



Financial Reporting Council

# Major Local Audits

## Audit Quality Inspection

October 2021

## The FRC



The purpose of the FRC is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.



We have responsibility for the public oversight of statutory auditors.



The FRC engages with key local audit stakeholders, such as DLUHC, NAO, ICAEW, CIPFA and PSAA in order to contribute to sector wide initiatives and governance.



## AQR



We monitor audit quality of major local audits (which include the larger health and local government bodies).



We promote continuous improvement in audit quality.



Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms completing major local audits.

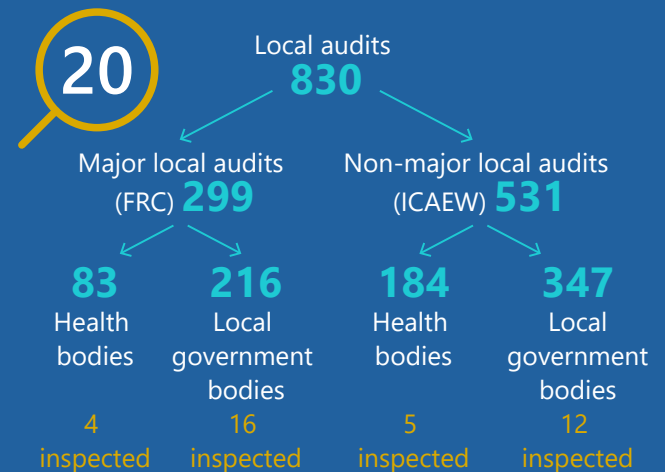


## The Firms



Audit firms undertaking local audits	Number of major local audits (within scope of AQR inspection)	Market share %	Reviewed by AQR in 2020/21
Grant Thornton UK LLP	122	40.8%	9
Ernst & Young LLP	73	24.4%	4
Mazars LLP	46	15.4%	4
KPMG LLP	25	8.4%	1
BDO LLP	16	5.4%	1
Deloitte LLP	16	5.4%	1
PricewaterhouseCoopers LLP	1	0.2%	0
<b>Total</b>	<b>299</b>		<b>20</b>

## Our inspection process



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



We assess the overall quality of the audit work inspected.

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The FRC's Purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.

We consider all reviews assessed as requiring improvements or significant improvements against the Regulated Framework for Auditing and under the Auditor Regulatory Sanctions Procedure (<https://www.frc.org.uk/auditors/audit-quality-review/auditor-regulatory-sanctions-procedure>). Where findings indicate that the Registered Auditor has failed to comply with the Framework, the FRC Enforcement Committee can sanction an audit firm for such breaches under the procedures or may refer the conduct in question for consideration under the FRC Accountancy Scheme or the disciplinary procedures of the relevant Recognised Supervisory Body.

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The Financial Reporting Council Limited is a company limited by guarantee.

Registered in England number 2486368.

Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

The FRC is the independent body responsible for monitoring the quality of major local audits<sup>1</sup>, as defined by the Local Audit (Professional Qualification and Major Local Audit) Regulations 2014. This monitoring is performed by the FRC's Audit Quality Review (AQR) team. Our reviews of individual major local audit engagements are intended to contribute to safeguarding and promoting improvement in the overall quality of local audit in the UK. Audit firms are required to audit the financial statements and Value for Money (VFM) arrangements conclusion and exercise their additional powers or duties, as required, in accordance with the Local Audit and Accountability Act 2014<sup>2</sup>.

This report sets out the principal findings arising from the 2020/21 inspection of six of the seven audit firms completing major local audits in England (the firms). No audits were inspected at PricewaterhouseCoopers LLP in 2020/21. We commenced the inspections in January 2021 and concluded our fieldwork in July 2021.

Our report focuses on the key areas requiring action across the firms, in relation to major local audits, to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the various firms' audit work. Our findings cover matters arising from our reviews of both individual audits and the various firms' policies and procedures which support and promote audit quality.

High quality audit is essential to maintain stakeholder confidence by providing an independent, impartial view of a major local audit body's financial statements and arrangements in place to secure value for money. Poor auditing may fail to alert management, the public and other stakeholders to material misstatements (including those arising from fraud) or financial control weaknesses.

The combination of management not meeting their responsibilities in this respect and poor auditing could potentially put resources and jobs at risk. We have commented on our engagement with audit committee chairs on page 11. High quality audit matters and we will encourage all audit firms to implement the necessary changes to reach the required standards.

Of the 20 audits that we reviewed in the year across the six firms, four were health bodies and 16 were local government bodies. This included: Pension Funds – 5, County Councils – 5, Metropolitan Borough Councils – 3, City Councils – 2, and one London Borough. We reviewed 15 associated VFM arrangements conclusions, as Pension Funds have no separate VFM arrangements conclusion.

In addition, we reviewed two Foundation Trust audits for which NHS Improvement<sup>3</sup> has responsibility. The results of these inspections are not included in this report, as they are reported separately to NHS Improvement under a non-statutory reporting arrangement.

To provide a more holistic picture of audit quality, the report also includes other measures of quality at the firms. The Quality Assurance Department (QAD) of the Institute of Chartered Accountants in England and Wales (ICAEW) inspects a sample of the firms' local audits that do not meet the definition of a major local audit, the results of which are presented alongside ours.

The firms also conduct internal quality reviews. A summary of the firms' internal quality review results is included at Appendix 2.

1 The definition of a major local audit is one which meets the following criteria:

- Total income or expenditure of at least £500 million; or
- For a Local Authority pension scheme, at least 20,000 members or gross assets in excess of £1,000 million.

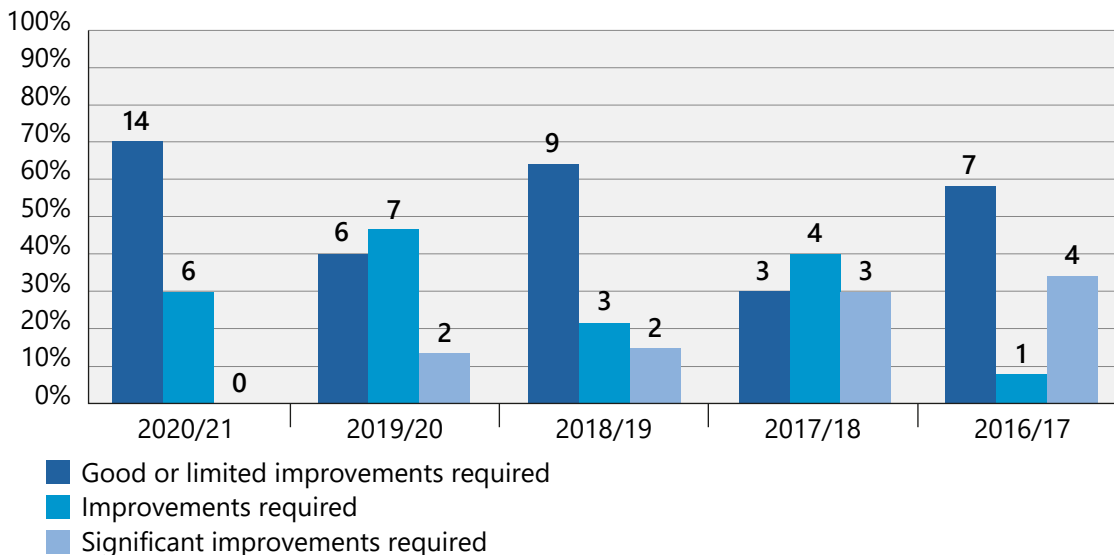
2 Further information on auditors' additional powers and duties is available in Auditor Guidance Note 4 issued by the National Audit Office (NAO). <https://www.nao.org.uk/code-audit-practice/guidance-and-information-for-auditors/>

3 NHS Improvement is responsible for overseeing NHS Foundation Trusts, NHS Trusts and independent providers.

# 1 Overview

## Our assessment of the quality of audits reviewed

### All financial statement reviews – for the firms inspected



An audit is assessed as good or limited improvements required where we identified either no or only limited findings or concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more key findings. Significant improvements required indicates we had significant concerns, typically in relation to the sufficiency or quality of audit evidence or the appropriateness of key audit judgments. The quality results for 2016/17 to 2018/19 above and in the VFM chart include local audit inspection work completed by the FRC on a consistent basis to 2020/21, but under contract to Public Sector Audit Appointments Limited (PSAA) and reported publicly by them. Not all audit firms were inspected in each year.<sup>4</sup>

The purpose of the annual financial statements is to give members of the public, electors, those subject to locally levied taxes and charges, elected members, employees and other interested parties clear, reliable information about a local audit body's finances. This allows users to understand the financial position of the body and have confidence in the body's stewardship of public money and that it has been used and accounted for in an appropriate manner.

We reviewed 20 individual audits this year across six firms and assessed 14 (70%) of them as requiring no more than limited improvements. The number of audits reviewed was a planned increase from the previous year, to achieve our target number of reviews for local audit.

There has been an improvement in the number of audits requiring no more than limited improvements compared to the number of such audits identified in our 2019/20 public report. While it is too soon to identify this improvement as a trend, it is encouraging. We have seen tangible actions taken by the firms to respond to the previous quality issues that the FRC has identified and reported. It is imperative that the firms work to build on this progress, including addressing the key findings identified in this report, to ensure the observed improvement is

<sup>4</sup> In 2020/21 six firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2019/20 all seven firms were inspected.

In 2018/19 six firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2017/18 and 2016/17 five firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP or Deloitte LLP

# 70%

of audits required no more than limited improvements. While it is too soon to identify this improvement as a trend, it is encouraging.

We have seen actions taken by individual firms in response to our previous findings.

31 March 2020 year ends were reviewed by the FRC in the 2020/21 inspection cycle.

both permanent and continuous. Such continuous improvement is essential as overall local audit results in 2020/21 are now comparable to those on Companies Act inspections which we describe as falling short of our expectations.

We completed 20 audit and 15 VFM reviews in 2020/21, more than in previous years. 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 selection of audits for review was impacted by the challenges experienced by local auditors completing their local government audits to the target timetable. Figures published by Public Sector Audit Appointments Limited (PSAA) showed that 55% of 31 March 2020 audit opinions for local government bodies were not issued by 30 November 2020. We replaced half of the local government audits initially selected because the audits had not been finalised. The audits replaced included those that we considered the highest risk. In our next cycle, we are likely to select some 31 March 2020 audits that we were unable to review this year.

