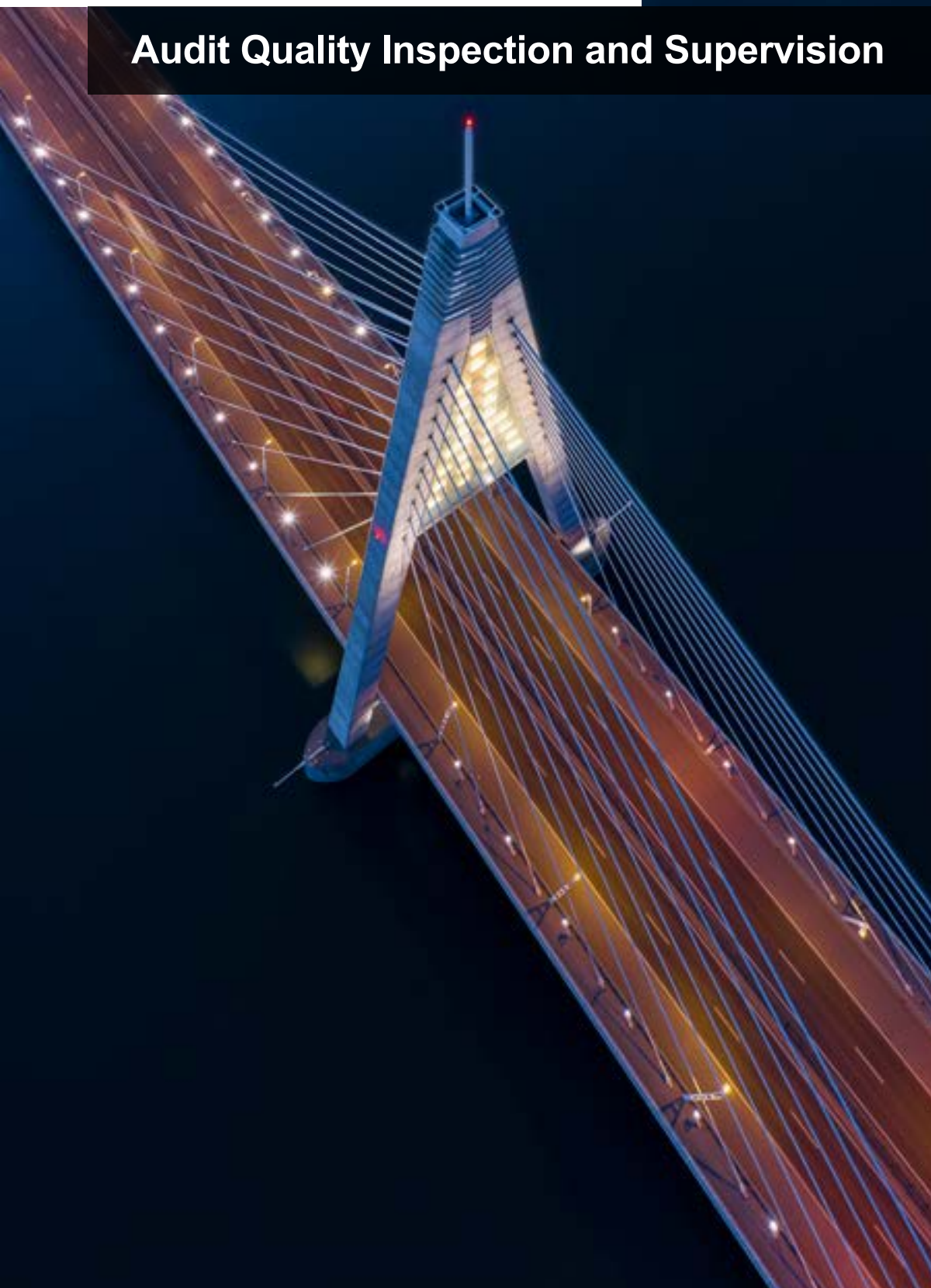




Financial Reporting Council

# Ernst & Young 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 Ernst & Young LLP (EY 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 (PIEs<sup>1</sup>). 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.

<sup>1</sup> 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 area<sup>2</sup>.

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 firm 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.**

<sup>2</sup> <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).

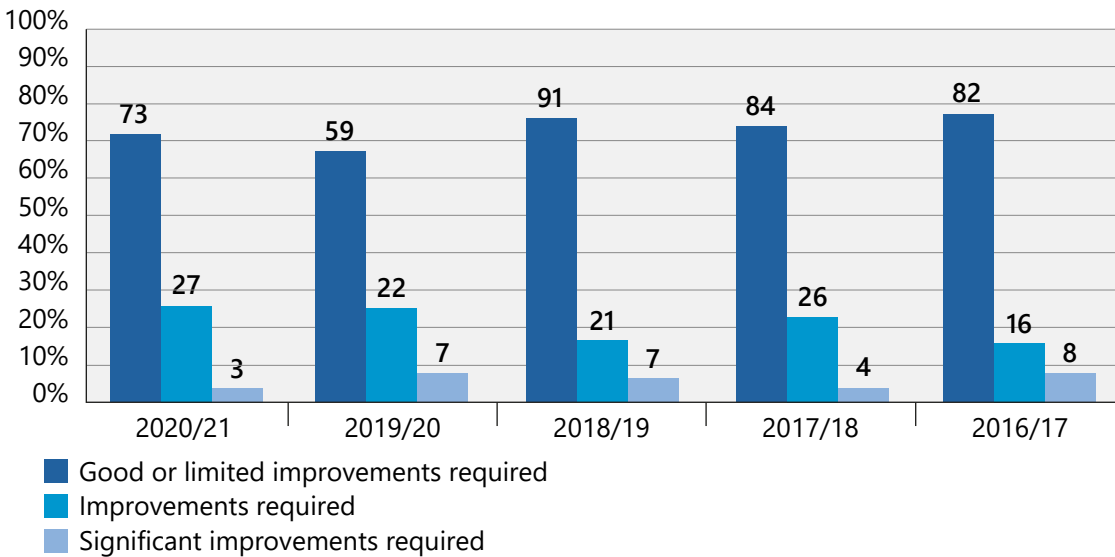
Central to achieving consistent audit quality is a healthy culture within the audit practice that encourages challenge and professional scepticism, as we set out in our letter to Heads of Audit in [December 2020](#). We have a major project underway to examine audit culture, including an international 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 teams<sup>3</sup> 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.



