independence prior to the consultation with the ethics team so any deficiencies can be highlighted and resolved.

Good practice



We identified examples of good practice in the audits we reviewed, including the following:

- **The extent of the group audit team's oversight of and interaction with the component audit team:** As in the prior year, we identified an example of good group audit team direction, supervision and review of the work of an overseas component team. This included high levels of interaction with the component team in respect of significant risk areas and a robust review of the component team's working papers.
- **The assessment of going concern and viability:** The firm enhanced its procedures, following the impact of Covid-19, to respond to the increased risks relating to going concern. This included a requirement for internal technical panel consultations on listed audits. On one audit, where the audit team consulted with the technical panel, the resulting challenge led to the audit team performing additional audit procedures, including enhanced sensitivity analysis.
- We also identified good practice on two further audits, where the audit teams clearly evidenced: challenge of going concern disclosures, assessment of management's historical budgeting accuracy and the use of computer aided audit techniques to check the integrity of management's going concern cashflow model.

As we have identified key findings over the audit of going concern on four audits, including two audits where good practice was identified for aspects of the work performed, the firm should use the examples of good practice to address this inconsistency.

Good practice examples included the extent of group audit team oversight and the assessment of going concern and viability.

3 Review of firm-wide procedures

We review firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 (ISQC1), in some areas on an annual basis and others on a three-year rotational basis. The table below sets out the areas we have covered this year and in the previous two years:

Annual	Current year 2020/2021	Prior year 2019/2020	Two years ago 2018/2019
<ul style="list-style-type: none"> • Audit quality initiatives, including action plans to improve audit quality. • RCA process. • Audit quality focus and tone of the firm’s senior management. • Complaints and allegations processes. 	<ul style="list-style-type: none"> • Audit methodology and training. 	<ul style="list-style-type: none"> • Partner and staff matters. • Acceptance and Continuance (A&C) procedures. 	<ul style="list-style-type: none"> • Ethics and Independence. • Internal Quality Monitoring. • Quality Control matters (including consultation and EQCR). • Audit documentation and data security.

In this section we set out the key findings and good practice we identified in the firm-wide work we have conducted this year, and a summary of our findings reported publicly in the previous two years, and the firm’s related actions, with updates where relevant, as follows:

- Audit quality initiatives.
- RCA process.
- Audit methodology and training.
- Firm-wide findings and good practice in prior inspections.

Audit quality initiatives

Background

Firms should develop audit quality plans that drive measurable improvements in audit quality. Audit quality plans should include initiatives which respond to identified quality deficiencies as well as forward-looking measures which contribute directly or indirectly to audit quality.

Last year we reported that we had reviewed the firm’s AQP which is designed to maintain and monitor audit quality as part of its wider System of Audit Quality Management. The AQP was devised as a working document, formalising and linking quality initiatives that the firm had been using for several years, including hot reviews, consultations and root cause analysis. BDO’s initial AQP was approved by the firm’s Audit Stream Executive in January 2020.

Audit quality plans should include forward-looking measures which contribute directly or indirectly to audit quality.

When we reviewed the AQP last year, we identified good practice in terms of the real-time support provided by the hot review process. We also found that the firm should take prompt and specific action and should strengthen and enhance the AQP and/or audit quality initiatives by:

- Ensuring that its plan was coherent and was clear on how it would deliver continuous improvement and enhanced audit quality, linking to the outputs from quality control processes.
- Further embedding a culture of challenge in the audit process.
- Improving the assessment of resources.
- Enhancing project management, such as through a milestone program.

BDO's response to our findings last year indicated that the firm would take a variety of actions aimed at implementing and strengthening the AQP and that the Audit Executive would consider required changes to the AQP or actions on an ongoing basis. The firm has made progress on all of the key findings we reported last year, although the extent of progress has varied. In March 2021 BDO launched a refreshed AQP.

This year, we have not conducted a detailed benchmarking of all firms' audit quality plans (AQPs) and quality initiatives, but at each of the seven firms we have brought our view up to date by work including:

- Assessing any key changes to the firm's AQP, arising from the actions taken in response to our findings last year, or for other reasons.
- Undertaking meetings with the firm to discuss and challenge aspects of the AQPs.
- Considering the oversight of the AQP at the firm including presentations made to the Independent Non-Executives (INEs) and any audit oversight bodies.
- Assessing the extent to which culture and the culture of challenge have been incorporated into the AQP.
- Considering, in hindsight, the effectiveness of the AQP and key initiatives with reference to current year findings and observations.