In addition, we were not provided with access to certain audit working papers for one of the audits we reviewed on the grounds that they were legally privileged, and the entity declined to waive privilege.

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.

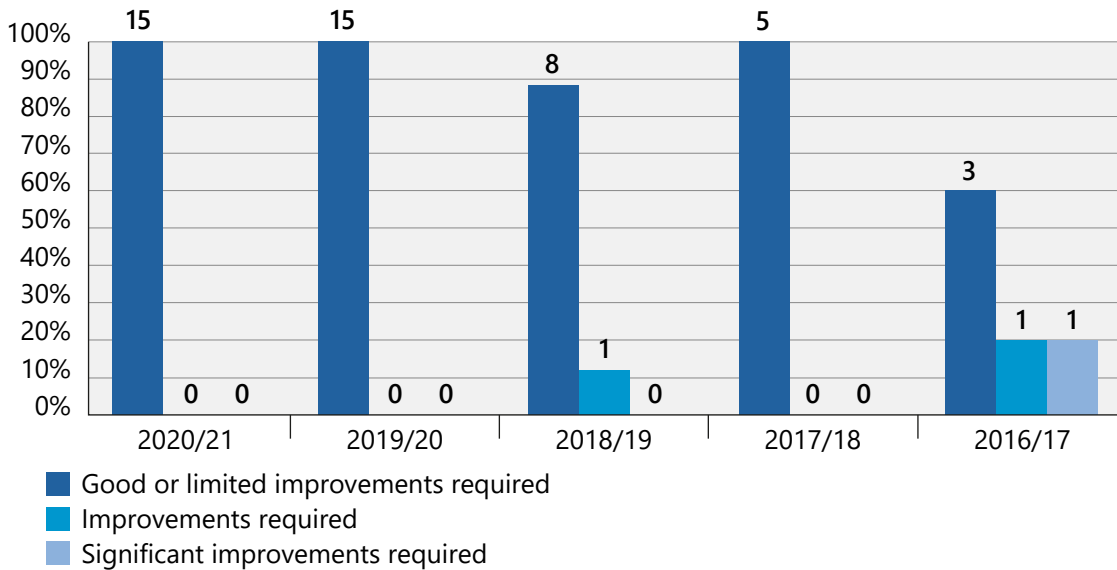
We take robust action for all reviews assessed as requiring improvements or significant improvements and will consider such audits for possible enforcement action.

# 55%

**of 31 March 2020 audit opinions for local government bodies were not issued by 30 November 2020. We replaced half of the local government audits initially selected for review because the audits had not been finalised.**

## Value for Money Arrangements Conclusion

### All VFM reviews – for the firms inspected



**100%**

of VFM arrangement conclusions required no more than limited improvements.

The Value for Money arrangements conclusion is the auditor's conclusion on whether or not a body has put in place proper arrangements to secure value for money in its use of resources.

Based on our reviews, the quality of work to conclude on VFM arrangements across all firms remains high. All 15 reviews were assessed as either good or requiring limited improvements and, as in the prior year, no reviews were graded as requiring improvements. We have raised few findings over the firms' work in this area across the past five cycles.

Audit firms will need to comply with the new National Audit Office (NAO) Code of Practice, applicable for the first time for 31 March 2021 year-end financial statements. The work of auditors in this area is being re-focused to:

- Promote more timely reporting of significant issues to local bodies.
- Provide more meaningful and more accessible annual reporting on VFM arrangements issues in key areas.
- Provide a sharper focus on reporting in the key areas of financial sustainability, governance, and improving economy, efficiency and effectiveness.
- Provide clearer recommendations to help local bodies improve their arrangements.

AQR will review the work of auditors under the new Code in the next inspection cycle, including how firms have changed their methodologies to meet the new requirements.



## Monitoring review by the Quality Assurance Department of ICAEW

The FRC granted ICAEW a recognition order as a recognised supervisory body (RSB) in November 2015. Under this framework, ICAEW is responsible for the licensing, registering and monitoring of auditors who carry out audits of local public bodies. Audit monitoring under the Local Audit and Accountability Act 2014 had a phased implementation. The first year (2019) of monitoring covered a firm's portfolio of local health body audits of years ended 31 March 2018. For subsequent reviews, monitoring has covered all local audits (local government and health bodies). ICAEW reviews audits outside the FRC's population. ICAEW does not undertake work on the firm-wide controls as it places reliance on the work performed by the FRC.

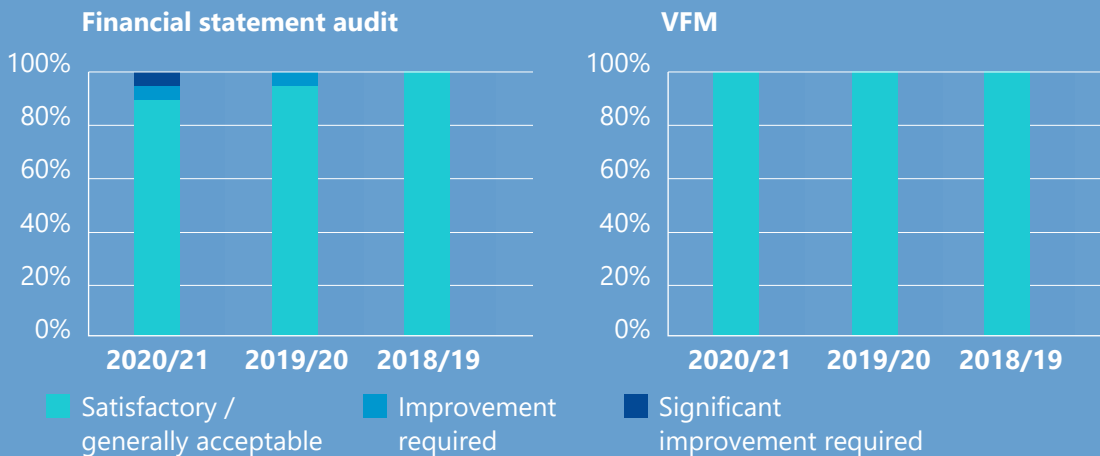
ICAEW's reviews are risk-based, with the aim of reviewing a representative sample of a firm's local audit portfolio over a six year cycle. ICAEW adopts a cyclical approach to the monitoring of registered local auditors.

ICAEW reviews are designed to form an overall view of the quality of the audit. Where applicable, both the financial statement opinion audit and work to support the VFM conclusion are reviewed. ICAEW assesses the audits it reviews as either 'satisfactory/generally acceptable', 'improvement required' or 'significant improvement required'. Visit [icaew.com/auditguidance](https://www.icaew.com/auditguidance) for further information about ICAEW's audit monitoring process including its approach to assessing audits.

ICAEW has completed its 2020/21 monitoring review and the reports summarising the audit file review findings and any follow up action proposed by the firms will be considered by ICAEW's Audit Registration Committee in December 2021.

# 88%

**Of the seventeen ICAEW financial audit reviews, fifteen were either satisfactory or generally acceptable**



### Summary

Overall, the audit work continues to be of a generally good standard. Of the 17 reviews, 15 were either satisfactory or generally acceptable. One audit required improvement and one audit required significant improvement. These results are not quite as good as the 2019/20 reviews when ICAEW graded 11 files satisfactory or generally acceptable, and one file required improvement.

Work to support the VFM arrangements conclusions continues to be of a good standard with all reviews being either satisfactory or generally acceptable in both 2020/21 and 2019/20.

ICAEW continues to identify and share examples of good practice across all of the firms subject to review.



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## Results of our inspection work

### Review of individual audits

For financial statement audits our key findings related to:

- Strengthening testing of expenditure.
- Improving the evaluation and challenge of assumptions used in investment property valuations.
- Improving the evaluation of assumptions used in property, plant and equipment valuations.
- The reasoning to support a modified audit opinion.

Our review of the work performed by auditors on the VFM conclusions identified no key findings.

### Good practice observations



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

- Delaying issuing the auditor's report until all required information was received.
- Challenge of management's property valuer to declare an undisclosed material valuation uncertainty.
- Use of an auditor's expert to help audit highly specialised property.
- Response to the risk of fraud in revenue recognition.

We identified good practice in the VFM arrangements conclusions we reviewed, as follows:

- The extent and timing of involvement by the audit partner on the VFM conclusion work.

### Review of firm-wide procedures

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

- Root cause analysis (RCA) process and audit quality initiatives.
- Audit training and methodology.
- Engagement Quality Control review (EQC).
- Prior period adjustments (PPAs).

### Root cause analysis process and audit quality initiatives

We focus on RCA and audit quality initiatives given the importance of taking effective action to address our previous inspection findings. AQR reviewed the firms' responses to these findings and considered the efficacy of actions taken through current year inspections.

We observed improvements at individual firms that were clearly linked to the implementation of quality action plans. This is a pleasing outcome.

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## Audit training and methodology

Key findings at individual firms related to:

- Ensuring audit practitioners complete their mandatory training on a timely basis.
- Increasing the amount of mandatory training audit practitioners are required to complete.

We identified one finding specific to local audit:

- The need to train local audit practitioners how to effectively evaluate key assumptions used in investment property and PPE valuations.

## Engagement Quality Control review

Our key finding related to the need to maintain focus on the robustness of EQC reviews given that:

- Some audits were assessed as requiring more than limited improvements despite having a reviewer.
- Some audits were allocated a reviewer who had themselves been assessed as needing more than limited improvements on one of their audits inspected by AQR in a previous year.

## Prior period adjustments

Our key findings related to the need for each firm to:

- Review arrangements to evaluate the underlying causes of PPAs for material error and determine the actions required to reduce future occurrences.
- Assess whether there is a need to enhance scepticism and challenge of audited bodies in areas where PPAs for material error are typically recorded.

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## 2 Review of individual audits and firm-wide procedures

### Audit selections

We aim to cover the population of major local audits with the same average frequency as our other Companies Act inspection activities.

Our selection of audits for review provided appropriate coverage of the audit firms in the market and aimed to select for inspection audits with higher risk attributes. Higher-risk engagements frequently require audit teams to assess and conclude on complex judgmental issues. We define audits as higher risk where the body:

- Is in a high-risk sector or geography.
- Is experiencing financial difficulties or reducing levels of financial reserves.
- Has balances with high estimation uncertainty.
- Has identified governance or internal control weaknesses.

