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Key issues for audit

We expected the year to be one of transition as we commenced our journey towards becoming the Audit, Reporting and Governance Authority (ARGA), but no one could have predicted how external events would affect this journey. The impact of Covid-19 has been, and remains, a significant test for the profession, making auditing judgements and estimates more difficult, with unprecedented economic uncertainty adding to the complexity of many accounting considerations. It has also challenged the resilience of the audit firms both financially and operationally. Against the backdrop of the pandemic, which has exacerbated the public’s need for reliable financial information, the audit profession needs to achieve consistently high standards of audit quality.

- What is driving inconsistent audit quality?
- How do we achieve a healthy and resilient audit market?
- What are we doing to address these issues?

In this report we consider these questions and focus on how we are working within our current powers to drive improvements. Alongside our existing initiatives, and in response to three recent reviews (Sir John Kingman’s Independent Review of the FRC, the Competition and Markets Authority’s (CMA’s) Statutory Audit Services Market Study, and Sir Donald Brydon’s Review into the Quality and Effectiveness of Audit) the Government will shortly consult on wide-ranging proposals for more effective corporate governance and reporting, audit reform and a regulator with enhanced powers. Given the timing of this consultation, these proposals are not covered in this report.

Inconsistent audit quality

Our inspection activities, which have focused increasingly on higher-risk audits, again showed that audit quality remained too inconsistent. 49 out of the 130 audits inspected in our 2019/20 inspection cycle, primarily covering audits with year-ends between July 2018 and June 2019, required either improvement or significant improvement.

The key issues identified related principally to insufficient challenge of management in areas of complexity and forward-looking judgements. An example is goodwill impairment, where auditors need to assess assumptions of the future, like expected revenue growth and cost savings. Obtaining objective supporting evidence for inherently subjective judgements can be difficult and auditors can slip into solely corroborating management’s assumptions, rather than challenging them. We recognise the significant efforts and investment being made by the audit firms to improve their methodologies and build a culture of challenge. However, we have not yet consistently seen the difference such investment is making in developing the necessary systems, controls, culture and mindset to support effective challenge of management.

Higher-risk audits

We define audits as higher-risk where the group or entity:
- is in a high-risk sector or geography;
- is experiencing financial difficulties;
- has balances with high estimation uncertainty; or
- where the auditor has identified governance or internal control weaknesses.

Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues, for example:
- materiality becomes a key factor in determining the significance of audit judgements for entities that have low profitability;
- headroom on impairment assessments may be lower and the entity’s balance sheet may be more sensitive to changes in key assumptions; and
- going concern assessments are less clear cut.
Key issues for audit (continued)

We look at how we are responding, within our current remit, to the audit quality monitoring results. The detail is included in section 1, with the key strands being:

- the development of a new supervisory approach to audit firms, including restructuring the current Supervision Division and taking control of the registration of public interest entity (PIE) auditors;
- continuing to take enforcement action, where it is in the public interest;
- obtaining agreement of the Big Four audit firms (Deloitte, EY, KPMG and PwC) to the operational separation of their audit practices from the rest of the firm, so that the audit practice is focused first and foremost on audit quality;
- performing more audit inspections across all audit firms, including more audits which are higher-risk or require the most complex accounting judgements;
- increasing the transparency of our work by publishing individual audit inspection findings, starting from our 2020/21 review cycle (where we obtain the consent of the audit firm and audited entity); and
- driving enhancements to key auditing standards, such as going concern, group audit and estimates.

We have developed our thinking on FTSE 350 audit market reform and the steps that may be needed to deliver a well-functioning and resilient market that will consistently deliver high-quality audits. We consider a well-functioning FTSE 350 market would deliver the following specific outcomes:

- audit committees select auditors based on audit quality and provide support to auditors to carry out a high-quality audit, including challenge of management;
- sufficient choice of audit firms to help ensure market resilience, and to mitigate the risk of failure of a Big Four firm. This will require one or more firms outside the Big Four to grow their market share of FTSE 350 audits and become credible auditors for most FTSE 350 companies;
- audit firms being focused first and foremost on audit quality; and
- regulators provide a transparent and consistent measure of audit quality, support enhancements to audit quality, highlight areas of good practice and hold audit firms and auditors accountable for breaches of audit and ethical standards.

We are supporting the Government to bring forward legislation that would improve resilience and choice in the FTSE 350 audit market. We have also developed our monitoring so that we can understand the extent to which the market is delivering these outcomes, including undertaking research with audit committee chairs on their approach to driving audit quality. More information on the market can be found in section 2.

Audit market health and resilience

The Big Four firms dominate the FTSE 350 audit market. Other firms have little involvement in these audits, although there is some evidence of FTSE 250 companies being more willing to appoint challenger firms in the last two years. The Competition and Markets Authority set out long-standing concerns about this situation in its 2019 statutory audit services market study, including the concentration of the market, the lack of choice available for companies to obtain a high-quality audit, and the market’s vulnerability to the failure of one of the Big Four firms.

The introduction of mandatory audit tendering and rotation in 2016 has marginally improved the functioning of the audit market. Nonetheless, the CMA found that the market was not consistently delivering high-quality audits and exhibited deep-seated problems. The CMA found that putting the selection of auditors in the hands of Audit Committees of independent non-executives has only been a partial solution to the issues arising from companies selecting their own auditors.

Covid-19 pandemic

The Covid-19 pandemic has been a significant shock for the audit profession. At this time of heightened economic frailty, performing high quality audits is fundamentally more crucial, but harder to execute. The economic impact of the pandemic has increased the complexity of many forward-looking accounting judgements because of the uncertainty about the prospects of many companies. This makes effective challenge of management even more difficult, particularly given auditors have been inconsistent in performing this challenge in more stable and certain times. Auditors must therefore accelerate their efforts to effect change.

The practical impacts of Covid-19, including remote working, both in the audit profession and the underlying audited entities, have also added pressure on controls, and added further complexity to obtaining audit evidence that is sufficient...
Key issues for audit (continued)

and appropriate. The most significant impacts of the pandemic on auditing have been and will continue to be in the following areas:

- **Judgements, especially around going concern** – Covid-19 and its consequences have made the business prospects of some companies highly uncertain, raising questions for companies and their auditors about whether there is a material uncertainty around going concern. Other judgements have also become more difficult, for example, valuation of illiquid or intangible assets and impairment assessments.

- **Remote working** – Every audit engagement has been made more difficult by the need to switch to remote working. The inability to meet with entity management face-to-face continues to create additional risks and complexities in how to conduct an audit, particularly for areas where auditors normally obtain evidence in person, such as inventory counts. Travel restrictions have also made oversight of the work of overseas components more challenging for group auditors.

- **Controls and fraud risk** – Remote working might also have made controls less effective, as some companies may have cut back on the number of people involved in the internal control processes. For example, a survey by the Chartered Institute of Internal Auditors found that 45% of internal audit staff had been redeployed to support other areas of the business, while 15% were furloughed. These factors, combined with greater financial pressure on companies, could increase the risk of control failures and fraud.

We have been working with other UK regulators, including the Financial Conduct Authority and the Prudential Regulation Authority, to provide additional guidance to support the provision of high-quality financial information to markets and high-quality audit work. This includes guidance for companies preparing financial statements and a bulletin for auditors covering factors to be considered when carrying out audits during the Covid-19 crisis. Further details are included in section 1.

The inconsistent audit quality that we observed during our inspection work and described in section 1 was found in audits that were completed before the impacts of the Covid-19 pandemic were felt. Auditing during the pandemic and its aftermath will be more challenging. Audit firms therefore need to redouble their efforts to ensure the required improvements in audit quality are delivered.

The pandemic has also tested the resilience of the audit firms themselves. Firms have addressed multiple resilience risks simultaneously, including strategic risks relating to their business models, financial risks relating to their cash and income generation, and operational risks relating to their staff and supplier wellbeing. Their operating models have withstood significant challenges, such as transferring thousands of staff to remote working in under a week within a secure IT environment. They took actions early to reduce costs and conserve cash, including in some cases delaying partner drawings. So far, the audit firms have proven resilient financially and operationally.

We have requested detailed information from the firms on their responses to the pandemic and financial resilience. We assessed the measures taken by the senior leadership of each firm and increased our supervision of the firms to monitor their Covid-19 response and resilience.
Section 1: Audit quality results and our response
Section 1: Audit quality results and our response

The results of the 2019/20 FRC audit inspection cycle showed that audit quality is still unacceptably inconsistent. Across all 130 audits inspected directly by the FRC’s Audit Quality Review team, we assessed only 62% as good or requiring limited improvements. Results for the smaller challenger firms and for our inspections of local authority audits were poorer than for the company audits inspected at the seven largest firms. As a result, our combined results across all 130 files inspected are slightly worse than those for the 88 files inspected at the seven largest firms (67% of audit assessed as good or requiring limited improvements), that we separately reported on in July 2020 (refer to appendix 1 for further details).

Nonetheless, any inspection cycle identifying 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.

In this section we look in detail at the key drivers behind these inconsistent results, and also highlight areas of good auditing we have observed. We then look at how we are responding to these results within the remit of our current powers.

While the FRC’s audit inspection results are a key measure of audit quality in the UK, other mechanisms for monitoring audit quality are also important, particularly the monitoring of the quality of audits of smaller entities, which is delegated to the Recognised Supervisory Bodies (RSBs), such as the Institute of Chartered Accountants in England and Wales (ICAEW). The table below outlines the suite of monitoring arrangements in the UK. In addition, audit firms perform their own programmes of internal audit quality monitoring of completed audits. The results of each of these monitoring activities are touched on throughout the report.

Overview of key audit monitoring activities in the UK

<table>
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<tr>
<th>Entity type</th>
<th>Monitoring body</th>
<th>Monitoring capacity/arrangement</th>
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<tbody>
<tr>
<td>UK Public Interest Entity (PIE) audits</td>
<td>FRC</td>
<td>Competent Authority</td>
</tr>
<tr>
<td>Large Alternative Investment Market (AIM) listed entities</td>
<td>FRC/ICAEW</td>
<td>Private contractual arrangement</td>
</tr>
<tr>
<td>Lloyd’s Syndicates</td>
<td>FRC</td>
<td>Competent Authority</td>
</tr>
<tr>
<td>Crown dependency incorporated entities with securities traded on regulated European Economic Area market</td>
<td>FRC/ICAEW</td>
<td>Private contractual arrangement</td>
</tr>
<tr>
<td>Third country audits</td>
<td>FRC</td>
<td>Competent Authority</td>
</tr>
<tr>
<td>Local Audits</td>
<td>FRC/RSBs</td>
<td>Local Audit and Accountability Act 2014</td>
</tr>
<tr>
<td>Other (non-FRC scope) audits</td>
<td>RSBs</td>
<td>Delegation agreement</td>
</tr>
<tr>
<td>National Audit Office audits</td>
<td>FRC</td>
<td>Independent supervisor/private contractual arrangement</td>
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Changes to the proportion of audits falling within each grading category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our inspections are also informed by the priority sectors referred to in appendix 1. We are also cognisant, when making our selections, of the CMA’s recommendation that FTSE 350 company audits should be subject to inspection approximately every five years. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across a firm’s entire audit portfolio, nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at a firm.
Section 1: Audit quality results and our response (continued)

Due to resourcing constraints and broadening the scope of our inspections, we reviewed fewer audits overall in this inspection cycle than in recent years. Across all firms, we completed 130 audit inspections compared to 160 in 2018/19. We have specifically broadened the scope of our inspections to include more aspects of the audit, including enhanced focus on the auditor’s response to fraud risk and the review of some overseas component audit work. In 2020/21, we plan to inspect around 145 audits.

What is high audit quality?