The review work we performed was focused primarily on the AQP in place up until March 2021. As a result of our work, we have observed that:

- The firm's approach to culture of challenge in the audit process has been strengthened. The firm has rolled out a Professional Judgement Framework, which has been communicated to and used in training staff. The firm has also enhanced key documents in its planning and consultation approaches and incorporated this into its ongoing principles.
- The firm has improved its assessment of resources, by enhancing its use of utilisation metrics and better reporting. In recent months the firm has appointed a partner to be responsible for People & Resourcing.
- The firm has taken a number of other actions aimed at strengthening audit quality. These include expanding its programme of hot reviews in recognition of increasingly complex audits and appointing a dedicated Audit Quality Partner for the UK.
- The role of the Quality Steering Committee, which is pivotal in adapting and implementing the AQP, has been enhanced.

- The firm has strengthened its AQP by identifying a number of key audit quality risk areas that if not audited effectively pose the most significant threat of corporate failure and reputational damage to BDO. These areas will be subject to heightened focus and monitoring.

Key findings



We identified the following key findings based on the AQP in place up until March 2021:

- **Embedding and oversight of the AQP:** the AQP was not widely known, communicated or embedded. Progress against the AQP was not subject to ongoing monitoring and oversight as part of regular audit quality considerations. With the approval of an updated AQP, the firm has the opportunity to embed and manage their progress on their audit quality objectives. We will assess progress more in our next review period.
- **Incentives and recognition, promotion:** the firm should ensure that its AQP incentivises and is aligned to achieving audit quality. Positive quality should be recognised. All relevant performance, promotion and monitoring processes should take account of audit quality on an ongoing basis.
- **Clarity on priorities and milestones:** the firm's near-term priorities in the AQP should be made clear. Further, the AQP should be enhanced to ensure that medium-term audit quality initiatives take into account the firm's strategic growth intentions.

BDO's audit quality plan needs to be further developed to cover improved risk assessment and there should be more clarity on the independent oversight of the plan.

Good practice



We identified the following area of good practice:

- **Audit governance restructure:** The firm has restructured its Audit Stream Executive and changed its membership to provide more management capacity and enhance capability. These changes respond to existing changes in scale and complexity of the BDO's audit business and put the firm in a stronger position to manage future change.

We will continue to assess the AQP and encourage all firms to develop or continue to develop their audit quality plans including the focus on continuous improvement and measuring the effectiveness of the key initiatives.

Firm's response and actions:



As noted above in our overall comments we have undertaken a full reform of our Audit Quality Plan which we believe will clearly link issues in relation to audit quality with a robust action plan. The AQP has been widely communicated to the audit stream and debated and approved by the Audit Executive, Leadership Team, Quality Risk Management Committee and Public Interest Committee and is central to decision making around the firm's strategic growth plans. On an ongoing basis, the Head of Audit Quality is required to report progress against the plan and significant revisions to the firm's executive and governance bodies to ensure appropriate monitoring and oversight and will be formally captured in the Audit Quality Plan.

The firm has invested further in the area of resourcing and appointed a partner who sits on the Audit Executive as Head of Resourcing.

The Audit Quality Plan includes four key quality risk areas which will be the focus of communications and training during the year and are regularly covered in communications to the stream.

Audit quality forms a key component of partner appraisals through a risk and quality assessment undertaken by a panel, considering audit quality outcomes and indicators. The Head of Audit Quality has an objective to further enhance the risk and quality appraisal process for FY 2021/2022. Poor audit quality is considered as part of partner profit share allocations whilst exceptional audit quality behaviours are rewarded, where appropriate, with additional bonus profit share in a period. Audit quality, including performance in internal and external file reviews, is considered as part of promotion to director and partner and poor audit quality prohibits promotion to these levels.

A new performance appraisal system is currently being implemented by the firm and will strengthen the linkage between audit quality and the individual's performance assessment, including factors such as findings from internal and external files reviews, completion of mandatory training and behaviours. In turn this will strengthen the alignment of audit quality and reward / promotions.

We will enhance the Audit Quality Plan to provide clarity on the near and medium-term priorities and are updating the live plan accordingly. The Audit Quality Plan has been designed to respond to the firm's strategy in relation to controlled growth. Central to delivery of the strategic growth plans is continued investment in resources and skills, expansion of central support functions, enhanced tender approval and portfolio management. Our strategic growth plans are conditional on such activities. The alignment of the strategic growth plans and audit quality is subject to active oversight by the Leadership Team and the Public Interest Committee.

