Financial Reporting Council

DEVELOPMENTS IN AUDIT 2019

November 2019

CONTENTS

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

HEADLINES

RESULTS

- Audit quality is not consistently reaching the necessary high standards expected
- The biggest seven firms failed to meet the FRC's 2019 inspections target for FTSE 350 entities
- Insufficient challenge of management remains the dominant finding, but worrying shortcomings also seen in routine audit procedures
- Thematic review found work over the "front half" of annual reports inconsistent and not always in line with Auditing Standards

OUR RESPONSE

- We levied £42.9 million of financial sanctions last year
- Grant Thornton placed under increased scrutiny after unsatisfactory inspection results
- The FRC has significantly strengthened auditors' requirements for going concern

A CHANGING WORLD

- The FRC will be replaced by a new statutory body, the Audit, Reporting and Governance Authority (ARGA), with a new mandate, enhanced powers and accountability to Parliament
- The Government has consulted on the CMA recommendations to reform the audit market
- The Brydon Review into the quality and effectiveness of audit is planning to report early next year
- The Redmond Review into the quality of local audits is currently seeking views

1. EXECUTIVE SUMMARY

The UK audit market

Audits are not consistently reaching the necessary, high standards required to provide confidence in financial reporting. A series of high-profile corporate failures has dented trust in the profession and highlighted the need for improvement. These concerns have prompted four separate reviews into the sector, including a review of the FRC. Detailed commentary on these reviews has been deliberately excluded from the scope of this report, which focuses on the work we undertake in our audit monitoring, supervision and policy functions.

What we found

In July 2019 we reported that the overall inspection results of the biggest seven firms were unsatisfactory, with only 75% of the FTSE 350 audits we reviewed being classified as good or requiring no more than limited improvements[1]. These results fell significantly short of our target set three years ago that by 2019 at least 90% of FTSE 350 audits would be assessed in this category. The results at Grant Thornton and those for the FTSE 350 audits at PwC were particularly poor.

Our 2018/19 AQR inspections show auditors still struggle to challenge management sufficiently, with long-term contracts and items held at fair value being two areas where this was particularly prevalent. While these areas are typically considered more judgemental and thus harder to audit, we also observed instances in other areas where auditors failed to perform more routine procedures to a consistently high level, notably when auditing revenue. We expect these shortcomings to be remediated swiftly.

Across all inspections we considered the work over internal controls, which was an area of focus during this inspection cycle. Our work indicated that controls are not being consistently tested and therefore relied upon, even in areas which would typically lend themselves to this approach (for example, significant transaction volumes involving limited judgement). In our thematic review of the auditor's work on other information, often referred to as the "front half" and frequently used by investors to inform their assessments of a company's future prospects, we highlighted inconsistency in their work and found it did not always meet the requirements of Auditing Standards.

Our response

Stakeholders rightly demand, and are entitled to expect, high quality work on all audits.

Where poor inspection results extend beyond an individual audit and are pervasive across several audits performed by a firm, we consider placing it under increased scrutiny. Such measures were recently taken for Grant Thornton following their unacceptable inspection results in the 2018/19 cycle, combined with concerns identified from inspections in the past few years. The FRC required Grant Thornton to produce a new audit quality improvement plan and increased the number of its audits to be inspected in 2019/20 by 25%. Similar measures were taken for KPMG in the previous year and, as a result, KPMG implemented an Audit Quality Plan at the end of 2017. We continue to monitor progress in detail.

[1] See Appendix 2 for the definition of AQR assessment of audit quality.

Audits are not consistently reaching the necessary, high standards required to provide confidence in financial reporting.

Where we identify specific concerns around aspects of a firm's practice, we may also commission targeted reviews. Earlier this year we announced such a review of KPMG's governance, controls and culture. Once this review is complete, the FRC will consider what actions it requires KPMG to take in response.

The Audit Quality Review team (AQR) considers for referral to our Enforcement team all audits assessed as requiring more than limited improvement. In the last two inspection cycles, 17 audits have been referred to the Case Examiner for potential enforcement action. Ten of these were subsequently referred to the Conduct Committee and led to the opening of investigations.

In the last year, enforcement activity has seen record financial sanctions levied, with a near trebling from £15.5m in 2017/18 to £42.9m in 2018/19 and a far greater use and range of non-financial sanctions, rising from 11 in 2017/18 to 38 in 2018/2019. Our Enforcement team grew by 25% last year, and we have significantly reduced the backlog of legacy cases.

From an audit policy perspective, the FRC has recently strengthened the auditor's requirements around going concern. The revised Auditing Standard extends significantly beyond the requirements of current international standards, including improved transparency of the auditor's work on, and assessment of, going concern.

Looking at the bigger picture

More broadly, we continue to develop our enhanced programme of monitoring, AFMAS (Audit Firm Monitoring and Supervision), for the six largest UK audit firms, which we announced in April 2018. AFMAS' objective is to monitor the stability and resilience of the largest audit firms. It undertakes work to assess the firms in four areas – leadership & governance; values & behaviours; business models & the firms' financial soundness and risk management & control. We took this step to support our expanded responsibilities as the competent authority and to address the risks posed to the stability of the financial markets by the concentration of the audit market, particularly for FTSE 350 companies. This work is not underpinned by formal statutory powers and requires the active cooperation and engagement of audit firms, all of which have responded positively to date.

Working in a changing environment

In December 2018, Sir John Kingman reported on his review of the FRC and recommended that the regulator be replaced by a new statutory body, the Audit, Reporting and Governance Authority (ARGA), with a new mandate and enhanced powers. The FRC is actively working with the Government to implement the review's recommendations. We are reviewing the format of our individual reports with a view to publishing them from the 2020/21 inspection cycle with the consent of the audit firm and the entity.

The FRC has, and continues to, input into the other three independent reviews, namely the Competition and Markets Authority's formal market study, the Brydon and the Redmond reviews. Meanwhile, we continue to maintain our focus on audit quality and are taking strong measures to improve it through our monitoring, supervision, enforcement and policy functions.

