



# DEVELOPMENTS IN AUDIT 2016/17 SUMMARY REPORT

JULY 2017

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High quality audit provides investors and other stakeholders with a high level of assurance that the financial statements of an entity give a true and fair view, and provide a reliable and trustworthy basis for taking decisions. Auditors carrying out high quality audit act with integrity and objectivity, are demonstrably independent and do not act in a way that risks compromising stakeholders' perceptions of that independence.

High quality audit complies with both the spirit and the letter of regulation and is supported by rigorous due process and quality assurance. It clearly demonstrates how it reflects investor and other stakeholder expectations, is driven by a robust risk assessment informed by a thorough understanding of the entity and its environment, and provides challenge, transparency and insight in a clear and unambiguous way.

High quality audit provides a strong deterrent effect against actions that may not be in the public interest, underpins stakeholder confidence, and drives continuous improvement.

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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# SUMMARY REPORT

2016/17 was our first year as the designated Competent Authority for Audit, which has increased our responsibilities and enhanced our powers. The FRC has a strategic objective to promote justifiable confidence in UK audit. Such confidence is underpinned by the commitment of auditors to deliver high quality audit and focus on continuous improvement, as well as a commitment by companies to the highest standards of corporate governance and financial reporting.

Our assessment of the quality of UK audits results from our audit monitoring activity, which gives us a unique insight into the quality of individual audits of public interest entities (PIEs), and from the outcome of detailed thematic reviews focused on particular aspects of the PIE audit firms and their audit practices. This is supported by information from the professional bodies about their inspections of non-PIE audits and lessons learned from our enforcement activity. We also consider a range of other perspectives, including our survey of Audit Committee Chairs and the broader insight we gain from our interactions with UK and international stakeholders, including from the investor community.

There is evidence from these sources of improving audit quality and a commitment to continuous improvement.



## Evidence from audit monitoring

The key message from our audit monitoring activity in 2016/17 is that the overall standard of audit work being done for FTSE 350 companies in the UK is improving. Audit opinions are reached independently and are generally well supported by audit work. There is evidence of continuous improvement, particularly for larger audits. However, a higher proportion of audits we reviewed outside the FTSE 350 main market required more than limited improvements. As a result we report no overall change in audit quality across all the audits we reviewed in 2016/17. Across all audits, outcomes are inconsistent between the firms, with areas of identified good practice such as enhanced quality control procedures also often those areas where there is most room for improvement.

Through our audit inspections we observe significant investment in programmes of improvement, and have seen examples of good quality procedures demonstrating:

- Greater involvement of senior team members in key aspects of the audit, including in the planning and review processes;
- A greater focus by firms on continuous improvement and root cause analysis when things go wrong;
- Firms also conducting root cause analysis when things go right, which we believe to be a powerful tool for identifying good practice to disseminate more widely;
- A high standard of design and direction of the component auditors' work over significant risks; and
- Situations where auditors have demonstrated greater scepticism when evaluating management assumptions and estimates.

## AQR Inspection Results: FTSE 350

Audits assessed as either good or only requiring limited improvements<sup>1</sup>

2016/17	81%
2015/16	77%
2014/15	70%
2013/14	69%
2012/13	68%
2011/12	56%

## AQR Inspection Results: non-FTSE 350<sup>2</sup>

Audits assessed as either good or only requiring limited improvements

2016/17	72%
2015/16	74%
2014/15	63%
2013/14	53%
2012/13	48%

However, the picture is not consistent across all firms, market sectors and audit procedures. High profile accounting failures, as well as the results of our audit monitoring, continue to identify cases where auditors have not met expectations. Whilst we see evidence of greater professional scepticism for example, this is also the area where we continue to find the greatest number of issues and problems with the way auditors are conducting their work.

Audit firm leaderships' focus on audit quality is a key driver of good audits and is vital to promoting a culture of continuous improvement. While the progress made by individual firms differs, all firms are investing in audit quality and have set out further action to improve to deliver sufficiently consistent quality outcomes. A strong commitment to continuous improvement is vital to meet and then exceed the target we have set to be achieved by the time of our 2018/19 inspections that for FTSE 350 audits at least 90% will require no more than limited improvement.

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<sup>1</sup> Note that our inspection evidence can only ever be based on a sample of the audits conducted in any year. This means although the data suggests linear and continuous improvement, care should be taken when assessing the overall trend.

<sup>2</sup> The scope of these inspections includes listed companies outside the FTSE 350, including large AIM and other Public Interest Entities including non-listed insurers, banks, building societies, Lloyd's syndicates and mutuals.