RCA process

Background

The RCA process is an important part of a continuous improvement cycle designed to identify the causes of specific audit quality issues (whether identified from internal or external quality reviews or other sources) so that appropriate actions may be designed to address the risk of repetition.

The firm has been performing RCA for a number of years and has designed a process with input from an external provider.

When we reviewed the firm's RCA process last year, and the RCA conducted on our 2019/20 inspection findings, we found that the process was still evolving and that the firm should develop and enhance its RCA process by:

- Expanding the scope and coverage of centrally-led RCA on internal inspections to ensure the consistency of approach and to improve the quality of the firm's resulting actions.
- Enhancing the investigation of the effectiveness of supervision and review (on both positive and negative inspections) to determine whether this was a causal factor.
- Expanding and varying the suite of remediation actions set for recurring and common findings.

Root cause analysis is an important part of a continuous improvement cycle.

BDO's response to our findings last year indicated that the firm would extend the coverage of RCA across regulatory inspections and strengthen the resourcing of the RCA function. Further, BDO would review other aspects of its process including the appropriate capture of internal reviews in RCA and the consideration of supervision as a root cause. Where there were recurring themes, the firm sought to address these by directly linking these to audit quality. Although progress has been made, some of these actions have not been fully implemented as the firm has advised that broader resource pressures and Covid have contributed to the speed of progress.

This year, we have not conducted a detailed benchmarking of all firms' RCA processes, but at each of the seven firms we have brought our view up to date by performing work including:

- Assessing any changes to the firm's RCA process, arising from the actions taken in response to our findings last year or for other reasons.
- Conducting follow-up meetings with the firm to discuss and challenge aspects of the RCA process and linked processes.
- Considering the oversight of RCA at the firm and communication of key findings.
- Considering, in hindsight, the efficacy of the historical RCA process and the actions taken with reference to current year inspection findings.

As a result of our work, we have observed that:

- The firm has demonstrated that it has given more consideration to the effectiveness of supervision and review as a causal factor and as a theme. We would encourage the firm to consider this further in forthcoming stream-wide and sector-wide RCA reviews.
- The firm has started to strengthen its RCA process through increasing its internal resource. This has been complemented with the skills and objectivity added by the targeted involvement of the external provider in relation to sector-wide and thematic reviews and a focus on revenue.
- The firm has not performed any RCA reviews of firm-wide findings this year as it had assessed where further actions were required and was implementing these actions.

Key Findings



We identified the following key findings where the firm needs to:

- **Accountability and oversight:** ensure there is appropriate quality control of, and senior-stakeholder ownership of, RCA findings within the audit practice. In addition, the firm needs to ensure that there is appropriate oversight of RCA findings within its governance frameworks. RCA findings should be reported and challenged on a periodic basis.
- **Coverage:** expand the scope and coverage of the RCA process to include internal inspections with significant findings and ensure these findings are considered appropriately in its themes analysis. The firm has now started to do this in response to last year's findings. Continuous improvement should also capture the drivers behind positive quality occurrences.

BDO needs to continue to develop its root cause analysis.

- Analysis of root causes: review the level and granularity of its analysis to ensure it identifies and clearly articulates the underlying root causes. A more effective process needs to be put in place to identify common themes (for example, relating to processes and behaviours, and focus the appropriate remedial action to prevent recurring themes). The RCA process needs to be sufficiently developed to capture the root cause risks from more complex audits.

Our review of the firm's RCA on current inspection findings reinforced the need to have a consistent, granular, methodology to assist in evaluating common causal factors. This would assist with ensuring the root causes identified were sufficiently specific and would also assist the firm in identifying how specific root causes change in frequency, or evolve, between periods. The benefit of having more granular root causes is the ability to develop more targeted actions.

- Challenge of management and scepticism: ensure that the range of actions that the firm seeks to take in relation to challenge of management and scepticism are sufficiently focused on achieving the desired behaviours.

In addition, the firm needs to reconcile how to take an effective risk-based audit approach (directed toward those areas of the financial statements which may have mis-statements due to the risk face by the entity) with performing an audit of sufficient quality across all areas.

Good practice



We identified the following area of good practice:

- **Sector-wide and thematic reviews:** the firm has undertaken sector-wide and thematic reviews where it has identified quality occurrences that are common to audits in a sector, or within audits that have a common feature. These are in addition to the individual RCA reviews. Sector-wide, or thematic, reviews can be effective in identifying where changes in the overall approach are required, or remedial actions should be set at a sector level.