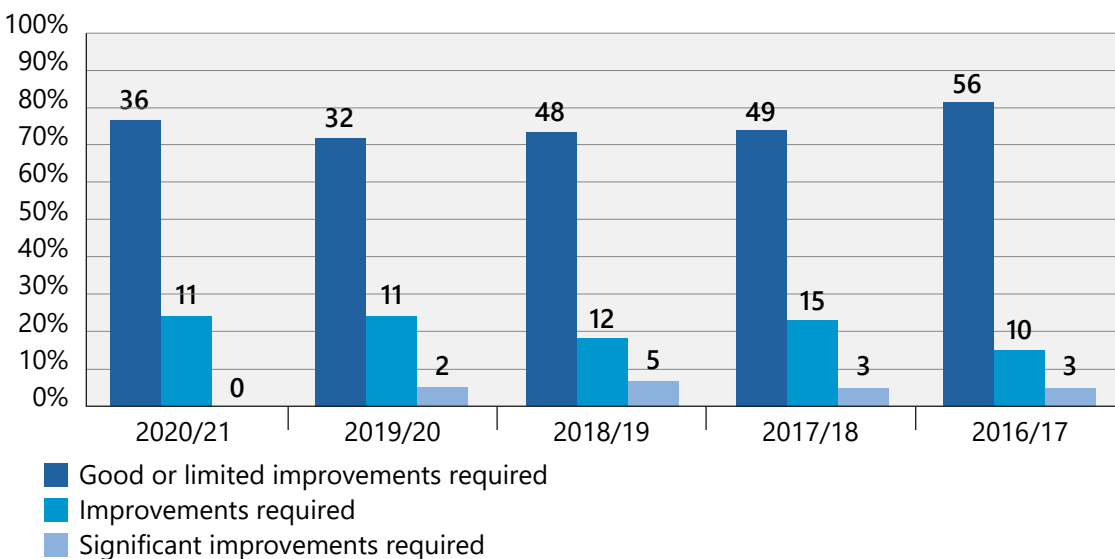
**Our supervision teams are increasing the range of pro-active and forward-looking work.**

### 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



<sup>3</sup> 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>

## EY overall assessment

**We reviewed 19 individual audits this year and assessed 15 (79%) as requiring no more than limited improvements. Of the 12 FTSE 350 audits we reviewed this year, we assessed nine (75%) as achieving this standard.**

The firm has taken steps to address the key findings in our 2019/20 public report, with actions that included enhancing the extent of professional scepticism, as well as ensuring the appropriate identification and assessment of contradictory audit evidence. We have identified areas where improvements have been made, for example, in the group audit teams' oversight of component audit teams, which had been a key finding in the previous two years. We also identified good practice in a number of other areas of the audits we reviewed (including in relation to first year audits, going concern assessments and expected credit loss assessments) and in the firm-wide procedures (including the firm's initiatives in relation to training and new audit guidance, including challenging management on the allowance for expected credit losses).

The main recurring finding in these results was the need to enhance the evaluation or challenge of aspects of management's impairment assessments, with new key findings in relation to the audit of going concern assessments, expected credit loss allowances and deferred tax assets. We note, however, that the audit of going concern was strengthened by enhanced procedures implemented by the firm since the impact of Covid-19.

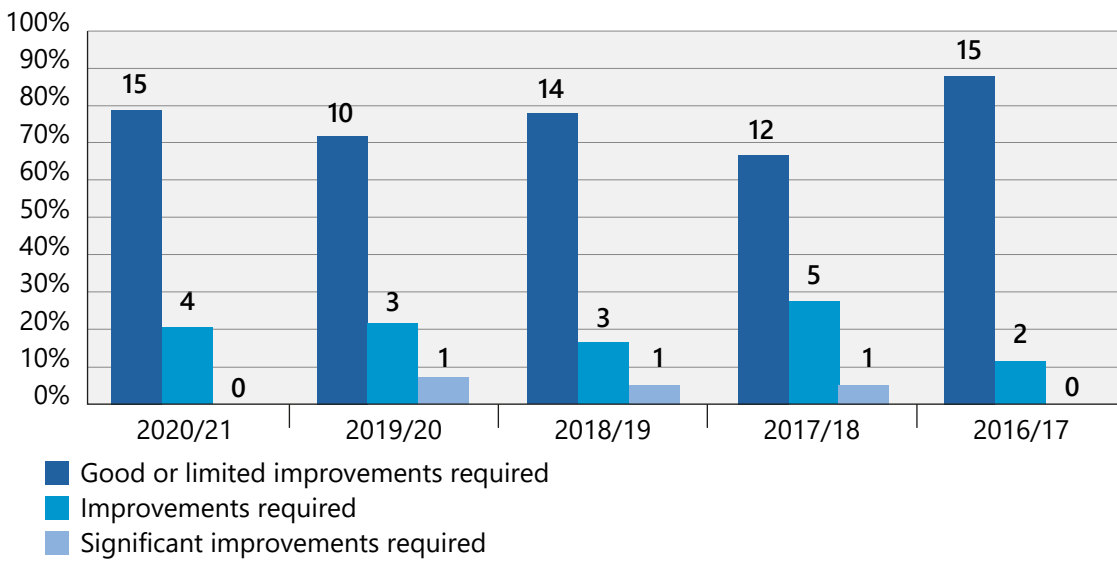
EY's Audit Quality Plan (AQP or the plan) was re-designed in 2020. The updated plan, which is the UK's implementation of the Global Sustainable Audit Quality Programme, contains eleven strategic quality initiatives over a rolling three-year period. Under this plan there is an emphasis on behaviours, and a recognition that a cultural shift in mindset is needed. The firm has identified three areas as priority focus areas, which are to embed a culture of challenge and scepticism, continually focus on high quality audit outcomes using their behavioural model and drive consistent quality control. The plan has a clear linkage between the initiatives, is adaptable and has key milestones. Going forward the firm should continue to develop how it assesses the overall effectiveness of the plan and acts on those findings.

The firm's Root Cause Analysis (RCA) processes are well established, following methodology and guidance set by the global firm, supplemented by UK-specific procedures. The firm has continued to strengthen its RCA process (including in response to feedback from the FRC) and has further broadened the coverage and scope of its RCA. The firm's RCA dashboard tool enables more precise interrogation of causal factors. Findings are regularly shared with and considered by senior members of the audit practice. A number of the firm's approaches are good practice. Nonetheless, the firm needs to identify and address the root causes of our findings, including the recurring finding in relation to the audit of impairment.

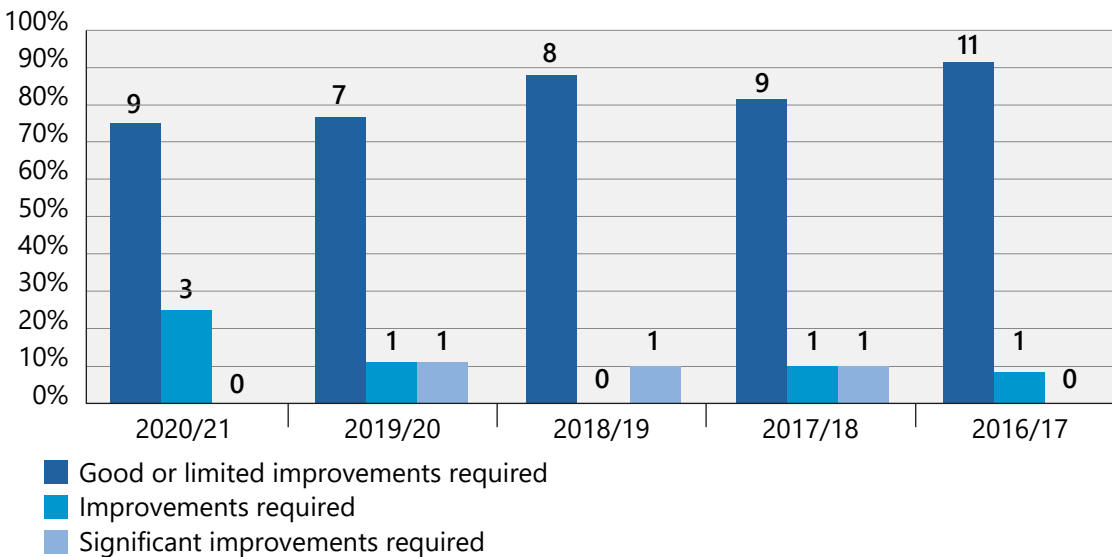
# 79%

**At EY, more of the audits reviewed in the current inspection cycle were assessed as either good or limited improvements required.**

### Our assessment of the quality of audits reviewed: Ernst & Young LLP



### FTSE 350



The audits inspected in the 2020/21 cycle included above had year ends ranging from 30 June 2019 to 2 May 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

Audit work continues to be of a good standard in most areas. Nine of the ten reviews were either satisfactory or generally acceptable and one required significant improvement.

