Guidance

Financial Reporting Council

May 2015

Audit Quality

Practice aid for audit committees

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Audit Quality Practice aid for audit committees

1 Introduction

Background

1.1 Many recent and forthcoming changes in the governance and auditing framework[1] continue to emphasise the fundamental role of audit committees in effective stewardship. Audit committees serve the interests of investors and other stakeholders through their independent oversight of the annual corporate reporting process, including the company's relationship with the external auditor.

1.2 In 2012, the Financial Reporting Council (FRC) introduced changes to the UK Corporate Governance Code that have encouraged audit committees to report about the work they do and their interactions with the auditor. The Code now contains a provision requiring the audit committee's annual report to include an explanation of how it has assessed the effectiveness of the external audit.[2]

1.3 The quality of reporting by audit committees on these matters can make an important contribution in building investor confidence in the quality of the external audit and ultimately in the credibility of the financial statements.

1.4 Anticipating the implementation of these changes, a report was issued in October 2013 by the FRC's Financial Reporting Lab[3] to provide insights from companies and investors on effective approaches to audit committee reporting, addressing both the content and style of reporting. These included suggested enhancements to reporting about a number of the matters audit committees are required to address, including the audit committee's explanation of how it has assessed the effectiveness of the external audit.

1.5 Many audit committee members have asked the FRC to provide some practical guidance on how they might conduct their assessment of the effectiveness of the external audit. In particular, they often suggest that it is relatively straightforward to assess service levels in the external audit process, but less so to assess audit quality.

Developing this practice aid

1.6 The FRC organised five roundtables where an approach to assessing the effectiveness of the external audit was field tested, with a focus on audit quality and the financial statement process. The roundtables included key market participants relating to companies with a UK Premium listing – including audit committee members, investors, financial management and auditors, who gave feedback on the proposed approach, and shared some of their own experiences and expectations.

1.7 This practice aid arose out of the feedback from those roundtables and is intended to provide audit committees with some guidance on audit quality and best practice that they may wish to consider as they design or update their own assessment processes.

1 This includes a revision to the UK Corporate Governance Code in September 2014 (a brief overview of the key changes to the UK Corporate Governance Code can be found at https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/September/FRC-updates-UK-Corporate-Governance-Code.aspx). Further Code changes will be likely in 2016 as a result of the Government's implementation of the EU Audit Directive and as follow up to the report by the Competition Commission (now the Competition and Markets Authority) on the market for audit services in FTSE 350 companies

2 Section C.3 UK Corporate Governance Code (Revised in September 2014)

3 The aim of this Lab project (Reporting of audit committees) was to provide further insight from companies and investors on effective approaches to audit committee reporting

1.8 Audit committees have wide-ranging, time-consuming roles and they bear a significant responsibility. Roundtable participants felt, therefore, that it was important to recognise that audit committees comprise non-executive directors who are not expected, and do not have the resources, to perform detailed procedures or to make comprehensive inquiries of the auditor or other parties about all aspects of the audit. Their assessment is therefore not an 'audit of the audit' and it does not involve them obtaining access to the auditor's working papers.

1.9 Roundtable participants also recognised, however, that members of an audit committee typically have a range of business and financial backgrounds, [4] which provide them with a collective ability to challenge the auditor to demonstrate that they have performed a high quality audit, and evaluate the auditor's responses through a variety of different lenses.

1.10 Roundtable participants generally suggested that the assessment should not be a separate compliance exercise, or an annual one-off exercise, but rather should form an integral part of the audit committee's activities. These allow it to form its own view on audit quality, and on the effectiveness of the external audit process, based on the evidence it can reasonably obtain during the year. This should both improve the effectiveness of their assessment and reduce the burden of their year-end activities.

Applicability

1.11 The FRC is keen to encourage audit committees to develop their own approaches to the assessment of external audit that are relevant to their circumstances, rather than recommending a particular path, or providing definitive guidance. The FRC does not intend that audit committees need to understand or apply all the guidance in the practice aid, but to have regard to it as relevant in the circumstances of the particular audit engagement.

1.12 While the practice aid is designed for audit committees of Premium Listed companies it may assist audit committees of other entities, particularly those adopting the Code voluntarily.