Summary of reviews across the audit sector

Sir John Kingman's Review of the FRC

Sir John Kingman's Review of the FRC concluded in December 2018.
The Government's consultation closed in June 2019.
We are working with the Government on the 83 recommendations.

Competition and Markets Authority Market Study

The CMA conducted a formal market study into the statutory audit services market. The final report was issued in April 2019 and included proposals for the joint audit of FTSE 350 entities as well as an operational split between audit and non-audit practices. The Government's consultation period on the report has recently closed.

Brydon Review

The Brydon review, announced in December 2018, is examining the quality and effectiveness of external audit. It is looking at the purpose, scope and quality of audit, both from a process and product point of view. Sir Donald is expected to report to the Secretary of State by mid-January next year.

Redmond Review

In July 2019, the Redmond review was launched into the quality of local authority audits, assessing the effectiveness of local authority financial reporting and audit regime. The review is currently calling for views[2].

[2] www.gov.uk/government/consultations/review-of-local-authority-financial-reporting-and-external-audit-call-for-views

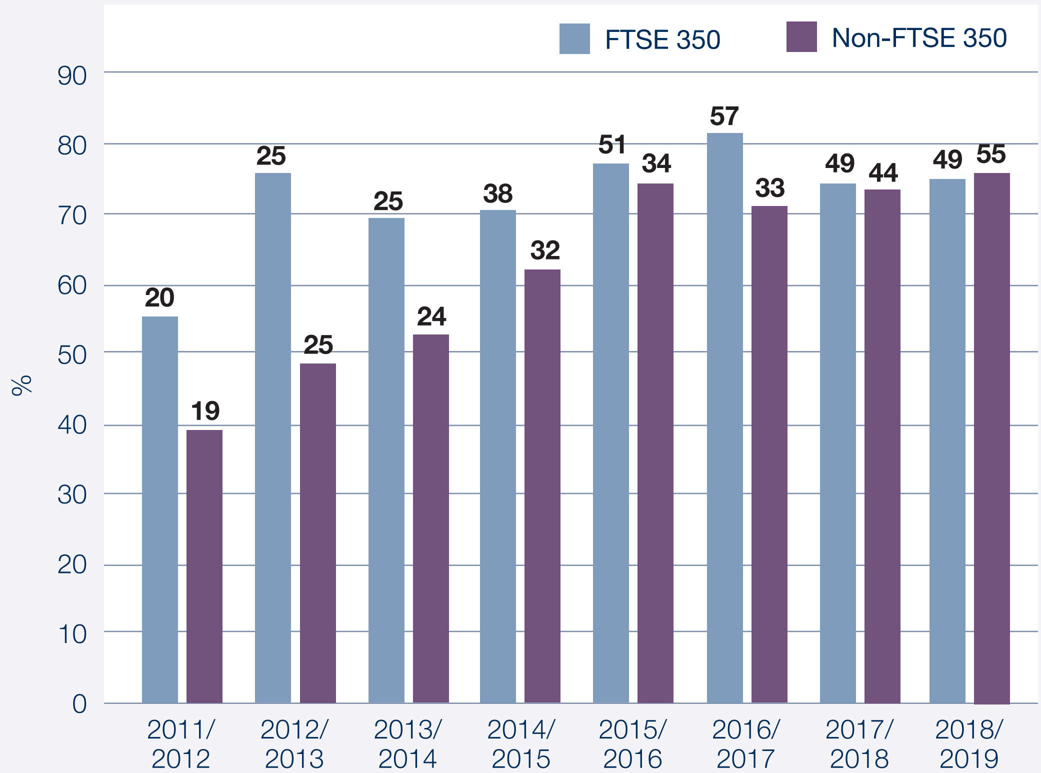
2. AUDIT QUALITY AND OUR RESPONSE

FRC MONITORING RESULTS

The overall AQR results for the 2018/19 inspection cycle were unsatisfactory, with only 75% of FTSE 350 audits reviewed being classified as good or requiring no more than limited improvements. These results fell significantly short of the target set three years ago that by 2019 at least 90% of FTSE 350 audits would be assessed in this category.

The biggest seven firms missed the FRC's 2019 target for FTSE 350 audits.

2.1 AQR monitoring results: percentage of reviews inspected requiring only limited improvements



Footnote: This chart shows that improvements in AQR inspection results are taking too long, given the FRC's target of 90%. Behind these figures is also a more worrying variation in results and a lack of consistency at an individual firm level (see Appendix 3)

The FRC does not review the quality of every audit and its sample is biased towards higher risk audits. These results cannot therefore be considered a precise measure of overall audit quality across the market. They are nonetheless a good indicator.

2.2 FTSE 350 - Percentage of reviews inspected requiring only limited improvement - Big 4 firms

	2014/15	2015/16	2016/17	2017/18	2018/19
Deloitte	75	81	82	79	75
EY	55	81	92	82	89
KPMG	75	60	65	50	80
PwC	77	82	90	84	65

At Grant Thornton only 50% of audits inspected were deemed to be good or requiring limited improvements (see Appendix 3). That not only represented a significant drop on the prior year but came against a five-year backdrop of 26% of audits inspected requiring significant improvement. In response, the FRC has increased its scrutiny of the firm, requiring Grant Thornton to produce a new audit improvement plan and increasing the number of audits inspected by the FRC in the 2019/20 inspection cycle.

In our 2018 Developments in Audit, we detailed our increased scrutiny of KPMG. The firm implemented an audit quality plan at the end of 2017, which we continue to review as part of this year's inspection. We consider that the actions taken to date demonstrate the firm's commitment to improve audit quality and we have seen improvements in several of the areas where we identified key findings last year. However, these actions are part of a longer-term plan which needs to be sustained by the firm. Areas where further progress is needed include improving the quality of financial services audits and robust challenge of company management.

Only 65% of the FTSE 350 audits we reviewed that were carried out by PwC were assessed as good or requiring only limited improvements. This compared to 84%, 90% and 82% respectively in the previous three inspection cycles. The firm has announced details of an action plan, including enhanced investment in people, training and technology, which the FRC will be monitoring carefully.