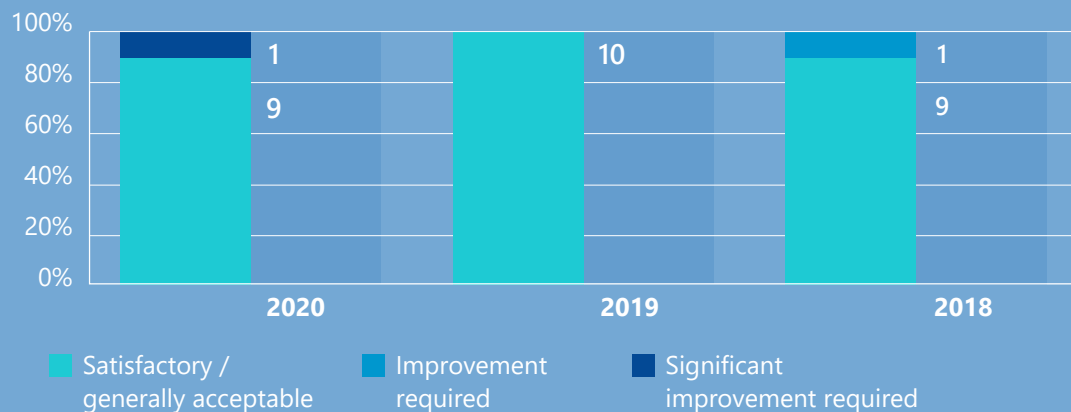
On the review requiring significant improvement there were widespread issues across the audit. There was a lack of evidence to support intangible asset balances and numerous instances where key documentation was either missing or incomplete. There were also material errors and omissions in the financial statements.

On the audits assessed as generally acceptable, there were some gaps in audit evidence and other areas where the documentation needed improvement. In each case this was limited to only one or two matters per audit. There were financial statement presentation and disclosure deficiencies on three of these audits.

ICAEW identified and shared examples of good practice across the audits.

### 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.

# 90%

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



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## Review of individual audits

Our key findings related primarily to the need to:

- Enhance the evaluation or challenge of aspects of management's impairment and going concern assessments.
- Strengthen the testing or evidence over aspects of the assessment of the Expected Credit Loss allowance.
- Enhance the evidence and justification for the recoverability of deferred tax assets.

### Good practice observations



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

- Effective group audit oversight.
- First year audits.
- Going Concern assessments.
- Impairment assessments.
- Expected Credit Loss assessment.
- Revenue recognition.

## 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 related primarily to the need to:

- Ensure effective implementation of the plan: Going forward the firm needs to continue to develop its procedures to monitor the effectiveness of the plan's implementation.

### RCA process

We had no key findings to report.

### Audit methodology and training

We had no key findings to report.

## Good practice observations



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

- **Audit quality initiatives** – Audit quality communications; Using predictive audit quality indicators; and Quality Initiative Sponsors.
- **RCA process** – Extent of challenge from Audit Leadership; Targeted thematic analysis; Breadth of information used in RCA analysis and RCA reporting; and Analysis of good practices.
- **Audit methodology and training** – The amount of mandatory training provided at the manager grade; Illustrative audit procedures of a high standard for auditing the allowance for expected credit losses; and Good disclosure guidance provided to teams performing banking audits.

## Firm's overall response and actions



### Introduction

Ensuring we conduct high quality audits is our priority, which is supported throughout EY. We have made a significant investment in people, technology and centres of excellence to improve audit quality over the last seven years and we are seeing benefits from this investment. This year we are pleased that the FRC is reporting an overall improvement in our inspection results and that they did not identify any audits which required significant improvement. This shows positive progress, but we know we have more to do. The FRC included six first year audits in the sample reviewed and it is pleasing to see the FRC report good practice on these. We also have no audits with findings equivalent to the FRC's 'significant improvements required' rating in our own internal inspections as summarised in Appendix 1. We are very disappointed that one of the audits reviewed by the ICAEW has been assessed as requiring significant improvement, and we are conducting a detailed root cause analysis on this audit. We know, and the inspection results support, that we perform high-quality audits in most cases, but our consistency needs to improve. This is evident in the FRC's observations that it has identified good practice in areas where it also reports findings.

We recognise the importance of robust firm-wide procedures and controls. We are working currently to implement ISQM 1 and the FRC's principles around operational separation. Our audit methodology and training are critical aspects of our firm wide procedures. There were no key findings arising from the FRC's work in this area. We have a clear, robust strategy and acknowledge the importance of the key finding in respect of the implementation of the Audit Quality Strategy ("AQ Strategy") and have plans to respond to it, accordingly.

## Current environment

Recent audit failures have eroded the level of trust society has in audit. This has prompted the need to reconfirm the purpose of an audit, who our stakeholders are and the expectations of auditors. The scope of reform impacting the profession is wide ranging; operational separation will impact the way our business is structured and governed, and the scope of the audit is likely to change. We are fully supportive of the desire to create an audit ecosystem that better meets the expectations of our stakeholders and society. Therefore, we are taking this opportunity to consider how we can play our part in ensuring the changes have a positive impact on audit quality, increasing trust in the profession and wider business as well as on our own people, and the attractiveness of the profession.

Auditing in the current environment continues to be challenging. The majority of the audits reviewed by the FRC in this cycle were largely completed before the country entered lockdown but there were some audits for which virtually all of the year end work was completed remotely. Remote working has continued to be the norm and uncertainty about future working patterns remains. Our teams worked extremely hard to overcome the challenges this has brought, including:

- exercising group oversight without being able to travel;
- dealing with significant judgements on going concern and impairments;
- undertaking additional work due to enhanced consultation requirements in response to the increased risks; and
- coaching and supervising teams of people working remotely.

This required us to take some difficult decisions to defer signing opinions, with audit quality taking precedence over timetables. We increased our support for teams during this time, not only on technical matters but also doing all we can to protect their wellbeing. We are exceptionally proud of how our teams have risen to this challenge and we would like to take this opportunity to thank them for their outstanding contribution.

## Root cause analysis

We place great emphasis on carrying out root cause analysis to identify why audits were not of the appropriate quality as well as understanding and being able to replicate good practices. The root cause analysis work is led by a partner independent of the quality team using EY's global methodology and tools. During the year we increased the number of root cause reviews carried out from 51 to 84; this includes audits subject to internal and external inspection. Our root cause analysis continues to identify that our best audits incorporate a high degree of executive involvement. Other drivers of good audit quality include effective use of specialists and good project management, two of the areas on which we have placed emphasis in recent years. We comment in section 2 of this report on the results of our root cause analysis on the key findings identified by the FRC following their review of individual audits. The key themes identified from all our root cause analysis work included some knowledge gaps, a need to improve review procedures and resourcing issues on certain audits. We have already taken actions to address these themes and have further planned actions as part of our AQ Strategy.