We will continue to assess the firm's RCA process. We encourage all firms to develop their RCA techniques further as well as focus on measuring the effectiveness of the actions taken as a result.

Firm's response and actions:



The firm acknowledges the importance of a robust and widespread RCA process to help put in place appropriate actions to address quality issues and this is a fundamental part of our Audit Quality Plan.

In order to enhance our RCA process for the future, we have:

- Implemented a more robust governance and oversight process in that RCA findings are reported to the Quality Steering Committee and Leadership Team on a monthly basis. Key findings and actions are discussed and implemented. The firm has moved from an annual to a quarterly RCA reporting cycle to take in to account the need for more frequent consideration of findings and the increased level of RCAs undertaken.
- Recruited a dedicated resource with the sole responsibility of overseeing and developing the RCA process.

- Identified and trained a number of other individuals in the central team who can support the RCA manager to increase our capacity to perform more RCA on a timely basis.
- Implemented a new cloud-based version of the RCA software from our external provider which will allow the existing detailed RCA to be supplemented with common themes analysis and track trends over time.
- As noted in the good practice points above, we identified a number of sector-wide and cross audit-stream causes from our individual RCA investigations which required further consideration and employed an external RCA specialist to assist.

The changes made will allow us to substantially increase the number and scope of RCAs we are able to perform.

Audit methodology and training

Background

The firm's audit methodology and the guidance provided to auditors on how to apply it are important elements of the firm's overall system of quality control. Our inspection primarily evaluated key changes to the firm's methodology and guidance including how it had been updated to incorporate recent changes to auditing and accounting standards, including:

- ISA 540 revised (Auditing accounting estimates and related disclosures).
- ISA 570 revised (Going concern).
- IFRS 9 (Financial instruments) with a focus on the audits of banks, building societies and other credit institutions (banking audits).
- IFRS 16 (Leases).

We also considered other key topics such as the policies for using specialists and experts on audits and updates to audit software. We performed the majority of this work on methodology and guidance in place on 31 March 2020, including a consideration of the firm's initial response to the impact of Covid-19.

Firms' training arrangements must provide auditors with the knowledge and skills necessary to fulfil their role effectively, and as such, are also an important element of the firm's overall system of quality control. Our inspection included an evaluation of the amount of training provided by the firm in the year ended 31 March 2020, the subjects covered and how the training was delivered. We also considered the firm's processes for monitoring course attendance and evaluating whether participants had met the learning objectives by conducting post-course assessments.

Key findings



We identified the following key finding where the firm needs to:

- Ensure audit practitioners complete their mandatory training on a timely basis: The firm needs to ensure that individuals complete their mandatory training on a timely basis, with clear, enforced consequences for any non-compliance.

The firm's audit methodology and the guidance provided to auditors on how to apply it are important elements of the firm's overall system of quality control.

We identified findings in all the firm-wide areas reviewed in the current year which the firm needs to address.

- Improve the guidance issued to audit teams in relation to auditing lease accounting in accordance with IFRS 16: The firm has issued work programmes, templates and related guidance in relation to IFRS 16. These should be enhanced to ensure audit teams receive additional guidance on certain key aspects of the standard.
- Improve the quality and extent of IFRS 9 methodology and guidance relating to banking audits: The firm should issue a comprehensive IFRS 9 methodology including clear baseline expectations of the procedures audit teams are required to perform on banking audits, to ensure consistency and quality across IFRS 9-related audit work. This should be integrated into the firm's core methodology, supplemental guidance and audit programmes/checklists. This will be an ongoing process of improvement as the firm develops and expands its banking practice.

Good practice



We identified the following area of good practice:

- **Mandating the use of experts when auditing multiple economic scenarios on banking audits:** The firm mandates the use of an economist to inform the audit work performed on multiple economic scenarios.

In addition to the firm-wide procedures above, we performed a thematic review on the enhanced audit policies and procedures at the seven largest firms in relation to going concern, given the impact of Covid-19. The themes we observed were publicly reported in [June 2020](#) and [November 2020](#) and have not been included here.

Firm's response and actions:






The firm has increased focus on the completion of mandatory training which is one of the Audit Quality Indicators reported monthly to the Quality Steering Committee. The consequences of non-compliance and its effect on performance gradings and promotions were clearly communicated and we have noticed a clear improvement in completion rates for mandatory training. This will be a continued focus for the firm.