We accept that our planned focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm. The change in our approach to audit selection over time also means that historical comparisons of results need to be treated with care, although we have taken the same approach for the last two years.

Our planning of local government reviews was impacted by the 55% of opinions that were not issued by the target date of 30 November 2020. Of the 16 local government audits we initially selected on the basis of risk, eight had to be replaced because the audits were not finalised. The audits we had to replace included those where auditors had exercised their additional powers and were those we considered the highest risk. We selected replacement reviews from 31 March 2020 audits only, to allow us to assess the improvements made by firms in response to our previous findings.

These factors combine to require care in interpreting the results of our inspections.

### Engagement with those charged with governance

We aim to engage in a two-way process to assist those charged with governance in ensuring the highest levels of audit quality and holding their auditors to account.

We offered to speak with all audit committee chairs, or other persons responsible for governance, for all 20 audits selected for review. One audit committee chair did not respond to our offer. Initial discussions focused on the role of the chair, areas of audit risk they focus upon and any concerns over the audit process. Following our reviews, we sent a private report to each chair and we plan to meet the chair again for those audits where the quality of the audit was assessed as requiring more than limited improvements.

**We accept that our planned focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm.**

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## Scope of individual inspections

The scope of individual inspections was risk-based. Areas of focus on individual inspections were informed by:

- The risks that resulted in the audit being selected.
- Discussions with audit committee chairs.
- Findings of previous inspections.
- Matters considered significant in the sector.
- The impact of the Covid-19 pandemic.
- The auditor's risk assessment.
- Matters identified in a body's financial statements.

Significant challenges were posed by the Covid-19 pandemic on the delivery of 31 March 2020 audits. The pandemic created practical difficulties for auditors with staff working remotely and experiencing difficulties carrying out audit testing and gathering audit evidence (for example, the inability to attend stock takes).

Examples of matters considered significant that we inspected included:

- The exercise of auditor's additional powers or duties.
- The disclosure of senior officer remuneration.
- The appropriateness of capital expenditure.
- Investment property valuation.
- In local government, adjustments between the accounting basis and the funding basis such as minimum revenue provision.

## 2.1 Financial statement audit

We set out below the key areas where we consider improvements in audit quality are required. As well as findings on audits assessed as requiring improvements, the key findings can include those on individual audits assessed as requiring limited improvements but considered a key finding for this report due to the extent of occurrence across the audits inspected.

### Strengthen audit procedures over expenditure

Auditors should undertake appropriate procedures to test the accuracy and occurrence of expenditure. The validity of recorded expenditure is important to users of the accounts as financial planning, including savings plans, is based upon it.

We raised findings on the testing of employee expenses on three audits, although in two audits only limited improvements were required. The findings assessed as requiring more than limited improvements were from one audit:

- Arithmetical errors and failure to test the completeness and accuracy of source data when performing substantive analytical procedures.
- Not evaluating or concluding on variances between recorded amounts and supporting documentation when performing tests of detail.

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We raised findings on the testing of other expenditure on six audits, although in four cases only limited improvements were required. The findings assessed as requiring more than limited improvements were:

- On one audit, not appropriately identifying the expenditure subject to the controls being tested and failing to test a sample size that met the firm's own requirements.
- On one other audit, not establishing a sufficiently reliable basis for setting the expectation when performing substantive analytical procedures.

## **Improve the evaluation and challenge of assumptions used in investment property valuations**

Accurate valuation of investment property provides users of the financial statements with assurance over a body's stewardship of public money. Valuations can assist users in holding bodies accountable for the decisions made when investing public money in property. The valuation of investment property is complex and involves the use of assumptions and the application of judgment. Auditors should evaluate and challenge those assumptions which could have a material effect on valuations.

We raised findings on three audits, although in one case only limited improvements were required.

On two audits more than limited improvements were identified due to either insufficient or no evaluation and challenge of key assumptions used in the valuation of investment property.

## **Improve the evaluation of assumptions used in property, plant and equipment (PPE) valuations**

PPE represents a significant asset on the balance sheets of most local audits. Auditors' materiality levels are typically low relative to the value of these assets and revaluations are usually identified by auditors as a significant risk. When concluding that PPE is not materially misstated, auditors are required to obtain more persuasive audit evidence the higher their assessment of risk.

The valuation of PPE is complex and involves the use of assumptions and the application of judgment. Auditors should evaluate and, if necessary, challenge the reasonableness of those assumptions which could have a material effect on valuations.

Of the nine audits that required more than limited improvements in our 2019/20 inspections, three (33%) have subsequently recorded a prior period adjustment for material error and three have not yet been completed.

Auditors have strengthened audit procedures over PPE during this year, for example by improving access to auditors' experts, embedding new work programmes, and providing training. However, we identified more than limited improvements required on four audits. Three of these audits also had other key findings. Findings requiring more than limited improvements were:

- On three audits, insufficient evaluation and, if necessary, challenge of the key assumptions used in the valuation of PPE. This included commercial property held as PPE.
- On two audits, insufficient audit procedures had been performed over properties not revalued in the year to conclude that they were free from material error.

**From our 2019/20 inspections, three of the nine audits (33%) identified as requiring more than limited improvements in the audit of PPE valuations have subsequently recorded a prior period adjustment for material error and three have not yet been completed.**

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## **Ensure modified audit opinions are supported by reasoning that reflects the underlying audit evidence**

An auditor forms an opinion on the financial statements by evaluating the audit evidence obtained, modifying their report if sufficient audit evidence cannot be obtained to conclude that the financial statements are free from material misstatement. Audit teams must ensure that modified audit opinions are supported by clear reasoning that is consistent with the underlying audit evidence. We identified improvements required on one audit where there was insufficient evidence to support the auditor's reasoning for issuing a modified opinion.

The audit file concluded that assurance had been obtained over part of an inventory balance through attendance at a stock take. The remaining untested inventory balance was immaterial. During our inspection we were informed that alternative conclusions were drawn, and that sufficient assurance had not been obtained over any part of the balance. The conclusions not on file were relied on when modifying the audit opinion. No contemporaneous evidence of the final conclusions or basis for them exists.

## **Improve evidencing of technical panel discussions and conclusions as part of the audit evidence**

Technical consultation between audit teams and technical experts or senior partners in firms is important in ensuring that difficult or contentious matters are appropriately addressed, and that the audit team's conclusions are supported by the audit evidence.

We identified improvements required on one audit where the team's initial position was reversed by the consultation panel giving rise to a modified audit opinion. No contemporaneous evidence exists to explain the basis for the final conclusions drawn.

## **Management override of controls – testing of journal entries**

Management override of controls is presumed to be a significant risk and a fraud risk on all audits. The level of risk varies, but this risk is present in all entities and appropriate testing should be performed.

Auditors are required to design an appropriate response to this risk, which must include testing of journal entries.

We raised key findings in this area last year and auditors have made improvements. Encouragingly, no audits were identified in the current year that required more than limited improvements in this area. However, we identified nine audits that required limited improvements. Our findings included:

- On six audits, insufficient rationale for thresholds used to select journals for testing.
- On the same six audits, insufficient assessment of the risk presented by journals below thresholds that had fraud risk characteristics identified by the auditor.

## Good practice observations



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

- **Response to revenue recognition risk:** we identified two examples where auditors gave particularly thorough consideration to how the risk manifested itself in each material revenue stream. This led to a proportional response to this presumed significant fraud risk, including in one case a rebuttal of the risk.
- **Disclosure of the impact of Covid-19:** the auditor insisted that management disclose the significant uncertainties arising as a result of Covid-19 within the financial statements and appropriately included an Emphasis of Matter in the audit report drawing attention to these disclosures.
- **Robust procedures relating to issue of the audit report:** the auditor delayed issuing their audit report until appropriate evidence was obtained and evaluated by the audit team. An audit adjustment made as a result was material in one case.
- **Robust response to internal audit findings:** The team performed robust audit procedures to respond to control deficiencies identified by internal audit over supplier mandate changes.
- **Challenge of management's property valuer:** the audit team communicated with the valuer to understand why their report did not include a material valuation uncertainty related to the impact of Covid-19 on property valuations. As a result of this challenge, the valuer's report and financial statement disclosures were updated to include a material valuation uncertainty.
- **Use of an auditor's expert to assist with the audit of property valuations:** the team appropriately evaluated the competence, capabilities and experience required to audit a highly specialised property held by a consolidated company. It engaged an auditor's expert to provide support in testing the valuation which enhanced the team's audit evidence in this higher risk area.

## 2.2 Value for Money arrangements conclusion

In our review of the VFM conclusion work performed by auditors, there were no key findings giving rise to any audit being assessed as requiring more than limited improvements.

In a number of cases, we identified limited improvements required in the evidencing of judgments made during VFM risk assessments but none of these findings were assessed as significant enough to require more than limited improvements. It is, however, an area that all firms should maintain a focus on in future.

## Good practice observations



We identified the following example of good practice in the work reviewed:

- **The extent and timing of involvement by the audit partner on the VFM conclusion:** we saw detailed involvement in all aspects of the work and, importantly, upfront time spent in thoroughly reviewing the risk assessment, which clearly evidenced the audit partner's evaluation of all relevant matters.

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## 2.3 Review of firm-wide procedures

In this section, we set out the key findings we identified in the firm-wide work conducted this year. Our firm-wide work primarily focused on:

- Root cause analysis (RCA) process and audit quality initiatives.
- Audit training and methodology.
- Engagement Quality Control (EQC) review.
- Prior period adjustments (PPAs).

The reason for the focus on audit quality initiatives and RCA is the importance of taking effective action to address recurring inspection findings.

Our firm-wide work covered all seven firms completing local audits.

### 2.3.1 Root cause analysis process and audit quality initiatives

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.

All firms have been performing RCA for a number of years. We reviewed the firms' RCA processes last year and in the current year have brought our view up-to-date by:

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

The key findings and good practice identified is reported in each firms' Audit Quality Inspection and Supervision report on UK Companies Act audits.<sup>5</sup>

We reviewed the RCA on all local audits we had assessed as requiring more than limited improvements in 2019/20. All four of the firms impacted use the same RCA processes as on UK Companies Act audits. The four firms developed actions to address our findings. We:

- Ensured actions were coherent and clear on how they would deliver continuous improvement and enhanced audit quality, linking to our findings.
- Assessed whether they included evaluation of required training.
- Conducted follow-up meetings with firms to discuss and challenge aspects of the RCA process and linked action plan.
- Considered, in hindsight, the efficacy of the RCA process and the actions taken with reference to current year inspection findings.