We are pleased the FRC has identified good practices in our root cause analysis. We recognise that good root cause analysis drives continued improvements in audit quality, and this will remain a priority for us.

## AQ Strategy

During 2020 we undertook a major redesign of our AQ Strategy, which we consider to be fundamental to responding to the root cause analysis carried out and achieving our audit quality ambition to have a high degree of confidence that we will have no audit failures. It is a multi-year strategy designed to deliver sustainable, consistently high-quality audits, which supports our adoption of ISQM 1 and involves further significant investment. It was launched to the audit practice at our annual Audit Quality Summit in September 2020. Under the six pillars of our Global approach to Sustainable Audit Quality, we designed eleven workstreams. Each workstream is sponsored by an Audit Quality Executive Committee member. The AQ Strategy is managed by a central strategy management team. There is regular reporting from the workstreams into the central team and monthly reporting to the Audit Quality Executive Committee and the Independent Non-Executives.

Progress has been made within all eleven workstreams but at the outset we prioritised three workstreams to focus improvements within the audit practice where we believed individuals could make the biggest impact. These were determined taking into account the prior year root cause analysis, the results from external and internal inspections, feedback from people surveys and focus groups and insights shared by the FRC. The three priority workstreams are:

- embedding a culture of challenge and scepticism;
- further development of our EY audit team behavioural model for high quality outcomes; and
- driving consistent quality control.

The audits reported on by the FRC in this inspection cycle were largely completed before the launch of the redesigned AQ Strategy and therefore have not benefitted from the actions taken, although we have had previous initiatives from which they have benefitted. We expect to see the additional impact come through in future years, but we know that embedding change takes time and will not all be achieved in one year. We are pleased that in section 3 of this inspection report the FRC identify areas of good practice within our AQ Strategy. We continually assess whether the changes made are being implemented effectively and whether they are satisfying the objectives set so that we can adapt either the AQ Strategy or its implementation accordingly, and we recognise the importance attached to this by the FRC. We are completing a formal re-assessment of the AQ Strategy and will be communicating priorities at our September 2021 Audit Quality Summit. Although a lack of challenge was not identified this year as one of the major themes of our root cause analysis, we anticipate retaining the workstream on embedding a culture of challenge and scepticism as a key priority recognising how fundamental this is to high quality audits. We anticipate including further enhancements within it on fraud risk assessment. We will also prioritise implementation of the EY Digital Audit which is a full transformation of the audit approach to be data driven. The final priority on which we expect to be focusing audit teams is precise writing skills alongside greater standardisation of our workplans and documentation.

Further details of all the workstreams are set out in our Audit Quality Report which we published in November 2020 alongside our Transparency Report. We will publish the 2021 Reports in November 2021.

## Culture, Values and Behaviours

Auditing by its nature is judgemental; it is built on human decisions that are influenced by an individual's attitudes, experiences they have encountered and behaviours to which they have become accustomed. Our culture must empower our people to challenge the companies we audit in the right way, and without fear, if we are to deliver consistently high-quality audits.

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Alongside our work on the AQ Strategy we are also taking the opportunity to focus on the culture, values and behaviours within our audit practice.

Over a number of years, we have invested in understanding the culture within the audit practice including running detailed surveys focusing on the values our people consider important and the values they see in practice. We have also worked to reinforce the importance of audit quality through measures such as establishing a link from audit quality to partner remuneration, an area identified by the FRC as good practice last year. As we prepare for operational separation, we are taking the opportunity to formalise an EY Audit Culture Framework. This articulates our desired audit culture, identifying the key elements we consider to be important to foster the behaviours we want in our audit practice. Our purpose, values and Global Code of Conduct together provide the foundation for setting the tone of our culture. This Code of Conduct provides an ethical framework for the behaviours expected from our people and promotes a culture of integrity among our people. We have taken the EY values and defined more specifically what that means for an EY Auditor. We are sharing this new framework with our people and will emphasise it at the annual Audit Quality Summit in September 2021.

### **Conclusion**

Given the significant challenges driven by the pandemic in terms of remote working and evaluating the significant changes in risks faced by the companies we audit over the last year, we are encouraged to see progress in many aspects of audit quality. However, we are not complacent and recognise more must be done to execute our AQ Strategy more consistently across all our audits. Our focus on purpose will guide our people to focus on doing the right things to increase the trust society has in audit. We believe we have the right plans in place and are focussed on executing them to play our role in providing confidence to the capital markets.

We appreciate that the FRC has also faced challenges conducting remote reviews. We welcome the independent perspective and insights the FRC brings and would like to thank the FRC for its work.

## 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.



EY<sup>4</sup>

RIs  
238

Offices  
18



12,670  
Professional Staff

EY

## Audits within the FRC's inspection scope

Inspection Cycle <sup>5</sup>	FTSE 100 audits	FTSE 250 audits	Total audits in FRC scope
2021-22	25	41	358
2020-21	18	53	349
2019-20	15	44	324

EY

Audit fee income<sup>6</sup>  
£m



EY

Audits inspected by the FRC<sup>7</sup>



EY

Local audits<sup>8</sup>



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.

### Enhance the evaluation or challenge of aspects of management's impairment and going concern assessments

Impairment and going concern assessments include the estimation of future cash flows and are subjective. Changes to key assumptions in the assessments could result in an impairment. Any material uncertainties for going concern will require enhanced disclosures in the financial statements. Auditors should therefore sufficiently evaluate and challenge management's assumptions and cash flow forecasts for these areas.

#### Key findings



We reviewed the audit of impairment of goodwill and other assets on all audits that we inspected where this was identified as an area of significant risk. While good practice was highlighted in some of these audits, we identified the following issues relating to the consideration and challenge of management's impairment assessments on four audits, including one assessed as requiring improvements:

- On three of these audits there was insufficient consideration or challenge (or evidence thereof) for aspects of the short-term cash flow forecast assumptions. On one of these the audit team did not sufficiently challenge management over the improvement plans and why the trend of poor performance was not forecast to continue. On another the audit team did not sufficiently challenge the basis for certain adjustments to the profit related assumptions. On the third there was insufficient evidence of consideration of the pricing, margin and volume assumptions.
- On the same three audits the audit team did not sufficiently challenge the adequacy of the sensitivity analysis or related disclosures.
- On another audit there were insufficient audit procedures performed to test the completeness of property, plant and equipment used in the impairment model.

We also reviewed the audit of going concern on the majority of our inspections, including all audits where it was identified as an area of significant risk. We noted that the firm enhanced its procedures to respond to the increased risks relating to going concern arising from Covid-19 and we noted several good practices in this area following those changes, including increased consultation requirements. However, we also identified the following issues relating to the consideration and challenge of aspects of management's going concern assessments on two audits, one of which was undertaken before the impact of Covid-19 and was assessed as requiring improvements.

**We identified issues in relation to challenge by audit teams of aspects of management's impairment and going concern assessments.**

- On one audit, in concluding on whether a material uncertainty relating to going concern existed, there was insufficient evidence that the audit team had adequately considered the significance of the requirement to refinance, over a year after the date of the auditor's report, and the appropriateness of not formally consulting.
- On the other audit, there was insufficient justification for the level of assessment completed by the audit team over management's forecasts and assumptions relevant to the period after a year from the audit report date.
- On both of the above audits, the audit team did not ensure that the length of the going concern assessment period was adequately disclosed in the financial statements.