More broadly, the failure of all firms to meet the FTSE 350 target suggests that the firms' current root cause analysis procedures have not been appropriately designed, executed or acted upon to reduce instances of poor-quality auditing. Firms need to re-evaluate their root cause analysis to ensure it is appropriately designed to meet its objective.

The Audit Quality Review team (AQR) considers for referral to our Enforcement team all audits assessed as requiring more than limited improvement. In the last two inspection cycles, 17 audits have been referred to the Case Examiner for potential enforcement action. Ten of these were subsequently referred to the Conduct Committee and led to the opening of investigations. Further detail on enforcement activities and outcomes is included later in this section.

Inspection results suggest firms' current root cause analysis procedures have not been appropriately designed, executed or acted upon.

Key findings and observations

The most common findings across all of our audit inspections in the 2018/19 cycle were: the sufficiency of challenge of management, the audit of revenue and the audit of long-term contracts. In this section, we also comment on notable findings in our areas of focus, namely in relation to the audit of controls and the audit of fair value. Finally, we also comment on our observations from our reviews in financial services, our biggest priority sector, and our reviews of IT audits.

Inspection findings theme: Challenge of management

Insufficient challenge of management is the most frequent issue we raise. This is most prevalent when auditors are evaluating management's estimates in areas of judgement, where information is often hard to assess but can be highly material to the financial statements. Underlying information can be based on an array of uncertain factors such as the resolution of litigation or the effect of new entrants to a market. Establishing the extent of evidence needed to support the audit judgement in relation to such uncertainties is a skill. It requires the right mindset and sufficient professional scepticism in evaluating the facts presented by management and how these compare to other evidence obtained. Given the pivotal role that challenge of management plays in executing a high-quality audit, firms need to increase urgently their efforts to understand why audit partners and their teams continue to underperform in this area.

Whilst not an exhaustive list, we see the following issues as pivotal in challenging management:

Auditor mindset – familiarity with the audited entity can lead to the same audit approach, even when circumstances demand a different audit strategy (for example, when an entity has problems with a major contract or wider economic difficulties);

Confirmation not challenge – audit teams can be too ready to confirm what management tells them rather than questioning its plausibility. This lack of professional scepticism is especially prevalent where teams have to address significant management judgements;

Audit is more than discussion – audit teams have to discuss difficult accounting judgements with management to understand the assumptions underpinning key decisions. This should, however, be a starting point for the auditor not the main audit procedure. Challenge and corroboration are essential to test whether management's explanations hold good; and

Insistence on realistic deadlines – whilst we saw isolated examples of good practice where firms pushed back on reporting deadlines, we also identified audit teams accepting unrealistic deadlines (resulting in inadequate work and significant shortcomings).

In our July press notice[3], we stated that we will be "undertaking detailed work to assess how the audit firms are responding to this."

Appropriate challenge of management requires the right mindset and sufficient professional scepticism.

Our 2018/19 AQR inspections show auditors still struggle to challenge management sufficiently.

[3] https://www.frc.org.uk/news/july-2019/latest-frc-audit-inspections

Inspection findings theme: Revenue

Revenue is a significant driver of financial results and frequently considered a key performance indicator. It is an area we review on most audits we inspect and we continue to raise findings. In the current inspections cycle, we highlighted concerns at five of the largest seven firms inspected, with many of the findings relating to more routine audit procedures. For example, we noted poorly performed substantive analytical procedures (comparing actual and estimated revenue), insufficient work over key sales reconciliations and a lack of evidence obtained over the occurrence of transactions. We expect firms to address these concerns swiftly.

Inspection findings theme: Long-term contracts

Accounting for long-term contracts requires significant estimation, such as estimating future costs to completion and forecast revenues in the construction industry. Often these estimates are difficult to substantiate, especially when they relate to bespoke and more challenging contracts for which corroborating and comparative information is not as readily available. This makes auditing these estimates challenging. Given the level of audit risk and the potential impact on entities' results, we reviewed the audit work over long-term contracts on all applicable audits.

We found that teams often struggled to challenge management appropriately in key areas of judgement and obtain sufficient evidence to support the judgements made. This included estimates of future costs and margins, forecast revenues for onerous contracts and revenue recognition for multiple-element and complex contracts.

Area of focus: Fair value

Fair value accounting, measuring assets and liabilities at their current market value, can involve significant management judgement, especially where access to reliable information is limited or subjective, for example when valuing investment property, shares in unlisted entities or assessing impairment of goodwill and intangibles. For auditors, the combination of high impact and high judgement can make auditing of fair value items challenging. Investors have shared with us their concern about poor quality auditing of fair value items and the impact this has on the reliability of financial information.

In the 2018/19 cycle we included fair value as an area of focus. This covered the audit work of all accounting estimates.

A large number of inspection findings in this area concerned audit work on the fair value of financial instruments, which management typically calculate using complex models based on assumptions and other inputs. Often valuations relating to Level 2 and Level 3 assets were some of the most significant estimates made in the financial statements. When examining the audit work performed in this area, we noted concerns across a range of procedures, from the review of model methodology, to control and substantive testing. Further we found issues with the risk assessment and scoping of work over these items, with auditors not demonstrating how and why they had been able to conclude that certain parts of a portfolio or entire portfolios were sufficiently low risk to warrant not being included in their testing sample or covered by other procedures.

We identified shortcomings at five of the largest seven firms inspected around revenue, with many of the findings relating to more routine audit procedures.

Other notable inspection findings related to the audit work over the valuation of investment properties as well as the impairment of goodwill and intangibles. Here we found issues relating to a lack of understanding of macroeconomic factors affecting the valuation of properties in specific areas and industries, and when considering impairment of goodwill, a lack of challenge over expected future cashflows and the discount rates applied to reflect the cost of capital.

Drawing on the work of experts and specialists can be highly effective to audit items held at fair value. However, if executed poorly, this can lead to gaps in audit testing and evidence. We noted instances where experts had not been instructed clearly or where their work had not been suitably assessed. Care should also be taken to establish and evidence clearly the nature of the roles being performed by the expert or specialist and the oversight of those roles by the audit team.