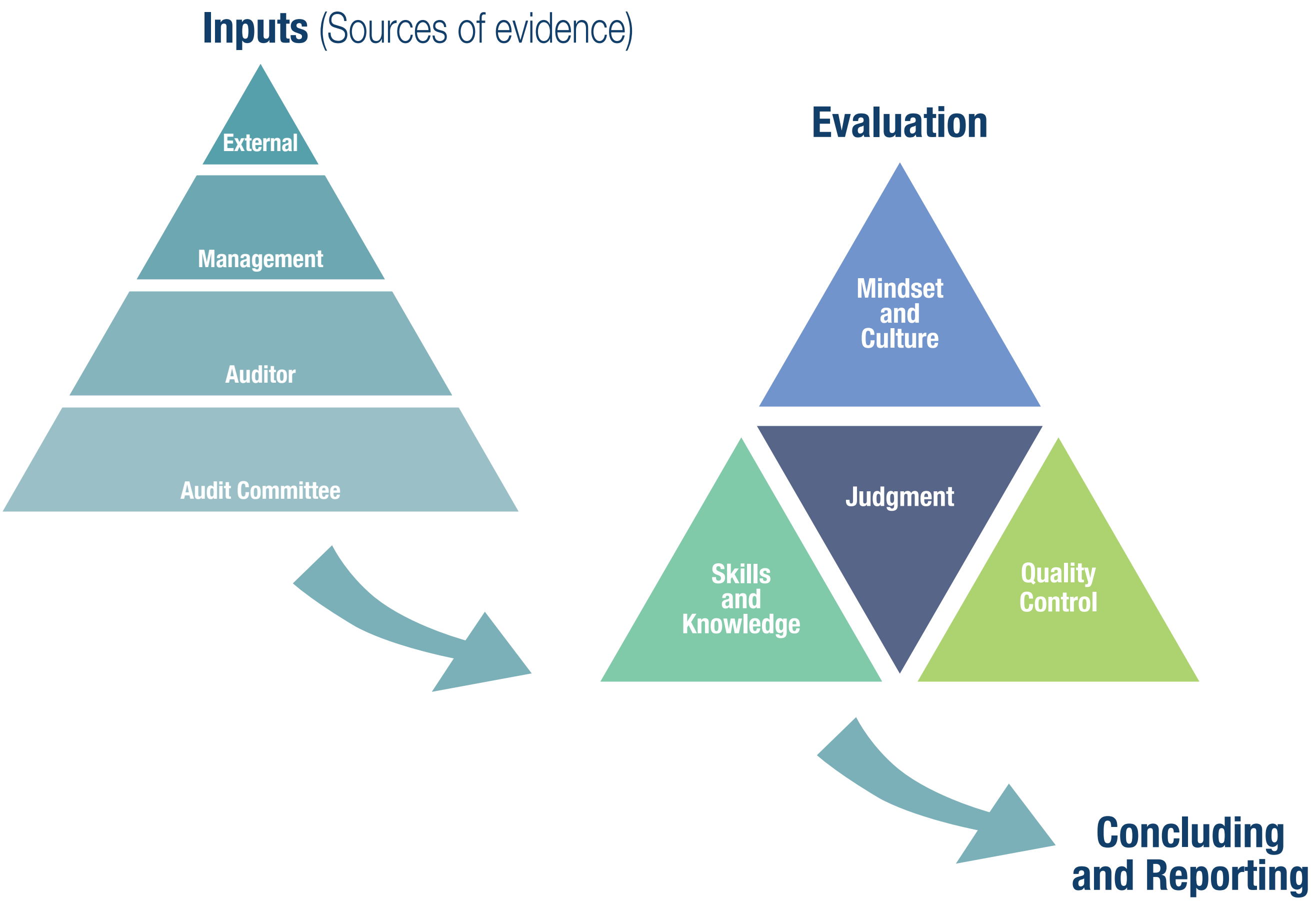
How the practice aid is structured

1.13 **Section 2** presents an **overview of audit quality**, highlighting factors that audit committees could consider when making their assessment and steps they could take in doing so. **Section 3** describes the **possible inputs (sources of evidence) for the assessment. Section 4** discusses the key professional judgments the auditor makes during the audit and how audit committees might assess them. **Section 5** describes three further elements that audit committees can **consider when evaluating the quality of their auditor:** Skills, Character and Knowledge; Mindset and Culture; and Quality Control.

4 Section C.3.1 of the UK Corporate Governance Code (Revised in September 2014) requires the board to satisfy itself that a least one member of the audit committee has recent and relevant financial experience. This provision overlaps with FCA Rule DTR 7.1.1 R

2 Overview of an assessment

Diagram 1: Overview of an assessment



Introduction

2.1 This section presents an overview of audit quality. It highlights factors that audit committees may consider when making their assessment of the quality of their external audit (and hence the effectiveness of the external audit). The roundtable discussions, provided feedback on the steps that committees could take when carrying out their assessment.

2.2 The 'evaluation pyramid' shown in Diagram 1 above, can be used to assess audit quality in the particular circumstances of the company. The evaluation is informed by the company's business model and strategy, the business risks it faces and the audit committee's perception of the reasonable expectations of the company's investors and other stakeholders.

2.3 A high quality audit is one that either achieves a high level of assurance that the financial statements comply with the financial reporting framework (or if necessary ensures they are amended to do so) or results in an auditor's report that communicates the auditor's disagreement or restricted ability to opine.[5] A high quality audit also complies with applicable laws and regulations (including relevant professional standards).

5 In the UK, the auditor's opinion is on whether the financial statements give a true and fair view in accordance with the framework. ISA 700: The Auditor's Report on Financial Statements (UK and Ireland) paragraph 18

Inputs (sources of evidence)

2.4 Roundtable participants suggested that the audit committee bases its assessment on inputs obtained in the course of undertaking its normal activities for oversight of the financial reporting process. The primary source of such evidence is likely to be its observations of, and interactions with, the auditors.

2.5 They also suggested that audit committees obtain important supplementary evidence through interactions with management and other key company personnel, such as internal auditors, and directly or indirectly from certain external parties such as regulators.

2.6 Section 3 provides more detail on some of the inputs that roundtable participants believed could inform the audit committee's assessment.

Evaluation

2.7 As is summarised in Table 1, the evaluation of audit quality entails assessing four key elements:

Mindset and culture

2.8 Audit is a professional discipline that provides assurance about financial (and other aspects of) public reporting by companies. Auditors must concern themselves with the interests of the company's investors and other stakeholders eschewing all personal and commercial interests that would conflict with their responsibilities. Accordingly, auditors are expected to adhere to high professional and ethical principles such as integrity and objectivity.

Skills, character and knowledge

2.9 Auditors need to be highly skilled and knowledgeable about business and audit. This includes the industry and the environment in which the company operates, and about the legal and regulatory frameworks that underpin both their responsibilities as a statutory auditor and the company's financial reporting process and outputs. Auditors should demonstrate strong personal attributes in performing their work, such as effective communication skills, and rigour, perseverance, and robustness. These attributes enable auditors to undertake their role with professional scepticism, whilst maintaining effective working relationships with those subject to audit i.e. management and other employees.

Quality control

2.10 The audit firm's quality control processes help the audit engagement team to deliver a consistently high quality audit. Quality control includes the provision of appropriate software and methodologies, training, technical support, and the tone at the top of the firm. The audit engagement partner, however, ultimately has responsibility for the quality of their audit engagement. In international group audits, the group audit engagement partner must ensure that the firms within the entire international audit engagement team also observe consistently high standards. The audit engagement partner should therefore be able to demonstrate to the audit committee how they have established and maintained effective quality control and delivered a high quality audit.

Judgment

2.11 Most critically the auditor's mindset and culture, skills, character and knowledge, and their quality controls, are necessary to support them in making reliable and objective judgments, at all stages of the audit. These judgments underpin their audit opinion and are critical to delivering high audit quality and enable them to win the trust of those to whom they report.

Table 1 Elements of an evaluation

Judgment – Professional judgment is applied at all stages of planning and performing the audit (See Section 4). Making appropriate judgments lies at the heart of audit quality and is supported by the three critical elements described below and identified in the audit committee evaluation pyramid in Diagram 1.
Mindset and culture – Adherence to high professional and ethical principles, in particular integrity and independence, eschewing all personal and commercial interests that would (or would be seen to) conflict with the responsibilities of their role supports an appropriate personal mindset for auditors and an appropriate audit firm culture. (See Section 5)
Skills, Character and Knowledge – The competence to perform a high quality audit is founded on: strong auditing skills (investigative, analytical and judgmental) developed through effective training and relevant experience; effective communication skills; and the strength of character to approach the audit with a high degree of professional scepticism. Necessary personal attributes include: rigour, perseverance and robustness; a sound knowledge of business, its industry and the environment in which it operates; and understanding of the legal and regulatory frameworks (including professional standards) that are relevant to the audit and the financial statements. (See Section 5)
Quality Control – Effective quality control of an audit engagement involves identifying the risks to audit quality and establishing adequate controls at the engagement level to address these, taking account of controls at the audit firm level. In a group audit, this includes establishing controls over risks to audit quality relating to component auditors' work. (See Section 5)

2.12 In summary: auditors need to have the competence and to demonstrate to the audit committee that they have:

- made appropriate judgments about materiality;
- identified and focused on the areas of greatest risk;
- designed and carried out effective audit procedures;
- understood and interpreted the evidence they obtain;
- made reliable evaluations of that evidence; and
- reported with clarity and candour.