### Firm's actions:



We are encouraged that the FRC has identified good practice in our audits in relation to both impairment reviews and going concern assessments but are disappointed there are also areas identified which require improvement. We have placed focus in recent years on improving our work on impairment reviews but recognise we are not yet achieving consistency. The actions we have taken in the last year as part of our refreshed AQ Strategy will not have benefitted the audits reviewed this year and we anticipate that these actions will support further improvement.

Our root cause analysis on the audit requiring improvements in relation to the impairment of goodwill identified that the audit work did not fully articulate the basis for the audit team's conclusion and did not sufficiently evidence the team's scepticism, and that the time pressure the team experienced was a key contributing factor which impacted the review procedures.

One of the three priority workstreams of our refreshed AQ Strategy is focused on embedding a culture of challenge and scepticism. This was launched at the Audit Quality Summit in September 2020 with the introduction of two new tools to help our teams. The Active Scepticism Framework supports teams as they audit judgemental areas, in particular helping teams identify any internal biases they may have or other external factors which may impact judgements taken. The Audit Purpose Barometer is designed to assist teams in assessing how well their planned audit meets societal expectations. We have also enhanced the information sources available to our teams by using an external provider of industry data to support teams in their challenge of assumptions and as a source of alternative and potentially contradictory evidence. Application of scepticism has also been an area of focus in training run throughout the practice.

The EY Head of Audit has taken an increasingly firm stance on the need to push back on companies when they do not meet agreed timetables or where there are complexities that will take more time to deal with. This has been particularly important during the Covid-19 pandemic when forecasting future outcomes has been challenging for companies but also means we need more time to audit them. As the situation has evolved, we have provided partners with letters to use as a basis for communicating with Audit Committee Chairs on this topic. In the last year an increasing number of audit opinions have been delayed due to resource challenges or additional work required by companies and our teams to ensure the necessary standard of audit work is completed before issuing our opinion.

The most common theme arising from our root cause analysis on the other findings noted in this area was deficiencies in review procedures.



Driving consistent quality control is one of our three priority areas and we have run additional training and developed new tools to improve our reviews. We know that our documentation on impairment reviews is inconsistent. Our workstream on precise writing will likely be prioritised as we move into the next audit cycle.

The Covid-19 pandemic necessitated a significant focus on going concern assessments and we have revised our processes a number of times in response to the evolving situation. We have also used the insights provided by the FRC's thematic work in this area as we have kept our processes under review. We are therefore pleased that the FRC has identified several audits with good practices in this area.

In relation to the audit that was assessed as requiring improvements regarding audit work on going concern, our root cause analysis identified that the review procedures carried out did not identify that the working papers prepared by both the company and the team were not clear that the going concern period was 12 months and the refinancing was four months after this. There was a lack of clarity about the extent of the work performed on the refinancing occurring after the going concern period. We note that our policies at the time did not require a formal consultation in these circumstances and would only require one currently due to the additional procedures in place in response to the circumstances arising from Covid-19.

In the other example highlighted by the FRC, the audit team were satisfied there was no need to perform extensive procedures beyond the 12 month going concern period in order to assess whether there was a material uncertainty in relation to going concern because the company and we had already concluded there was a material uncertainty based on the 12 month period. However, the length of the going concern period was not clearly disclosed.

In light of the FRC's guidance, issued in November 2020, requiring that companies are specific about the period they have considered in their going concern review, we have included updates in our mandatory training sessions on this guidance alongside emphasising the need to be specific in our own working papers on the going concern period under review.

## Strengthen the testing or evidence over aspects of the assessment of the Expected Credit Loss allowance

The assessment of the Expected Credit Loss (ECL) allowance, in accordance with IFRS 9, is subjective and involves significant management assumptions and estimation uncertainty. Audit teams should adequately assess management's judgements and perform appropriate procedures to respond to the associated risks.

### Key findings



We reviewed the audit of the ECL allowance on four audits. We assessed one of these audits as requiring improvements, mainly in relation to the audit of several aspects of the ECL allowance. The findings included insufficient justification for certain risk assessment and scoping considerations and inadequate testing for the completeness and accuracy of data and IT automated controls. The audit team's quality control procedures should have resolved the deficiencies on this audit.

On the three other audits, limited improvement points were identified, relating to the risk assessment or testing of aspects of the ECL allowance, and we also identified areas of good practice. On one of these audits, there was inadequate justification for the conclusion that certain of the ECL models, linked to the significant risks, did not require the model code to be reviewed as part of a first-year audit.

**Improvements were needed in the audit testing of the assessment of the Expected Credit Loss allowance.**

## Firm's actions:



Since the implementation of IFRS 9 we have invested significantly in developing and updating our IFRS 9 methodology. We are pleased that the FRC has identified examples of good practice on individual inspections and in relation to our methodology.

Our root cause analysis identified that where there was a high degree of executive involvement upfront and where audit teams obtained a thorough understanding of ECL related processes and ECL models they were able to better document the key risks and related audit procedures in response. In relation to one audit assessed as requiring improvements, our root cause analysis identified that the adequacy of the second level review procedures to ensure that all the relevant documentation was included was insufficient as a result of an overconfidence in the team. This was exacerbated by the first-time implementation of IFRS 9 and instances of poor team communication.

We have responded to the root cause analysis by ensuring the findings from the reviews relating to risk assessments, scoping and documentation of data testing have been incorporated into the updated methodology and further consideration for first-year audits will be incorporated into future iterations of our methodology. Driving consistent quality control is one of our AQ Strategy initiatives and addresses all levels of review. Additional training on conducting timely, efficient and effective reviews has been delivered for all our audit teams. To further drive consistency we intend to deliver IFRS 9 specific training based on our revised methodology and this will form an important element of our autumn update training in 2021.

## Enhance the evidence and justification for the recoverability of deferred tax assets

The recognition of a deferred tax asset (DTA), to the extent that it is probable that taxable profits will be available against which they can be utilised, is a judgemental area. The audit team should therefore demonstrate an appropriate level of consideration and challenge to assess the judgements made and conclude on their appropriateness.

## Key findings



We reviewed the audit of the DTAs on five audits and identified issues relating to the evidence and justification for the recoverability of deferred tax assets on four of these audits which were individually assessed as requiring limited improvements.

- On one audit there was insufficient consultation and evidence of consideration over the use of certain assets, which were not yet under the control of the group, in the assessment of the recoverability of a DTA. The audit team's analysis did not adequately evidence and demonstrate how the recovery of the DTA was supported by management's calculations and forecasts.
- On two audits there was insufficient evidence to support the level of recoverability of the DTAs against future profits. On one of these there was a lack of challenge and on another insufficient evidence to support the forecast profits.
- On a further audit there was insufficient justification why the planned audit procedures evaluating the recoverability of a material DTA were not performed.

**We identified issues relating to the evidence and justification for the recoverability of deferred tax assets on four out of five audits reviewed.**

## Firm's actions:



As noted by the FRC, the issues identified in relation to deferred tax assets were individually assessed as limited improvement points. We have carried out root cause analysis and included this topic in our practice wide focus group discussions on the findings.

The root causes identified for the issues in this area include inadequate response by the audit team where the information provided by management was not of sufficient quality, teams prioritising the accounting review over the audit evidence considered, and a lack of clarity between the audit and tax professionals as to the division of responsibilities in this area which impacted the project management. There was one area where our guidance was not sufficiently clear.