The Recognised Supervisory Bodies (**RSBs**) also carry out audit inspections, with changes in results broadly consistent with our own.

RSB Monitoring Visits <sup>3</sup>	2014	2015	2016
Audit files receiving the highest grade	18%	18%	21%
Audit files receiving the lowest grade	17%	18%	13%

## Other perspectives of audit quality

Our view of continuous improvement is supported by the results of our YouGov survey of Audit Committee Chairs which shows a further marginal increase in confidence about the quality of audits being done for Public Interest Entities (PIEs).<sup>4</sup>

## What has been done to promote continuous improvement in audit quality?

### Retendering and Rotation

Changes to the rules relating to audit tendering and rotation have put differentiation on the grounds of quality at the heart of competition between the firms. Stakeholder feedback suggests that new auditors are bringing fresh challenge and new perspectives for companies that have previously retained an incumbent auditor for some considerable time. The evidence we have suggests that whilst the Big Four audit firms continue to dominate the FTSE 350 audit market, there has been greater competition based on quality between the firms within that market. There is no evidence to suggest that competition has led to a simple downwards pressure on audit fees.

In total 213 (61%) of the FTSE 350 have announced they have completed a tendering exercise in the past 6 years. 74% of tenders have resulted in the appointment of a new audit firm.

Overall, the Big Four firms have increased their total share of FTSE 350 audit market from 95% to 97% (based on number of audit clients).

2015 and 2016 are likely to represent peak years in the short term for the number of audit tenders as the initial impact of the policy changes works through – with approximately 50 tenders in the FTSE 350 in 2015 and 70 in 2016.

### Greater Transparency

The simultaneous reforms we introduced in 2012 to the Corporate Governance Code and to Auditing Standards continue to help drive better quality financial reporting and make audit more transparent. The UK was one of the very first capital markets to introduce an Extended Auditor's Report, alongside extended Audit Committee reporting, which has been broadly welcomed by the users of financial statements, and is now being taken up in the international auditing standards and in the US. The UK audit firms have innovated in the first 3 years, starting from the basic principles and requirements we set and generally avoiding boilerplate or overly technical descriptions of their audits. As these reports now become commonplace outside the main listed market in the UK we will continue to monitor progress and encourage further innovation and responsiveness to the needs of users. Investors tell us there is appetite for more innovation and insight.

### Broadened Perspectives of Quality

In recent years the FRC has shifted focus to help sustain ongoing improvements in the quality of UK audit. We have increased the number of individual inspections we carry out, and now communicate more

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<sup>3</sup> The scope of RSB inspections includes the audit of non-PIE entities. See the section in the detailed report on our professional oversight activity for more specific detail. Caution should be exercised when considering trends over time since the population of firms, and therefore audit files, reviewed each year differs because of the cyclical nature of the selection process.

<sup>4</sup> For more detail see the main body of our report and the section setting out the role of the audit committee.

directly with Audit Committees about the results of our inspections and have set an expectation that Audit Committees in turn report on our findings. We have completed thematic reviews of areas where we believe there is an opportunity to enhance audit quality, for example data analytics and root cause analysis.

### 2016/17 thematic reviews

Firms' audit quality control procedures and other quality initiatives – quality is embedded better through strong leadership and the right firm culture. However, our wider monitoring work demonstrates that this improvement is still not yet sufficient to prevent poor inspection findings.

Root Cause Analysis – all firms have improved how they do root cause and it is now in widespread use. More training, greater consistency and more external perspective would drive greater improvements – as well as more use of root cause analysis when things go right as well as wrong.

The Use of Data Analytics – UK firms are at the forefront of developing analytics with the potential to improve audit quality. Their use in audits is not yet widespread.

We combine this with fuller engagement with the firms' leadership and Independent Non-Executives (INEs) to encourage continuous improvement. Our revised Audit Firm Governance Code focuses the role of the INEs on audit quality and requires there to be more and broader INE input. We see a greater focus by the firms on looking at the root causes of both good and poorer quality audits, and a commitment to embed lessons learnt into future practice.

## Where will further improvement be focused?

Moving forward there are areas where we continue to have concerns or where there are risks to continuous improvement and we are focused on playing our part to address them.