Additional guidance produced by BDO Global in relation to IFRS 16 has been released to the firm.

The banking sector are working on enhancements to the guidance and audit tool in relation to IFRS 9 as applicable to the current base of audit engagements.

Firm-wide key findings and good practice in prior inspections

The following table summarises the firm-wide findings included in our previous two public reports, as well as the actions taken by the firm in response to our key findings, in those areas of ISQC 1 which we review on a rotational basis. We consider that the firm has appropriately responded to these findings based on the actions taken and planned. We did not highlight any good practice observations from our firm-wide inspection work.

Key findings in previous public report 	Update on firm's actions in response 	Good practice 
<p>Partner and staff matters (2019/20): Processes relating to the appraisal and remuneration of partners and staff are a key element of a firm's overall System of Quality Control and are integral to supporting and appropriately incentivising audit quality. Our inspection included an evaluation of the firm's policies and procedures and their application to a sample of partners and staff for the FY18 appraisal year, across the following areas: Appraisals and remuneration; Promotions; Recruitment; and Portfolio and resource management.</p>		
<ul style="list-style-type: none"> Enhance staff's compliance with the firm's requirements for objective setting and appraisal completion. Improve the consideration and assessment of audit quality within the appraisal process. Introduce a formal and standardised assessment process for senior manager promotions that takes into account audit quality. 	<ul style="list-style-type: none"> The firm set and monitored deadlines for the completion of objectives. Pay rises were deferred until objectives were complete. The Operations Board has agreed a set of actions to reinforce audit quality within the appraisal process. The senior management promotion process is being designed and an Audit Promotion Process pack has been created. This is in the process of being rolled out. 	<p>No specific good practice examples raised.</p>

Acceptance and continuance procedures (2019/20):

ISQC1 requires firms to have detailed policies and procedures relating to acceptance and continuance decisions for audited entities. We reviewed the firm's processes as at October 2019 and their application. We also discussed with senior leadership proposed changes to these processes together with each firm's strategic decisions. In addition, we considered firms' policies relating to withdrawal / dismissal from audits and, for a sample of audits, the statements provided to the public, successor auditors and the regulatory authority in connection with withdrawal / dismissal.

<ul style="list-style-type: none"> Strengthen the acceptance and continuance approval process, in particular the evidence to record and conclusions reached. 	<ul style="list-style-type: none"> The Audit Executive (AE) reviews the PIE client list on an annual basis for any that exhibit an unacceptable level of risk. The firm implemented a new client take on system last year and a new acceptance and continuance questionnaire was implemented for the audit stream in January 2021. The AE approves all new audits in the public interest market or that will require a substantial resource investment. Key considerations are reputation, resourcing and risk. 	<p>No specific good practice examples raised.</p>
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We did not raise any other key findings in 2018/19 or 2019/20.

Appendix 1

Firm's internal quality monitoring

This appendix sets out information prepared by the firm relating to its internal quality monitoring for individual audit engagements. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

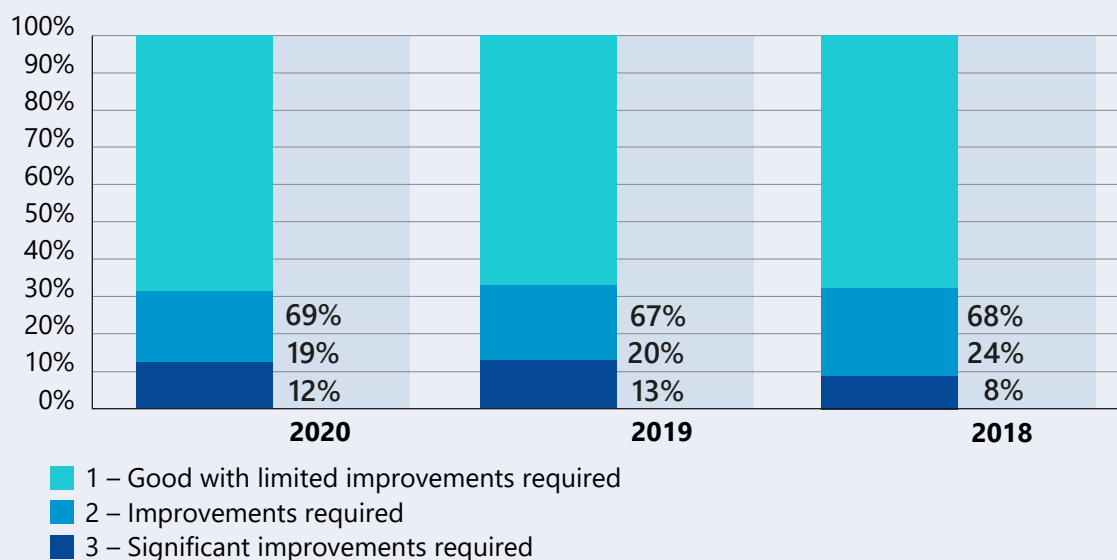
The appendix should be read in conjunction with the firm's [Transparency Report](#) for 2020, which provides further detail of the firm's internal quality monitoring approach and results, and the firm's wider system of quality control.