Area of focus: Internal controls

Audit work performed over internal controls was a focus area during our most recent inspection cycle. Our reviews identified the following themes:

Understanding and evaluation of the design and implementation of controls

Some of the audits reviewed lacked sufficient evidence of the audit team's understanding of processes and controls and/or evaluation of the design and implementation of controls relevant to the audit risks. We also observed too many audits where the audit team had not identified any relevant controls which mitigate certain significant risks, which auditors are required to do irrespective of whether they intend to rely on them.

Responding to identified control deficiencies

Often we found insufficient evidence of the audit team's response to control deficiencies (controls that are not designed or operated in a way that would prevent or detect a material misstatement). This included the audit team's testing of whether the control deficiencies had been exploited (i.e. ensuring that they had not been used to commit fraud), or the sufficiency of changes to the audit plan and approach to address the increased risk. While appropriate substantive procedures may demonstrate that the financial statements are free from material error, audit teams need to hold management to account to ensure that control deficiencies are resolved in a timely manner and ensure that disclosures regarding the effectiveness of the control environment are fair, balanced and understandable.

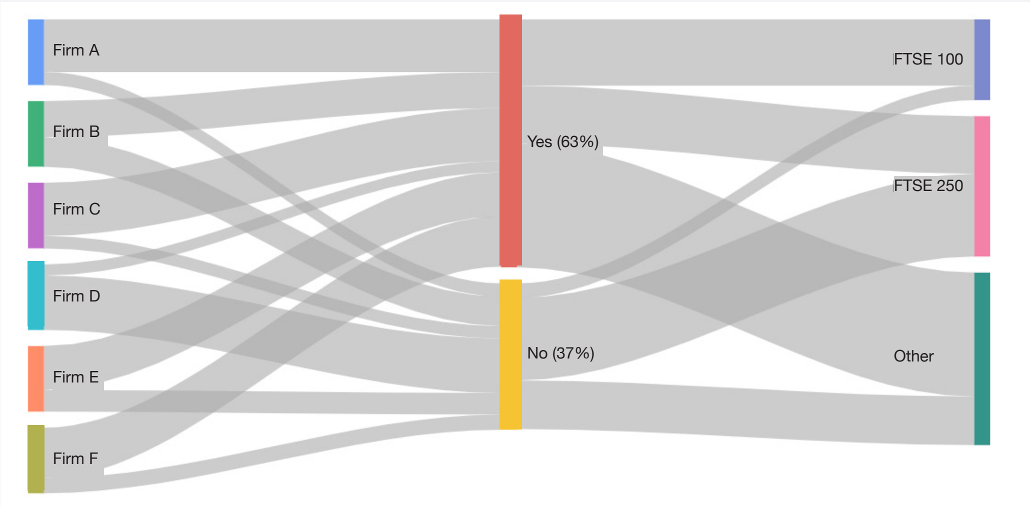
Controls reliance

Even where audit committees report that internal controls are effective, we still see audits where the operating effectiveness of controls is not tested and therefore not relied upon (See chart 2.3). Testing of controls, particularly those that are automated and preventative, provides assurance over a significantly larger proportion of transactions than could be covered through testing a sample of transactions.

We see significant variation in teams' approaches to controls testing.

The chart below is based on data from a majority of reviews undertaken at the largest six firms during our 2018/2019 inspection cycle.

2.3 Was operating effectiveness of controls tested for any significant risks?



Areas where there are a significant number of transactions with limited judgement, such as aspects of revenue and costs, lend themselves well to a controls-based approach for the audit of revenue. We noted the extent of controls testing varied significantly between audit firms and sizes of entity.

Management review controls

Management review controls are often designed to mitigate the most significant risks of misstatement, frequently in areas of significant estimation uncertainty. Testing the design and operating effectiveness of these controls is inherently difficult, and often the evidence to support the operation of the control is hard to obtain. Our inspections identified that audit teams frequently find these more challenging to test and firms should continue to focus on improving their work in this area.

Priority sector: Financial Services inspections

Financial services audits are an important component of our programme of reviews and the sector has been deemed a priority sector since the 2017/18 inspection cycle. Effective from June 2016, the provisions of the EU Audit Regulation brought all insurance entities to which Solvency II applied into AQR's scope for review. This significantly increased the number of insurance entities within our scope. In the four years from 2015/16 to 2018/19 inclusive, AQR reviewed the quality of 54 insurer entity audits performed by 11 audit firms. Similarly, AQR have increased the number of banking and building society audits reviewed each year. Over the same time period, we reviewed the audits of 46 banks and building societies across eight audit firms, spanning FTSE 100 banks, unlisted banks, and building societies.

2.4 FS Inspection summary results

The tables below provide a snapshot of our inspection findings across the sector.

Insurance audits

The table below shows the quality categories of the 54 audits reviewed in the past four years:

	Number of audits	Good or limited improvements required (Category 1 & 2A)	Improvements required (Category 2B)	Significant improvements required (Category 3)
Across all 11 audit firms	54	81.5%	14.8%	3.7%
Big 4 audit firms only	37	89.2%	10.8%	0.0%
Non-Big 4 audit firms	17	64.7%	23.5%	11.8%

Banking audits

The table below shows the quality of the 46 banking audits reviewed over the past four years:

	Number of audits	Good or limited improvements required (Category 1 & 2A)	Improvements required (Category 2B)	Significant improvements required (Category 3)
Across all 8 audit firms	46	67.4%	30.4%	2.2%
Big 4 audit firms	39	64.1%	33.3%	2.6%
Non-big 4 audit firms	7	85.7%	14.3%	0.0%

2.5 FS Inspection summary findings

The principal weaknesses we identified concerned the audit of:

Insurance	Banking & Building Societies
• The valuation of technical provisions, including actuarial input • The valuation of complex and illiquid financial investments • Business processes, system change and IT controls	• Loan loss provisioning • Litigation and conduct provisioning • Fair value of financial instruments

Insurance

The valuation of technical provisions, including actuarial input

In all cases, the valuation of technical provisions was the most significant estimate that audited entities made in the preparation of their financial statements. Auditors invariably identified this area as a significant risk and reported on it as a Key Audit Matter. It required auditors to confirm the completeness and accuracy of data for actuarial modelling and to evaluate the appropriateness of the level of technical provisions which was itself dependent on the selection of appropriate actuarial assumptions. Recurring weaknesses arose in the following areas:

- Testing of the completeness and accuracy of data;
- Sufficiency of the rationale for the selection of key assumptions;
- Use of benchmarks without sufficient evidence of their appropriateness; and
- Reporting to the audit partner, particularly lack of analysis of the potential impact of uncertainties identified by the auditor's actuaries.