Carrying out the evaluation

2.13 A key message identified at the roundtables was that audit committees often focused more on the outputs of the external audit. Participants thought audit committees could focus more on obtaining evidence of quality throughout the audit, and particularly at the planning stage. For example, audit committees could:

- **Hold an initial audit committee discussion without the auditor** (perhaps shortly after the completion of the previous year's audit) to 'brainstorm' factors that could affect audit quality for the current year audit. This exercise can draw on: past experience of the audit, the audit engagement team and the audit firm; anticipated changes in the business and the business environment; and the financial reporting framework. This discussion might be primed by asking the auditor to provide relevant inputs and by obtaining, through company resources, relevant inputs from other public sources (such as inspection reports). It would also be informed by audit committee members' own experience and knowledge.

- **Ask the auditor**, when presenting the audit strategy and plan for the current year, to explain the **risks to audit quality** that they identified. The committee could ask the auditor how they intend to address those risks in developing the audit strategy and plan. In particular to:

  - explain the **risks to audit quality by reference to the specific circumstances** of the company's audit;
  - explain if any are new risks and the reason for them, and which risks previously identified have been assessed as less significant and why;
  - identify key audit firm and network level controls the auditor expects to rely on to address the identified risks to audit quality. The auditor should also explain the basis on which they are satisfied it is reasonable to do so. For example, in a group audit, the group audit engagement team and the component auditor(s) may be subject to common policies and procedures for performing the work (i.e. common audit methodologies); and
  - what inputs they have received from internal and external inspections of their audit and their audit firm, and of network firms performing audit work on significant components in the case of a group audit;

- **Probe and challenge the auditor's strategy and plan** in light of the outcome of the audit committee's initial audit quality discussion. The audit committee may wish to do so with some broader challenges but could also 'deep dive' in one or more areas of particular significance identified in the initial discussion. Doing so may provide the audit committee with greater insight into the topic of discussion, including activities of the auditor, as well as giving the auditor an opportunity to demonstrate their mindset and culture, and their skills, character and knowledge.

2.14 Roundtable participants also suggested that a **greater focus on challenging audit quality at the planning** stage could then be linked to steps the audit committee may take later in the audit such as:

- When discussing the auditor's findings, ask the auditor to **explain how they addressed the risks to audit quality** (identified and discussed at the planning stage) in performing their audit work and concluding and reporting on the issues that arose in the audit.

- **Hold an audit committee discussion to reflect on their views on audit quality** based on the earlier steps in the process and weigh the evidence they have received in relation to each of the judgment areas (Section 4) and each of the supporting elements (Section 5).

2.15 The audit committee may also want to ask the auditor for their perception of the external audit, to provide constructive feedback on their interactions with senior management and other members of the finance team. This should include their interaction with component management and component auditors.

Audit committee conclusions and report

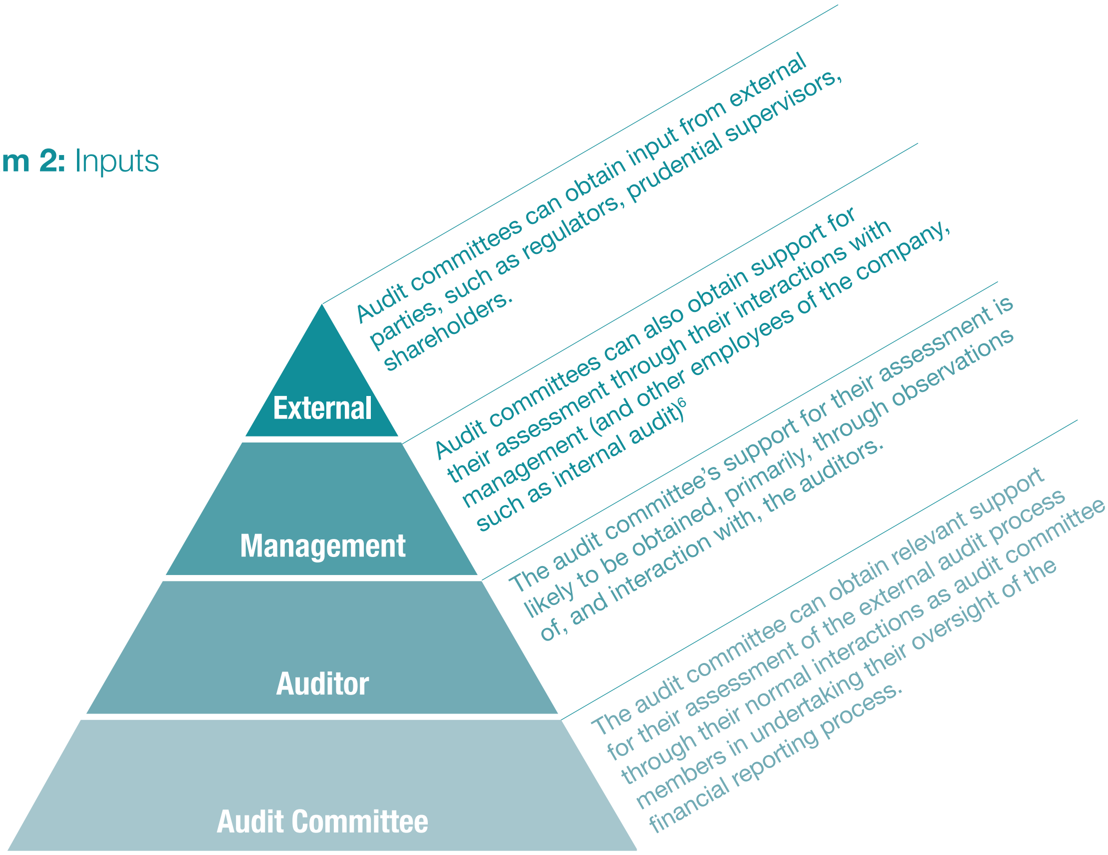
2.16 Before concluding and reporting on their assessment in the annual report, the audit committee may need to consider whether the evidence they have obtained is sufficient for them to draw reasonable conclusions about the quality of the audit and the effectiveness of the external audit. The audit committee may wish to make further inquiries if they do not believe they have a sufficient basis to conclude. For example, if they have not already done so, they may wish to understand if the auditor has met the agreed audit plan and obtain reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditors to address those risks.

2.17 In the FRC Financial Reporting Lab project report: Reporting of audit committees (October 2013), we reported that extensive disclosure explaining the process followed by the audit committee could become repetitive year after year. Audit committees may find it helpful, in avoiding boilerplate and in adding more colour to their reports by tailoring the suggested assessment model to the specific circumstances of their company and its external audit and the audit committee's areas of particular emphasis.

3 **Inputs** – Sources of evidence

3.1 This section gives an overview of inputs that roundtable participants believed could inform the audit committee's assessment.

Diagram 2: Inputs



Auditor inputs

3.2 The auditor's initial communications with the company may include tender documents and related interviews. During the audit cycle, the most important documents will include the audit plan, the audit findings and the auditor's external report.