### Responding to Auditing Failures

However encouraging the overall trends in audit quality are, investor and wider public confidence in audit remains inherently vulnerable to evidence of inappropriate conduct by auditors and of poor audit work. This is particularly true where circumstances indicate a failure by auditors to be sufficiently independent of their clients, or to demonstrate the willingness and ability to provide robust challenge to management. We have enhanced our enforcement procedures to address cases where standards are not met. We also recognise that confidence is undermined if swift action is not taken in the face of wrongdoing or failure. We brought several cases to conclusion in 2016/17, and since then, and are working to conclude our cases quicker not just to ensure that we hold auditors to account but also to ensure that we are able to promote lessons learnt quickly. The leadership and continuous improvement culture of the audit firms has an important role to play. The level of cooperation received from firms under investigation varies considerably case by case and can have a significant impact on the efficiency of our investigations and our ability to express lessons learnt quickly. A separate section of our report describes in detail the outcomes and lessons to be learnt from our concluded investigations, as well as the list of open cases.

An independent panel will shortly advise on the effectiveness of the sanctions we apply in deterring poor quality and promoting high quality audit supporting public confidence.

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## Quality Focused Culture

Our objective to see continuous improvement in the quality of audit in the UK, means that we will focus on practices which can ensure the greatest enhancements. Audit firm governance and culture, ensuring that the right tone is set from the top are a key focus. We continue to monitor how effectively the firms apply the Audit Firm Governance Code.

A thematic review of how the audit firms are promoting, measuring and assessing their own culture will be carried out in 2017/18, with a particular focus on the implications for audit quality.

We will continue with thematics given evidence that previous reviews have stimulated improvements across the firms. In 2017/18 we will follow up previous work in areas such as the auditor's application of the concept of materiality, as well as examining the consistency of their approach to the 'other information' included in annual reports.

Our focus in standard setting will be on underpinning continuous improvement through development of the international standards and guidance as well as our own. The IAASB's focus on a quality management approach resonates with our thinking.

## Promoting Scepticism

At the heart of an effective audit is the demonstration by the auditor of an independent and sceptical mind-set, as well as the capacity for self-challenge. This is true of all aspects of the audit, but is perhaps most important when evaluating management's estimates. Failures by auditors to be sufficiently sceptical, and therefore independent and objective in the way they approach their work, continues to be a theme running through poorer quality audits identified in our inspections and in our enforcement cases. This is a particularly important area given the increasingly complex nature of accounting estimates, and recent and upcoming changes to International Financial Reporting Standards (IFRS).

Current proposed revisions to International Standards on Auditing (ISAs), and particularly to ISA 540 on the audit of management estimates, are designed to further embed a sceptical approach in the audit of management's estimates. We have been heavily involved in the work by the International Auditing and Assurance Standards Board (IAASB) to make these revisions.

## Consistency of Execution

We intend to concentrate on the consistency of high quality execution in all audits. As a result of our current inspection cycle, we have an emerging concern about differential quality with improvements in large PIE audit quality potentially being at the cost of quality elsewhere. We will focus on the how the firms lead on quality – including the ongoing revisions to ISQC1 (the international quality control standard) which will embed a quality risk management approach. Our culture thematic will set out what audit firms are currently doing in this area and provide examples of good practice. Some firms, for example, are increasingly able to use technology and data to facilitate real-time audit quality monitoring across a range of indicators, such as timely planning and consistency of risk identification with industry expectations. We will monitor and encourage such developments.

More widespread use of data analytics and artificial intelligence software in the audit may also drive up audit quality. We are already engaging with the firms to identify the opportunities and challenges, including how compliance with auditing standards can be preserved. We will continue to highlight good practice.

## Principles Based Auditor Independence

In our firm-wide work on systems of ethics and independence we observe higher levels of compliance. We have recently reviewed how the firms have addressed implementation of new requirements and it is clear that all firms have adopted a robust approach. However independence cannot be assured through rules.

Our objective to see continuous improvement in the quality of audit in the UK, means that we will focus on practices which can ensure the greatest enhancements. Audit firm governance and culture, ensuring that the right tone is set from the top are a key focus.

In applying the principles of our Ethical Standard, auditors should focus on the perspective of a reasonable, informed and objective third party. In a small number of instances investors have raised concerns that firms have sometimes applied a rules based mentality, resulting in a perception that the firm's interests have been promoted over the public interest. We will continue to engage with stakeholders and the firms to address such incidences and to develop market understanding as to how the principles of independence apply.