The valuation of complex and illiquid financial investments

In many cases, auditors identified the valuation of complex and illiquid financial investments as a significant risk and reported on it as a Key Audit Matter. It required auditors to confirm the fair value of assets for which there were no observable inputs (Level 3 financial assets) either by means of cash flow models or by reference to investment managers' valuation statements. We identified weaknesses in the following areas:

- Audit procedures that were ineffective for confirming the reasonableness of investment managers' valuation statements;
- Insufficient testing of the completeness and accuracy of data that underpinned cash flow models;
- The mis-classification of financial assets between fair value hierarchy levels; and
- The non-involvement of valuation specialists to support the audit team.

Business processes, system change and IT controls

Some of the insurers whose audits we reviewed, were addressing weak IT control environments or were upgrading (or planning to upgrade) their IT systems. We identified insufficient procedures or evidence to confirm:

- That auditors could place reliance on IT work performed by the third parties; and
- The proper operation of: (a) Privileged access rights and hence the related authorisation controls on which auditors relied; and (b) Automated controls that generated reports on which auditors relied and interface controls, including the complete and accurate extraction of data.

Bank and building societies

Across our reviews of the banks and building society audits, the principal weaknesses identified concerned the audit of three areas, all of which were typically identified as a significant risk and reported on as a Key Audit Matter. These areas were loan loss provisioning, litigation and conduct provisioning as well as the work over fair values of financial instruments, which was described above.

Loan loss provisions

Our inspection work in the 2018/19 cycle was predominantly focused on IAS 39 as only one small bank in our sample adopted IFRS 9 early. Since our thematic review on loan loss provisioning in 2014/15, we have noted some improvement in the work performed over modelled provisions on the audits of larger entities. But similar improvement has not been seen consistently in the audits of smaller entities, where some auditors continue to offer insufficient challenge over assumptions and fail to perform appropriate procedures over the data used in the models. The audit work over individual credit exposures has seen less improvement across the full spectrum of entities reviewed. Many audit teams failed to demonstrate sufficient evidence supporting key facts and judgements in relation to the recoverability of individual exposures or struggled to demonstrate that they had performed appropriate procedures over the information relied upon in concluding on exposures.

In the 2019/20 cycle we will be focusing on audit work over the implementation of IFRS 9.

Litigation and conduct provisions

In the past two inspections cycles we have looked more closely at the area of litigation and conduct provisioning across all banking and building society audits. Across the spectrum of entities reviewed, we noted findings in relation to the sufficiency of challenge of management and professional scepticism. Often procedures were more akin to high-level ‘supporting’ discussion with management, rather than a challenge of management. For cases with a longer history, audit teams often failed to refresh the facts and consider their continued appropriateness, including the validity of any expert opinions obtained in prior periods.

Observations from our reviews of IT audits

For many organisations, financial transactions are highly dependent on IT and the automated nature of the underlying systems. Entities often have a complex infrastructure of IT systems, relying on both new and old to work together. This level of automation requires auditors to respond by increasing the use of IT specialists on audits. In this section we have detailed key observations from our review of this work.

Completeness and accuracy of data inputs and reports

Completeness and accuracy of dataflows between systems or system inputs into financial models need to be appropriately assessed as any errors or omissions can have a material effect on company financial statements. We continue to see the greatest number of findings relating to IT around the testing of data

We continue to see the greatest number of findings relating to IT around the testing of data where audit teams have not clearly understood the initial recording, processing and reporting of transactions.

where audit teams have not clearly understood the initial recording, processing and reporting of transactions. Audit teams need to consider how controls or substantive procedures can provide assurance over the completeness and accuracy of data. This may include procedures to test report parameters or the underlying logic within reports or interfaces.

Access controls

Access controls continue to be the area that provides a challenge to audit teams as entities' controls restricting privileged access are frequently found to be deficient, particularly around performing periodic appropriateness reviews. However, we now see that audit teams are performing improved substantive procedures which are far more responsive to the control failure and financial statement impact. Audit teams should continue to ensure that evidence supporting these procedures is sufficient and appropriate.

Thematic reviews

Thematic reviews, which we have undertaken since 2013, supplement our annual programme of inspections of individual audits. They are more focused in scope and go to greater depth than is generally possible in our review of individual audits. Our two latest reports looked at audit firm transparency reporting and other information in the annual report.

Transparency reporting thematic review[4]

Sitting alongside the reports on audit quality that the FRC publishes, Transparency Reports by the firms should provide stakeholders with important information about each firm's governance and quality processes to inform their assessment of how appropriate their auditor is for the role. We published our thematic review on transparency reporting in September 2019 and raised that many firms treat the reports wrongly as a marketing tool which damages their perception among stakeholders and limits their usefulness. We called on the firms to reduce the length of their Transparency Reports and explain within them the challenges they are facing in seeking to deliver consistently high-quality audits, along with their assessment of how successful they are being at meeting those challenges.

The intended beneficiaries of the reports have an important role to play here as well. The reports are produced by the firms, they are generally readily available and yet they are often not being used or read. Our research showed that, on a sample basis, 84% of audit committee chairs were unaware that the reports exist. Whilst the current reports need to be improved, they still contain a considerable amount of useful information, and the firms put a great deal of effort into producing them. To change the reports for the better, we believe that more dialogue is needed between the firms and the key stakeholders. We will continue to push firms to disclose more useful information and to be more balanced, but at the same time other stakeholders need to provide the firms with a greater incentive to do so by reading, using and feeding back on the reports.