3.3 Under the new extended auditor reporting regime,[7] audit committees have a further opportunity to assess audit quality by reviewing the auditor's external report. The audit committee can assess the auditor's ability to explain in clear terms what work they performed in key areas, and also assess whether the description used is consistent with what they communicated to the audit committee, e.g. in the detailed audit plan.

6 Guidance on Audit Committees (September 2012) Paragraph 4.35: At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should obtain feedback about the conduct of the audit from key people involved, forexample the finance director and the head of internal audit.

7 Effective for audits of financial statements for periods commencing on or after 1 October 2012, ISA 700 (UK and Ireland) "The Independent Auditor's Report on Financial statements" (Revised) requires auditors reporting on companies which apply the UK Corporate Governance Code to explain more about theirwork, particularly with regard to audit scope, risks of material misstatement and materiality.

Audit committees and auditor interaction

3.4 The most direct support (evidence) however, can be obtained by the audit committee asking open questions of the auditor and management. The committee can challenge where it needs further explanations or where it identifies apparent inconsistencies with its own knowledge. Roundtable participants noted that the level of engagement of the audit committee with the auditor and management, and the tone of the audit committee, can be very influential on the effectiveness of the external audit process.

3.5 Regular and open communication and interaction can help both the audit committee and the auditor fulfil their responsibilities, and is an iterative process. The appropriate timing for communications will vary with the circumstances of the engagement. For example, a significant difficulty encountered during the audit may need to be communicated promptly to avoid exacerbating the issues further. However, the audit committee should not need to seek out interactions with the auditor as the auditor should be proactive.

3.6 The frequency of communication is important, but communication is also likely to be of more value to the audit committee if it is constructive and informative and not littered with technical terms.

3.7 Audit committees might also seek input from those subject to the audit. For example, they might use tailored surveys to help with their assessment of audit quality, taking appropriate account of the risks of incentives to bias from these sources. Asking for demonstrable evidence and examples of effective auditor challenge is one way of reducing these risks.

Evidence from management and others

3.8 The inputs the audit committee receive are likely to be more credible to them the more evidence-based they are. If the audit committee seeks input from management through the use of an auditor assessment checklist, the audit committee may wish to discuss the completed checklists with selected respondents and ask specific questions to identify why the respondent believes that the auditor has demonstrated certain characteristics. This can avoid the completion of checklists becoming a "tick box" exercise.

3.9 The audit committee may be able to corroborate information with assurances they have received from internal sources such as the internal audit function. If the company has a finance function which has been the subject of adverse internal audit reports or errors in its monthly management information, then the auditor is more likely to communicate significant difficulties encountered during the audit such as extensive unexpected effort required to support audit evidence, or the unavailability of expected information. Conversely, the audit committee may be surprised to hear of such significant difficulties if the finance function has sufficient qualified resource with only minor internal audit findings.

External evidence

3.10 Roundtable participants noted that obtaining external inputs from shareholders and investors could also help to inform the audit committee's views as it considers matters of audit quality.

3.11 Audit quality inspection reports are a key source of external inputs on aspects of audit quality. The FRC's Audit Quality Review team (FRC AQR) writes a report on each individual audit it reviews and sends a copy directly to the audit committee chair of the company concerned. These reports are specifically designed to assist audit committees in undertaking their assessment of the effectiveness of the external audit.[8]

3.12 From time to time, the FRC AQR may also highlight key issues arising from their inspection programme that may be of more general relevance for audit committees to consider in making their assessment of audit quality.

3.13 The FRC AQR also issues annual public reports on its audit quality inspection findings for the six largest audit firms, together with thematic inspections reports, and periodic public reports on its inspections of other firms which audit a significant number (more than ten) of listed and other major public interest entities. Included in the FRC AQR reports are the results of Third Country Auditor inspections.

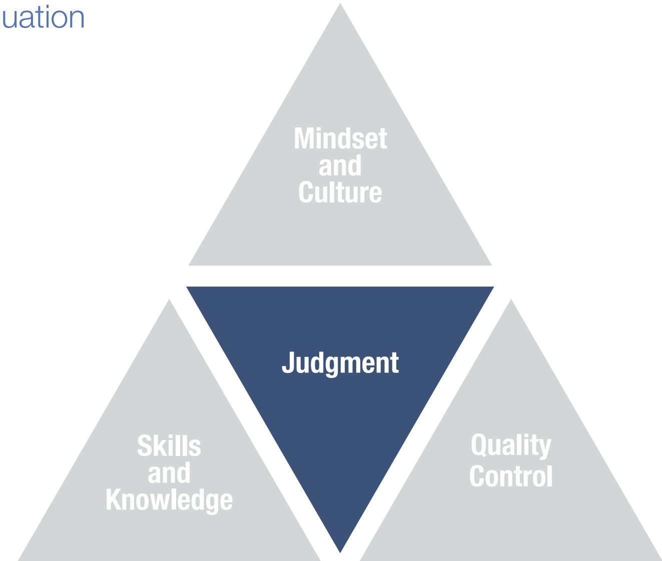
3.14 Audit committees should discuss the issues raised in their company's external audit inspection report with their auditors to ensure they fully understand the potential implications for the quality of their audit. Committees should also discuss remedial actions taken or planned by the audit engagement partner and the audit firm to address these issues. Audit committees may also wish to seek a meeting with the audit inspectors in connection with the auditor's inspection report.

3.15 Audit committees can adopt a variety of different activities to obtain inputs to assess the effectiveness of the external auditor in delivering a high quality audit. Set out in Appendix I are a number of examples, many of which were suggested by audit committee members.

8 Where a company's audit has been reviewed by the AQR, the FRC would expect audit committees to discuss findings with their auditors and consider whether any of those findings are significant for disclosure in the Report of the Audit Committee on the effectiveness of the audit process. Such disclosures should be in the audit committee's own words and deal with what action(s) they and the auditor plan to take. FRC Statement: Transparency of AQR Findings (20 November 2014)

4 **Evaluation** – Judgment

Diagram 3: Evaluation



4.1 This section addresses the key professional judgments the auditor makes during the audit. These judgments are supported by the other evaluation elements described in Section 5. Judgment is exercised at every stage of the audit and is therefore critical to audit quality and effectiveness.

4.2 Adherence to high professional and ethical principles supports a mindset and culture that enables the auditor's judgments to be made without being affected by conflicts of interest. Ensuring that auditors have the appropriate level of skills, the right strength of character and the depth of knowledge necessary for the audit engagement enables them to make informed decisions. Quality control, including firm level controls, can help auditors improve their application of professional judgment by setting a tone that emphasises the need to apply professional scepticism.

Judgments during the audit

4.3 Audit judgment is often thought of primarily in the context of the auditor's challenge of management on contentious issues. In fact, audit judgment is applied throughout the audit.