We observed improvements at individual firms that were linked to the implementation of quality action plans. This is a pleasing outcome.

Further commentary on individual firms is provided in Section 3, our review of individual firms.

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<sup>5</sup> <https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports>



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## 2.3.2 Audit methodology and training

Our inspection across the firms included an evaluation of each of the seven firms' policies and procedures. Key findings at individual firms were to:

- Ensure that audit practitioners complete their mandatory training on a timely basis.
- Increase the amount of mandatory training audit practitioners are required to complete.

The key findings and good practice identified is reported in each firms' Audit Quality Inspection and Supervision report on UK Companies Act audits.<sup>6</sup>

We identified one finding specific to local audit. We identified five audits where more than limited improvements were required to the audit work over investment property and PPE valuations. Four had key findings related to the evaluation and, if appropriate, challenge of valuation assumptions. In all cases the audit team, rather than an auditor's expert, performed the testing. Our recommendation is that all firms should:

- Provide training to local audit practitioners on how to effectively evaluate key assumptions used in investment property and PPE valuations.

## 2.3.3 Engagement Quality Control review

The scoping of EQC reviewers across the seven firms continues to see some variation. Four of the firms assigned an EQC reviewer to all of their major local audits. The remaining three firms appointed an EQC reviewer dependent on risk characteristics. In aggregate, 59% of major audits had EQC reviewer involvement compared to 32% in the last cycle. This is an encouraging response to the findings we raised in prior years. All firms are encouraged to keep the criteria for selection of EQC reviewers under evaluation as major local audits clearly benefit from the rigour and challenge applied.

The EQC process should ensure consistent high quality. AQR has identified audits which were allocated an EQC reviewer yet were assessed by us as needing more than limited improvements. Similar findings were identified by us in the prior year inspection cycle, and were recurring findings for at least one firm.

Our recommendations are that all firms should maintain focus on the robustness of EQC reviews as:

- Some audits were assessed as requiring more than limited improvements despite having a reviewer.
- Some audits were allocated a reviewer who had themselves been assessed as needing more than limited improvements on one of their audits inspected by AQR in a previous year.

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<sup>6</sup> <https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports>

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### 2.3.4 Prior period adjustments

Six of the seven firms issued audit opinions on financial statements containing a PPA for material error. The proportion of major local audit financial statements containing a PPA for material error was 16%. This was similar across all local audits. When compiling these figures, 13% of local audits were not signed so the final figures may show some variation.

Some PPAs were identified from the increased scrutiny by the audit team in areas we identified as key findings last year. All firms should aim to understand and address the underlying causes of PPAs for material error.

Our key recommendations are that all firms should:

- Review arrangements to evaluate the underlying causes of PPAs for material error and determine the actions required to reduce future occurrences.
- Assess whether there is a need to enhance scepticism and challenge of audited bodies in areas where PPAs for material error are typically recorded.

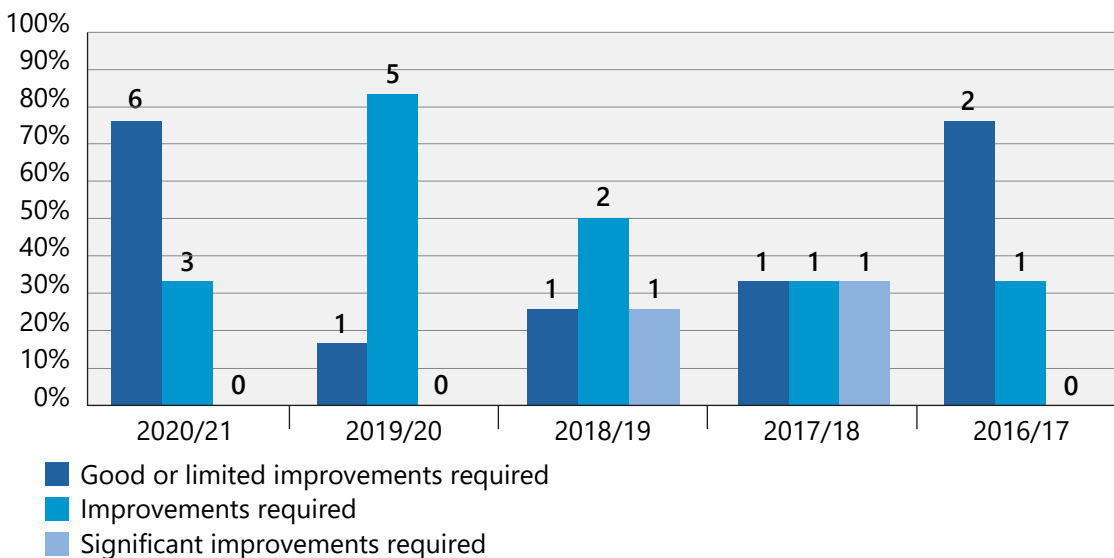
### 3 Review of firms

In this section, we set out our assessment of the three firms with the largest shares of major local audits: Grant Thornton UK LLP (nine audits reviewed), Ernst & Young LLP (four audits reviewed) and Mazars LLP (four audits reviewed).

We completed one audit review at three other firms (BDO LLP, Deloitte LLP and KPMG LLP) and these three results have been aggregated into one graphical summary and also presented below. These results are aggregated to avoid publicly identifying the results of individual inspections.

#### Grant Thornton UK LLP

##### Our assessment of the quality of audits reviewed – financial statements audit



**67%**

At Grant Thornton, six of the nine audits reviewed in the current inspection cycle were assessed as either good or limited improvements required.

The audit quality results for our inspection of the nine audits showed improvement, with 67% of audits assessed as requiring no more than limited improvements (17% in 2019/20). While too soon to identify this improvement as a trend, it is an encouraging response by the firm to the quality findings reported in the prior year.

In response to previous audit quality results, AQR increased the number of audit reviews by half (three additional reviews). When scoping the reviews in 2020/21, we considered prior year findings at the firm and assessed these findings as areas of focus.

AQR reviewed the firm’s Public Sector Quality Investment Plan (PSQIP), which was the firm’s response to our inspection findings from 2019/20. The plan included a combination of updated and extended guidance to auditors, additional training for audit teams and the implementation of new workbooks and audit tools.

In considering the most frequent findings from 2019/20, AQR:

- Reviewed the assessment and subsequent testing of fraud risks on all nine inspections and identified no key findings in this area. The AQR work included reviewing the audit that piloted the firm's new audit tool.
- Reviewed the audit of property valuations on all inspections with material property balances. We observed increased engagement of auditors' experts and the implementation of new workbooks to facilitate testing. Two audits were identified as requiring more than limited improvements in this area. Both related to insufficient evaluation of certain significant valuation assumptions. This testing was not performed by the expert.

AQR will continue to test the efficacy of the firm's actions from its PSQIP in our inspection cycle for 2021/22. This may include selecting higher-risk 31 March 2020 audits that we were unable to review this year due to the timing of audit reports.

The key findings in the current inspection cycle were:

- On one audit, there was insufficient audit evidence to support the audit team's rationale for issuing a modified audit opinion. This included not retaining notes or other evidence setting out the final conclusions of a technical panel that reversed the position initially adopted by the audit team.
- On a different audit, not evaluating the reasonableness of significant assumptions in investment property valuations.
- Not sufficiently evaluating, on a further audit, the reasonableness of certain significant assumptions in PPE valuations.

The firm should:

- Continue to perform a full RCA for each audit assessed as requiring more than limited improvements. This should help establish the reasons for individual instances of poor audit quality and how consistently high audit quality might be achieved.
- Consider the results from its internal monitoring and of inspections performed by QAD to establish if there are any other areas of concern.
- Consider our firm-wide recommendation to provide training to local audit practitioners on how to evaluate effectively key assumptions used in investment property and PPE valuations.
- Update its ongoing PSQIP for all findings and required actions from this inspection cycle.

We also recommend that the firm performs RCA on a sample of the audits assessed as good or limited improvements to identify practice that could have a positive impact on other audits.

Encouragingly, good practice points were identified on six local audits, including:

- Robust response to control deficiencies identified by internal audit.
- Challenge of management's valuer to disclose a material valuation uncertainty.
- Use of an auditor's expert to assist with the audit of a highly specialised property valuation.
- The extent and timing of involvement by the audit partner on the VFM conclusion.

All nine VFM arrangements conclusions that we reviewed were assessed as requiring no more than limited improvements (all good or limited improvement in 2019/20). This is a pleasing result.

# 100%

**At Grant Thornton, all of the VFM arrangement conclusions reviewed were assessed as good or limited improvements required.**



## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of Grant Thornton UK LLP

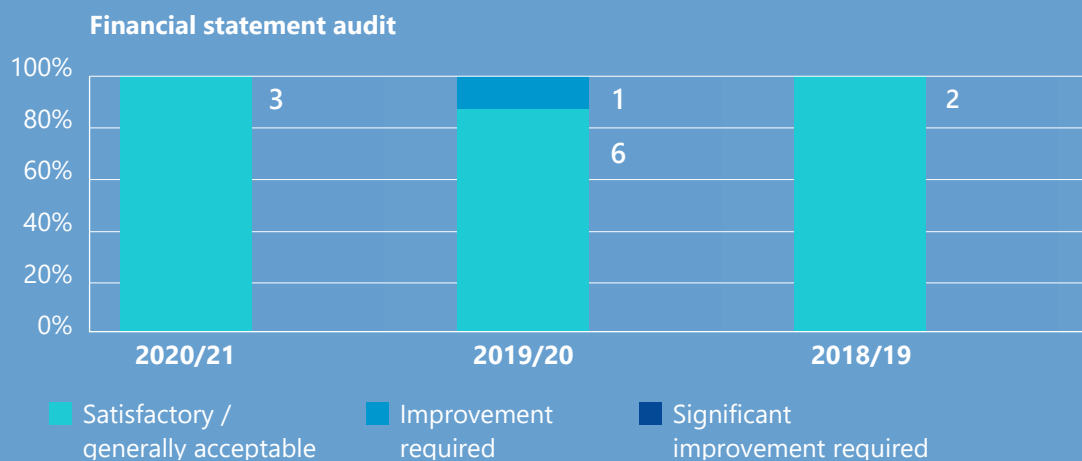
Audit work continues to be of a good standard in most areas, with all three audits assessed as generally acceptable.