In addition, we concluded that for the full benefits of Transparency Reporting to be realised, the existing requirements need to be rethought. We will begin work in 2020 to consider how this is done and, importantly, how any changes can complement the outcomes of the significant reviews of the audit market that are taking place at the moment.

Effectiveness of Transparency Reports has been reduced by the perception that they are a marketing tool.

[4] https://www.frc.org.uk/getattachment/3c124043-70b7-428a-af03-9359b32652e2/Transparency-Reporting-Final.pdf

Other information in the annual report thematic review[5]

In December 2018, we published our thematic on 'Other Information in the Annual Report', where we looked at the procedures performed by auditors at the six major UK audit firms on information in the annual reports outside the financial statements. This information, which is often referred to as the "front half", is frequently used by investors to inform their assessments of a company's future prospects and has grown significantly over time.

Other Information, if materially mis-stated, can undermine the credibility of the audited financial statements or may inappropriately influence the decisions of users of the Annual Report. The auditor's opinion on the financial statements, however, does not cover the Other Information. Instead, as part of an audit of the financial statements, the auditor is required to consider whether the information is materially inconsistent with the audited financial statements or the auditor's knowledge and report on this in the auditor's report.

We reported that auditors' work on Other Information does not meet the requirements of Auditing Standards consistently. Inconsistency in the extent and quality of the work in part reflects the lack of prescriptive requirements in the Auditing Standards. Firms' own guidance to their auditors also lacks prescription, which has led to varying approaches being taken to this work, even by different audit teams within the same firm. In response, we have included Other Information as an area of focus in our 2019/20 inspection programme. This will enable us to assess how firms have responded to the concerns highlighted by the Thematic Review.

Technology in audit thematic review

We are currently undertaking a review to consider how the use of technology has widened beyond data analytics, such as the use of artificial intelligence. We have already discussed how this might affect audit quality with audit committee chairs and will hold similar discussions with investors. We will look to identify and encourage the use of technology where it contributes to audit quality as well as areas of concern or caution. We are hoping to report early in 2020.

Audit quality indicators thematic review

We are currently performing a review of the quantitative and qualitative measures ("audit quality indicators") that are being monitored and assessed by the seven largest audit firms to provide them with insights on key factors that influence audit quality. We aim to identify examples of good practice in this area and to share where firms should seek to further develop their monitoring, particularly in respect of preventative indicators that allow action to be taken by the firms to ensure consistently high quality audits. We are aiming to publish our report in the Spring of 2020.

Other Information, if materially mis-stated, can undermine the credibility of the audited financial statements. Auditors' work around this does not meet the requirements of Auditing Standards consistently.

[5] https://www.frc.org.uk/getattachment/7afae1fe-75c8-43fc-9f60-3f2a78b438a9/AQR-Thematic-Review-Other-Information-in-the-Annual-Report-Dec-2018.pdf

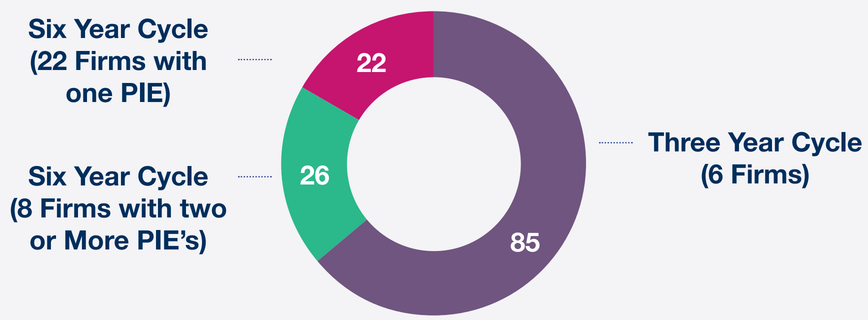
Inspection findings of firms in a non-annual cycle ("smaller to medium-sized firms")

Whilst a large portion of the PIEs[6] are audited by the seven largest accounting firms, approximately 133 PIEs are audited by 28 smaller to medium-sized firms. The majority of these entities have listed equity or debt. The population also includes large AIM entities, unlisted banks and Lloyd's insurance syndicates. These all fall within the scope of our audit quality review programme but are inspected on a different cycle. In the following section we have outlined our approach for this aspect of our monitoring.

FRC inspection cycle for smaller to medium-sized audit firms

Since 2016, we have inspected small to medium-sized firms on a six-year cycle, or, for firms that audit a large PIE[7], a three-year cycle. The majority (85) of the 133 PIEs are audited by six firms[8] that we visit on a three-year cycle. The firms that audit the remaining PIEs are visited on a six-year cycle, including eight firms that audit two or more PIEs.

2.6 Distribution of PIE audits across the smaller firms, by inspection cycle



Inspection findings of small to medium-sized firms from the last three years

In 2018/19 we inspected four firms. The scope of our work that we performed included seven audit file inspections and firmwide procedures at each firm. We use risk-based criteria to select the audits we review and therefore the results of our inspections cannot necessarily be extrapolated or deemed reflective of the entire population. The inspection process for each file review is the same as that applied to the seven largest audit firms, including the quality categories we award each audit we inspect.

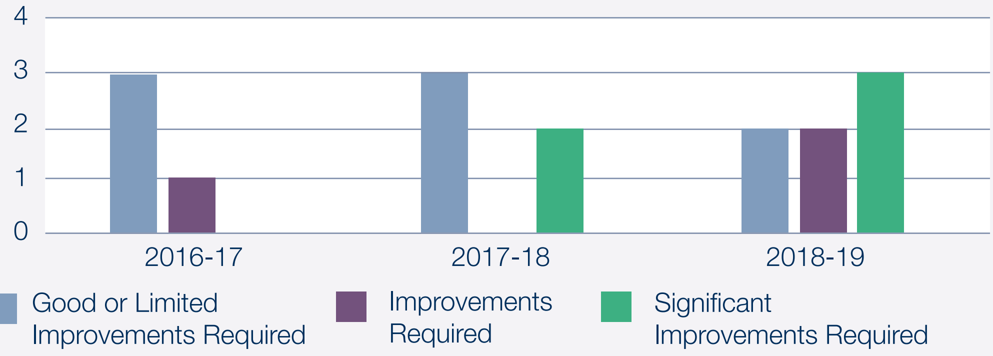
The profile of the categories is significantly worse than in previous years with only 29% of audits reviewed being classified as good or requiring no more than limited improvements.