4.4 The core of the audit comprises two stages. There is a planning stage, to design audit procedures to look for potential material misstatements in the financial statements based on a preliminary risk assessment; and a performance and evaluation stage. The effectiveness of the overall process in delivering a high quality audit depends on the judgment undertaken at each stage.

4.5 In the planning stage, the auditor:

- Develops an understanding of the company, its business and the environment in which it is operating, including the company's financial reporting process and the applicable financial reporting framework;

- Makes judgments about materiality (i.e. what would influence the economic decisions of users based on the financial statements);

- Identifies risks of material misstatement in the financial statements whether inherent or control related, and assesses their likelihood and impact; and
- Designs procedures that are both appropriate by their nature for the assertions[9] to be tested, and sufficient in extent, to enable the auditor to conclude, with a high level of assurance, whether the financial statements contain material misstatements. These procedures are focused most intensely on addressing the risks judged most significant.

4.6 In the performance and evaluation stage, the auditor makes judgments when:

- Performing the procedures designed;
- Scrutinising any issues that arise to determine whether there are in fact material misstatements; and
- Determining the implications for the financial statements and the auditor's report.

The planning and evaluation stage also involves evaluating management's judgments and determining whether sufficient, appropriate evidence has been obtained or whether more work needs to be done.

4.7 In summary, the auditor's judgments made in an audit include judgments about:

(a) Materiality;

(b) Their risk assessment;

(c) Their response – the nature, timing and extent of further audit procedures (scope); and

(d) Their conclusions and reporting – based on their performance and evaluations.

4.8 The auditor's key communications with the audit committee include the audit plan[10] and the audit findings. The former deals with the auditor's planning judgments and the latter with their judgments about the key issues arising. The auditor has ample opportunity, therefore, to demonstrate that they have applied sound judgment in both the planning stage and in the performance and evaluation stage of the audit. The auditor can also demonstrate that they have the necessary skills, character and knowledge, mindset and culture and have exercised effective quality control over the audit.

4.9 The following pages contain material that provides context relevant to a proper understanding of the judgments element of the evaluation pyramid. They address the key areas of judgment set out in paragraph 4.7 above in relation to planning, and in relation to concluding and reporting on the key issues arising from the audit.

4.10 The FRC is keen to encourage audit committees to develop their own approach that is relevant in the circumstances of the particular company, rather than to provide definitive guidance. Accordingly, it is not intended that audit committees need to understand or apply all the guidance and examples in the following tables, but to have regard to it as relevant in the circumstances of the particular audit engagement.

9 Assertions - Representations by management, explicit or otherwise, about financial information embodied in the financial statements, as used by the auditor to consider the different types of potential errors that may occur.

10 Guidance on Audit Committees (September 2012): At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit (paragraph 4.30). In particular, the audit committee should consider whether the auditor's overall work plan, including planned levels ofmateriality, and the proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regards also to the seniority, expertise and experience of the audit team (paragraph 4.31).

Materiality

Judgments about materiality are critical to the audit. The auditor has to determine an 'overall' level of materiality, this is essentially a judgment the auditor makes about the level of errors (misstatements) that would render the financial statements unacceptably incorrect. In planning the audit, materiality, taken together with the risk assessment, drives the extent and nature of the audit work.

The auditor is required, in accordance with their professional standards, to consider the perspective of users (shareholders and other stakeholders) when determining materiality i.e. Information is material when, if misstated, it could influence the economic decisions of users taken on the basis of the financial statements.

Other aspects of materiality also require judgment. The overall level is adjusted downwards by the auditor, to recognise that audit testing is never comprehensive and misstatements will always remain undetected by the auditor. This is known as performance materiality. Misstatements identified are also evaluated from a qualitative perspective and are not automatically immaterial if they fall below the qualitative materiality levels the auditor judges appropriate.

Failure to make appropriate materiality judgments, or to update materiality during the audit, reduces audit quality by driving an inappropriate work effort, even if the auditor's risk assessment is valid.

Examples of matters audit committees might consider when assessing the auditor's judgments about materiality:

- What are the bases for the materiality levels set, and how appropriate are those benchmarks used by the auditor in determining materiality levels? How do these reflect the needs and expectations of users? "5% of net profit" is the most common threshold used by auditors[11], but how did the auditor assess the relevance of this to the users of the financial statements for this type of business?[12]
- What is the overall performance materiality and what factors were taken into account in determining it?
- How will materiality levels affect the scope and level of audit work? Is the auditor applying their informed judgment or adopting a limit in the audit firm's methodology with little or no judgment? What are the reasons for any change in materiality levels, and how does this affect the level of auditor's work?
- What is the auditor's approach to qualitative aspects of materiality, for example, how does the auditor evaluate misstatements in narrative disclosures?
- In a group audit, how has the auditor evaluated the appropriateness of materiality applied to group subsidiaries? Has the auditor explained the allocation of materiality across the parent company and its subsidiaries?
- How does materiality drive the nature and extent of audit work in significant areas?
- Have materiality levels been adjusted in the light of significant events arising near the year end and/or actual results that are very different from plan?
- At what level are identified misstatements reported to the audit committee and why?

11 FRC Extended Auditor's Reports – A review of experience in the first year – March 2015

12 The FRC AQR Thematic Review 'Materiality' (December 2013) includes matters audit committees could consider in relation to materiality

Risk Assessment

The auditor's risk assessment process should be a critical appraisal of what can go wrong in the financial reporting process and actively considers the risks of material misstatement in the financial statements. The auditor uses their analytical skills when applying their knowledge of the company's business and operating environment, and of the financial reporting framework, to identify risks that the financial statements might be misstated. If the auditor's skills or knowledge of these matters are inadequate, audit quality would be reduced because of a failure to identify and evaluate relevant risks, and direct their audit testing appropriately.

Risks of misstatement may arise, for example, because: (a) particular elements of the financial information required to be reported are difficult to prepare; or (b) because of design or operational challenges in: (i) the systems for capturing, processing, and reporting financial information in accordance with the financial reporting framework; or (ii) the controls management has established over those processes that are designed to prevent, or to detect and correct, misstatements. The auditor should be able to demonstrate that they have considered these matters carefully and that they have carried out a robust risk assessment. The auditor considers risks arising not only from error but also from unintentional bias and fraud; and should be alert to cultural factors and incentives that may create or reinforce them.