### Impact of Rotation and Retendering

Rotation and retendering of the audit engagement enhances stakeholder confidence in audit, particularly in respect of the perceived independence of the auditor. Audit committees report that a fresh perspective brings benefits to audit and reporting quality. We have provided guidance to Audit Committees on the factors which can help ensure an effective tender process; one which embeds quality considerations and avoids disruption to the audit service. Audit Committees need to ensure they have allowed sufficient time to make the change, and that they have a clear strategy for procuring non-audit services.

Our analysis of the relationship between audit fee income and rotation of auditors does not provide conclusive evidence about whether fees are increasing or decreasing as a result. Firms report that the costs and challenges connected with tendering, as well as those related to taking on new clients with complex businesses are high. It is important that the audit firms devote sufficient resources and focus to ensure that these challenges are met. We monitor first year audit quality in our inspections, and we will also monitor, and as necessary give transparency to, concerns as to the impact on the sustainability of quality from audit fees.

### Harnessing Technology

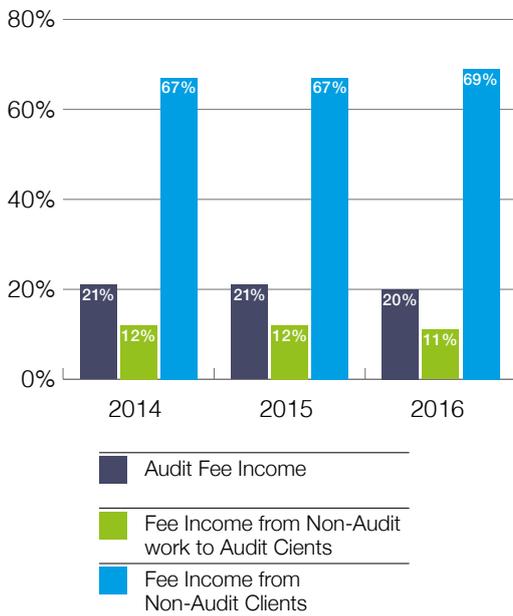
We recognise the significant opportunities and challenges ahead for the audit profession, including developments in technology and the related opportunities for innovation. We continue to engage with our stakeholders to ensure that the potential benefits and disbenefits of new technology are understood, and that our standards help auditors continue to improve the quality and relevance of their work. We intend to monitor risks relating to cyber threats, both from the perspective of audited entities and of the audit firms which handle significant and increasing amounts of client data.

### Audit's Role in Multi-disciplinary Practices

We monitor and report on the relative importance of fees from audit and non-audit services for the major firms. The challenge is to ensure that audit remains at the heart of their businesses; a healthy and competitive audit market underpins the UK capital market. We will continue to monitor fees, to focus on how the firm's leadership and culture places sufficient emphasis on audit and ensures that the firm's reputation is not adversely affected by other lines of service.

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**Graph 1: Analysis of Big Four Fee Income (2014-16)<sup>5</sup>**



**Impact of Global Networks**

The audit firms recognise the impact of network issues on reputation and brand. The opportunities for efficiency and improved quality through technology makes investment globally imperative. We observe the firms adopting an increasingly global culture and approach, providing further oversight and challenge to domestic firms. Our culture thematic will explore how global firms impact on UK firm culture.

Finally, the FRC recognises that it is regulating domestic audit in a global market; emerging issues and problems in the global network firms have a knock on effect for the UK. We liaise closely with the firms to obtain evidence that they respond to these kinds of issues in an appropriate and timely way and have contingency plans in place. We liaise with other independent audit regulators internationally under individual Memorandums of Understanding and with European regulators in firm colleges to better identify and manage risks to audit quality.

**Our in depth report**

Developments in Audit provides a more in depth report of recent developments in the market, and where we fit in as the market regulator. The report provides detail about:

- The market context, including the size and reach of the largest audit firms and the impact of new requirements on audit tendering and rotation;
- The FRC and the regulatory environment, including a summary of our objectives, our strategy and our priorities for 2017-18;
- What we are doing, and what outcomes we see:
  - Setting auditing standards, codes and guidance; the Audit Firm Governance Code; and our work with international standard setters;
  - Promoting the effectiveness of Audit Committees to enhance audit quality, including the results of our survey of Audit Committee chairs on audit quality;
  - Monitoring audit quality, including an overall position and firm-by-firm information;
  - Overseeing the profession including our delegation to the Recognised Supervisory Bodies (RSBs)
  - Taking enforcement action, including the resolution of closed cases and ongoing investigations; and drawing out lessons learnt.

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<sup>5</sup> Source: FRC, *Key Facts and Trends in the Accountancy Profession* (July 2017), p.41, Figure 32.



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