Due to differences in how inspections are performed and rated, the results of the firm's internal quality monitoring may differ from those of external regulatory inspections and should not be treated as being directly comparable to the results of other firms.

Results of internal quality monitoring



The results of the firm's most recent Audit Quality Assurance Review (AQAR), which comprised internal inspections of 90 individual audits with periods ending between 31 December 2018 and 31 March 2020, are set out below along with the results for the previous two years.



* The grading categories used in the graph above are as follows:

1 – Good with limited improvements required: This grade covers audits which are of a good or acceptable standard. Any key findings should be limited both in significance and in number.

2 – Improvements required: Generally, an audit is graded 2 where there are either a number of key findings relating to weaknesses in the audit evidence obtained or where there are some concerns in relation to the appropriateness of one or more significant audit judgements, the impact of which is unlikely to be material.

3 – Significant improvements required: Audits are graded 3 where the audit procedures planned or audit evidence obtained did not provide reasonable assurance that no undetected material misstatements, individually or collectively, in the financial statements were present; or there are significant concerns in relation to the appropriateness of one or more significant audit judgements.

Firm's approach to internal quality monitoring



The firm's internal inspection program considers the full population of audits performed.

The AQAR is designed to cover each Responsible Individual (RI) at least once every two years, and to ensure that an average of 60% of RIs are reviewed in any one year. The sample of audits selected for review is weighted to ensure that an appropriate number of public interest entities are included. The AQAR reviews of FRC in-scope audits are designed around the FRC focus areas, are completed by the firm's central AQAR team and are overseen by the AQAR partner. Audits not within FRC's remit (Non-FRC in-scope) audits are peer reviewed by individuals in the audit stream under the guidance of a review team leader (an audit partner) and are moderated by the AQAR partner. The central AQAR team provide all review team members with training and guidance for performing the AQAR reviews.

During 2020 all AQAR reviews were performed remotely due to Covid-19 restrictions. Peer reviews were started earlier in 2020 compared to 2019 and due to delays in signing off 31 December 2019 and 31 March 2020 audits, a higher proportion of audits selected were for earlier year ends. The 2020 AQAR reviews took longer to complete due to the impact of Covid-19 on both reviewers and audit teams.

The firm undertakes RCA for all audits receiving a grade 3 and from this period has introduced RCA for FRC in-scope audits receiving a grade 2. The firm does not perform RCA on positive findings such as for audits graded 1 as this is the expected standard. All RCAs are undertaken by a central team. The results of the RCA consider both actions for the audit team itself at an audit level and any actions for the audit stream as a whole.

Internal quality monitoring themes arising



The key themes where audits required improvement were in the challenge of management in relation to accounting estimates, property valuations and impairments, the audit approach to revenue, unidentified errors and omissions in financial statements and weaknesses in the documentation of the audit approach taken, the evidence obtained and/or the conclusions reached.

Firm's actions



Overall, the firm's AQAR results are comparable with prior years. Whilst the number of audits assessed in the highest category are slightly improving year-on-year, the number of audits assessed in the lowest grade, whilst slightly down this year, are higher than two years ago. The firm wants to see a greater reduction in the number of audits assessed in the lowest grade. The 2020 AQAR findings which are recurring from prior years are the challenge of management, the audit of revenue and the audit of going concern. The firm held a Summer School in 2020 (mandatory for seniors and above) focusing on how audit quality can be improved in these specific areas. All of the audits reviewed, except for two, were completed prior to Summer School 2020 and therefore the impact of this training on audit quality cannot be assessed until the 2021 AQAR reviews.

Of the audits graded as good we identified examples of good practice in three quarters of these. The key drivers of good quality on these audits can be summarised as well thought out and structured audit planning (including for group audits), good evidence of the RI's review and involvement in the audit, good use of specialists and clear evidence of the audit team's challenge of management's estimates.