The FRC defines high-quality audits as those that:

• provide investors and other stakeholders with a high-level of assurance that financial statements give a true and fair view;
• comply with both the spirit and the letter of auditing regulations and standards;
• are driven by a robust risk assessment, informed by a thorough understanding of the entity and its environment;
• are supported by rigorous due process and audit evidence, avoid conflicts of interest, have strong quality management, and involve the robust exercise of professional judgement and professional scepticism;
• challenge management effectively and obtain sufficient audit evidence for the conclusions reached; and
• report unambiguously the auditor’s conclusion on the financial statements.

Audit quality is not directly visible to stakeholders and can be defined in different ways depending upon what different stakeholders expect from an audit. The results of our audit quality inspections are a key measure of audit quality and are designed to provide an indicator of audit quality for a broad range of stakeholders.

Audit Quality Review inspection analysis – Key issues

We performed detailed analysis of all the inspection findings identified through our monitoring programme, including identifying areas of good practice, which are described in more detail below.

We have identified the most common areas needing improvements to be:

• sufficiency of challenge of management;
• audit of going concern;
• group audit oversight; and
• quality control over the audit.

Additional analysis of our inspection results using criteria such as commercial sectors companies operate in, and size of the audit firm, is included in appendix 1.
Section 1: Audit quality results and our response (continued)

Sufficiency of challenge of management

Insufficient challenge of the management of audited entities remains one of the most frequent issues we identify, although we have seen some cases where it was performed well. The need to challenge management most often arises when auditors evaluate management’s forward-looking judgements and estimates, including impairment of goodwill and intangibles, revenue and contracts, and provisions. Tangible evidence is often difficult to access and assess, and the results can be highly material to the financial statements. Challenge of management requires an auditor to exercise professional scepticism, a fundamental ingredient of a robust audit, as management may be biased towards particular outcomes or assumptions – consciously or unconsciously. Auditors may also have an unconscious bias towards corroborating management’s assumptions, rather than challenging them or seeking alternative evidence. They may also rely too much on prior knowledge, leading to a ready acceptance of management’s assumptions.

Establishing the extent of evidence needed to support a judgement in relation to uncertainties is a skill rather than a specific audit test. It requires the correct mindset and sufficient professional scepticism in evaluating the facts presented by management and how these compare to other evidence obtained. It does not necessarily mean distrusting management and assuming information is incorrect until proven otherwise. To help achieve timely and constructive challenge, auditors should, as early as possible during the audit, form their own informed expectations which take account of a range of information including sector and business specific factors. This approach would allow the auditor to identify and consider objectively the range of evidence relevant to the audit issue, and to ask the right questions, often through an iterative process requiring multiple discussions and time for reflection.

Challenge of management has become a more important element of high-quality auditing as accounting standards have increasingly become based on forward-looking estimates. It is even more critical on high-risk audits, where the financial position of companies may be more uncertain and, in some cases, precarious. Audit firms need to understand why audit partners and their teams continue to underperform in this area. They should increase their efforts to eliminate the culture of unconscious bias towards corroborating rather than challenging management’s positions. Audit firms should encourage audit partners to take the time required when dealing with large and complex judgements. Where necessary, effective challenge of management should be given a higher priority than meeting deadlines. Audit firms’ senior management need to be clear that taking difficult decisions is an appropriate and necessary response to improving audit quality, even if ultimately it might mean losing some audit engagements.

Audit teams may need to draw on a range of specialist experts, both internal and external to their firm, to help them challenge management’s judgements and estimates effectively.

Example – challenge of management:
In the following example we aim to demonstrate the importance of effective challenge of the estimates and judgements made by management of an audited entity, and the difficulties presented by it. This example draws from several inspections of actual audits:

• Management performed a goodwill impairment assessment, which included forecasting future revenue growth, operating margin improvements and expected cost savings. The forecasted cost savings showed performance improving across the next five years, with higher sales and profit. This was despite recent trends showing the group’s performance was declining and management were not consistently achieving their previous targets. The budgets, which were the basis of these forecasts, were developed by different members of divisional management at each of the group’s trading locations, using a “bottom-up” budgeting process, and reviewed and approved by central management, the Audit Committee and the Board of Directors.

• The audit team’s approach to challenging management’s assumptions within these forecasts was: to review the detailed budgets and plans; to corroborate the future growth and cost savings through discussions with the respective divisional management at each of the group’s trading locations, and to benchmark the company’s position compared to its peers.

• In this instance, the audit team did not challenge effectively the assumptions used by management to forecast future cashflows. While benchmarking is useful in identifying potential outliers within an industry, it rarely provides evidence that assumptions are appropriate for the particular entity. Also, management outside of the group’s central finance team are still considered to be management for the purposes of the audit, and management information cannot simply be corroborated by other management information.

• In such situations, auditors should understand what source information was being used by divisional managers to generate their forecasts (whether internal or external) and consider whether this information is appropriate. They should assess whether the company’s forecasts are realistic and achievable in the current environment. They should also obtain evidence to support the assumptions about growth and cost savings, such as reviewing management’s historical performance against budgets, comparing to other internal and external information such as industry projections by analysts, and assessing the level of actual results which can be demonstrated post year-end before the audit is completed. Management often need to take immediate steps to generate higher revenue/profits and save costs in the very short term, and so audit teams should be able to corroborate that such steps have been taken.
Audit of going concern

Auditors are required to obtain sufficient audit evidence around whether the going concern assumption is appropriate for the financial statements, and if so, whether there is a reasonable possibility that the going concern assumption may not be appropriate over the following 12 months (known as a material uncertainty relating to going concern). They are also required to consider the adequacy of management’s disclosures if events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern, even if the auditor concludes that no material uncertainty exists.

While assessing going concern is the sole responsibility of the directors, auditors play a vital role by providing an independent challenge. Boards and their Audit Committees should accept and facilitate this challenge.

Companies often have financial covenants attached to their revolving credit facilities and long-term debt. Assessing the risk that a company might breach these covenants can be a critical part of a going concern assessment. The judgements involved in how a company complies with covenants have changed in recent times, with more companies now using exceptional or adjusted metrics within their covenant certificates to assert compliance with covenants. These exceptional measures are not consistently defined in the covenant terms and are based heavily on management’s judgements. This creates the risk of lenders possibly disagreeing with these judgements and challenging whether covenants are calculated in line with the contractual requirements.

We have found several instances where auditors failed to assess and challenge adequately management’s going concern assumptions. Issues we have found include:

- audit teams not sufficiently understanding and challenging management cashflow forecasts for the next 18 months, where the forecasts showed significant revenue and profit growth without a committed plan for how to achieve this growth;
- management preparing annual or quarterly cashflow forecasts and audit teams not challenging whether such high-level forecasts were appropriate to identify and assess liquidity shortfalls adequately, compared to monthly or weekly forecasts;
- audit teams placing too much reliance on information provided by management around future actions to save costs or increase revenue, and not considering external data which might contradict management’s information (for example: independent market-wide projections produced by analysts);
- management assuming that debt facilities due to expire in the next 12 months would be refinanced on the same terms and conditions, and audit teams not assessing how likely this would be or discussing with the relevant banks involved;
- audit teams placing undue reliance on management’s lawyers to confirm that management’s interpretations of covenant terms and conditions were appropriate rather than obtaining assessments from independent legal advisers; and
- audit teams not challenging management to disclose all their key assumptions in their assessment of going concern in the financial statements, and not highlighting key assumptions in the auditor’s report.

We have also identified examples where the audit team’s assessment of going concern was performed well, with consideration of a range of adverse factors and the resulting impact on the company’s cash projections, financing arrangements and liquidity management. Open and transparent communication between the auditor and the company about upcoming risks and challenges was key.

The Covid-19 pandemic has increased the risk around the appropriateness of going concern assumptions and possible material uncertainties. As part of our response to the pandemic, we have reviewed the largest seven firms’ revised policies and procedures around going concern. Details of this are included later in this section.
Group audit oversight

Group audit teams are responsible for the direction, supervision and co-ordination of the work performed by overseas auditors at the component level. This is a particular challenge for auditors of large multinational groups.

Group auditors should be sufficiently involved in their component audits, understand the key judgements made by component auditors, and challenge these as if they were making the judgements themselves. While different cultures and norms across the globe may make this difficult, the group audit team remains responsible for the global audit, and should challenge group and component management, and component auditors.

In many instances the group audit team visits component auditors to hold discussions and review local audit files. Often these visits are key to the overall audit assurance obtained, but they are frequently executed in a very short timeframe (due to time and cost burdens) and involve many meetings with component auditors and component management. Group auditors need to ensure they have sufficient time to have appropriate discussions with component auditors around the key risk areas and subsequently to reflect these on the group audit file.

We have identified several instances where the group audit team were unable to demonstrate how they had understood the component teams’ procedures or how they had challenged their international colleagues in areas of significant judgements. This included the following examples:

- component auditors not challenging their local management around critical judgements and estimates and incorrectly assuming that the group audit team performed this challenge;
- component auditors changing the scope of their own component audit due to misunderstandings that the group audit team would be performing additional procedures;
- component auditors ignoring the group audit team’s instructions and performing different procedures to those instructed;
- component auditors not completing their procedures in time for the group audit team to assess them adequately and follow up on any shortcomings;

- group auditors copying component audit working papers directly into their group audit file without adequate review, and deficiencies within the component auditors’ work therefore not being detected; and
- significant issues identified in component audits not being reported adequately to the group audit team and the group audit committee.

We have also seen the group oversight role performed well. In such cases, teams have evidenced their oversight across each phase of the component audit, including risk assessments, audit approach development, execution of audit approach and reporting to the component level management of the audited entity.

Going forward, with Covid-19 travel restrictions, group auditors may not be able to physically visit component auditors and may need to perform their oversight remotely, which will create challenges many group auditors have not encountered before. It remains important for group auditors to ensure that appropriate oversight is performed throughout the Covid-19 pandemic.

Auditing Standards

Auditing standards are also integral to improving audit quality and therefore need to evolve as required. We have played a leading role in developing revised auditing standards around going concern and group audit in order to increase the quality of all audits in these areas. In addition, we have worked closely with the International Auditing and Assurance Standards Board to develop a new standard for auditing management estimates, which better focuses on challenge of management and includes measures to reinforce professional scepticism. Further detail on the changes made to the standards are included in appendix 2.
Quality control over the audit

Robust quality control procedures are essential to achieving high-quality audits. This means an appropriate review of all the audit work performed and the evidence of that review retained on the audit file by the audit engagement partner and other senior members of the audit team.

The audit file is evidence of the cumulative effort of the audit team and, for larger entities, can represent tens of thousands of hours of work. While stakeholders never see the work contained on an audit file, it remains the fundamental cornerstone supporting the auditor’s report. An auditor’s report, without a full and comprehensive audit file supporting it, loses its value and usefulness to those who read it, as the statements and opinions included may not be backed by robust evidence.

We have seen instances where the quality control and review procedures were not sufficiently rigorous to identify shortcomings in audit work. These have included quality control procedures failing to flag:

• unclear and unsupported risk assessments over key management judgements and estimates resulting in highly judgemental areas being subject to minimal audit procedures;
• audit approaches not distinguishing between controls or substantive tests, or executing incorrect procedures, resulting in deficient audit approaches which did not cover all relevant risks;
• miscommunication of expected procedures between the audit team and their specialists and experts resulting in planned procedures not being performed; and
• material balances not being tested due to incorrect applications of materiality.

Audit quality review inspection analysis – Good practice

Through our inspections we also identify areas of good practice. It is important to recognise and share these as a powerful means to foster audit quality. We have already highlighted a few examples of good practice in the sections above, but want to draw out further the following examples:

• audit teams delaying the signing of audit reports to complete necessary audit procedures or await key information from management, even when this meant original timetables were not met;
• effective use of the audit firm’s experts to provide appropriate support to the audit, with clear instructions to the experts and a thorough evaluation of the work performed;
• evidence of challenge of management around estimates and judgements, where the audit team laid out all internal and external evidence obtained, assessed each element objectively, and used this to challenge management; and
• clear and justified risk assessments with detailed explanations of the reasons why some management judgements and estimates were considered significant risks and others were not (particularly around highly judgemental valuations and provisions).