These audits contained some weaknesses in audit evidence relating to Property, Plant and Equipment (PPE) valuations, weaknesses in the challenge of management in relation to the reasonableness of a bad debt provision, insufficient group analytics on a non-significant component and too long a gap between the date of the letter of representation and the audit report date.

The work to support the VFM arrangements conclusion was assessed as satisfactory on all three reviews.

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

The results of ICAEW's financial audit reviews for the last three years are set out below



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

# 100%

The three ICAEW financial audit reviews were either satisfactory or generally acceptable.

## Grant Thornton UK LLP's response to AQR and QAD reviews:



We are pleased that this year's inspection programme has found that our audit work has shown good improvement compared to previous years, with 6 out of 9 files inspected by the FRC and all 3 files reviewed by the QAD requiring only limited improvements. Our work on Value for Money has maintained the high standards of the previous years, with all 6 VFM files inspected by the FRC and all 3 inspected by the QAD requiring no more than limited improvement. We also note the good practice identified including in respect of specialist property valuations. Our focus now is on sustaining this high level of quality across all our audits. Over the past year we have continued to invest heavily in Public Sector Assurance in audit quality, in line with the approach adopted by the wider firm. We have expanded the size of both our Public Sector audit quality and financial reporting teams, and provided extensive training, guidance and support for audit teams. In terms of the key thematic issues raised by the FRC and QAD, we have made widespread use this year of auditor's experts for our valuation work on property, plant and equipment on our larger and more complex audits. We have also introduced a new and improved approach for journals testing, supported by the data analytics tool, Inflo.

Looking ahead, we are not complacent, and will continue to invest in audit quality. As part of our refreshed Quality Investment Plan, we are increasing the Director level input for our audit approach, regulatory and financial reporting work. We will also be increasing the extent of scope and coverage for our Engagement Quality Control Review work as well as increasing the scope of our second line of defence (Quality Support) work. We have strengthened our opinion panels through the involvement of the Head of Audit or her nominated deputy for any complex technical issues.

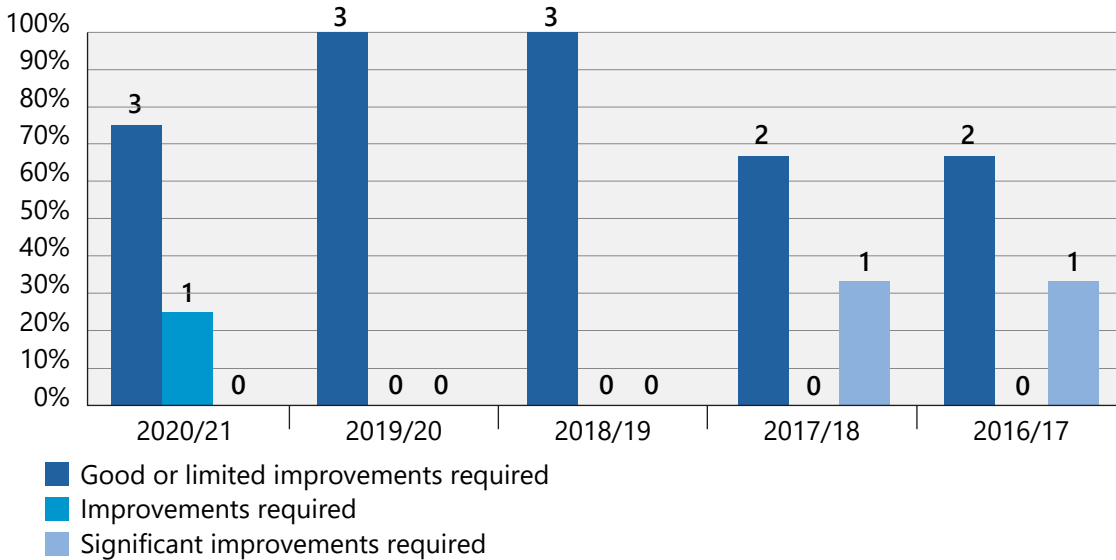
Specifically on the recommendations included in the report, we are taking the following actions:

- **Root Cause Analysis:** As last year, our RCA team will be undertaking full reviews for every audit subject to external inspection, as well as a programme of review for our internal monitoring. These will be used both to identify areas for practice wide improvement as well as good practices which can be shared.
- **Internal monitoring and results of other inspections:** We have already developed an action plan to respond to the findings of the current inspection round. Our internal monitoring programme will take place over the coming weeks and we will evaluate the results of this as soon as it is completed.
- **Evaluation of key assumptions in respect of Investment Property and PPE:** We will arrange training for our audit teams to support them in better undertaking this work. We will also engage with our expert valuers to provide support on an appropriate basis, including the targeted use of our valuation experts to consider selected property valuations' assumptions.
- **Update our quality improvement plan:** As outlined above, we have already refreshed our quality plan. We continue to invest heavily in audit quality, including the back office support for our teams, as well as the front line training and audit delivery tools.

We are committed to ensuring that we deliver local audits of the highest quality, serving the needs of taxpayers and users of local services. Whilst we recognise this is not an easy objective, it will continue to be our highest priority.

# Ernst & Young LLP

## Our assessment of the quality of audits reviewed – financial statements audit



The audit quality results for our inspection of the four audits assessed one as requiring improvements. No audits were assessed as requiring significant improvements.

In previous years, the firm had increased both local audit training and the rigour of its audit methodology. These actions have contributed to the improvements in the firm’s quality results since 2017/18.

The key finding in this cycle related to insufficient evaluation and challenge of the appropriateness of key valuation assumptions in investment property and PPE valuations. The firm should:

- Perform a full RCA on the audit assessed as requiring more than limited improvements. This should help establish the reasons for individual instances of poor audit quality and how consistently high audit quality might be achieved.
- Consider our firm-wide recommendation to provide training to local audit practitioners on how to evaluate effectively key assumptions used in investment property and PPE valuations.
- Consider the results from its internal monitoring and inspections performed by QAD to establish if there are any other areas of concern.

Good practice was identified on one audit related to insisting that management disclose the significant uncertainties arising as a result of Covid-19 within the financial statements and appropriately including an Emphasis of Matter in the audit report drawing attention to these disclosures.

All VFM arrangements conclusion reviews were assessed as good (all required no more than limited improvements in 2019/20). This was a very pleasing result.

**75%**

At EY, three of the four financial statements audits reviewed were assessed as either good or limited improvements required.

**100%**

At EY, all of the VFM arrangement conclusions were assessed as good.



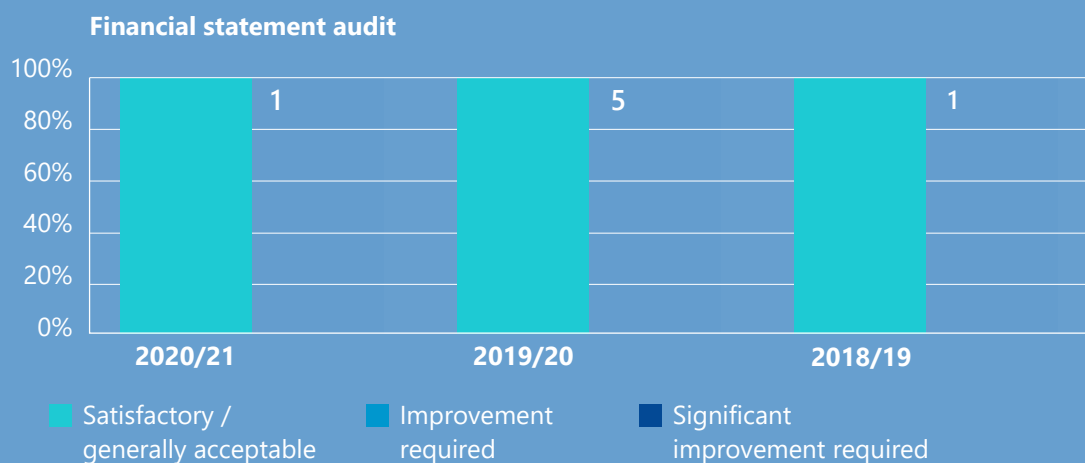
## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of Ernst & Young LLP

The quality of the firm's work on the financial statements audit reviewed was of a good standard, with no issues identified. The work to support the VFM arrangements conclusion was assessed as satisfactory.

ICAEW identified and shared examples of good practice on the audit reviewed.

The results of ICAEW's financial audit reviews for the last three years are set out below



# 100%

The one ICAEW financial audit review was either satisfactory or generally acceptable.

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



## Ernst & Young LLP response to AQR and QAD reviews:



The results of four out of five of the financial statement audit engagements reviewed by the FRC and QAD reflect the effort and investments we continue to make in delivering high-quality public sector audits. We are encouraged by examples of good practice identified within these files and that there were no themes identified in the findings on the files. We are also encouraged by the FRC and QAD inspection results achieved for our value for money conclusion reviews in the last 2 years.

We are disappointed that one engagement reviewed required improvements in a specific area of the audit. This audit fell short of our high expectations of audit quality. We welcome the insights and recommendations on areas for improvement noted in this report and are undertaking specific actions in response.

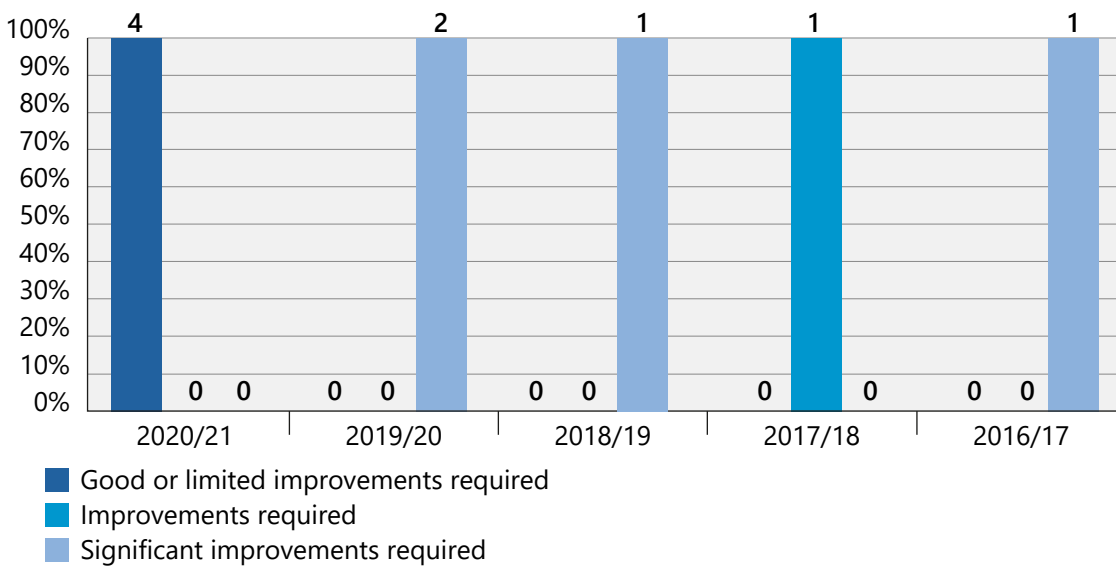
We have begun the root cause analysis (RCA) process and will be sharing lessons learnt (both positive and negative) and actions taken in response to the RCA with the practice to improve audit quality more broadly.