Examples of matters audit committees might consider when assessing the auditor's judgments in making their risk assessment include:

- What are the most significant identified risks of misstatement? Are they specific and relevant to the company?
- Has the auditor demonstrated an understanding of the incentives, culture and other business factors that may drive such risks? Are they aware of any circumstances giving rise to the emergence or intensification of such factors?
- Is it clear that the auditor has the necessary understanding of the business, its operating environment and the financial reporting framework and has applied an informed fresh perspective in making their risk assessment?
- In relation to key business risks that are not risks of material misstatement, can the auditor explain why they are not included in their audit strategy?
- Has the auditor identified risks inherent in the business model? If so, can the auditor adequately explain those risks and any implications for the company's strategy?
- Where risks do not differ from the previous year, has the auditor adequately explained why they remain relevant and, where new risks are identified or previous risks omitted, has the auditor been able to explain what has given rise to them, or to such risks no longer being relevant?
- To what extent did the auditor speak to employees outside the finance function in assessing risks?
- Where relevant, has the auditor captured risks at significant components (subsidiaries)? To what extent was the group auditor involved in determining the risks at components?
- Companies operating in the same industry may be susceptible to common risks. Why is a common industry risk not identified by the auditor or why does the auditor's articulation of the risk fail to properly reflect the particular circumstances of the company. For example, audit plans for banks and building societies are likely to identify risks in relation to loan loss provisioning as significant, but what are the underlying factors that drive that risk in the particular circumstances of the company's business?
- Has the auditor captured: regulatory risks; fraud risks; revenue recognition risks; and the risks of management override of controls?[13]
- Where relevant, has the auditor identified any laws or regulations affecting the business that may have a material impact on the financial statements?

13 See FRC Audit Quality Thematic Review 'Fraud Risks and Laws and Regulations' (January 2014)

Nature and extent of audit work

The auditor has to make judgments about the nature and extent of audit work that needs to be performed, so that it is responsive to the risks identified, and takes account of the materiality levels set.

Designing an appropriate response to the risks identified requires the auditor to use their auditing skills to design tests of the financial reporting processes and controls and/or the reported financial information that will enable them to evaluate whether the identified risks have materialised.

The auditor also has to perform some testing of material amounts and disclosures in the financial statements, irrespective of their assessment of risks.

Examples of matters audit committees might consider when assessing the auditor's judgments about audit testing include:

- Has the auditor been able to articulate their testing strategy in a manner that is understandable? Is the auditor able to articulate their choice of testing strategy in particular areas and why alternatives were not appropriate?
- Are there specific areas of risk that are of greater concern to the audit committee, where they might want to probe the auditor's judgments more deeply?
- Are there specific areas of the testing strategy that are not clear? For example, can the auditor explain clearly how they are applying data analytics techniques?
- To what extent does the auditor intend to rely on the effectiveness of internal controls? Is this consistent with the audit committee's understanding of the reliability of the company's relevant internal controls?
- To what extent are the risks to the quality and the effectiveness of the financial reporting process addressed in the audit plan?
- Can the auditor clearly explain their testing strategy in relation to fraud, revenue recognition, laws and regulation, and management override of controls?
- What areas has the auditor identified relating to amounts or disclosures in the financial statements, where special audit consideration is necessary? (For example, related party disclosures).
- In group audits, can the auditor clearly articulate how the size, resources and geographical coverage of the audit are appropriate in the circumstances? How is evidence going to be drawn out across the different components to enable the auditor to reach conclusions at the group level?
- To what extent are the audit quality issues identified by the FRC AQR in their public reports related to the testing strategy and what remedial action has the auditor considered? Has the auditor considered recent guidance from regulators on testing strategies and how has this been incorporated into the audit plan?[14]
- Auditors are also required to consider their response to assessed risks of material misstatement at the financial statement level. Audit committees can ask questions about the auditor's intended response to financial statement level risks (e.g. if the company has effective internal control, the auditor may choose to conduct more audit procedures at an interim date rather than focusing all effort at the year-end).

14 For example, see the FRC Audit Quality Thematic Reviews; The Basel Committee on Banking Supervision Supervisory Guidance on the External Audit of Banks

Audit Conclusions and Auditor Reporting

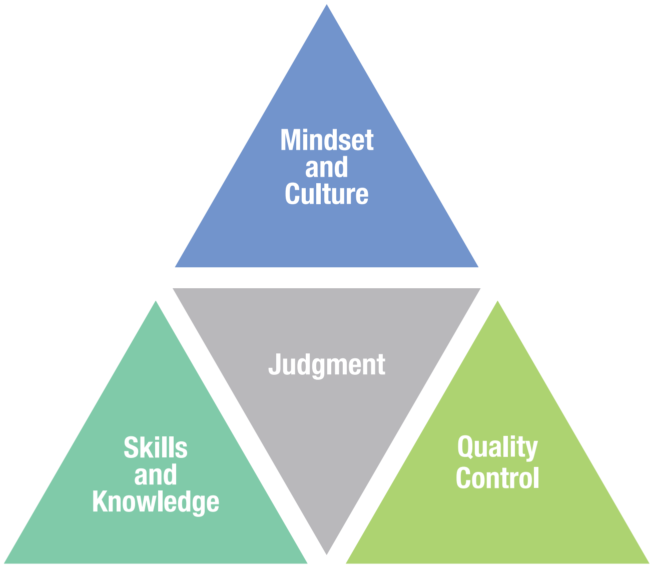
In considering the issues arising in their work, the auditor makes judgments about whether the evidence they have found is sufficient and appropriate for them to conclude that the financial statements as a whole are not materially misstated. The auditor will discuss with the audit committee significant issues that remain unresolved (but they also may wish to discuss those that arose during the course of the audit and were subsequently resolved directly with management). For serious matters, the auditor will engage with the audit committee as and when the matters arise. The auditor is also required to communicate the levels of misstatements identified during the audit, and explain the implications for their audit.

Examples of matters audit committees might consider when assessing the auditor's judgments about audit findings include:

- Has the auditor communicated key accounting and audit judgments, and conclusions, to the audit committee in a way that is understandable[15]? Does the communication clearly demonstrate that they have exercised an appropriate degree of challenge to management? Have the auditors been robust and perceptive in their handling of questions from the audit committee on the key accounting and audit judgments?[16]
- Reviewing and monitoring the content of the auditor's management letter, in order to assess whether it is based on a good understanding of the company's business. Establish whether auditor recommendations have been acted upon and, if not, the reasons why they have not been acted upon.[17] Review and monitor management's responsiveness to the auditor's findings and recommendations.[18]
- Has the auditor been able to explain why uncorrected misstatements, if any, have not been corrected by management?[15] The audit committee may also want to address this matter directly with management, in particular, to establish whether management's reasoning was appropriate and whether the auditor provided sufficient challenge.
- Where there have been debates about alternative treatments of an item in the financial statements (e.g. different valuation bases), does it appear to the audit committee that the auditor's conclusion on a particular option reflects an appropriate mindset? The auditor should be able to demonstrate that their conclusion and rationale are related to the nature of the challenges raised in the underlying work, the strength of the evidence obtained and the perspective of investors and other stakeholders.
- Has the auditor been able to explain how major issues that arose during the course of the audit have subsequently been resolved, or if relevant, why those issues have been left unresolved.[15]
- For group audits, how was the auditor satisfied that they had received sufficient appropriate evidence on components audited by component auditors?
- Reviewing whether the auditor has met the agreed audit plan and obtaining reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditors to address those risks.[17]
- Consistency of the auditor's risk assessment with risks reported in the audit committee's report. Whilst the auditor's report and audit committee report are not required to mirror one another, if there are differences the audit committee and the auditor might discuss those differences and consider the need to articulate reasons for those differences within either the auditor's report or the audit committee report.
- Reviewing the written representation letters, giving particular consideration to matters where representation has been requested that relate to non-standard issues.[19] Consider whether the information provided is complete and appropriate based on the audit committee's own knowledge.[20]
- Confirmation that any changes made to the materiality levels and reporting threshold initially advised upon have been reported to the audit committee.