Interestingly, we have identified several instances of good practice in areas where we have also found significant issues – primarily the sufficiency of challenge of management and group audit oversight. This highlights that all audits are unique, and differing audit approaches can result in different levels of audit quality. The audit approach must be tailored to the individual requirements of each company and it is encouraging to see some audit teams doing this well.
Section 1: Audit quality results and our response (continued)

How is the FRC responding to the audit monitoring results?

The Government’s consultation on restoring trust in audit, reporting and governance will address the range of changes needed to be made by audit firms, companies, investors, regulators and legislation. In parallel, we are moving forward with significant changes to our regulatory approach to drive improvements in audit quality.

Change in supervisory approach

We are strengthening our forward-looking supervision of the large audit firms and increasing our thematic work across the audit market, alongside more individual audit file inspections. A revised structure sees the creation of audit firm ‘supervisors’, bringing together in one place functions which were previously split across the FRC. Further details around the change to our supervisory approach are contained in section 3.

As part of our changing supervisory approach, we are looking at the approval and registration of PIE audit firms and auditors. Currently, registration of all UK audit firms and auditors is delegated to the RSBs. Sir John Kingman recommended that the FRC reclaim the approval and registration of PIE audit firms from the RSBs, incorporating a range of sanctions, including some that are less severe than audit firm deregistration.

How is the FRC responding?

- Change in supervisory approach
- Root cause analysis review
- Operational separation of Big Four audit firms
- Transparent reporting of individual AQR inspections
- Thematic inspections
- Enforcement
- Review into challenge of management issues
- Response to Covid-19
- Changes in AQR audit inspections

We are developing proposals for how we will implement the review recommendations and will consult with the affected audit firms and RSBs. These will cover:

- reliable and comprehensive capture of relevant intelligence (including audit inspection and audit market evidence);
- efficient assessment of conditions and other measures that will apply to firms’ registrations;
- governance arrangements that will support our decisions; and
- implementation of fair and independent appeals processes.

This will provide us with an improved toolkit for the supervision of auditors, as supervision concerns can be taken into account when addressing approval and registration issues.

Changes in AQR audit inspections

Our AQR inspection selections do not look at every audit every year, and judgements must be made to ensure our limited time and resources are focused on key areas of the audit market. In recent years, we have selected for inspection an increasing number of ‘higher-risk’ audits (as defined on page 3). Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues.

Each year we identify priority industry sectors, which are typically those subject to greater stress in the current economic climate, or those undergoing a large number of financial reporting changes. Entities in these sectors will feature more heavily in our selection. For 2019/20, our priority sectors were financial services, general retailers and retail property, construction and materials, and business support services. An analysis of our inspection observations in these sectors is included in appendix 1. For 2020/21, the sectors are construction and materials, retail including retail property, travel and leisure, financial services and manufacturing.

Root Cause Analysis (RCA) review

Effective RCA is crucial for an audit firm to understand the underlying causes of audit weaknesses, so that the firm learns from the experience, and develops appropriate actions to prevent repetition. Where audit firms do not perform RCAs in detail or with enough rigour, it is likely that any responses will only target the
Section 1: Audit quality results and our response (continued)

symptoms of the problems, rather than the causes, increasing the likelihood of issues reoccurring.

Key underlying themes identified by audit firms through their RCAs include:

• audit teams using a corroborating mindset rather than a challenging mindset;
• a lack of resourcing to allow the audit to be completed in a timely manner;
• insufficient levels of training and guidance for audit teams that performed detailed testing of key risks;
• ineffective project management to ensure that high-risk audit work was being performed in a timely manner to allow for full consideration of key risks; and
• an inconsistent level of supervision and review from senior members of the audit team.

We have reviewed the progress of the audit firms’ RCA processes over recent years and requested that they perform RCA as part of their development of actions to address our findings. Overall, we have noted that the firms’ RCA, in particular the reporting of themes and actions, has improved, but the implementation of actions to address the root causes will still take time. The Big Four firms’ RCA processes and outputs have reached a higher standard than that of other firms, so there is an opportunity for the smaller firms to learn from these developments. We have summarised additional improvement areas and good practices in our individual inspection finding reports for each firm, published in July 2020.

In addition, the new quality management standard ISQM 1 (covered in more detail in appendix 2), will bring added focus to RCA. The standard will require significantly enhanced monitoring and remediation processes that demand an evaluation of findings and identified deficiencies, and their related root cause, and subsequent remediation and communication activities.

Operational separation of Big Four audit practices from the rest of the firm

Earlier in the year, we published objectives, outcomes and principles for operational separation of the Big Four audit practices from the rest of the firm. We asked the Big Four to agree to these and provide us with their plans for implementation. Our objectives for operational separation are to ensure that audit practices are focused above all on delivery of high-quality audits in the public interest, and do not rely on persistent cross-subsidy from the rest of the firm. The CMA recommended separation of audit practices to reduce conflicts of interest between the audit and non-audit services provided by firms.

Our desired outcomes include:

• audit practice governance prioritising audit quality and protecting auditors from influences from the rest of the firm that could divert their focus away from audit quality;
• the total amount of profits distributed to the audit partners not persistently exceeding the contribution to profits by the audit practice;
• the culture of the audit practice prioritising high-quality audit by encouraging ethical behaviour, openness, teamwork, challenge and professional scepticism; and
• auditors acting in the public interest and working for the benefit of shareholders of audited entities and the wider society.

Following review of each firm’s plans, we will agree transition timetables for full implementation by 2024 at the latest. We expect that firms will have implemented most of the changes well before that date. We will publish annually an assessment of whether firms are delivering the objectives and outcomes of operational separation.

Review into challenge of management issues

As explained earlier, poor challenge of management’s key estimates and judgements continues to be our most common inspection finding. We have started a review of the instances of lack of challenge of management that we have observed over the past few years and are analysing these for common themes. We aim to create a consistent, understandable definition of inadequate challenge of management and look to identify the characteristics needed to allow for effective and practical challenge of management. We plan to use the results of this analysis to support audit teams develop effective challenge, as well as to guide our AQR inspections in the future. The analysis will also inform planning of a future thematic review and help provide more tangible examples to audit teams regarding where their challenge of management needs further improvement.

By ensuring that audit practices are focused first and foremost on audit quality, we expect operational separation of audit practices from the rest of the firm to support a culture of independent challenge within audit. Given the importance of improved
Section 1: Audit quality results and our response (continued)

challenge of management to audit quality, we are planning to hold a series of events on this topic over the course of the next year.

Enforcement

Enforcement action serves the public interest by holding to account those who fail in their responsibility to deliver high-quality auditing and reporting.

Our enforcement activity in relation to statutory audits is carried out under the Audit Enforcement Procedure (AEP). 2019/20 was the third full year since the AEP came into force. It brought a significant shift in audit enforcement, by expanding the FRC’s remit to all Pies, large AIM companies and Lloyd’s Syndicates, and by changing the threshold for statutory audit failures to breaches of relevant requirements as opposed to the higher bar of misconduct. The AEP also introduced ‘constructive engagement’ to deal with cases where the audit quality concerns can be appropriately and satisfactorily addressed, and the risk of repetition mitigated, without the time and expense of full enforcement action. The AEP has been subject to a post-implementation review over the past 12 months and this will lead to a public consultation on proposed amendments. Details of specific cases considered in the year to 31 March 2020 are included in appendix 3.

Transparent reporting of individual AQR inspections

Upon completing our 2020/21 inspection cycle and in line with the recommendations of the Kingman Review, we plan to publish findings for each of our individual inspections in July 2021 alongside our established summary reports on audit quality at each of the larger firms. Publishing these individual reports will allow stakeholders such as investors and audit committee members to see the issues and good practice identified at a more granular level across all our inspections. They will provide investors with information to enhance their dialogue with audit committees about audit quality, which the Brydon Report recommended. Publication should also sharpen incentives for auditors to perform high-quality work. Our current intention is to publish the key findings of each individual audit inspection on an annual basis on our website at the conclusion of the inspection cycle. At present, we will only be able to do this where we have received the consent of both the relevant company and the audit firm. We will also report if a company or audit firm does not provide this consent.

Response to Covid-19, including review of audit procedures over going concern

In March 2020, we issued a joint statement with the Financial Conduct Authority (FCA), and Prudential Regulation Authority (PRA) on our response to Covid-19 intended to:

• ensure that information continued to flow to investors;
• help companies and their auditors prepare financial statements in the uncertain climate; and
• help market participants and lenders respond appropriately to audit report modifications and loan covenant breaches.

We also issued guidance to companies on financial reporting and a bulletin for auditors.

The bulletin reminded auditors that they must obtain sufficient, appropriate audit evidence to support their audit opinion. However, in the circumstances of the pandemic, they would need to consider the use of alternative procedures, including remote working and technology to obtain that evidence. This would not work in all circumstances and it was likely that there would be more modified opinions arising from the impact of Covid-19 on businesses.

Subsequently, in July 2020, we issued a letter to the largest seven audit firms, following a review of their policies and procedures in relation to the audit of going concern, and published this on our website. The review focused on how firms had responded to the heightened risks created by Covid-19 and found that the additional policies and procedures introduced were appropriate and reasonably consistent across the firms. Since the start of Covid-19, audit firms have increased the extent of required consultations and central guidance for audit teams and have had regular communications with them, to ensure consistency in the audit of going concern. These additional measures have encouraged additional challenge by auditors to company boards and management about their key assumptions, stress testing and disclosures in the financial statements.

We are in the process of reviewing a sample of completed audits, as the next stage of the review, to assess how the revised going concern policies and procedures are being applied in practice, and plan to report on our findings before the end of the year. We are also reviewing a sample of other audits, completed after the initial impact of Covid-19, as part of our 2020/21 inspection cycle.
Thematic inspections
Thematic inspections supplement our individual audit inspections and firmwide inspection work. They are not firm-specific inspections, but rather reviews of a focused area related to audit quality across multiple firms. The thematic areas we look at each year depend upon the forward-looking risk factors identified across the profession. We plan to perform more thematic inspections going forward to identify and share common areas of good practice and weakness. Further information on the thematic inspections performed in the year are included in section 3 of this report.

Audit Quality Monitoring of companies that are not Public Interest Entities
Beyond audits of PIEs, audit quality monitoring is performed by the RSBs under delegation agreements with the FRC and subject to our oversight. The largest of these RSBs in terms of registering audit firms is the ICAEW, which had registered 2,661 statutory audit firms as at December 2019.

ICAEW monitoring results
The ICAEW has recently published its report outlining the audit quality results and findings of their inspection activities. The chart to the right shows the results of ICAEW’s audit file reviews, indicating that around a quarter are still requiring improvements or significant improvements. The year-on-year comparisons indicate that the results have remained largely static. While the audits reviewed by the ICAEW are smaller and different to those inspected by the FRC, the results are broadly in line and show that audit quality remains inconsistent.

As with the FRC’s inspections, the common theme from ICAEW’s inspections was insufficient auditor scepticism and challenge of management’s judgements.

FRC’s monitoring of RSBs
The FRC’s Professional Oversight Team monitors the RSBs’ work in fulfilling their regulatory tasks under the FRC’s delegation agreements. During the current year, we carried out an in-depth review of the RSBs’ audit quality monitoring processes, including planning, fieldwork, reporting and finalisation to assess how each RSB applies its audit quality monitoring policies and procedures in practice. This led to changes being required at certain RSBs, including adoption of a top-down risk-based approach to file selection as well as a requirement to report audit quality review grades in the RSBs' report to the firms.

In June 2019, we agreed with the RSBs an audit quality key performance indicator that 75% of completed audit file reviews by the registering RSB on a Registered Auditor should require no more than limited improvements. Where an audit requires more than limited improvements, the RSB will apply guidance agreed with us to determine whether a root cause analysis should be conducted by the firm. The RSBs implemented these KPis starting in February 2020 and will report their first results in 2021.
Audit firms’ internal quality monitoring

Audit firms also perform their own audit quality monitoring. This section briefly outlines the key findings from this form of monitoring. It should be read in conjunction with each individual firm’s Transparency Report for 2019 and the FRC’s inspection findings reports for the largest seven audit firms published in July 2020. These provide further detail of each firm’s internal quality monitoring approach and results, and its wider system of quality control. Due to differences in how firms perform and rate their internal inspections, 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.