We have already communicated the results of the FRC and QAD reviews to the public sector audit practice highlighting the findings identified at the firm and how to avoid similar findings in future audits. In addition, the audit of PPE valuations was the topic of a sector specific training session run in the Spring of 2021. This training session was devised to share the experience, knowledge and best practices of the corporate audit teams who specialise in real estate audits. The audits reported on by the FRC and QAD in this inspection cycle were completed before this training was undertaken. In the autumn of 2021, we plan to build on this session with further training focussing on examples of good practice specifically in relation to the evaluation and challenge of the appropriateness of key valuation assumptions in investment property and PPE valuations. This training will be devised with the support of our real estate experts.

We continue to invest in audit quality with both sector specific training for our public sector audit teams and audit quality initiatives and training for all auditors across the UK firm. 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. The audits reported on by the FRC and QAD in this inspection cycle were completed before the launch of the redesigned AQ Strategy in Autumn 2020 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. Our AQ strategy continues to evolve and will incorporate the findings from these reviews. We know that embedding change takes time and will not all be achieved in one year.

# Mazars UK LLP

## Our assessment of the quality of audits reviewed – financial statements audit



The audit quality results for our inspection of the four audits showed significant improvement compared to the prior years, with all audits assessed as requiring no more than limited improvements. While it is too soon to identify this improvement as a trend, it is highly encouraging. The firm needs to maintain a focus on audit quality and ensure that this standard is achieved on future inspections.

In response to previous quality results, AQR determined it appropriate to increase the number of audit reviews to four. When scoping reviews, we considered prior year findings an area of focus.

AQR reviewed the firm’s Local Audit Quality Plan. The firm’s response to our specific review findings in the prior year was a combination of updated and clarified guidance to auditors, ensuring auditors had access to appropriate property valuation expertise, additional training or briefings for audit teams and the issuing of new or revised work programmes and workpapers. In addition, the firm’s quality plan included actions to address wider matters, including tone from the top, manager and partner behaviours, team working, staff development, accountability and audit resourcing.

The results of our inspections reflect positively on the efficacy of actions that the firm has taken. AQR will continue to assess these areas in our next inspection cycle, where we may also select higher-risk 31 March 2020 audits that we were unable to review this year due to the timing of audit reports.

It is also pleasing to report that on each of the four audits inspected we identified an area of good practice, these included:

- Demonstrating the robustness to delay issuing an audit report until appropriate evidence was obtained.
- Detailed consideration of how the risk of revenue recognition manifested.
- Evaluation and challenge of property valuations including comparison to third party data.

The firm should aim to maintain the observed improvement and consider the results of its internal monitoring and inspections performed by QAD to establish if there are any areas of concern.

All VFM arrangements conclusion reviews were assessed as good (all required no more than limited improvements in 2019/20). This was a very pleasing result.

# 100%

At Mazars, all of the financial statement audits reviewed were assessed as either good or limited improvements required.

# 100%

At Mazars, all of the VFM arrangement conclusions reviewed were assessed as good.



## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of Mazars LLP

Audit work continues to be of a good standard in most areas. Four of the five reviews were either satisfactory or generally acceptable. One audit required improvement.

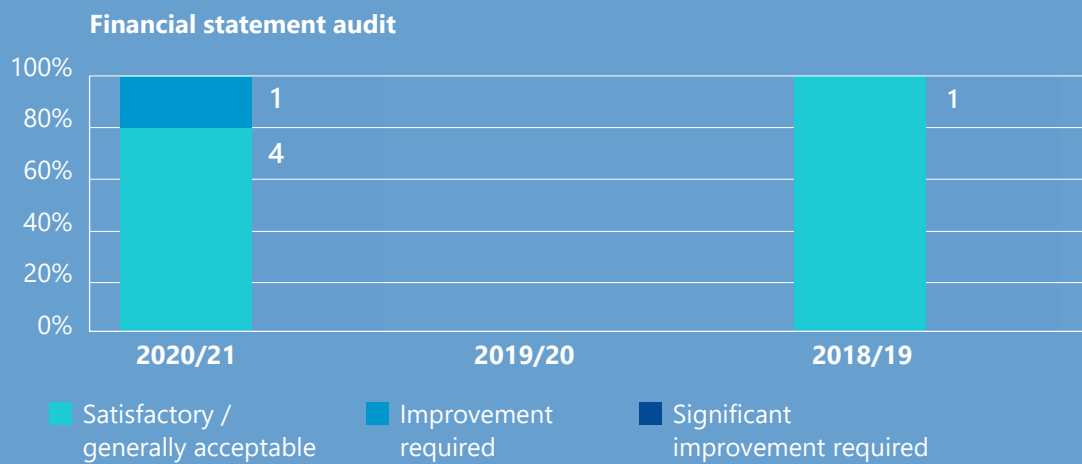
On the audit requiring improvement, there were a number of issues across the audit file. There was a lack of assurance over the allocation of housing stock, no record as to why management were happy that the auditors' challenge represented a materially accurate valuation to use as the basis of adjustment, inadequate evaluation of key assumptions in an expenditure substantive analytical review and insufficient consideration of whether a balance identified as not recoverable was an isolated issue.

On one audit assessed as generally acceptable, the audit report failed to cover a supplementary financial statement.

The work to support the VFM arrangements conclusion was assessed as satisfactory on all five reviews.

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

The results of ICAEW's financial statement audit reviews for the last three years are set out below



Note: Given the sample size, changes from one year to the next in the proportion of audits falling within each quality category cannot be relied upon to provide a complete picture of the firm's performance or overall change in audit quality. The firm was not inspected in 2019/20.

# 80%

**Of the five ICAEW financial audit reviews, four were either satisfactory or generally acceptable.**

## Firm's response to AQR and QAD reviews:



We are committed to the delivery of high-quality audits and welcome the FRC's findings in respect of our work in 2019/20.

In respect of the financial statements audit, we have responded robustly to the findings raised in previous years' reviews through our Local Audit Quality Plan (LAQIP). The actions we have taken to strengthen our teams, provide more detailed guidance and enhanced training, as well as access to property valuation expertise, have led to a step-change in the quality of our work. We are pleased to note the AQR's view that our results are indicative of the efficacy of the actions we have taken to improve the quality of our work.

Examples of good practice have been identified by both the AQR and QAD in relation to areas of the audits where weaknesses had been identified previously, including the audit of property valuations and our work on the valuation of defined benefit pension liabilities.

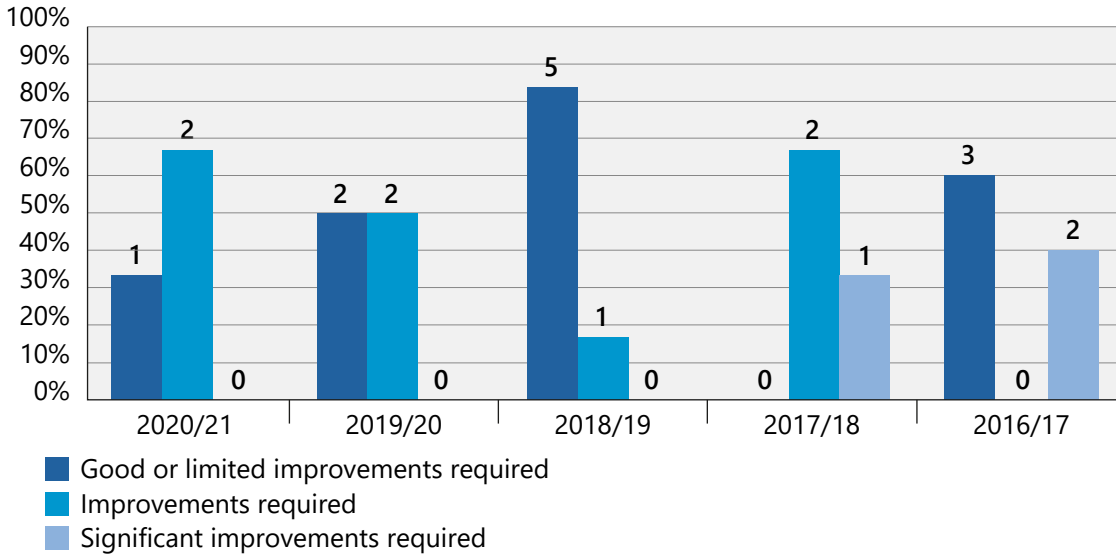
While we are pleased with the result of the 2019/20 AQR reviews, our commitment to quality means that we continue to invest in our teams, methodology and guidance, and technical support functions. Since the completion of the 2019/20 audits, we have recruited internal property valuation expertise and additional resource into our Audit Quality Team to lead the development of our local audit methodology and guidance. These actions and our plans to further invest in our local audit teams, leave us well-placed to continue our quality improvement plans as part of our 'No Compromise' quality agenda.

Our LAQIP will be refreshed following the completion of our root cause analysis process in respect of the single file that QAD identified as requiring improvements and will continue to provide a framework for our focus on continuous improvement.

AQR and QAD continue to assess our work on value for money arrangements to be of high quality and we are proud of our history of quality in this core element of local audit. We have updated our methodologies and internal quality assurance processes to ensure this quality is maintained as we undertake our value for money work under the revised Code of Audit Practice for the first time in 2020/21.