[6] PIE (Public Interest Entity) - Any entity with listed debt or equity on an EEA regulated market (e.g. London Stock Exchange); a credit institution (e.g. bank) or an insurance undertaking. In addition, the FRC also includes within the AQR's scope the audit of AIM listed entities and Lloyds Syndicates.

[7] A large PIE is any entity that meets two of the following three criteria: balance sheet total >€20m, net turnover > €40m, average no of employees > 250

[8] PHF Littejohn LLP, RSM UK Audit LLP, Crowe U.K. LLP, Haysmacintyre, UHY Hacker Young LLP, Beever and Struthers

2.7 Three year inspection results for smaller firms



Whilst the number of inspections is modest and care needs to be taken when interpreting the results, we noted the work around going concern was often weak and, more broadly, we identified issues with regards to audit teams obtaining sufficient and appropriate audit evidence.

How the FRC responds to poor quality in the small to medium-sized firms

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 ICAEW's Audit Registration Committee ("ARC") with a recommendation on whether the firm should continue to be registered to undertake PIE and smaller entity audits and whether other steps should be considered by the ARC to ensure actions are taken by the firm to improve or safeguard audit quality.

Third Country Auditors

Third Country Auditors (TCAs) are auditors of companies incorporated outside the EEA that have issued securities on EU-regulated markets, which, in the case of the UK, means the main market of the London Stock Exchange. Regulation of TCAs is the responsibility of the FRC.

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 TCAs from countries where the European Commission deemed that the system of auditor oversight is not "equivalent" or "transitional" to that required within the EU (known as "Article 45" TCAs.)

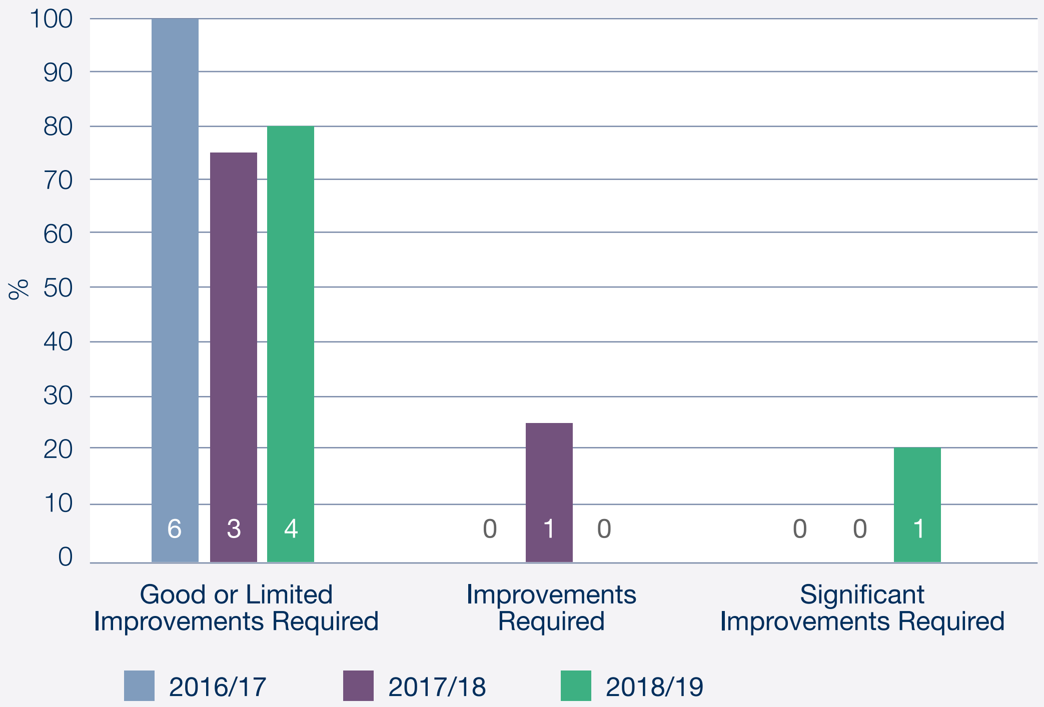
At 30 June 2019 there were 104 TCAs, including those from equivalent or transitional countries, with 154 issuers with UK traded entities, across 37 countries. At that date, there were 35 Article-45 TCAs from 16 countries who audited 35 issuers with traded securities on UK regulated markets. We commenced inspections of Article 45 TCAs in 2013/14.

In 2018/19 five audits were inspected, one at each of the following firms:

- SR Batliboi & Co, India
- PwC Oman
- KPMG Vietnam
- Ernst & Young, Nigeria
- Deloitte, Kazakhstan

The following graph summarises our assessment of the quality of audits inspected in the last three years:

2.8 TCA: Three year audit inspection results



How the FRC responds to poor quality in third country audits

TCA reviews, assessed as requiring improvements or significant improvements, are also considered under the FRC's enforcement procedures. We also have the ability to deregister audit firms in response to poor quality in third country audits.

Local audits

The FRC is also responsible for the oversight of Major Local health body audits (excluding Foundation Trusts) for 2018/19 under transitional statutory duties under 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 £500m.

The LAAA legislates that local government bodies will also be subject to audit oversight monitoring by the FRC but, with effect from 2019/20, the role will be transitioned from Public Sector Audit Appointments Limited ("PSAA").

Once we have oversight responsibility of these bodies, we intend to prepare a separate public report.

For 2018/19, the FRC's Audit Quality Review team reviewed the audits of four major health bodies with a 31 March 2018 year-end, completed by four separate audit firms. The FRC review covered both the audit of the financial statements and the audit firm's conclusion on arrangements for Value for Money ("VfM").