Common issues identified by the firms themselves follow similar themes to our inspection results. The most common issues identified were:

• audit teams not appropriately challenging management around key estimates and assumptions which were fundamental to the accounting of certain balances;
• audit teams not identifying relevant financial reporting requirements when faced with infrequent transactions and transactions which were outside of the normal course of business;
• weaknesses in the execution of mandated firm procedures or incorrect applications of the firm’s methodology around core audit areas (particularly around mandatory journal entry testing); and
• poor audit partner review which did not identify shortcomings in the audit work.

We encourage audit firms to continue their programmes of internal quality monitoring and use them to identify good practice and areas of improvement. A robust and effective internal quality monitoring programme embeds a culture of quality and encourages audit partners to be accountable to their peers. As noted above, we recognise the significant efforts and investment being made by audit firms to improve their methodologies and to improve their approaches to challenging management. It will, however, take time for these investments to have an impact on audit quality.
Section 2: Audit market developments
Section 2: Audit market developments

This section provides details of the latest developments in the FTSE 350 audit market since our publication of Developments in Audit 2019 and the CMA’s Statutory Audit Services Market Study, drawing on data analysis of indicators of competition in the audit market. These provide a starting point against which we will be able to assess the impact of measures such as operational separation of audit and non-audit practices.

The market indicators we are focused on reflect the concerns about the market and the outcomes we are seeking from a well-functioning market. The key indicators being analysed and used include:

### Key Indicators

- **Audit fees**
- **Audit market share**
- **Auditor changes & rotation**

#### Audit fees

In 2019, FTSE 350 companies paid £970 million for audit services. This represents a 9% increase on 2018. The largest sector by audit fees in the FTSE 350 was finance, insurance, and real estate, (representing around 33% of the total audit fees paid in the FTSE 350), followed by manufacturing (25%) and services (12%), based on audit fee data obtained from Audit Analytics and North American Industry Classification System (NAICS) and London Stock Exchange (LSE) sector classifications.

The following table to the right shows the top 10 FTSE 350 companies by audit fee in 2019 and the auditor of each company. This shows that the distribution of audit fees is highly skewed with the banking and oil and gas sectors paying the highest audit fees overall. The highest fee is four times as high as the 10th highest fee.

<table>
<thead>
<tr>
<th>Company</th>
<th>Auditor</th>
<th>Audit Fees (£million)</th>
<th>LSE Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>PwC</td>
<td>66.7</td>
<td>Banks</td>
</tr>
<tr>
<td>Barclays</td>
<td>KPMG</td>
<td>46.2</td>
<td>Banks</td>
</tr>
<tr>
<td>Royal Dutch Shell</td>
<td>EY</td>
<td>39.1</td>
<td>Oil, Gas &amp; Coal</td>
</tr>
<tr>
<td>BP</td>
<td>Deloitte</td>
<td>33.7</td>
<td>Oil, Gas &amp; Coal</td>
</tr>
<tr>
<td>WPP</td>
<td>Deloitte</td>
<td>30.3</td>
<td>Media</td>
</tr>
<tr>
<td>The Royal Bank of Scotland</td>
<td>EY</td>
<td>30.3</td>
<td>Banks</td>
</tr>
<tr>
<td>GlaxoSmithKline</td>
<td>Deloitte</td>
<td>29.9</td>
<td>Pharmaceuticals &amp; Biotechnology</td>
</tr>
<tr>
<td>Lloyds Banking Group</td>
<td>PwC</td>
<td>25.9</td>
<td>Banks</td>
</tr>
<tr>
<td>Aviva</td>
<td>PwC</td>
<td>16.7</td>
<td>Life Insurance</td>
</tr>
<tr>
<td>Glencore</td>
<td>Deloitte</td>
<td>16.4</td>
<td>Industrial Metals and Mining</td>
</tr>
</tbody>
</table>

Note: Audit fee amounts converted from EUR to GBP using the ONS average 2019 exchange rate. As a result, these may not reconcile to quoted currency disclosures within the financial statements of individual companies. Source: Audit Analytics Audit Opinion Data; London Stock Exchange as of October 2020.

#### Firms’ revenues from audit and non-audit services

The major audit firms are multi-disciplinary and provide a range of services beyond audit, with the vast majority of these services being supplied to companies not audited by the firm. The Big Four derived around 74% of their revenue from companies they were not auditing in 2019. This varies from 66% for KPMG to 81% for Deloitte. The Big Four derived around 19% of their revenue from the audit services they provided to companies they were auditing in 2019. The remaining 6% of revenue came from non-audit services provided to audited entities.

Non-audit services supplied to companies that the firm did not audit accounted for over half of the main challenger firms’ revenue in 2019. Challengers derived around 57% of their revenue from entities they did not audit in 2019. This varies from 49% for BDO to 60% for RSM. The challenger firms derived around 29% of their revenue from audit services in 2019. The remaining 14% of revenue came from non-audit services provided to audited entities.
Section 2: Audit market developments

The following chart shows the fees arising from audit and non-audit services, covering only fees each firm receives from companies they audited in the FTSE 350. The figure shows the declining importance of non-audit fees from FTSE 350 companies that the firms audit, compared to the audit fees received from those companies.

For challenger firms, a larger proportion of total fees is generated from audit fees compared to the Big Four and the share of revenue from non-audit services from companies that they do not audit is lower than for the Big Four. Both these proportions have remained relatively constant since 2014.

The next two charts show the evolution in audit and non-audit services revenues for the Big Four and non-Big Four firms respectively since 2014. For the Big Four, there is a downward trend in the proportion of overall revenue earned from non-audit services provided to companies audited by the firm, from 12% in 2015 to 6% in 2019. We expect this trend within the Big Four to continue, following the limits on the provision of non-audit services implemented by firms voluntarily and the subsequent publication of our revised Ethical Standard on 17 December 2019, which means public interest entity auditors can only provide non-audit services closely linked to the audit itself or required by law or regulation.
Section 2: Audit market developments (continued)

Composite of revenue from audit and non-audit services for non-Big Four firms from PIE engagements

<table>
<thead>
<tr>
<th>Year</th>
<th>Audit revenue</th>
<th>Non-audit services from companies being audited</th>
<th>Non-audit services from companies not being audited</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>60%</td>
<td>27%</td>
<td>13%</td>
</tr>
<tr>
<td>2016</td>
<td>60%</td>
<td>27%</td>
<td>15%</td>
</tr>
<tr>
<td>2017</td>
<td>60%</td>
<td>27%</td>
<td>13%</td>
</tr>
<tr>
<td>2018</td>
<td>59%</td>
<td>26%</td>
<td>17%</td>
</tr>
<tr>
<td>2019</td>
<td>58%</td>
<td>28%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Audit market share

The Big Four firms were the statutory auditors of 96% of FTSE 350 companies in 2019. This is slightly lower than the 97% share they had in 2017. The Big Four firms also accounted for 99.3% of FTSE 350 audit revenue in 2019. This is a small decrease compared to 2017, where they accounted for 99.5% of audit revenue. The only non-Big Four firms that audited FTSE 350 companies in 2019 were BDO (eight audits), Grant Thornton (six audits), and RSM (one audit).

The following chart shows the number of firms providing audit services to FTSE 100 and FTSE 250 companies in each year between 2015 and 2019. Only the Big Four firms have provided audit services to FTSE 100 firms in the past five years.

Number of audit firms signing the audit opinions of FTSE 350 companies - split between FTSE 100 and FTSE 250 audits

Note: FTSE 350 clients as at 26 June 2020. Audit Analytics does not contain information on companies no longer listed as FTSE 350, therefore the data used does not enable a perfect identification of historical FTSE 350 engagements. Sources: Audit Analytics Audit Opinion data; Bloomberg.
Section 2: Audit market developments (continued)

Audit distribution by market capitalisation
The following chart shows audit firm market shares of FTSE 350 audits based on the market capitalisation of FTSE 350 companies. Each FTSE 350 company is allocated to one of six percentile bands. For example: The top 10% of FTSE 350 companies based on market capitalisation are allocated to the 90-100 band, while the bottom 10% of companies are allocated to the 0-10 band.

The figures show the following:
• The majority of revenue from FTSE 350 audits in all bands is captured by the Big Four firms.
• The presence of all Big Four firms varies between bands and there is no clear pattern.
• Challenger firms are mainly present among companies in the lower half of the distribution of market capitalisation bands and no challenger firms audit any of the top 25% companies in the FTSE 350 by market capitalisation.

FTSE 350 audit market share by market capitalisation percentile bands and by number of engagements in 2019

Note: 90th percentile corresponds to companies with a market capitalisation above EUR17.4bn, similarly for the 75th, above EUR6.1bn, 50th above EUR2.2bn, 25th above EUR1.3bn, and 10th above EUR0.8bn. “Others” include non-Big Four firms and unknowns (i.e. observations for which Audit Analytics does not detail the identity of the auditor). Source: Audit Analytics Audit Opinion data.

Auditor changes and auditor tenure
The proportion of FTSE 350 companies switching auditors was around 9% per year between 2015 and 2019. The highest proportion in this period, 11.7%, was in 2017, and the lowest proportion, 6.6%, was in 2018. The proportions show no clear consistent trend in switching rates.

Among the switches that occurred, there is some evidence more recently of more switching away from the Big Four firms to challenger firms.
• The average across the period 2015-2019 was 5% of switches from a Big Four firm to a challenger firm with 6% moving from a challenger firm to a Big Four firm.
• In 2019, 13% of switches were from a Big Four firm to a challenger firm and with 6% moving from a challenger firm to a Big Four firm.

The following chart provides a break-down of switching between the Big Four and challenger firms, based on the number of FTSE 350 companies switching between auditors in 2019. It also shows the corresponding break-down of FTSE 350 companies as at June 2020 switching between auditors for all switches that happened between 2015 and 2019.
The following chart sets out the distribution of current auditor tenures for FTSE 350 companies over time. This shows that the proportion of FTSE 350 companies whose current auditor’s tenure is five years or less has increased over time, demonstrating the impact of the requirement for audit tendering that commenced in 2016. Conversely, the proportion of companies whose current auditor’s tenure is over five years has generally decreased over time, but there are still 5% of companies who have had the same auditor for over 20 years.

Switching in the FTSE 350 between the Big Four firms and challenger firms

Note: Challengers include all auditors other than Deloitte, EY, KPMG, and PwC. This chart includes all switching observed in the period 2015 to 2019 for companies in the FTSE 350 as at 26 June 2020. Because of rounding, the percentages as presented do not always add up to 100%; unrounded percentages do add up to 100%. Source: Audit Analytics Auditor Change data.

Distribution of current auditor tenures for FTSE 350 companies in 2012, 2017 and 2019

Note: Observations with missing tenure data are not included. FTSE 350 companies as at 26 June 2020. Sources: Audit Analytics Auditor Engagements Data; FRC Developments in Audit 2018; Accountancy magazine.
Section 3: Our new supervisory approach
Section 3: Our new supervisory approach

During the year, we re-organised the FRC into four divisions, as set out below. The changes will streamline operations, clarify accountabilities between the Board and the Executive and improve the effectiveness and speed of decision making. This was a significant step towards building a new regulator that serves the public interest by setting high standards of corporate governance, reporting and audit and holding to account those responsible for delivering them.

FRC Divisions

- **Regulatory Standards**: Setting and influencing standards and codes and promoting good practice, including international liaison and investor and other stakeholder engagement.
- **Supervision**: Monitoring and assessing compliance with the applicable laws, codes and standards that we set, ensuring that audit firms prioritise actions to improve audit quality, supervising the work of professional institutes, and promoting the resilience of the audit market.
- **Enforcement**: Proportionately holding to account, in the public interest, those responsible for breaching required standards.
- **Corporate Services**: Running the FRC effectively, as a public body in line with Government expectations of an independent regulator and the laws and regulations that apply to it.