Our actions in response to the findings include updating the firm's guidance, a focus on reviewing forecast information as part of our work on embedding a culture of challenge and scepticism, and reminders on the audit of deferred tax in our training. We will be running a further training session to set out the conclusions of the root cause analysis which will include more detail on the root causes identified in this area, as well as reviewing how we organise work within our own teams.

## Good practice



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

- **Effective group audit oversight:** We identified good practice on five audits. This included, on one first year audit, the group audit team organising a three-day conference to brief partners and managers from all component audit teams on the group audit approach. In addition, on that audit, the oversight of the component auditors' IT audit work included clear mapping of IT systems, responsibilities and recording of scope changes, risk-based assessment of tools and evidence of review by the group audit team.
- **First year audits:** We identified good practice on all six first year audits. In particular, on two audits, thorough first year procedures were observed including, on one audit where the audit team identified a number of prior year adjustments. As part of the consultation in relation to each prior year adjustment, the audit team evidenced a thorough challenge of the root cause of each matter to understand the potential for the underlying causes to have a pervasive impact.
- **Going concern assessment:** 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 technical panels on listed audits. On four audits the good practice identified related to the extent of audit work to assess management's going concern assessments. For example, on one first year audit, the audit team's evaluation was well-reasoned, with good interaction between the audit team and the firm's specialists.
- **Impairment assessments:** On three audits there was good practice identified including, on one audit, the audit team rigorously assessed the risks related to the carrying value of a cash generating unit, in particular by means of: a sensitivity and reverse stress analysis, detailed consideration of the key assumptions and the link to historic results, and challenge and recalculation of management's expert's weighted average cost of capital.

**Good practice examples included the extent of group audit team oversight and the audit work in areas including revenue recognition testing, first year audits and going concern assessments.**

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- **ECL assessment:** On two audits there was good practice, including, on one first year audit, there was a good overall audit approach to IFRS 9, including the comprehensive nature of audit procedures performed and the underlying support for the audit team's conclusions. In particular the firm's approach to the review of model code and the independent model rebuilding approach, with the level of supporting evidence retained, was of a high quality.
  - **Revenue recognition:** On two audits good practice was identified, including on one audit where the testing of the integrity of management's unbilled revenue calculation effectively used computer-aided audit tools.

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

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 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 key aspects of the firm’s audit quality plan. EY has been evolving its plan for a number of years, informed by the Global Sustainable Audit Quality Plan.

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

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When we reviewed the plan last year, we identified good practice in relation to project management procedures and with respect to the EY audit team behavioural model (PLOT). We also found that the firm should improve the plan and/or quality initiatives by:

- Enhancing the monitoring of audit quality initiatives by those independent of audit.
- Strengthening the culture of challenge in the audit process.

EY's response to our findings last year indicated that the firm had current initiatives that would address our findings and that they were in the process of establishing a new oversight structure. In September 2020, EY launched their re-designed audit quality plan.

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 under 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 challenge of culture 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.

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

- The process for monitoring of the audit quality initiatives by those independent of audit has been strengthened. The status of each quality initiative in the plan is monitored monthly by the Audit Quality Executive and by a committee of independent non-executives who form the Audit Quality Independent Oversight Committee (AQIOC).
- The firm has built on its Purpose Led Outcome Thinking (PLOT) initiative to develop frameworks and tools that focus on embedding a culture of challenge and active scepticism. Initial RCA indicates these initiatives have had a positive quality impact. We would encourage a continued focus on culture of challenge and the broader culture.
- The current overall plan, and the associated monitoring and reporting, had evolved and continued to improve. There was a shift away from establishing processes and structure to greater emphasis on behaviours, and recognition where cultural shift in mindset was needed. Strategic quality initiatives were prioritised within a multi-year forward vision.
- The firm has a structured approach to ensuring that the plan is forward-looking and adaptable including: public policy strategic sessions, drawing in quality topics from the broader EY network, and seeking the input from areas with specialist skills. The firm formally re-assesses the plan periodically taking into account future priorities and the changing environment.

## Key findings



Ensuring effective implementation of the plan: The firm needs to continue to develop its procedures to monitor the overall effectiveness of the implementation of the plan. In addition, the firm needs to remain focused on the challenges inherent in the implementation of the plan, including continuing commitment from all staff. It is also important to maintain emphasis on the initiatives and drivers of audit quality that have become part of the business as usual activities of the firm.

## Good practice



- **Audit quality communications:** the firm has made a tangible investment in its audit quality communications to ensure that key audit quality messages are communicated coherently and consistently. The messages from the Audit Quality Summit on the importance of audit quality and having a culture that supports audit quality are reinforced across communication channels (including leadership communication, technical communication, all staff messages and training) on an almost daily basis.
- **Using predictive audit quality indicators:** the firm has used predictive audit quality indicators as the basis for active interventions to maintain audit quality.
- **Quality Initiative Sponsors:** Partner Sponsors are appointed for each quality initiative. This avoids “group think”, allows innovative ideas to emerge and supports accountability.

EY’s audit quality plan was re-designed in 2020, has clear linkage between the initiatives, is adaptable and has key milestones.

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:



We have invested in our Audit Quality Initiatives for many years. Although these initiatives have improved audit quality, and a large proportion of our audits are performed to a high standard, we are clear that we have more to do. That is why in 2020 we performed a full reassessment of our AQ Strategy with a view to making the step changes necessary to ensure that we can confidently and consistently deliver high-quality audits that meet all our stakeholders’ expectations of us every time. The strategy went through a rigorous review process including the involvement of EY’s Independent Non-Executives as part of the new oversight structure put in place following the recommendations made by the FRC last year. We launched the redesigned AQ Strategy at our Audit Quality Summit in September 2020. The audits reviewed and reported on by the FRC in this cycle had not benefitted from these new initiatives.

Our redesigned AQ Strategy will support our adoption of ISQM 1 and has workstreams in a number of areas. We have focused on three key priorities during the last year. This focus includes embedding a culture of challenge and scepticism which we recognise has been an area of repeat findings despite the actions already taken. We set out on page 12 more detail on the specific actions taken in this area.

An internal audit review of the AQ Strategy was conducted during the year. The objective of the audit was to assess processes, risks and controls to provide assurance that the strategy’s governance, implementation and monitoring is appropriate. The overall outcome was positive. Areas of good practice were noted in the structure of the governance process,

communication plan and Project Management Office (PMO) function. The PMO function has devolved responsibility to partners to deliver specific workstreams with standardised reporting and meetings scheduled to drive accountability and consistency.

We are pleased that the FRC is satisfied we have addressed the findings identified last year and also noted a number of areas of good practice. We share their view that it is important to keep ensuring the effectiveness of the actions we take. In a people business we need to ensure that the improved processes and procedures put in place are adopted consistently by all our people on all audit teams. As the FRC notes we have invested in regular and consistent communications to support this. We have also prioritised a focus on culture and behaviours, an area that is being enhanced further as we implement our operational separation plans. We set out in our overall response the actions we are taking to develop our EY Audit Culture Framework.

## 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 follows methodology and guidance set out by the global firm, supplemented by UK specific procedures.

When we reviewed the firm's RCA process last year, and the RCA conducted on our 2019/20 inspection findings, we found there had been an overall improvement in RCA related processes with various elements of good practice, such as timing of reviews and use of questionnaires designed by behavioural specialists. Nonetheless, we found that the firm should further improve the RCA process by:

- Extending its coverage of internally inspected audits.
- Enhancing the reporting of RCA themes, and ensuring that themes arising from internal inspection findings were reported to the Board or INEs on a timely basis.