During 2020 the number of FRC in-scope audits reviewed by AQAR was increased substantially (2020:19 – 2019:13) to reflect the increasing number of FRC in-scope entities that the firm audits. We are disappointed that the proportion graded as good has decreased slightly from the prior year (2020: 79% compared to 2019: 83%) however we are pleased that none of the FRC in-scope audits reviewed by AQAR in 2020 was graded as requiring significant improvement (2019: 1).

Given the relatively small population of audits reviewed by both the AQAR and the FRC it is difficult to make direct comparisons between the internal and external results. One FRC in-scope audit was reviewed by both the FRC and AQAR and, whilst the reviews did not exactly cover the same aspects of the audit, some of the detailed findings were similar and the gradings awarded were consistent.

The grading profile of FRC in-scope audits reviewed is stronger (79%) than non-FRC in-scope audits (67%). Root cause analysis has identified that on some occasions, teams did not apply the same degree of rigor to non-FRC in-scope audits as would be applied to FRC in-scope audits. This is possibly due to the firm's messaging with FRC in-scope teams having specific courses focussed on this type of work coupled with some mandatory consultations and/or documentation requirements that are voluntary for other audits. Recent messaging to audit teams has emphasised that there is a single standard of audit quality and that an appropriate level of documentation of audit evidence and challenge is expected for all audits.

RCAs following the 2020 AQAR reviews are in the process of being completed. The initial themes arising from these at this stage include:

- Ineffective supervision and review by more senior team members over the more junior members.
- Resourcing challenges where audits were delayed meaning that the senior members of the team became too involved in completing and finalising the detailed audit work.
- Lack of confidence by the audit team to push back on timetables when management did not deliver on time.
- Lack of scepticism where the audit team does not fully consider the impact of significant transactions on their risk assessment and does not fully consider the alternative accounting treatments, instead relying on what management provides.
- Allocating audit procedures to team members who do not have the appropriate level of technical experience to perform the audit work with a resulting tick box approach to the work done.

In response to these findings the firm has refreshed its Audit Quality Plan ("AQP"). The AQP helps to ensure that audit quality remains at the top of our agenda both amongst the leadership of the firm but also in the focus and behaviours of each individual member of the audit stream. The AQP is used to drive improvements in audit quality, focusing on the key risks and the actions being undertaken and how the effectiveness of these will be monitored. The AQP is updated regularly as a result of recurring findings from both internal and external quality reviews and includes detailed actions to improve quality in these areas. In response to these findings the AQP therefore focuses on the audit of revenue and going concern, detecting material fraud and challenge of management and has been communicated to the whole audit stream. The key actions being taken in 2021 include:

- Investing in the firm's in-flight audit review team to strengthen audit teams' assessments of revenue cycles (end to end) and their assessment of audit strategies and execution.
- Increased investment in specialist IT audit partners and team to enhance the testing of data environments that underpin complex revenue streams.
- Deep dive root cause analyses, utilising external specialists, into the effective use of IT specialists in the audit of revenue and the audit of long-term contracts in construction audits
- Summer School 2021 to focus on the audit of going concern and, revenue, detecting material frauds and effective challenge in practice. This will include case studies and what good looks like.
- A review and revision to the firm's approach to the audit of revenue, together with a full day training event on the audit of revenue for all members of the audit stream.
- Immediate and ongoing investment in the firm's AQAR and RCA teams.
- Launch of two pilots: a milestone programme, and of formal project management training.
- Consider the potential use of a behavioural specialist to help understand the drivers behind recurring findings.

Appendix 2

FRC audit quality objective and approach to audit supervision

Audit quality objective

The FRC is the Competent Authority for statutory audit in the UK and is responsible for the regulation of UK statutory auditors and audit firms, and for monitoring developments, including risk and resilience, in the market. We aim, through our supervision and oversight, to develop a fair, evidence-based and comprehensive view of firms, to judge whether they are being run in a manner that enhances audit quality and supports the resilience of individual firms and the wider audit market. We adopt a forward-looking supervisory approach to audit firms, and we hold firms to account for making the changes needed to safeguard and improve audit quality.

Auditors play a vital role in upholding trust and integrity in business by providing opinions on financial statements. The FRC's objective is to achieve consistently high audit quality so that users of financial statements can have confidence in company accounts and statements. To support this objective, we have powers to:

- Issue ethical, audit and assurance standards and guidance;
- Inspect the quality of audits performed;
- Set eligibility criteria for auditors and oversee delegated regulatory tasks carried out by professional bodies such as qualification, training, registration and monitoring of non-public interest audits; and
- Bring enforcement action against auditors, if appropriate, in cases of a breach of the relevant requirements.