## BDO LLP, Deloitte LLP, KPMG LLP and PricewaterhouseCoopers LLP

### Our assessment of the quality of audits reviewed – financial statements audit



The above graph aggregates the financial statement audits reviewed for these four inspected firms. We conducted no reviews at PricewaterhouseCoopers LLP in 2020/21 and not all of the four firms were inspected in each of the years 2016/17 to 2019/20.<sup>7</sup>

Care is required in interpreting the results of our inspections. The grade profile of our inspection findings may not be representative of audit quality across the whole portfolio of this group of audit firms.

However, with two of the audits being assessed as requiring improvements, all firms will need to consider the implications for the quality of their ongoing audits, with a focus upon methodology and execution of this, particularly the application of challenge, in future audits.

For the two firms with audits assessed as requiring more than limited improvements in the prior year, AQR reviewed local audit quality action plans and when scoping reviews considered prior year findings an area of focus. Action at one firm included transferring public sector audits into the audit practice from the advisory service line. Public sector audits not being part of the wider audit practice had led to a lack of training, knowledge, and available staff to support a core team of public sector specialists.

AQR will continue to test the efficacy of actions in our next inspection cycle, where we may select higher-risk 31 March 2020 audits that we were unable to review this year due to the timing of audit reports.

<sup>7</sup> In 2020/21 three firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2019/20 all four firms were inspected.

In 2018/19 three firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2017/18 and 2016/17 two firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP or Deloitte LLP

# 33%

Across these three firms, two of the three financial statement audits reviewed required more than limited improvements. In response we are likely to increase the number of inspections performed at these firms.

# 100%

Across these three firms, all of the VFM arrangement conclusions reviewed were assessed as good or limited improvements required.

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All audits inspected had findings but only two had key findings. The key findings related to:

- On two audits, deficiencies in the audit procedures performed over employee expenses and other expenditure.
- On one audit, insufficient evaluation and challenge of the key assumptions used in the valuation of PPE.
- On two audits, insufficient audit procedures performed over PPE not revalued in the year to conclude that they were free from material error.

Each firm needs to consider these findings and ensure that the actions committed to are completed. The two firms with audits requiring improvements should submit a full RCA to AQR. All firms need to consider the results from their internal monitoring and from inspections performed by QAD to establish if there are any other areas of concern.

No instances of good practice were identified on these inspections.

VFM arrangements conclusion – each firm’s review was assessed as requiring no more than limited improvements (all required no more than limited improvements in 2019/20). This is a pleasing result.



## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of BDO LLP, Deloitte LLP and KPMG LLP

To be consistent with AQR's reporting, the results of ICAEW's reviews for these three firms have been collated in one section and presented in one graphical summary.

Two reviews were undertaken at each of BDO LLP and Deloitte LLP and four reviews undertaken at KPMG LLP.

At BDO LLP one review was of a good standard with no issues identified and one required significant improvement.

On the audit requiring significant improvement, there were gaps in evidence relating to the audit team's assessment of whether the credit risk on the financial instruments held at amortised cost had increased significantly since initial recognition. Additional assurance was necessary in evaluating the reasonableness of estimates applied in arriving at some Property, Plant and Equipment (PPE) valuations and the audit team needed to consider whether the financial instrument disclosures gave enough qualitative disclosure as to the nature and risks of the investments entered into.

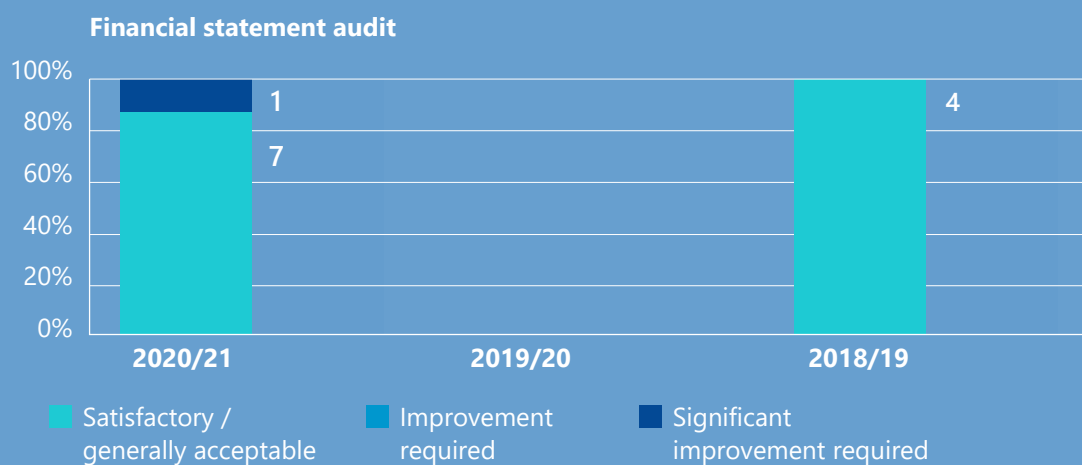
At Deloitte LLP audit work continues to be of a good standard in most areas. On the generally acceptable audit, aspects of the audit team's work on asset valuation had not been adequately recorded.

At KPMG audit work continues to be of a good standard in most areas, with all four files reviewed being generally acceptable. While we didn't identify any significant findings, we identified some weaknesses in audit evidence relating to PPE valuations on three of the four files. We also identified some isolated weaknesses in other areas relating to the work done to address the risk of fraud in expenditure recognition and housing benefit expenditure.

The work to support the VFM arrangements conclusion was assessed as satisfactory on all eight reviews.

ICAEW identified and shared examples of good practice across the audits concluded as satisfactory/generally acceptable.

The results of ICAEW's reviews for these three firms for the last three years are set out below



Note: Given the sample sizes at each firm, changes from one year to the next in the proportion of audits falling within each quality category cannot be relied upon to provide a complete picture of a firm's performance or overall change in audit quality. None of the three firms were inspected in 2019/20.

# 88%

Of the eight ICAEW financial audit reviews, seven were either satisfactory or generally acceptable.

## Firms' responses to AQR and QAD reviews:

### **BDO**

We note the findings from both the AQR and QAD during the period and are obviously very disappointed with the results of the audit assessed by QAD as requiring significant improvement. Audit Quality is a key focus of the firm and this is highlighted by the investment in our Audit Quality Plan and the appointment in the year of a Head of Audit Quality.

We acknowledge the need to ensure consistently high quality across all audits within the sector and are in the process of performing root cause analysis on the reviews noted in this report not only to identify the root causes of any issues but to also to enable us to emulate the good practice identified.

A number of actions have already been undertaken/are in the process of being undertaken to address the specific issues arising on the files reviewed in this area:

- Eight focused sessions 'Spotlight on Audit Quality' have been run by an experienced sector partner over the summer each focusing on specific areas of findings such as PPE Valuations and investment valuations.
- The central quality team have started attending the regular public sector learning seminars to discuss specific quality issues in this sector.
- The Public Sector Quality Team are developing a specific quality plan, using the firm's main Audit Quality Plan as a basis, for implementation in October 2021.

### **Deloitte**

Executing high quality audits remains our number one priority. We welcome the challenge provided by the AQR and QAD inspections and the findings help to inform our audit quality plan. We have performed independent root cause analysis on all of our external AQR and QAD inspections, including those which are assessed as good or needing limited improvements, in order to identify any actions to be taken in respect of findings and to assist us in identifying good practices and behaviours.

We note the areas of findings highlighted and we have taken, or are in the process of taking, wider actions within our audit practice to address these. Specifically, the audit approach and guidance in relation to property valuation across our local audits is in the process of being reviewed in response to regulatory findings in this area and the casual factors identified, and we expect to enhance the audit procedures in this area. We also hold regular AQR feedback meetings with all of our partners and directors to communicate recent inspection findings and common causes, as well as communicating all inspection findings to the wider audit practice. We have also held a number of sector specific 'deep dive' sessions one of which was focused on responding to findings from external and internal reviews.

### **KPMG**

We are pleased with the results we have achieved in the current inspection cycle. We have continued to invest heavily in our Audit Quality Transformation Plan in the period since the audits under inspection, which were delivered over a year ago, to continue to develop and enhance the foundations of audit quality within the firm. We remain focused on achieving consistent application of procedures and equipping our staff with the tools they require to deliver audits to the high standards expected of auditors. We have performed root cause analysis over all of the FRC and QAD findings from this cycle of inspections and have actions in place to address these.



## 4 Developments in local audit

### Response to the Redmond Review

At the end of 2019, the Ministry of Housing, Communities & Local Government (MHCLG)<sup>8</sup> announced that Sir Tony Redmond (former CIPFA President) would conduct an independent review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting (the Redmond Review).

The report arising from this review was published in September 2020. It concluded that the local audit market was very fragile and that without prompt action to implement its recommendations, there was a significant risk that audit firms would withdraw from the market. A key recommendation was the creation of a new regulatory body, the Office of Local Audit and Regulation (OLAR), responsible for procurement, contract management, regulation, and oversight of local audit.<sup>9</sup>

In December 2020, MHCLG delivered its response to the Redmond Review. MHCLG did not accept that a new regulatory body was required but the report set out the planned response to the recommendations, grouping them under five themes:

- Action to support immediate market stability.
- Consideration of system leadership options.
- Enhancing the functioning of local audit and the governance for responding to its findings.
- Improving transparency of local authorities' accounts to the public.
- Action to consider further the functioning of local audit for smaller bodies.

In May 2021, MHCLG published an update to its response, notably that the Audit, Reporting and Governance Authority (ARGA), the new regulator being established to replace the FRC, would be best placed to take on the role of local audit system leader.<sup>10</sup>

In July 2021, the Public Accounts Committee published its report entitled Local auditor reporting on local government in England. It summarised that "without urgent action from government, the audit system for local authorities in England may soon reach breaking point."<sup>11</sup>

MHCLG issued a public consultation on the proposed new regulatory arrangements in July 2021 and the FRC is working closely with the Department for Levelling Up, Housing and Communities to implement and effect these proposals.<sup>12</sup>

**Without prompt action to implement my recommendations, there is a significant risk that the firms currently holding local audit contracts will withdraw from the market.**

Sir Tony Redmond

8 In September 2021, the Ministry of Housing, Communities and Local Government (MHCLG) became the Department for Levelling Up, Housing and Communities (DLUHC)

9 <https://www.gov.uk/government/publications/local-authority-financial-reporting-and-external-audit-independent-review>

10 <https://www.gov.uk/government/publications/local-authority-financial-reporting-and-external-audit-spring-update/local-authority-financial-reporting-and-external-audit-spring-update>

11 <https://committees.parliament.uk/work/1138/timeliness-of-local-auditor-reporting-on-local-government-in-england/publications/>

12 <https://www.gov.uk/government/consultations/local-audit-framework-technical-consultation/local-audit-framework-technical-consultation>

## Timeliness of local auditor reporting

In March 2021, the NAO published its report entitled the Timeliness of local auditor reporting on local government in England, 2020. A key finding was the deterioration in the timeliness of bodies publishing audited accounts by the target date. The proportion of audits completed by the target date was 45% (2019/20), 57% (2018/19), 87% (2017/18), 95% (2016/17). This was despite MHCLG easing the target date for the completion of the 2019/20 audits from 31 July 2020 to 30 November 2020.