In addition, we found that the trail between the individual RCA findings and the reported themes was less clear than at some other firms.

EY's response to these findings indicated that the firm would take a variety of actions and the findings have now been addressed.

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.

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



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

- The coverage and scope of RCA has been enhanced. The firm now includes within RCA all inspections from its own internal quality monitoring processes, other than those with no or only minor findings. In addition, the firm has extended its coverage of external inspections and Prior Year Adjustments.
- The firm continues to invest in the RCA process, through expanding the size of the team and ensuring that the team has an appropriate mix of seniority, experience and skills.
- The firm uses a global taxonomy of risk factors which provides a consistent approach to risk classification. The firm should continue to contribute to updates to the global taxonomy to ensure that the categorisations remain appropriate and uncategorised root causes are minimised.
- The firm has now assessed some firm-wide inspection findings in RCA. We will consider how that approach further develops in our next periodic review.

## Key Findings



There were no key findings from our review. Having said that, we emphasise to all firms that further analysis of the RCA approach/actions needs to be taken in respect of recurring findings.

## Good practice



- **Extent of challenge from audit leadership** – the Head of Audit signs-off each root cause review. Audit leadership provides real-time push-back and challenge on individual RCA results and the adequacy of actions.
- **Targeted thematic analysis** – the RCA dashboard tool allows EY to look at themes across sub-components of the RCA population. Effective assessment of the aggregate information within the tool has enabled further targeted thematic RCA analysis (e.g. thematic RCA on cash-flows, led to identification of a knowledge gap.)
- **Breadth of information used in RCA analysis and RCA reporting** – the research and analysis ahead of RCA interviews, including pulling in information from audit quality indicators, facilitates a better-informed understanding and therefore more focused approach to the interviews. In addition, the analysis in the firm's periodic RCA report was strengthened by bringing together the RCA of all external regulators' inspections, internal quality reviews, prior year adjustments, and firm-wide findings into one report.
- **Analysis of good practices** – the firm's approach to the analysis of good practices, and the consideration of that analysis alongside specific audit quality occurrences has led to an enhanced understanding of the root causes and, in turn, the ability to take more targeted actions.

**EY's root cause analysis processes are well established.**

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:



We have enhanced our root cause analysis further during the last year including responding to the matters raised by the FRC. We have increased the scope of our work to include all audits reviewed by the FRC as well as additional audits from our own internal reviews and findings arising from firm wide reviews. In total we have increased the number of reviews from 51 in the prior cycle to 84 in the current cycle, this includes audits subject to internal and external inspection We have achieved this by increasing our resources and taking the opportunity to bring in team members with specialist skills in Financial Services and Government and Public Sector audits.

We have continued to explore other ways to develop our expertise in this area. During the year we have discussed our processes with colleagues from our consulting practice, other EY audit practices in the global network and a company that also carries out root cause analysis within its operations. We have recently appointed an external adviser to review our root cause analysis work. They are currently shadowing us as we undertake a number of reviews and will report back to us on areas of good practice and improvements we can make.

In response to the feedback provided by the FRC last year we increased our reporting this year to provide the Independent Non-Executives and the EY Board with a detailed report on the outcome of the reviews of internal inspection findings which are carried out in the first half of the year when these were complete. We will continue to prepare a report on the full year's cycle.

The root cause analysis performed by our team this year identified some knowledge gaps and a need to improve some review procedures as the two most significant overall themes on audits inspected by the FRC. We assessed the underlying causal factors to include some behavioural aspects. Accordingly, our priority actions include effective use of our behavioural model and reinforcing consistent quality control. Professional scepticism was not identified as a key theme this year but was a component part of other themes. Recognising how fundamental it is to high quality audits embedding a culture of challenge and scepticism remains a key area of focus. Our work on all our positive quality occurrences highlighted again the importance of a high degree of executive (including partner) engagement in the planning and execution of the audit.

We develop action plans for each audit, individual team members as well as actions that are firm wide to respond to the root causes identified. These action plans are discussed with and challenged by the Head of Audit before being approved. During the year we have worked on accelerating the implementation of firm wide responses to root causes identified. We continue to share the findings identified by the root cause analysis with the practice on a regular basis. We are also continuing the use of extensive focus groups to test out the root causes identified and proposed actions identified in response to these.

We are pleased that there are no key findings in this area and that areas of good practice have been identified. Recognising the importance of good root cause analysis to drive continued improvements in audit quality, this will remain a priority for us.

## 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 had no key findings to report.

### Good practice



We identified the following areas of good practice:

- **The amount of mandatory training provided at the manager grade:** EY mandates training at the milestone of becoming a manager and on completion of one year in the role. This training is a good addition to the annual update training provided to all qualified auditors.
- **The illustrative audit procedures for auditing the allowance for expected credit losses:** The firm issues good guidance on illustrative audit procedures, including examples of probing questions that can be used to challenge audited entities on the allowance for expected credit losses.
- **The disclosure guidance provided to teams performing banking audits:** The disclosure guidance is of a high standard and includes the EY "Good Bank" publication which provides illustrative examples of good practice disclosures.

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.

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 had no key findings to report in respect of audit methodology and training.

## Firm's response and actions:






We continue to invest significantly in training. Training curricula are reviewed each year to reflect the current needs of the business, taking account of inspection findings, new audit and accounting standards and other regulatory changes. All partners and staff are set minimum continuing professional development requirements in relation to accounting and auditing topics.

The period under review has been challenging as we have dealt with the new accounting standards identified above as well as providing extensive guidance on the implications of Covid-19, including the enhanced procedures required to respond to increased going concern risks. Therefore, we are pleased that the significant investment we have made has been recognised by the FRC with no key findings in this area alongside some areas of good practice noted.

## Firm-wide key findings and good practice in prior inspections

The following table summarises the firm-wide findings and good practice 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.

Key findings in previous public report 	Update on firm's actions in response 	Good practice 
<p><b>Partner and staff matters (2019/20):</b> Processes 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"> <li>Improvements to certain matters are required relating to the global performance management system (LEAD) implemented in 2017/18.</li> </ul>	<ul style="list-style-type: none"> <li>The firm issued guidance and a training video to ensure that the documentation of how quality has been assessed (as part of performance) is robust.</li> <li>Senior staff must include actions arising from adverse findings when setting their objectives.</li> <li>RCA is performed on all adverse quality findings. Actions coming out of RCA are captured and tracked to ensure they have been completed.</li> </ul>	<ul style="list-style-type: none"> <li>Link from audit quality to partner remuneration - we saw clear evidence that audit quality results are incorporated into long-term remuneration for partners.</li> <li>Manager promotion process - all candidates are required to attend and pass a formal assessment centre. The assessment of readiness for manager promotions is more robust than what we have observed at other firms.</li> <li>Partner portfolio reviews - the firm has a thorough process for the central review and monitoring.</li> </ul>

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We did not raise any other key findings in 2018/19 or 2019/20. The following observations were highlighted as good practice in relation to our firm-wide inspection work:

**Acceptance and continuance procedures (2019/20)**



- There is clear evidence of direct Board involvement in monitoring, oversight and challenge of high-risk audits.

**Quality Control matters (2018/19)**



- The firm centrally monitors consultation on high-risk clients on a quarterly basis and investigates where no consultation has occurred.