More recently we have also restructured the Supervision Division to:

- incorporate new functions as the FRC/ARGA gains new powers (for example, audit committee oversight).

The key changes within the Supervision Division are:

- **The evolution of Audit Market Supervision (AMS)** – The FRC’s Audit Firm Monitoring & Supervision (AFMAS) approach was first developed in 2017 to monitor the audit market and the largest firms within it to identify deficiencies within a firm or firms that might lead to poor audit quality, and the risk of failure of a major firm or withdrawal from the audit market of one of the major firms. The supervision of individual firms will now be the responsibility of the new Audit Firm Supervision (AFS) team, and AMS will continue with cross-market analysis of topics such as audit firm governance, risk management, recovery and resolution planning and information security. AMS will lead our cross-firm inspection work on firms’ audit quality control arrangements, including monitoring the firms’ implementation of the new ISQM 1 (see appendix 2 for more on this new standard). It will also lead our thematic inspections across the audit market, such as the recent reports on technology and audit quality indicators. More detailed insights into recent AMS activities are covered later in this section.

- **The genesis of Audit Firm Supervision (AFS)** – The new Audit Firm Supervision team will comprise the new audit firm supervisors who will lead our engagement with a firm, bring together our overall assessment of its audit quality and resilience, and hold a firm accountable for delivering improvements. They will produce our annual public report on a firm. They will also carry out any constructive engagement with a firm where this is considered appropriate instead of enforcement action. In future, the team will manage the registration of PIE audit firms and auditors.

- **The strengthening of Audit Quality Review (AQR)** – The AQR team will enhance its annual inspection regime of PIE audits and other audits and will work closely with the AFS and AMS teams to identify and respond to audit quality issues. The publication of the key findings of each individual audit inspection will be a significant enhancement to the team’s work.

The remaining teams within the Supervision Division are the Corporate Reporting Review team, which reviews corporate financial reporting to assess compliance with accounting standards and legal requirements, and the Professional Oversight team, which oversees the supervisory work of the RSBs. These two teams are unaffected by these changes.
Section 3: Our new supervisory approach (continued)

Teams in the new Supervision Division

AMS Activities
In addition to the work on operational separation and the broader assessment of audit firms’ resilience in the face of the Covid-19 crisis, we outline below other key areas of work over the past year.

Audit Firm Governance Code – implementation review
In 2019, we began a review of the way in which the six largest audit firms had implemented the Audit Firm Governance Code (the Code). The review covered relevant principles and provisions of the Code as applied by the firms and focused predominantly on leadership and governance structures and the degree of oversight by Independent Non-Executives (INEs) in areas identified in the Code, such as audit quality, risk management and internal control, whistleblowing, people management and culture.

The Code provides flexibility that allows firms to apply it in ways that suit their partnership models and the firms have each developed their own approaches, leading to differences in the governance structures, as well as the positioning and activities of the INEs. The extent of the differences in the governance arrangements makes comparability and assessment of the effectiveness of governance a challenge and hinders effective communication to external stakeholders about how the largest audit firms are governed and run.

Our review found that all firms had made a concerted effort to apply the Code, and in many areas, this had been done well. At the same time, we found that governance at the firms continues to evolve and improvements are called for in a range of areas. The Code requires the largest audit firms to have a minimum of three INEs. All six firms have appointed at least three INEs and two firms have more than three. All firms have complied with the Code requirements for the positioning of INEs and all have now created a public interest body with an INE majority. At some firms, INEs are also involved in other key parts of the governance structure, such as playing a pivotal role on firm boards.

INE workload is heavier than expected and has grown over time, with firms increasingly giving INEs a role on governance committees, usually in an advisory capacity, particularly in the areas of audit quality, people, remuneration and risk. This gives INEs better and earlier access to information and increases their visibility among partners. However, our review noted that increasing demands on INE time and the complexity of the audit firms, means that three INEs is unlikely to be enough at the largest firms going forward. It also found that active succession planning is needed, to avoid INE gaps caused by unplanned resignations and to ensure firms maintain a suitable mix of backgrounds and skills.

During 2021, we plan to consult on updates and enhancements to the Code. This will also address the role of INEs following operational separation of audit practices and the formation of audit boards and appointment of Audit Non-Executives (ANEs).
Section 3: Our new supervisory approach (continued)

Assessment of audit firms’ internal audit arrangements
We have assessed the internal audit arrangements of the seven largest audit firms. Our work concluded that firms varied in the level of resources devoted to their own internal audit and the areas subject to internal audit. The firms have put in place steps to make enhancements where needed. Further expansion of internal audit work is likely at all firms to meet the requirements of ISQM 1. Firms’ internal audit arrangements varied, with the best practice being to have a dedicated internal audit team.

Some firms use teams that provide internal audit for external clients to deliver their own internal audit work. This may impede the ability of the function to be fully independent and free from conflicts. We recommended that some firms expand Audit Charters and audit documentation. Not all firms have had an external quality assurance review within the last five years but generally they have robust quality assessment processes.

Non-financial conduct
In July 2019, we wrote to the large audit firms to establish regular, confidential, reporting to the FRC of non-financial conduct related matters and details of how these matters are dealt with. The purpose of the reporting is to provide assurance over the design and effectiveness of the firms’ monitoring of non-financial conduct. The reporting regime started from quarter ended 30 September 2019.

In addition to the regular reporting, we have reviewed the firm’s policies and procedures in relation to whistleblowing, grievances, disciplinary matters and external complaints, with a focus on those covering bullying, harassment, discrimination and alcohol/substance abuse. We also assessed any relevant extracts from intranet pages that provide guidance to partners and staff and relevant extracts of Board reporting packs.

The outcome of the policy and procedure review, coupled with the data analysis, was discussed with each of the firms and observations shared. The firms submitted proposed actions against each of the observations which we will follow up. Examples of good practice were identified and the commitment and engagement by the firms on this topic was high. We will continue to monitor this area and obtain the regular confidential reporting in addition to ad hoc confidential reporting of serious matters.

Thematic work
The AMS team is also responsible for our audit-related thematic inspections which cover a broad spectrum of topics, but typically focus on critical areas of public attention (climate change), techniques to improve the quality of audit procedures (use of technology) and ways to measure audit quality in a more timely and practical manner (audit quality indicators). We have summarised the findings from recent theemtics below.

Audit Quality Indicators Thematic Review
In May 2020, we published our thematic on ‘Audit Quality Indicators’ (AQIs). The review looked at how the larger UK audit firms use various AQIs to flag signs of poor quality audits so that timely corrective action can be taken.

If used well, AQIs can be a vital tool in helping audit firms track audit quality, address weaknesses and even identify problem audits early and take action to get them back on track. AQIs can also be reported publicly, either at firm level to give stakeholders additional measures of audit quality, or at engagement level to Audit Committees. We were encouraged that these indicators are being used by audit firms to highlight audits in need of improvement and to promote good practice so that this can be replicated. At firms outside the largest six, two had started a programme of monitoring AQIs on a regular basis. We continue to encourage other firms to adopt similar initiatives, and we plan to consult publicly on proposed standards for disclosure of AQIs by UK firms in 2021.
Section 3: Our new supervisory approach (continued)

The Use of Technology in the Audit of Financial Statements Thematic Review

In March 2020, we published our thematic on the use of technology in the audit of financial statements. The review updated a 2017 thematic on the use of data analytics in the audit of financial statements.

We found that the use of automated tools and techniques in the form of audit data analytics is now routine at the largest UK audit firms, with considerable investment being made in implementing the infrastructure, methodology and training required to use these techniques effectively. Other emerging technologies, such as machine learning and predictive analysis, although largely at a research stage, present further opportunities to improve audit quality but also raise challenges for both audit firms and regulators in terms of compliance with auditing standards. Improving audit quality continues to be cited by all firms as a driver for the continued implementation of automated tools and techniques and we believe that the appropriate use of technology has the potential to improve audit quality.

Climate Change Thematic Review

We have recently published an FRC-wide review of how companies and auditors assess and report on the impact of climate change, and are reviewing the extent to which UK companies and auditors are responding to the impact of climate change on their business to ensure reporting requirements are being met.

Our report highlighted the need for auditors to do more to treat climate change as an active issue which could have a material impact on many companies, rather than being an issue for the future only. Climate change and the global response to it can affect the prospects of all companies and is therefore a consideration relevant to all audits today.
Appendix 1: Detailed AQR analysis

In this appendix, we take a closer look at various aspects of our audit quality monitoring results such as findings emerging from inspections in our priority sectors, as well as the results of our inspection of smaller firms.

Areas subject to detailed AQR analysis

Priority sectors
As part of our risk-based approach to selecting our sample of individual audits for review, we determine priority sectors each year, which are typically those that are subject to challenge from the current environment or are undergoing large number of financial reporting changes. Entities in these sectors will feature more heavily in our selection, and upon conclusion of our inspections, we analyse the findings from these sectors, which are outlined below.

Our priority sectors for inspection in 2019/20 were:

AQR priority sectors

Of the 130 inspections in the year across all firms, the number in priority sectors was:

- Financial Services – 27;
- General Retailers – 16;
- Business Support Services and Construction and Materials – 9; and
- Retail Property – 8.
Appendix 1: Detailed AQR analysis (continued)

Financial services
Financial services audits, including insurance audits and banking and building society audits, remain an important component of our review programme. The sector has been deemed a priority sector since the 2017/18 inspection cycle.

Insurance inspections
We reviewed 10 insurance audits (five life and five non-life audits) in our 2019/20 inspection cycle. In most cases, audit teams identified the valuation of technical provisions (life and non-life) as a significant risk and reported on it as a Key Audit Matter. Specialist actuaries carried out reviews and reported on the basis and sufficiency of the technical provisions.

Key findings in this sector included:
- The completeness and accuracy of insurers’ data was a recurring challenge to audit teams and their actuaries, primarily on account of the continued use by many insurers of legacy systems and IT controls which audit teams found to be ineffective.
- In the life insurance sector, auditors generally identified and tested changes in the year to actuarial models and assessed the appropriateness of key assumptions such as longevity and the basis for changes to it. We identified instances where audit teams did not appropriately test actuarial models for several years to confirm that they were functioning as intended.
- In the non-life insurance sector, audit teams generally re-projected best estimate liabilities for the shorter-tail classes of business and conducted methodology and assumption reviews for the longer-tail classes. However, we identified some instances where there was insufficient evidence of the rationale for their conclusions, particularly on the appropriateness of the key assumptions and the reasonableness of incurred but not reported provisions and management margins.

Banking and building society inspections
We reviewed 17 bank and building society audits in our 2019/20 inspection cycle and continue to have concerns relating to the quality of audits in this sector. However we have seen greater variation, across a number of areas, in both the audit approaches and quality of work than in previous cycles. The most notable area was the valuation of financial instruments, where we observed instances of both high and low quality audit work.

Key findings in this sector included:
- The inspections covered the audits of the first year in which banks and building societies were required to report under IFRS 9: Financial Instruments. This brought in the requirement to account for expected credit losses as well as significant changes in the classification and measurement of financial instruments. We have seen notable variation in key aspects of audit approaches to IFRS 9, including how audit teams tested banks’ methodologies and models used in estimating key credit risk assumptions. In some cases, we have also seen some strong work performed over key areas of IFRS 9, in particular where there was good use of the firm’s technical experts in assessing the expected credit loss models.
- Valuation of financial instruments remains a key area of risk within the sector and involves significant management assumptions and estimation uncertainty. We have found auditors not performing appropriate assessments of the risk associated with complex valuations, including not adequately assessing management’s processes and, as a result, not performing procedures over relevant potential risks. In addition, we noted instances of weak audit procedures performed over the risk of unauthorised trading.
- We have also seen inconsistent procedures being performed over settlement and clearing accounts, with some auditors not appropriately understanding and testing management’s processes and reconciliations around these accounts, despite these being critical to the daily operations of the bank.