15 Guidance on Audit Committees (September 2012): paragraph 4.32
16 Guidance on Audit Committees (September 2012): Paragraph 4.35
17 Guidance on Audit Committees (September 2012): Paragraph 4.35
18 Guidance on Audit Committees (September 2012): paragraph 4.34
19 Further guidance can be found in the International Standard on Auditing (UK and Ireland) 580: Written Representations
20 Guidance on Audit Committees (September 2012): Paragraph 4.33

5 **Evaluation** – Supporting Elements



5.1 This section contains material that provides context relevant to a proper understanding of the three supporting elements of the Evaluation Pyramid. It includes examples of ways in which the auditor demonstrates their competencies discussed in Section 2 – Mindset and Culture; Skills, Character and Knowledge and Quality Control – and may be used to evaluate these competencies of the auditor.

5.2 As noted in Section 1.11, the FRC is keen to encourage audit committees to develop their own approach that is relevant in the circumstance of the particular company, rather than to provide definitive guidance. Accordingly, it is not intended that audit committees need to understand or apply all the guidance and examples in the following tables, but to have regard to it as relevant in the circumstances of the particular audit engagement.

Mindset and Culture

The auditor should adhere to high professional and ethical principles, including integrity and independence. The auditor should eschew all personal and commercial interests that would (or would be seen to) conflict with the responsibilities of their role. The audit firm should support both an appropriate personal mindset for auditors and an appropriate audit firm culture.

Such a mindset and culture recognises that the auditor's role is a statutory function that serves the public interest and that the auditor's ultimate client is the intended user (shareholders and other stakeholders) of the financial statements. Having such a mindset and operating within such a culture should free the auditor to fulfil their duties and provide their opinion without being affected by influences that would, or might reasonably be seen to, compromise their professional judgment, integrity, objectivity and professional scepticism.

The auditor should demonstrate that they maintain high standards of integrity, objectivity and independence and behave consistent with the underlying values, so that investors and other stakeholders have confidence that the auditor is acting in their interests.

In discussions with the audit committee and with company management, the auditor should be able to demonstrate to the audit committees satisfaction that they approach their work with an appropriate mindset and operate an appropriate audit firm culture by:

- Communicating key audit judgments and conclusions to the audit committee in a way that clearly demonstrates that they have exercised an appropriate degree of challenge to management and professional scepticism.
- Making decisions about ethical matters in a manner that demonstrates the auditor seeks to remain true to the values underlying the ethical standards (e.g. that the auditor has due regard to the perception of their independence by reasonable and informed stakeholders, where threats to their independence such as the provision of non-audit services may arise, including through network firms).
- Ensuring the audit committee is aware of significant evidence that is inconsistent with other evidence or calls into question the reliability of documents and responses to inquiries and explaining how this was resolved in making their judgments.
- Appropriately addressing and resolving issues that either are contentious or involve significant judgment that are brought to the audit committee's attention.
- Clearly articulating their rationale for particular conclusions, what alternatives were considered and why the specific judgment was considered to be the most appropriate of the alternatives, having regard to the interests of stakeholders.

Supplementary sources of evidence may include, for example:

- Inquiring of the auditor whether there have been any recent regulatory cases against the audit firm and what actions the audit firm is taking to avoid recurrence of such cases (whether in relation to the engagement or the audit firm as a whole, and whether internal or external) as these highlight public interest matters about the auditor's mindset or the audit firm's culture.

Skills, Character and Knowledge

The competence to perform a high quality audit is founded on:

- strong auditing skills (investigative, analytical and judgmental) developed through effective training and relevant experience;
- effective communication skills; confidence to communicate effectively in discussions, presentations, interviews, and debates, as well as in written form;
- the strength of character to approach the audit with a high degree of professional scepticism, including personal attributes such as rigour, perseverance and robustness; and
- a sound knowledge of the business, its industry and the environment in which it operates, and of the legal and regulatory frameworks (including professional standards) that are relevant to the audit and the financial statements.

Auditors should have the competence to:

- make appropriate judgments about materiality;
- Identify and focus on the areas of greatest risk;
- design and carry out effective audit procedures;
- understand and interpret the evidence they obtain;
- make reliable evaluations of that evidence; and
- report with clarity and candour.

In the auditor's discussions with the audit committee and with management, the auditor should be able to demonstrate to the audit committee's satisfaction that the auditor has strong auditing skills, strength of character and depth of knowledge about the company, its operations and activities, and the industry and environment in which it operates, through:

- Active engagement with the audit committee about the circumstances surrounding misstatements in the financial statements, including disclosures, whether due to fraud, unintentional bias or error and internal control deficiencies.
- An ability to develop their knowledge of the business and the challenges and opportunities it is facing beyond the finance function, (e.g. by meeting senior employees of the company outside of the finance function and visiting key operational sites).
- Describing how they have challenged information that appears to contradict their understanding of the company, its operations or activities.
- Providing concise, easy to understand explanations of the issues they present, particularly when the issues are difficult or contentious.
- A thorough understanding of and rationale for the audit strategy presented, particularly when challenged (see also Section 4: Evaluation – Judgment), for example, the auditor should be able to explain the circumstances giving rise to new risks and explain why risks in the prior year are no longer valid. They should be able to articulate clearly how they intend to obtain audit evidence on components.
- Exercising strong personal attributes to ensure effective interviews and to apply appropriate scepticism in challenging the evidence obtained.
- Articulation of how the strategic decisions of the company, changes in its environment and current or developing accounting standards might impact future financial statements.

Supplementary sources of evidence may be obtained by the audit committee through:

- Observing the business and technical expertise of the audit firm that may be available to support the audit engagement team through audit committee members attendance at industry and technical forums organised by the audit firm.
- Reviewing FRC AQR reports on the relevant firm and its competitors. Some inspection reports may specifically address concerns about the auditor's skills in applying the auditing standards based on the evidence in the audit files. Where such matters are raised, the auditor can be asked to explain the remedial actions the audit firm and the auditor are taking that will improve the Firm's audits.
- Asking the audit engagement partner whether they have been subject to review by the FRC AQR and internal firm processes, and what the results were.
- Checking publicly available regulatory action, professional body disciplinary action and any other press releases relating to the audit engagement partner and the audit firm.
- Obtaining feedback on auditor competencies (e.g. through surveys and discussion).