In March 2021 the Department for Business Energy & Industrial Strategy (BEIS) published a consultation document, *Restoring Trust in Audit and Corporate Governance*, which proposes broader supervisory powers for the FRC/ARGA covering auditors, audit committees and directors. The legislation that follows the consultation process will create ARGA and provide it with further powers.

Approach to audit supervision

In March 2021 we published [Our Approach to Audit Supervision](#) which explains the work that our audit supervision teams do.

These reports published in July 2021 provide an overview of the key messages from our supervision and inspection work during the year ended 31 March 2021 (2020/21) at the seven largest audit firms⁹, and how the firms have responded to our findings.

In accordance with our commitment to transparency, for the first time we will also be publishing later this year anonymised details of the key inspection findings and good practice points on the individual audits we reviewed.

In addition to our public reporting, we report our findings in more detail privately to the firms and also to their Recognised Supervisory Body for the purposes of its decision on their audit registration. From 2022, the FRC will be assuming responsibility for the registration of all firms which audit PIEs.

⁹ The seven largest firms are: BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP, Mazars LLP, PricewaterhouseCoopers LLP. We have published a separate report for each of these seven firms.

Our inspection and supervisory work in 2020/21 included:

- 103 statutory audits conducted by the largest seven firms, 16 at smaller firms and four at the National Audit Office. These audits were of financial statements for years ended between 30 June 2019 and 2 May 2020. We also inspected 22 local audits, which we report on separately later in the year, three other audits at the National Audit Office and one Third Country Audit, making an overall 149 inspections.
- Certain areas of the firms' quality control procedures (against the requirements of ISQC 1). We review these on a three year rotation basis at the seven largest audit firms and periodically for smaller firms.
- A focus on the firms' audit quality plans and RCA, both of which are important means of addressing audit quality issues and driving continuous improvement.

In 2020/21 our inspections focused on the following priority sectors and audit areas¹⁰:

Sectors	Audit areas
<ul style="list-style-type: none"> • Financial Services • Retail, including Retail Property and Travel & Leisure • Construction and Materials • Manufacturing 	<ul style="list-style-type: none"> • Going concern and the viability statement • The Other Information in the Annual Report • Long-term contracts • The impairment of non-financial assets • Fraud risk • Application of new accounting standards (IFRS 15: revenue and IFRS 16: Leasing)

Our firm-wide inspection work in 2020/21 focused on audit firms' methodology and training, particularly relating to: revised auditing standards on going concern and the audit of estimates; and new or recently issued accounting standards on financial instruments (IFRS 9), revenue (IFRS 15) and leasing (IFRS 16).

At the conclusion of all individual audit inspections that are assessed as requiring more than limited improvements, we will consider whether the audit should be referred for consideration under the FRC's enforcement procedures. UK statutory audits may be referred to FRC's Case Examiner for consideration under the Audit Enforcement Procedure (AEP)¹¹. The Case Examiner then decides on the appropriate course of action, which may involve Constructive Engagement with the audit firm to resolve less serious potential breaches of auditing standards and other requirements or referral to the FRC's Conduct Committee to consider whether an investigation should be opened. An investigation may result in financial and non-financial sanctions being imposed on an individual statutory auditor and/or the statutory audit firm. The FRC publishes details of all sanctions imposed. From our 2020/21 inspections, 18 audits have so far been referred to the Case Examiner (compared to 13 from our 2019/20 inspection cycle). The FRC's Annual Enforcement Review, published annually in July, contains further details of audits considered under the AEP.

As well as planned supervision and inspection activities, we also respond quickly to emerging issues. For example, during 2020/21 we responded to Covid-19 by issuing guidance to audit firms (and companies) and carrying out a thematic review of the audit of going concern which included inspecting samples of audit work. Our findings were that firms had reacted well to the new challenges. Our 2021/22 inspections will also focus on and take into account the impact of Covid-19 on audits.

¹⁰ [https://www.frc.org.uk/news/december-2019-\(1\)/frc-announces-its-thematic-reviews-of-corporate-re](https://www.frc.org.uk/news/december-2019-(1)/frc-announces-its-thematic-reviews-of-corporate-re)

¹¹ Other procedures apply to audits of non-UK entities (such as those incorporated in the Crown Dependencies)



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