General retailers and retail property
We saw varying quality in the results of general retailer and retail property audits. Many retailers are under significant financial pressure, as a result of high debt levels and cost increases which may be beyond their control (for example, rent reviews where a significant proportion of properties are usually leased). The high-street retail sector continues to face rapid structural change from online shopping with recent high-profile store closures and restructuring announcements. This sector pressure typically elevates the audit risk of the related entities.
Appendix 1: Detailed AQR analysis (continued)

Key findings in this sector included:

• Revenue and stock are two key aspects in the financial statements of retailers. Revenue is often used as a key performance indicator by companies to demonstrate market share and consumer demand. Stock indicates the future value of remaining products and is a representation of expected future sales. We found instances where auditors have not sufficiently tested the accuracy, completeness and cut-off of revenue. We have also found varying approaches to inventory stocktakes including instances where auditors performed disproportionately low amounts of testing over highly material stock balances.

• Property valuations are critical for retail property companies. They typically involve management hiring property valuation experts to assess the values of the retail property using market rental prices, floor space and other information. We found instances where auditors have not assessed the appropriateness of the information and the assumptions that valuers have used as part of their valuation approach.

Construction and materials

We have seen several poor quality audits of construction and materials companies over recent years. The construction and materials sector has faced a downturn in profitability and margins on large infrastructure contracts. The introduction of IFRS 15: Revenue from contracts with customers, has also rightly increased the level of tangible evidence needed before revenue can be recognised on contract receivables.

Key findings in this sector included:

• Insufficient audit work on the implementation of IFRS 15, in relation to accounting for revenue, margins and the recognition of recoveries and contract variations on long-term construction contracts. Contracts in this sector are typically long, complex and contain numerous terms and conditions, all of which are relevant to how performance obligations under contracts are assessed and how revenue can be earned from the contracts. We have found instances where audit teams have not recognised the requirements of IFRS 15 and obtained insufficient evidence to verify the revenue recognised under the contract and to support the outstanding claims recognised on long-term contracts.

• Construction projects typically take several years to complete, and it is rare for the initial contract not to be varied in some way as the scope of the project changes and new information comes to light. As contract terms change and the level of compensation is determined, contracts may become onerous to the company or additional recoveries may need to be negotiated with the counterparty. We found instances of auditors not challenging management around significant recoveries and contract variations.

Business Support Services

We have seen inconsistent quality in the audits of business support services. The sector has seen significant strains due to tighter margins, use of factoring and increasing requirements around debt covenants. Recent corporate failure has put this entire industry in the spotlight.

Key findings in this sector included:

• The decline in profitability within the industry has increased the risk of impairment of goodwill balances and other intangible assets. Management are required to test goodwill for impairment annually and this has become a standardised process. We found instances where auditors have not appropriately challenged management assumptions and forecasts when concluding on the appropriateness of impairment.

• Many companies in this sector have a large number of leases, often including dilapidation clauses for the restoration of leased properties back to their original condition at the end of the lease term. We saw instances where auditors had not understood the total obligations imposed by leases or challenged management appropriately on the sufficiency of any provisions raised.

Information Technology

Most companies are becoming more dependent on information technology with systems being used to process transactions automatically and implement controls, without manual intervention. Large, established companies often have a complex infrastructure of IT systems, relying on new and old systems to work together. This level of automation requires a tailored audit response and typically the use of IT audit specialists.
Appendix 1: Detailed AQR analysis (continued)

We have seen increased use of data analytic tools to analyse entire populations rather than samples, and testing IT automated controls, which provides continuous controls comfort throughout the financial year. However, we have observed audit teams responding insufficiently to the additional risks created by privileged access to IT systems:

- The flow of data between the operating and financial reporting systems is important for many audits, particularly where the volume of transactions is high (such as for revenue or inventory balances). We often found inadequate audit testing of data flows, including data inputs and reports. Even when an audit team decides not to rely on the business process controls, they may still need to test the integrity of data to ensure reports are complete and accurate for their substantive procedures. In some instances, auditors also only performed testing to validate that the data presented to them was accurate, and did not perform testing to ensure that the data itself is complete.

- Inadequate controls around privileged access to IT systems also remains one of the common deficiencies across most organisations. In these situations, certain individuals have unnecessary "super-user" access to systems and can make changes to systems or data without an audit trail and bypass other established controls. We have identified instances where auditors have not fully considered the implications arising from privileged access issues and have not enhanced or expanded their alternative procedures to respond to the additional risks created.

Smaller challenger firms

Whilst a large portion of the PIE, large AIM companies and Lloyd’s Syndicates population is audited by the seven largest accounting firms, approximately 137 of these entities are audited by 25 other smaller audit firms. Many of these entities have listed equity or debt and these fall within the scope of the FRC’s audit quality review programme, but are inspected on either a three or six-year cycle.

FRC inspection cycle for firms inspected on a non-annual basis

Since 2016, firms that are not inspected annually are visited on a six-year cycle, or, for firms that audit a large PIE, a three-year cycle. The majority (96) of the 137 PIE, large AIM companies and Lloyd’s Syndicates are audited by seven firms that we visit on a three-year cycle. The 18 firms that audit the remaining PIES are visited on a six-year cycle, including seven firms that audit two or more PIES.

Inspection findings of firms inspected on a non-annual basis

In 2019/20 we inspected five firms, being RSM UK Audit LLP, BSG Valentine LLP, UHY Hacker Young LLP, SBM Associated Limited, and French Duncan LLP. The scope of our work included eight audit file inspections and reviews of firmwide procedures at each firm. The inspection findings were poor, with only one audit of the eight reviewed being assessed as requiring no more than limited improvements. As we review different firms each year, year-on-year comparisons of an individual firm’s results cannot be made.

The main themes from our inspections were:

- We consistently observed the audit work around going concern to be weak, and audit teams did not always obtain sufficient and appropriate audit evidence to support their conclusions.

- We inspected the audit of several investment property companies and found concerns around the reliance placed on management’s experts, in particular insufficient challenge over the assumptions they used. Auditors did not engage their own experts to assist in challenging assumptions used and did not justify why an auditor’s expert was not necessary.

- Many firms’ audit methodologies permit capped or limited sample sizes. We raised findings where we saw limited samples employed on significant risk areas and Key Audit Matters. Audit teams tend to default to limited sample sizes which can prevent an objective assessment of the actual test results. Limited sample sizes also prevent audit teams from exploring more effective ways of obtaining appropriate audit evidence, such as controls testing, or the use of data analytics.

- None of the audits we reviewed placed reliance on controls. In all cases, the auditors decided it was more efficient to obtain audit evidence through fully substantive procedures. We encourage firms to revisit their training, methodologies and practical applications around controls testing, given the increasing importance of effective controls within growing companies.

How we hold these firms to account for poor results

Our findings from both firmwide and audit file inspections are reported to each firm in a private report. The findings are also reported to the firm’s professional body and its registration committee (or equivalent) with a recommendation on whether the firm should continue to be registered to undertake audits and whether other steps should
Appendix 1: Detailed AQR analysis (continued)

be considered to improve or safeguard audit quality (for example, accelerating the next inspection visit or restricting the firms’ ability to undertake PIE audits). In future, we will take control of this registration process for PIE audit firms (refer to section 1).

FRC engagement with non-annually inspected firms to improve audit quality
Throughout the 2019/20 inspection cycle, we increased our engagement with several firms, outside of the periodic inspection visits with a view to improving audit quality. For example, we attended some conferences and training events and for firms taking on new higher-risk audits, we held meetings to ensure that they have considered risks and necessary resources. We intend to continue to increase this engagement (including meetings open to all of the non-annually inspected firms to share common findings from AQR inspections and explain how to prepare for an AQR visit).

Firmwide work
We perform an annual review of aspects of each of the largest seven audit firms’ policies and procedures. In the current year, we reviewed procedures in relation to audit partner appraisals and performance management and acceptance and continuance of audited entities.

Partner and staff – appraisals and performance management
Policies and procedures relating to the appraisal and remuneration of partners and staff are a key element of a firm’s overall system of quality control, as these are vital in ensuring that appropriate personnel are assigned to individual audits with the necessary competence, skills and time to perform high-quality audits. Our inspection included an evaluation of firms’ policies and procedures, and their application to a sample of partners and staff for the most recently completed appraisal year (either 2018 or 2019 depending on the timing of the firm’s own process), across appraisals and remuneration, promotions, recruitment, and portfolio and resource management.

Key findings
We identified the following key findings:

• We found improvements needed to be made to the consideration of audit quality in the partner appraisal and remuneration process. We identified concerns over the lack of a clear link between audit quality and remuneration decisions, insufficient evidence retained to support remuneration conclusions and weaknesses in the underlying criteria and process followed to assess partners’ performance on audit quality.

FRC engagement with non-annually inspected firms to improve audit quality
Throughout the 2019/20 inspection cycle, we increased our engagement with several firms, outside of the periodic inspection visits with a view to improving audit quality. For example, we attended some conferences and training events and for firms taking on new higher-risk audits, we held meetings to ensure that they have considered risks and necessary resources. We intend to continue to increase this engagement (including meetings open to all of the non-annually inspected firms to share common findings from AQR inspections and explain how to prepare for an AQR visit).

Good practice
We also identified the following areas of good practice at one or more firms:

• effective use of a wide range of audit quality metrics to assess partners and staff performance;
• well-evidenced consideration of audit quality in partner appraisal documentation, including the results of internal and external quality inspections;
• incorporation of upward feedback into partner appraisal and promotion processes;
• clear linkage of audit quality performance to long-term remuneration and in-year variable pay decisions;
• robust processes for the centralised review and monitoring of partner portfolios; and
• robust processes for manager promotion, including the use of a formal assessment centre.

Acceptance & continuance
Effective acceptance and continuance procedures are fundamental to ensure that audit firms provide services to companies within their risk appetite and allocate appropriate people and resources to audit teams. Given the greater number of audit tenders in recent years, we reviewed these processes, and discussed with
Developments in Audit 2020
Financial Reporting Council

Appendix 1: Detailed AQR analysis (continued)

firms’ senior leadership proposed changes to align better with each firm’s strategic decisions related to tendering. We also considered firms’ policies relating to withdrawal/dismissal from audits and, for a sample of audits, the statements provided to the public, successor auditors and regulators in connection with withdrawal or dismissals.

Key findings
We identified the following key findings:

• We found that firms should strengthen their acceptance and continuance approval process, particularly around the evidence gathered to record and explain the conclusions reached. The IT systems employed by firms for recording decisions give auditors a limited choice of set responses, often without supporting narrative to explain the unique decisions being made.

• Furthermore, the acceptance and continuance process at some of the firms gave insufficient prominence to assessing the reputational risk of an engagement and the availability of appropriate resources, including specialists, required by the firm to undertake the engagement.

• We also identified that one firm needed to enhance its central monitoring and review of key documents within the acceptance and continuance process to ensure that the engagement team answered all relevant questions in sufficient detail. In addition, we found some audit continuance assessments were not completed on time and consequently staff were performing work on engagements before the continuance decision had been approved, increasing the risk to the firm.

Good practice
We also identified several areas of good practice by firms in assessing which companies they want to provide services to, including:

• enhanced consideration of potential damage to values, reputation and brand when making acceptance and continuance decisions;

• involvement of the Board in monitoring and oversight of high-risk audits;

• real-time monitoring of resourcing; and

• notification of entities that should not be accepted as an audited entity.