# Appendix 1

## Firm's internal quality monitoring

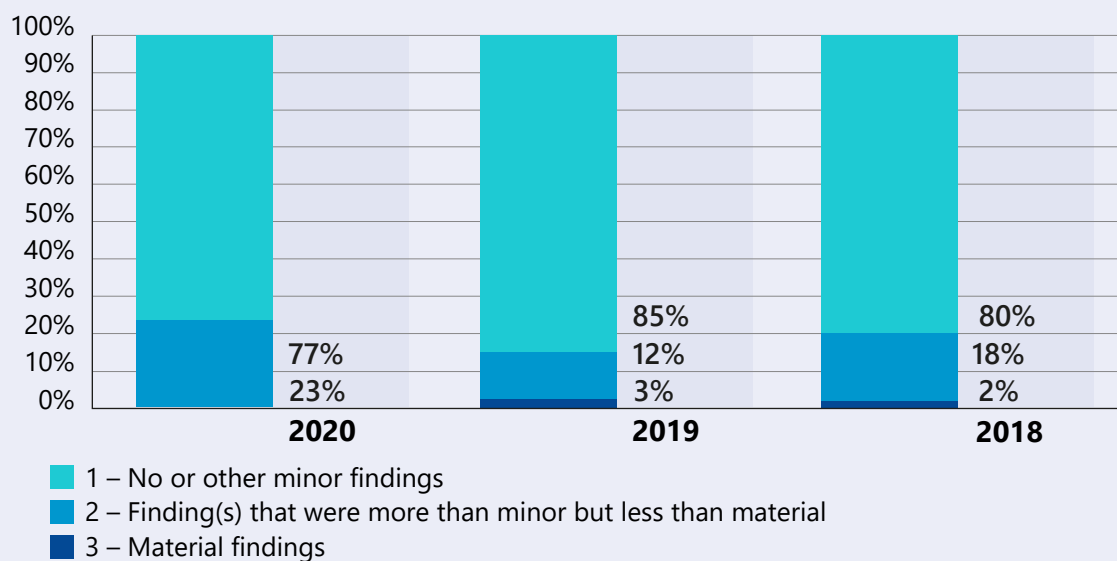
This appendix sets out information prepared by the firm relating to its internal quality monitoring for individual audit engagements. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified 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 Review (internal AQR), which comprised internal inspections of 87 individual corporate audits along with the results for the previous two years. The majority of the audits reviewed had year ends between March 2019 and March 2020 but also included nine December 2018 year-ends, where the signing of the December 2019 opinion was delayed due to the impact of the Covid-19 pandemic.



Minor findings are generally limited to cases where additional explanation or documentation is required for clarity of the audit file. More than minor findings typically require more detailed documentation improvements or arise when a piece of audit evidence was omitted from the audit file. Material findings either require additional audit procedures to be performed subsequent to the audit opinion or significant remediation of the audit file.

## Firm's approach to internal quality monitoring



The firm's internal inspection program considers the full population of audits performed. The internal AQR is designed to cover each individual responsible for signing audit opinions at least once every three years, and every FTSE 350 audit at least once every six years. Inspections are conducted by EY professionals from offices other than those in which the audit was undertaken, as well as a significant proportion of reviewers drawn from other EY member firms outside the UK. The reviews are subject to oversight from senior partners of other EY member firms in order to ensure the rigour, integrity and consistency of the process. In light of the challenges of Covid-19 in 2020, all reviews have been performed remotely but still maintaining the principle of being conducted by professionals from outside the EY office being reviewed and moderated independently of the UK firm.

The firm undertakes RCA of the findings from all audits reviewed in the internal AQR with more than minor findings (2 rated) or material findings (3 rated), as well as a sample of audits where good practice was identified. The results of the RCA are fed back into the firm's audit quality strategy.

At a minimum, for audits where a material finding is identified, the firm considers if the audit file requires remediation and, where required, performs additional audit procedures. In addition, in all such cases, action plans are drawn up aiming to ensure the same issues do not recur on those audits in the following year.

In 2020 there were no audits with findings equivalent to an FRC significant improvements required rating.

## Internal quality monitoring themes arising



Within the '2' graded engagements there are some findings that, whilst not concluded as material, have a greater significance. In the 2020 internal AQR these findings related to the following topics: Missing evidence of appropriate supervision and review of audit procedures performed; insufficient documentation of audit procedures performed in relation to the audit of taxation; omission of an "other matters" paragraph in the audit report; and insufficient follow up on variances noted while performing substantive analytical review procedures. The findings with greater significance and the material findings from the 2019 internal AQR related to: Missing evidence of appropriate supervision and review of audit procedures performed (also identified in 2020); insufficient documentation of audit procedures performed in relation to the audit of taxation (also identified in 2020); audit procedures performed in relation to five substantive areas (inventory existence, revenue, trade receivables, payroll and investments); and component team reporting to a primary team.

## Firm's actions



We are pleased that there were no audits with material findings identified in the 2020 internal AQR. Disappointingly we have seen a reduction in the total number of audits with no or minor findings (1 ratings). We have undertaken a major redesign of our audit quality strategy and see this as fundamental to improving audit quality in all audits and therefore increasing the number of audits with no or minor findings.

The results of our internal AQR process indicate a higher percentage of audits inspected as having no or minor findings than those reviewed by the FRC. The internal AQR process covered 87 audits this year and with every audit carried out by EY in its scope. The internal AQR process is therefore reflective of the full population of audits we undertake. The audits selected by the FRC for review (19 completed in the current year) are predominantly drawn from the population of listed and PIE company audits we perform, in line with the scope of its inspections disclosed on its website. As set out on page 3 of this report the FRC also focuses on those audits which it sees as higher risk.

We have carried out RCA on 29 of the audits covered by the internal AQR process. The RCA covered all 2 rated audits as well as nine audits that were identified as particularly high-quality audits with no or one minor finding.

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The RCA of positive review outcomes identified that the most significant contributor was a high level of involvement by senior team members (including partners). We also identified that those audits with particularly high quality tended to have a focus on coaching and supervision (including knowledge sharing) and effective project management. These themes are consistent with those noted in the prior year.

Conversely for those audits with more than minor findings the RCA identified a number of underlying causes which included:

- Failures in the detailed review. Effective detailed review should have identified inadequacies in either the quality of the underlying documentation or the appropriateness of the procedures performed.
- Failure to review and understand available guidance, which in certain instances included following an approach developed in prior years.

The most common internal AQR findings and the actions needed to prevent these findings from recurring, along with the output from the RCA, were communicated to the practice in mandatory training sessions. The output from our RCA on our internal inspections is then an input into our overall audit quality strategy and related actions.

The factors identified as contributors to high audit quality remain key programmes for the firm. Our milestones programme is designed to ensure that there is appropriate and timely involvement in the audit by senior team members supported by good project management throughout the audit. The importance of both coaching and executive involvement continues to be emphasised by one of the key priorities of our audit quality strategy which built around our PLOT methodology.

The key priorities of our audit quality strategy include a workstream focused on quality control. In response to the specific root causes for issues identified we have carried out targeted training on conducting high quality review processes and we have supplemented our guidance in areas where this was required. We have also increased the number of auditors in the practice.



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## 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 ARGAs 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 firms<sup>9</sup>, 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.

<sup>9</sup> 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 areas<sup>10</sup>:

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

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)<sup>11</sup>. 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.

<sup>10</sup> [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)

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



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