Quality Control

Effective quality control of an audit engagement involves identifying the risks to audit quality and establishing adequate controls at the engagement level to address these, taking account of controls at the audit firm level. In a group audit, this includes establishing controls over risks to audit quality relating to component auditors' work.

Risks to a high quality audit can relate to the auditor's skills, character and knowledge, mindset and culture, and judgments.

Audit committees will want to be sure that the audit is being run effectively. The quality control procedures in place might not always be obvious to them. Audit committees can ask questions about matters of particular relevance to the audit. Auditors should be able to demonstrate, to the audit committee's satisfaction, their focus on the quality of the audit engagement, through:

- Communicating in their audit plan how they assess risks to the quality of their audit, the key risks they have identified and the quality controls they have put in place to ensure they deliver a high quality audit.
- Communicating information about the quality of communications between the auditor and their teams in other countries; discussing judgments being made there that impact the group financial statements and how the auditor will be sure that those judgments are sound.
- Explaining how the auditor is satisfied that other audit firms in the group audit are demonstrating high standards of audit quality. In particular, how the audit firm supports the group audit engagement partner and what evidence there is of that support (e.g. to what extent are there common methodologies and software, or shared results from network firm internal quality reviews).
- Communicating certain aspects of inspection reports that are of importance to their engagement including, when appropriate, about overseas audit quality inspection findings and the auditor's response to those findings.
- Communicating their activity in remedying any deficiencies identified in internal or external audit quality inspections and the impact of those deficiencies on the company's audit. Audit committees can ask for the latest results of the Firm's internal monitoring reports, particularly with regards to the engagement partner and whether or not their particular audit was reviewed as part of that internal monitoring process.
- Explaining what resources they used to support audit quality in addressing contentious issues and key judgments, for example did they use an independent review partner, partner panel, technical consultations, etc.
- Explaining how the auditor's overall work plan, and the proposed resources to execute it, appear consistent with the scope of the audit engagement.
- Demonstrating that more senior members of the audit engagement team were actively involved in risk assessment, planning meetings, key audit judgments and conclusions.
- At the end of the annual audit cycle, demonstrating that they met the agreed audit plan, and discussing with the audit committee the reasons for any changes to the audit plan or delays in completion.

Supplementary sources of evidence may be obtained, for example, through:

- Obtaining a report on the audit firm's own internal quality control procedures and consideration of the audit firm's annual transparency reports, where available.[21]

21 Guidance on Audit Committees (September 2012): Paragraph 4.22

Appendix I – Examples: Assessing the quality and effectiveness of the audit

Audit Committee (AC) Chair attended regular meetings with the Engagement Partner (EP) throughout the year without management being present. This provided the AC Chair with an opportunity for open dialogue. The EP demonstrated their understanding of the company's business risks and the consequential impact on the financial statement risks. Was also able to obtain feedback on the conduct of the audit from the EP's perspective to determine if any challenges in the prior year audit would be sufficiently addressed in the next audit cycle.

The EP challenged the Finance Director (FD) with tough questions about how the FD reviews the company's supply chains and its business- disruption policies. In those discussions the EP could clearly articulate how improvements to the FD's review process could change the EP's approach to the audit. The FD noted that they were impressed with the EP's understanding of the business and industry challenges.

The EP called a meeting with the AC to discuss some of the findings in the audit quality inspection report. The AC raised a specific concern regarding a statement that the inspection team had found insufficient involvement in the subsidiary auditors' risk assessment. The EP shared several papers with the AC to demonstrate how the EP had addressed the matter to ensure appropriate challenge of the risks presented by the component would be undertaken.

Attended a meeting with the Group FD and the EP to discuss goodwill impairment where a different conclusion (to the Finance Team's) on future trends was being presented by the EP. The EP was able to demonstrate their conclusion and rationale to the AC and FD's satisfaction. For example, they had carried out a robust trend analysis on consumer behaviour and evaluated recent industry performance. They had also used their independent market specialists.

Met with the EP to discuss an issue with user access controls within part of the IT infrastructure platform which could have had an adverse impact on certain of the Group's controls and financial systems. Was satisfied that the EP had taken this issue seriously enough and discussed the EP's updated strategy to extend their controls and substantive testing to obtain comfort on the compensating controls and the completeness and accuracy of the management information derived.

Met with the EP a couple of times this year to discuss the acquisition of the Norwegian Company, and raise concern about the lack of knowledge and experience of local management. The EP was able to demonstrate that this matter had been built into the overall audit plan by placing more senior members of the team on that component audit. Also through addressing and resolving any audit issues through regular communication and cooperation.

The AC discussed the revenue recognition accounting policy and felt that the accounting for multi-element arrangements is a complex area of accounting, and therefore would like a better understanding of the audit approach. The EP had outlined their approach to the audit of revenue, as part of their presentation of the audit plan, but agreed to hold a separate meeting to 'deep dive' into this particular area. The audit committee was satisfied that the EP's attention in this area was appropriate.

Rotation of EP: Attended interviews of three candidates for next year's group audit. Twopotential EPs demonstrated strong industry knowledge. In particular, both were able to articulate how the strategic decisions of the Board might impact future financial statements. Asked both candidates how they control the quality of their audit. Both were able to demonstrate they understood the risks to audit quality by reference to thespecific circumstances of the company's audit.

Asked EP to explain why risks of material misstatement in the audit plan did not align exactly with business risks. Received satisfactory explanation and EP demonstrated their thorough understanding of the group's strategy. This led to a better understanding of implicit connections.

Attended the audit firm's 'Quarterly Financial Reporting Update'. Met with one of the auditors in the engagement team who introduced himself and we had good discussion about industry issues. The auditor demonstrated they had excellent knowledge of industry, and was robust when challenged.

I had a follow up question following the planning meeting with the EP regarding impairment of the Chile plant and contacted the Senior Manager. The Senior Manager responded to my accounting questions and demonstrated a precise understanding of the issue. Without prompt, the Senior Manager was also able to explain in an understandable manner how the audit team intend to get assurance on the impairment calculation.

Attended the group finance team conference in London. Found out that there had been some concerns raised about the sufficiency of knowledge of the engagement team on the Slovakia branch audit. The EP also brought this matter to my attention and explained the group audit team's remedial action. This demonstrated one aspect of the EP's commitment to quality control of the group audit.

The EP outlined their approach to materiality in the detailed audit plan. The AC questioned whether the use of the same benchmark of profit before tax year after year was appropriate. The EP was able to demonstrate why they considered it to be one of the principal considerations for users of the financial statements in assessing the financial performance of the Group.

Considered the audit quality inspection report. The observations from this assessment and remedial actions for thefinancialyear were presented to the AC by the EP. The committee was satisfied with the remedial actions and that the EP showed sufficient commitment to the success of the audit firm's remediation plan.

The AC discussed the detailed questionnaire completed by the FD that assessed external audit effectiveness. The AC were able to verify some of the findings by comparison to our own observations of the EP and the audit team, and therefore were satisfied that the FD's observations were reasonable.

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