Public sector audits
Local Government and Health Body Audits
The FRC is now responsible for the oversight of major local government and health body audits (excluding Foundation Trusts) and certain other bodies in England from 2019/20 onwards under statutory duties contained in the Local Audit and Accountability Act 2014 (LAAA). A Major Local Audit is defined as an audited body with either revenue or expenditure in excess of £500 million. Previously, this oversight role was with Public Sector Audit Appointments Limited (PSAA) who had delegated the audit review work by contract to the FRC. Audit inspection oversight of non-major local audit bodies is the responsibility of the ICAEW, although still under the oversight of the FRC’s Professional Oversight Team.

Our 2019/20 Inspection Results
For 2019/20, we reviewed the audits of 15 major local bodies with a 31 March 2019 year-end, completed by seven separate audit firms. Within the public sector, in addition to the traditional financial statement audit, auditors are required to assess whether the entity has proper arrangements in place to use funds in an efficient, economic and effective manner (known as “Value for Money” or VfM). Our review covered both the audit of the financial statements and the audit firm’s conclusion on VfM arrangements. The audits reviewed included NHS Trusts, Clinical Commissioning Groups, Unitary, Metropolitan and County Councils and Police and Crime Commissioners.

The overall results for our inspection of the 15 financial statement audits across the seven firms were concerning, with just 40% of audits requiring no more than limited improvement (64% in 2018/19). We note that local audit has seen a challenging year with record numbers of audits signed later than in any previous year. All firms have experienced resourcing pressures and an economic environment where local audit financial statements are increasing in complexity and audit fees falling by over 20% following the audit procurement process managed by PSAA.

Urgent action is required from auditors to respond to our findings and improve audit quality. The most significant quality findings related to challenge and corroboration of the valuation of properties (council dwellings, specialised properties and investment properties), improvements required in the audit of amounts receivable (sample sizes and the assumptions used for expected credit loss provisions), and improved audit responses required to the risk of fraud arising from management override of controls and fraud in expenditure recognition.
Appendix 1: Detailed AQR analysis (continued)

Certain firms reviewed have made some improvements and we have observed good practices (for example, increased use of internal specialists for property and pension valuation, improved workpapers to record evidence of challenge of management and better Value for Money risk assessments). A detailed analysis on our Local Audit quality inspection activity is provided in our first Local Audit public report, which was published on 30 October 2020.

Developments in Local Audit

On 8 September 2020, the Redmond Review was published. Its key purpose was to consider the structure and oversight arrangements for local audit and, consistent with the recommendations of the Kingman review, determine whether a single body should be created to oversee local audit. We will consider the report’s detailed findings when planning its future local audit inspection activity and other developments in the sector.

National Audit Office (NAO) Audits

The FRC is the Independent Supervisor of Companies Act audits undertaken by the NAO. In addition, we have contractual arrangements in place, agreed on a voluntary basis, to inspect certain non-Companies Act audits performed by the NAO. We also review the NAO’s policies and procedures to ensure audit quality (“firmwide” work) on a cyclical basis.

We currently report privately to the NAO on our overall inspection. In respect of our statutory work on Companies Act audit inspections, we provide a report to the FRC Board to support its reporting to the Secretary of State as Independent Supervisor.

Our 2019/20 Inspection Results

We reviewed seven audits performed by the NAO, which included four audits performed under the Companies Act 2006. Our key findings were in similar areas to those in our inspections of the seven largest audit firms. In particular, they related to improving the extent of challenge in areas of judgement and strengthening the assessment of and evaluation of work performed by internal/external experts and specialists.

Increasing transparency

We continue to encourage the NAO to increase the transparency of our reports, both publicly and with audit committees. For Companies Act audits, and in particular PIE audits, we recommend that our reporting is consistent with our inspections of the seven largest audit firms.

We continue to discuss with the NAO the scope for sharing our overall findings with other stakeholders, such as the Public Accounts Commission, the Parliamentary body which oversees the activities of the C&AG and the NAO. We will continue to discuss these issues with the NAO, as part of the Government’s response to the recommendations made by Sir John Kingman in December 2018 and the recently published Redmond Review.

Third Country Audits

Third Country Auditors (TCAs) are auditors of companies incorporated outside the European Economic Area (EEA) that have issued securities on the main market of the London Stock Exchange. Our regulation work includes registering audit firms as TCAs in the UK, and independent inspection of their audit work. We are required to undertake inspections of auditors from countries where the system of auditor oversight is not “equivalent” or “transitional” to that required within the United Kingdom (the EEA until the end of the EU Exit Transition Period at the end of 2020).

At 30 June 2020, there were 96 registered TCAs, including those from equivalent or transitional countries, with 136 issuers with UK traded entities, across 35 countries. We commenced inspections of TCAs in 2013/14. In 2019/20 five audits were inspected, one at each of the following firms – Price Waterhouse Coopers SRL (Argentina), Kesseltman & Kesselman (Israel), PwC (Kazakhstan), PwC (Nigeria) and Brightman Almagor Zohar & Co (Israel).

No significant issues were identified for the audits performed by TCA during this cycle with all inspections being assessed as good or only requiring limited improvements.
Appendix 2: Developments in Audit and Ethical Standards

Auditing is governed by auditing and ethical standards, which are essentially principles requiring professionals to apply judgements to each company’s unique situation and their respective industry. These standards play an important role in improving audit quality and are developed and revised as circumstances require. Since we last published Developments in Audit in November 2019, Auditing and Ethical standards have developed significantly. Not only have previously issued standards become effective, but we have revised and reissued several key standards and fully revised the Ethical Standard itself.

| ISA (UK) 540 (Revised December 2018) Auditing Accounting Estimates and Related Disclosures | We issued ISA (UK) 570 Going Concern (Revised September 2019). Also effective for audits of financial statements for periods commencing on or after 15 December 2019, the standard increases the auditor’s work effort in respect of going concern and enhances reporting. |
| In December 2019, we issued a revised Ethical Standard, effective from 15 March 2020 (except for provisions relating to Other Entities of Public Interest (OEPIS) which are effective from 15 December 2020). The new standard has more stringent prohibitions on non-audit services, including the introduction of a list of ‘permissible’ services for PIE and OEPI auditors. If the service is not on the list, then it cannot be provided. | We also issued a fully revised suite of Standards for Investment Reporting (SiRs) in March 2020, with an effective date of September 2020. |
| We also consulted on the adoption of International Standard on Assurance Engagement (ISAIE (UK) 3000) Assurance Engagements Other than Audits or Reviews of Historical Financial Information effective for assurance reports for which the standard has been applied dated on or after 15 September 2020. This standard was issued in July 2020. | A revised ISA (UK) 315 Identifying and Assessing the risk of Material Misstatement effective for audits of financial statements for periods beginning on or after 15 December 2021 was published in July 2020. |
| Looking forward, the International Auditing and Assurance Standards Board (IAASB) is finalising International Standards on Quality Management which will supersede ISQC 1. These standards relate to firm level procedures – International Standard on Quality Management 1 (ISQM 1), ISQM 2 – and engagement level, ISA 200 Quality Management for an Audit of Financial Statements. It has also consulted on and is finalising ISA 600 (Revised) Special Considerations – Audits of Group Financial Statements (Including The Work of Component Auditors), revisions to which enhance the risk-based approach taken to group audits. We will consult on UK adoption of these standards in 2021, with work beginning on the adoption of ISQM 1, 2 and ISA 220 in late 2020. |
Appendix 2: Developments in Audit and Ethical Standards (continued)

Revisions to the FRC’s Ethical Standard
The FRC’s Ethical Standard sets fundamental principles, supporting ethical provisions, and general requirements for the conduct of audits and other public interest assurance engagements. In the light of increased public and parliamentary scrutiny of auditor independence, we carried out a post implementation review of changes made to the Ethical Standard in 2016. We concluded that the Ethical Standard needed to go further in order to re-establish public and stakeholder confidence in auditor independence.

As a result, we moved from a list of non-audit services that auditors could not provide to PIE audits, to a shorter list of services which they could provide. The list also applies to larger AIM listed companies, large private pension schemes, large private companies, and Lloyd’s Syndicates – collectively known as Other Entities of Public Interest (OEPi). We also strengthened the role and status of the ethics partner at the audit firms and strengthened the objective, reasonable and informed third party test, where auditors are required to consider possible external perception of threats to independence. The majority of the new provisions of the revised Ethical Standard came into effect from March 2020, whilst the rules relating to OEPi’s will be for periods after 15 December 2020.

We have directly engaged with the major audit firms and the entities they audit on the practical impacts of these changes, and our revisions to the Ethical Standard were broadly welcomed. In the context of the Covid-19 pandemic, we have been flexible and responsive with the guidance we have produced on the new non-audit services rules. For example: we made it clear, that where auditors were helping companies with applications for government support schemes, that we considered those as part of the list of permissible services.

Accounting Estimates
Revisions to ISA (UK) 540 included recognition of the increasing complexity of accounting estimates and related disclosures, providing an enhanced risk assessment with a closer link to methods, data and assumptions used in making the estimates, including the use of complex models and external information sources, and an enhanced emphasis on the importance of professional scepticism.

We believe that the changes, including the requirement for auditors to design and perform audit procedures that are not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory, will improve the quality of audit work relating to accounting estimates in an often highly subjective area.

This standard will be of particular relevance as estimates are made in light of Covid-19 related disruption. Auditors utilising the revised ISA (UK) 540’s enhanced, risk-focused approach, will be better placed to conduct high-quality audit work at a time of significant uncertainty.

Going Concern
ISA (UK) 570 Going Concern was enhanced to require, amongst other things:

• More substantial work on the part of the auditor in robustly challenging management’s assessment of an entity’s ability to continue as a going concern; and
• Significantly more work on the auditor’s independent risk assessment and related activities to ensure the auditor is better able to direct their work and draw relevant conclusions about going concern.

We believe that the changes made will lead to a higher quality assessment of the entity’s ability to continue as a going concern, with improved transparency in the auditor’s work, particularly where the entity is a PIE.

Going concern is an area of significant interest for investors and other stakeholders and is under even greater scrutiny given the economic disruption resulting from Covid-19. We have worked throughout this period to support stakeholders, producing a range of guidance on topics such as reporting and going concern designed to provide as much clarity as is possible in a time of great uncertainty.

We will continue to engage actively with stakeholders on matters relating to going concern, learning lessons from the practical application of revised ISA (UK) 570.

Standards for Investment Reporting
The Standards for Investment Reporting (SIRs) are the standards and guidance applicable when reporting accountants undertake engagements connected to regulated investment circulars in the UK. The standards cover a variety of engagements including public reporting on financial information as well as private reporting, such as on working capital statements.
Appendix 2: Developments in Audit and Ethical Standards (continued)

The SIRs were last revised in 2005/06 and required revision to reflect changes to the relevant regulations, to ensure that they remain fit for purpose and to maintain consistency with current auditing and assurance standards. In addition to revisions to the existing SIRs, we issued a new SIR 6000 dealing with reporting engagements under the City Code in respect of Quantified Financial Benefits Statements.

Assurance Engagements Other than Audits or Reviews of Historical Financial Information

ISAE (UK) 3000 is a standard based on principles, designed so that it can be applied effectively to a broad range of subject matters. Requirements are included to address both reasonable and limited assurance attestation engagements, where an assurance provider measures or evaluates the subject matter being reported on against specific identified criteria.

Although there are currently no public interest assurance engagements for which we will require the application of ISAE (UK) 3000, it is anticipated that this will change in the future as recent reviews and recommendations on the scope of auditors’ reporting responsibilities are consulted on and potentially adopted.

Identifying and Assessing the Risks of Material Misstatement

In December 2019, the IAASB issued ISA 315 (Revised 2019) - Identifying and Assessing the Risks of Material Misstatement with conforming amendments to other standards. The effective date of the revised and amended standard is for audits of financial statements for accounting periods beginning on or after 15 December 2021.

When adopting this standard in the UK, we did not believe it necessary to include any additional UK supplementary material over that small amount which is already included within the current ISA (UK) 315.

Specific revisions include:

- Modernising and updating the standard for an evolving business environment. This includes requiring the auditor to understand the entity’s use of IT in its business, the related risks and the system of internal control addressing such risks. The related application material has also been significantly enhanced.
- Provisions designed to enhance the use of professional scepticism throughout the risk assessment process.