The report concluded that:

Since we reported on local authority governance and audit in 2019, despite efforts by the various organisations involved in the local audit system and by MHCLG, we can only conclude that the local audit system has worsened. The increase in late audit opinions, concerns about audit quality and doubts over audit firms' willingness to continue to audit local authorities all highlight that the situation needs urgent attention. This will require cooperation and collaboration by all bodies involved in the local audit system, together with clear leadership from government.<sup>13</sup>

The target date for completion of the 2020/21 audits was 30 September 2021. Figures compiled by PSAA showed that 9% of local government bodies' audits were completed by that date. PSAA also highlighted that the backlog of audits is a concern, with 70 of the 2019/20 audits still incomplete. This is disappointing and sector stakeholders need to address this as a matter of urgency.

## FRC engagement with annually inspected firms and other stakeholders to improve audit quality

We have increased engagement with government departments and other key stakeholders during 2020/21. These discussions and meetings with stakeholders have included the NAO, CIPFA, ICAEW and PSAA, together with participation in MHCLG Local Audit Monitoring Board meetings and the new Liaison Committee established to support the development of the systems leadership role.

The MHCLG Local Audit Monitoring Board (the Monitoring Board) has met quarterly and the FRC has been represented at all meetings. The FRC has two members on the Monitoring Board, one from the Professional Oversight Team and one from AQR. Other members of the board comprise key stakeholders responsible for delivery of aspects of the LAAA, such as the NAO (setters of the Audit Code for Local Auditors), CIPFA (responsible for the Accounting Code), PSAA (selected by most local government bodies to appoint auditors and negotiate audit fees on their behalf; formerly responsible for monitoring audit quality), the Local Government Association and other stakeholders. Registered audit firms conducting local audits are not permitted on the board.

MHCLG set up the Local Audit Capacity and Capability Working Group to consider proposals for delivering certain recommendations made by the Redmond Review. The FRC is represented on this group, created to respond to recommendations that:

- Statute be revised so that audit firms with the requisite capacity, skills and experience are not excluded from bidding for local audit work.
- All auditors engaged in local audit be provided with the requisite skills and training to audit a local authority, irrespective of seniority.

At an audit firm level, the FRC has continued regular engagement with the firms completing major local audits. This has included planning meetings before scoping the 2020/21 inspection cycle and regular updates and meetings throughout the inspection process.

<sup>13</sup> <https://www.nao.org.uk/report/timeliness-of-local-auditor-reporting-on-local-government-in-england-2020/>

# Appendix 1: Key local audit information

## Identifying major local audits

An analysis of available local audit data for 2020 identified 299 major local audits within AQR scope. The number of bodies changes annually as the definition of a major local audit is dependent upon meeting one of the following criteria:

- Total income or expenditure of at least £500 million; or
- For a local authority pension scheme, at least 20,000 members or gross assets in excess of £1,000 million.

The following table sets out the total number of local audits by sector, along with those assessed as meeting the major local audit definition. The audits for local government and other non-health bodies were awarded to five audit firms in five tiered tranches, following a full tender process conducted by PSAA. These audit appointments were made to cover five accounting periods, commencing with 31 March 2019. The table also sets out the number of major local audits subject to audit inspection by AQR.

No police and crime commissioners or other bodies (including fire and rescue authorities) were selected for review in 2020/21 because we reviewed a sample of these audits in 2019/20 with no significant findings.

Category	Total population	Major local audits	Reviewed by AQR in 2020/21
Health bodies (NHS trusts and clinical commissioning groups)	267	83	4
Local government councils	351	125	11
Police and crime commissioners & chief constables	75	14	0
Other bodies (including fire and rescue authorities)	59	4	0
Local authority pension funds	78	73	5
<b>Total</b>	<b>830</b>	<b>299</b>	<b>20</b>

## Audit firms completing local audits

There were seven audit firms that completed at least one audit of a major local body for the financial year ended 31 March 2020. The three firms with the largest market share of major local audits were Grant Thornton UK LLP, Ernst & Young LLP and Mazars LLP, with a collective share of 81%. All the firms involved, including the number of audits they completed, and their respective market shares were as follows:

Audit firm	Number of local audits	Market share %	Number of major local audits	Market share %	Reviewed by AQR in 2020/21
Grant Thornton UK LLP	315	38.0%	122	40.8%	9
Ernst & Young LLP	218	26.3%	73	24.4%	4
Mazars LLP	116	14.0%	46	15.4%	4
KPMG LLP	89	10.7%	25	8.4%	1
BDO LLP	53	6.4%	16	5.4%	1
Deloitte LLP	35	4.2%	16	5.4%	1
PricewaterhouseCoopers LLP	4	0.4%	1	0.2%	0
<b>Total</b>	<b>830</b>		<b>299</b>		<b>20</b>

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## Appendix 2: Firms' internal quality monitoring

### Results of firms' own monitoring

#### Background

This appendix sets out aggregated information relating to the seven firms' internal quality monitoring (IQM) for individual audit engagements. It should be read in conjunction with each firm's transparency report, which provides further detail of the internal quality monitoring approaches and results, and the firm's wider system of quality control. 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.

Due to differences in how inspections are performed and rated, the results of the firms' 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.

#### Firms' approach to internal quality monitoring

The firms' internal inspection programmes generally consider the full population of both major and non-major local audits performed. The programmes are varied but are usually risk-based as well as structured to cover Key Audit Partners over a fixed period of time. Audit files are selected for review based on a number of criteria, including risk and public interest. Reviews are supervised and reviewed by the firms' own internal quality teams.

#### Scope

The seven firms' IQM programmes, relating to local audit, covered 24 individual audits, of which 12 related to major local audits.

The aggregate number of major local audits covered by the firms' own IQM was less than that of the AQR and amounted to:

Coverage of all local audits 2.9%  
Coverage of major local audits 4.0%

Furthermore, not all firms reviewed the VFM arrangements conclusion work on each audit selected for review. One firm did not select any local audit files for review.

#### Results

In aggregate, the firms reported that across the 24 financial statement audits reviewed, 22 (91.7%) were of a good standard or required only limited improvements. There were two audits assessed as requiring improvements and no audits needing significant improvements.

For the firms' major local audits, 12 financial statements audits were reviewed and 11 (91.7%) were assessed as either good or requiring limited improvements and there were no audits assessed as requiring significant improvements.

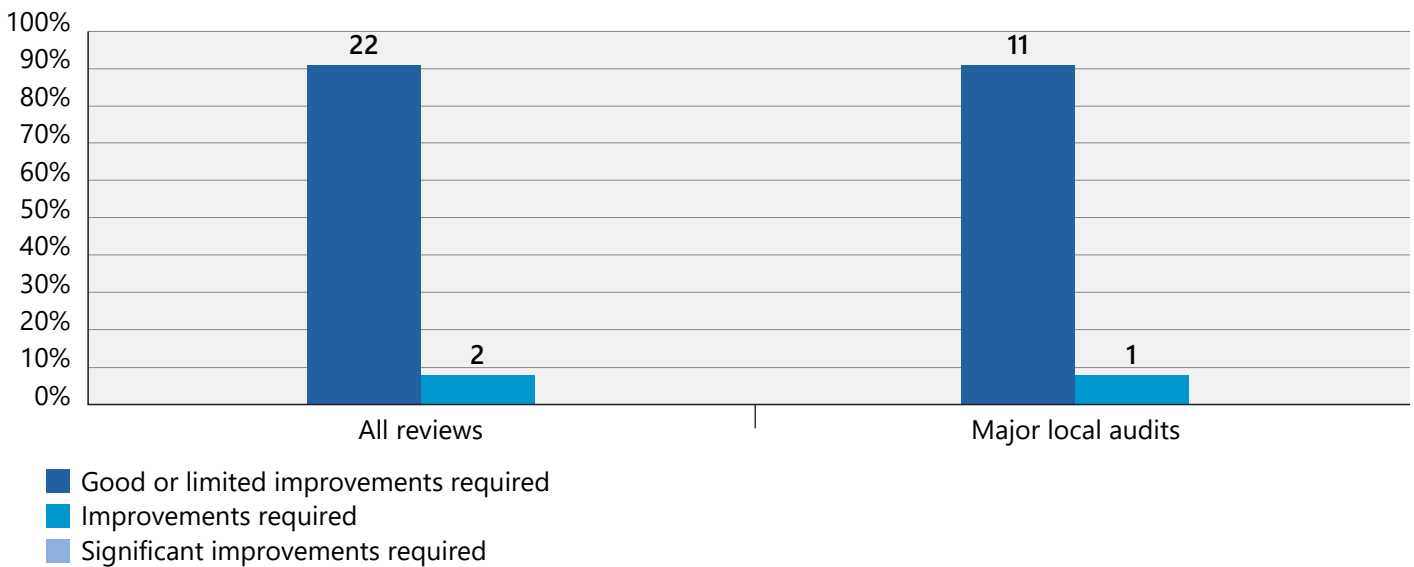
The firms reported that all VFM arrangements conclusions reviewed were of a good standard or required only limited improvements.

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The results of the firms' financial statement opinion reviews for local audits are set out below.

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### Aggregate of the firms' own internal quality monitoring



The firms' various IQM programmes generally use the same grading categories as AQR but where this is not the case, decisions on grading are aligned as closely as possible to those that would result from the AQR process.

The firms' results include a 31 March 2019 local audit reviewed by the firm as part of the current cycle of Internal Quality Monitoring where the 31 March 2020 audit was not complete.



Financial Reporting Council



**Financial  
Reporting Council**  
8th Floor  
125 London Wall  
London EC2Y 5AS  
+44 (0)20 7492 2300  
[www.frc.org.uk](http://www.frc.org.uk)