- Taking account of the increasing use of automated tools and techniques by some auditors. There are no specific requirements to use these, reflecting that there are multiple ways that audit procedures may be carried out, but specific application material has been added to give examples of where and how automated tools and techniques may be used.
- Enhancing and clarifying the requirements and application material pertaining to identifying and assessing the risks of material misstatement, including introducing new concepts and/or definitions for inherent risk factors, relevant assertions, spectrum of inherent risk and significant risks.

Fraud

In October 2020, we began our consultation on the proposed revisions to ISA (UK) 240 (Updated January 2020) – The Auditor’s responsibilities Relating to Fraud in an Audit of Financial Statements. The proposed changes aim to clarify auditor requirements in relation to fraud and promote a more consistent and robust approach to those responsibilities. The consultation process will close at the end of January 2021.

Technology

Technology has been at the forefront of many stakeholder discussions, leading to our consultation on Technological Resources: Using Technology to enhance Audit Quality, a follow-on to our Thematic Review on The Use of Technology in the Audit of Financial Statements. The responses to this consultation will inform future standards and guidance, ensuring we keep pace with the rapid evolution of technological resources deployed in audit.

IAASB Activities

We continue to work closely with the IAASB in its programme of enhancing and developing the international auditing standards. The FRC’s Director of International Standards is a member of the IAASB, and an active participant in key projects. 2020 saw significant progress in the revision to quality management standards, and to the group audit standard.
Appendix 2: Developments in Audit and Ethical Standards (continued)

Quality Management: ISQM 1, ISQM 2 and ISA 220
The current quality management standard (ISQC 1) is due to be superseded by two new standards ISQM 1 and ISQM 2 (quality control at the firm level) as well as revisions to ISA 220 (quality control at the engagement level). These new standards increase focus on:

- improving and increasing the responsibilities of a firm’s leadership to ensure that an appropriate tone regarding audit quality is pervasive within the firm; and
- ensuring the standards are fit for purpose by addressing the use of technology and third-party service providers, as well as the increasingly international reach of many audits.

ISQM 1 replaces ISQC 1 and includes a more proactive identification, assessment and response to quality risks, including issues identified from across the network of which the firm is part. ISQM 2 is a new standard, consolidating in one place the requirements relating to Engagement Quality Control Reviews (EQCR).

Through our involvement on the working groups responsible for the new standards, we have significantly influenced the development of these standards. ISQM 1, ISQM 2 and ISA 220 were finalised in September 2020, and we will be consulting on their adoption in the UK in 2021.

ISA 600 (Revised)
The exposure draft of proposed ISA 600 (Revised), the group audit standard, was open for consultation until 2 October 2020, and represents a significant step-forward in improving audit quality for group engagements. The standard emphasises a risk-based approach, focused at the group financial statement level, that is more closely aligned to ISA 315 (Revised) than the extant standard.

The proposed ISA 600 (Revised) also emphasises the need for robust and efficient communication between the group and any component auditors involved in the audit. This will help to ensure that risks are appropriately addressed and communicated throughout the audit process.

We conducted significant outreach to inform our response to the IAASB’s proposed ISA 600, helping to ensure that a diverse range of stakeholder views were considered in forming our response. With our response submitted, we await the approval of a standard to begin work in 2021 on the UK adoption of ISA 600.

Impacts of EU exit on audit regulatory framework
During 2019/20, we continued to work with the Department for Business, Energy and Industrial Strategy to address the impact on auditors of the UK leaving the European Union. Our objective is to ensure that the UK’s audit regulation framework remains fit for purpose when the Transition Period ends on 31 December 2020. This is important so that audit firms are still eligible to carry out audit work and their audit reports will have legal effect.

Building on previous EU exit preparations, amendments to UK legislation have been made. The European Union (Withdrawal) Act 2018 converts the existing body of directly applicable EU law into UK domestic law at the end of the Transition Period. Further, to ensure that this law is operable in an UK-only context, amendments have been made by Statutory Instrument to certain aspects of the legislation to reflect the UK’s new position outside the EU.

An important part of the UK’s negotiations with the EU concerns audit adequacy and equivalence. We worked closely with the Government to prepare a detailed summary of the UK’s and FRC’s audit regulatory framework for use in the negotiations and assisted with the preparation of questionnaires and responses.

After 31 December 2020, the EU Member States will be treated as third countries by the UK and the UK will be treated as third country by the EU. We have upgraded our systems for the registration of third country auditors to manage the anticipated increase in applications for registration from third country audit firms, which will include audit firms from EU Member States that audit entities listed on a regulated market in the UK.
Appendix 3: Details of enforcement activity

In the year to 31 March 2020, 13 audits were referred by AQR to the Case Examiner to consider. Six have been referred to the Conduct Committee and led to the opening of an investigation and seven were resolved through Constructive Engagement. In total 33 cases were resolved through Constructive Engagement in the year to 31 March 2020, which, in the majority of cases, led to bespoke remedial action being required from the audit firm. In two of the 33 cases, the Case Examiner concluded there was no allegation and no remedial action was required. The outcomes of individual Constructive Engagement exercises are not published.

In the 2019/20 year, total financial sanctions on audit firms and partners amounted to £16.5 million (discounted to £11.3 million for settlement), compared to £42.2 million (discounted to £31.3 million for settlement) in 2018/19, in addition to a range of non-financial sanctions, including:

- A requirement for a quality performance review process affecting each person who signs a Client Asset Report on behalf of KPMG, and a requirement to provide written reports to the FRC on the details, conclusions and actions arising from the reviews. The review requirement is to last three years. Each person who signs a Client Asset Report during that period shall be subject to at least one quality performance review in respect of their CASS audits.
- A requirement that PwC supplements the monitoring and support of the Leeds Office audit practice on terms which have been agreed with the FRC.
- A requirement for a quality performance review by KPMG’s London office of three Statutory Audits undertaken by the relevant audit partner within a period of two years from the date of the Decision Notice, to be reported annually to the FRC.
- A requirement for an audit partner at KPMG to undertake appropriate training, in a format to be agreed with the FRC.
- An agreement that Grant Thornton will establish an Ethics Board who will report to the FRC for three years, will review its Ethics function and will increase training and make further improvements to its policies and procedures.
- A permanent prohibition banning an audit partner from signing audit opinions.
- An order that KPMG monitors compliance with revised audit procedures on company capital and distributions, and report on this to the FRC’s Executive Counsel.
- Declarations in four cases that the Statutory Audit reports did not satisfy the Relevant Requirements.
The sanctions imposed during the 2019/20 year are set out below.

<table>
<thead>
<tr>
<th>Company</th>
<th>Audit Firm/ Audit Partner</th>
<th>Date opened</th>
<th>Outcome</th>
<th>Date closed</th>
<th>Sanction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redcentric plc</td>
<td>PwC</td>
<td>Feb-2017</td>
<td>Breaches admitted.</td>
<td>May-2019</td>
<td>A Severe Reprimand and a fine of £6.5 million (discounted to £4.55 million for settlement). A condition that PwC supplement the monitoring and support of the Leeds Office audit practice on terms which have been agreed with the FRC. A declaration that the Statutory Audit Reports did not satisfy the Relevant Requirements.</td>
</tr>
<tr>
<td></td>
<td>Auditor</td>
<td>Feb-2017</td>
<td>Breaches admitted.</td>
<td>May-2019</td>
<td>A Severe Reprimand and a fine of £200,000 (discounted to £140,000 for settlement).</td>
</tr>
<tr>
<td>BNY Mellon entities</td>
<td>KPMG</td>
<td>Jun-2015</td>
<td>Misconduct by Tribunal.</td>
<td>Jun-2019</td>
<td>A Severe Reprimand and a fine of £5.0 million (discounted to £3.5 million for admissions). An additional requirement for a quality performance review process in relation to Client Asset Reports, and written reports to the FRC, for three years.</td>
</tr>
<tr>
<td>Serco Geogafix Limited</td>
<td>Auditor</td>
<td>May-2016</td>
<td>Misconduct admitted.</td>
<td>Sep-2019</td>
<td>A Severe Reprimand and a fine of £120,000 (discounted to £78,000 for settlement).</td>
</tr>
</tbody>
</table>
### Appendix 3: Details of enforcement activity (continued)

<table>
<thead>
<tr>
<th>Company</th>
<th>Audit Firm/ Audit Partner</th>
<th>Date opened</th>
<th>Outcome</th>
<th>Date closed</th>
<th>Sanction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publicly listed company</td>
<td>KPMG</td>
<td>Nov-2017</td>
<td>Breaches admitted. Sanction agreed.</td>
<td>Dec-2019</td>
<td>A Reprimand and a fine of £700,000 (discounted to £455,000 for settlement). A declaration that the Statutory Audit report did not satisfy the Relevant Requirements. A requirement for a quality performance review by KPMG’s London office of three Statutory Audits undertaken by the relevant audit partner within a period of two years from the date of the Decision Notice, to be reported annually to the FRC.</td>
</tr>
<tr>
<td>Auditor</td>
<td></td>
<td>Nov-2017</td>
<td>Breaches admitted. Sanction agreed.</td>
<td>Dec-2019</td>
<td>A Reprimand and a fine of £45,000 (discounted to £29,250 for settlement). A requirement to undertake appropriate training, in a format to be agreed with the FRC.</td>
</tr>
<tr>
<td>Conviviality Retail plc</td>
<td>Grant Thornton</td>
<td>Sep-2017</td>
<td>Breaches admitted. Sanction agreed.</td>
<td>Mar-2020</td>
<td>A Severe Reprimand and a fine of £3,000,000 (discounted to £1,950,000 for settlement). A declaration that the Statutory Audit report did not satisfy the Relevant Requirements. A package of measures directed at improving the quality of future audits and compliance with ethical standards and requirements.</td>
</tr>
<tr>
<td>Foresight 4 VCT plc</td>
<td>KPMG</td>
<td>Feb-2018</td>
<td>Breaches admitted. Sanction agreed.</td>
<td>Mar-2020</td>
<td>A Reprimand. An order that KPMG monitor compliance with revised audit procedures on company capital and distributions, and report on this to the FRC’s Executive Counsel.</td>
</tr>
</tbody>
</table>

Further information on the activities of our Enforcement Division can be found in the Annual Enforcement Review 2020.
Appendix 4: Links to referenced reports

Page 3 – Independent Review of the Financial Reporting Council (Sir John Kingman)

Page 3 - Statutory Audit Services Market Study (Competition and Markets Authority)
https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf

Page 3 - Report of the Independent Review into the Quality and Effectiveness of Audit (Sir Donald Brydon)

Page 5 – Internal Audit in Lockdown - The impact of the coronavirus pandemic on internal audit teams in the UK and Ireland (Chartered Institute of Internal Auditors)

Page 16 – Audit Monitoring Report 2020 (Institute of Chartered Accountants in England and Wales)

Page 27 – Audit Quality Indicators – AQR Thematic Review (Financial Reporting Council)
https://www.frc.org.uk/getattachment/f116f7d7-94d8-4c82-94b2-ba24e3b195eb/AQTR_AQi_Final.pdf

Page 28 - The Use of Technology in the Audit of Financial Statements AQR Thematic Review (Financial Reporting Council)
https://www.frc.org.uk/getattachment/1c1478e7-3b2e-45dc-9369-c3d8d3c3a16/AQT-Review_Technology_20.pdf

Page 28 – Climate Thematic (Financial Reporting Council)
https://www.frc.org.uk/getattachment/ab63c220-6e2b-47e6-924e-6f369512e0a6/FRC-Climate-Thematic-%e2%80%93-summary.pdf

Page 36 – Major Local Audit – Audit Quality Inspection 2020 (Financial Reporting Council)

Page 36 – Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting (Sir Tony Redmond)

Page 43 – Annual Enforcement Review 2020 (Financial Reporting Council)
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https://www.frc.org.uk

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