The audits reviewed comprised two NHS Trusts and two Clinical Commissioning Groups ("CCGs").

Monitoring results and findings

The audit work within the scope of our review, relating to the four financial statement opinions, was assessed as follows:

NHS Trusts – Neither of the two reviews required more than limited improvement.

CCGs – Neither of the two reviews required more than limited improvement.

The most significant findings arising from the VfM reviews was insufficient audit procedures performed over the audited body's financial recovery plans, budgets and cost savings programme.

The Local Auditors (Transparency) Instrument 2015 ("Instrument")

We performed a review of the seven firms registered to conduct major local audits for reporting under 'The Local Auditors (Transparency) Instrument 2015, and raised areas for improvement in the firms' individual action plans, for which the firms have committed to take appropriate actions.

Overall, four of the seven firms failed to publish their transparency report within three month of the firms' year-end and one of these firms failed to publish any report.

Additionally, only one firm had published and retained on their website, the required transparency report for 2017.

Other areas of improvement identified from our review included: the need for improved reporting of revenues relating to Local Audit; accuracy and completeness of the individual major audits that were completed in the year; better reporting on local audit quality monitoring, both internal and by external regulators; and completeness of reporting on internal quality control systems, independence procedures and remuneration of partners.

FRC ENFORCEMENT

Enforcement action in cases where audit or ethical standards have been breached plays a vital role in supporting confidence in audit. It assists in upholding standards and deterring misconduct, not only through the imposition of financial sanctions but also through the wider range of non-financial sanctions encouraged following the Clarke sanctions review[9] which focused on maintaining and enhancing the quality and reliability of future audits.

In the year to 31 March 2019, total financial sanctions on audit firms and partners amounted to £42.2 million (discounted for settlement to £31.3 million)[10], compared with £15.2 million (discounted for settlement to £13.0 million) in 2017/18. This was combined with a range of non-financial sanctions, including:

- PwC to monitor and support its Leeds audit practice and to report to the FRC for three years;
- PwC to review, and if necessary, amend its policies and procedures with a view to ensuring that all audits of high risk or high-profile entities that are not listed companies are subject to an engagement quality control review;
- All Deloitte audit staff, including partners, to undergo training on the audit of subsidiary companies as part of group audits, including identification of areas of significant risk, the importance of stakeholder relationships of the wider group and the risk of fraud in that context;
- KPMG to undertake a review of its 2018 audits of insurance undertakings and to report to the FRC;
- KPMG to conduct additional quality reviews on all audits with credit institutions (banks and building

Enforcement action plays a vital role in supporting confidence in audit.

[9] https://www.frc.org.uk/getattachment/e7c1b326-55b9-4676-8b60-b191037b2486/Sanctions-Review-Report-(November-2017).pdf

[10] A further £0.7 million was levied against members in business.

societies) over the next three years and to report to the FRC;

- The prohibition on particular audit partners performing any audit work or signing audit reports in relation to PIEs; and
- The introduction of second review partners on audits of particular partners.

Current investigations

The FRC opened 12 investigations in the period under the Audit Enforcement Procedure ("AEP") including investigations into the audit of SIG plc, Conviviality plc, Patisserie Holdings plc and Interserve plc. In total, as at 31 March 2019, there were 28 live investigations into audits; three are legacy cases being investigated under the Accountancy Scheme and the remaining 25 are under the AEP. Four of the AEP investigations have been delegated to the ICAEW.

In addition, an investigation was opened under the Accountancy Scheme into the provision of materials to the FRC by KPMG in connection with the FRC's Audit Quality Review into aspects of the audit of Carillion for the year-end 2016.

The FRC opened 12 investigations in the period under the Audit Enforcement Procedure ("AEP") which concern a wide range of issues.

The 25 ongoing audit investigations concern a wide range of issues, including:

Cases concluded in current period

Sanctions were imposed in nine audit investigations, one under the AEP and the remainder under the Accountancy Scheme. In seven of these cases the audit firms and partners admitted misconduct and accepted fines and other sanctions. Two cases were brought before tribunals with the tribunal finding misconduct and imposing sanctions. One audit investigation conducted under the Accountancy Scheme was closed without enforcement action. Further details of published sanctions are set out below.

Company	Audit Firm/ Audit Partner	Date opened	Outcome	Date concluded	Sanction
Quindell plc	KPMG	Aug-15	Misconduct admitted Sanction agreed CTC[11] £146,000	May-18	A Reprimand and a fine of £4.5 million (reduced to £3.15 million after settlement discount)
	Auditor	Aug-15	Misconduct admitted Sanction agreed	May-18	A Reprimand and a fine of £120,000 (reduced to £84,000 after settlement discount)
BHS Limited	PwC	Jun-16	Misconduct admitted Sanction agreed CTC £595,000	May-18	A Severe Reprimand, a fine of £10 million (reduced to £6.5 million after settlement discount), a Condition that PwC monitor and support its Leeds Audit Practice and provide detailed annual reports about that practice to the FRC for the next three years and an undertaking by PwC to review and amend its policies and procedures to ensure that audits of all non-listed high risk or high-profile companies (including private companies which employ at least 10,000 individuals in the UK) are subject to an engagement quality control review
	Auditor	Jun-16	Misconduct admitted Sanction agreed	May-18	A Severe Reprimand, a fine of £500,000 (reduced to £325,000 after settlement discount), a Condition not to perform audit work for 15 years and an undertaking by Mr Denison to remove his name from the register of statutory auditors and not to apply to have his name re-entered on the register for a period of 15 years
Ted Baker plc	KPMG	May-16	Misconduct admitted Sanction agreed CTC £112,000	Jul-18	A Severe Reprimand and a fine of £3 million (reduced to £2.1 million after settlement discount)
	Auditor	May-16	Misconduct admitted Sanction agreed	Jul-18	A Reprimand and a fine of £80,000 (reduced to £46,800 after settlement discount)

[11] CTC - Contribution to Costs

Company	Audit Firm/ Audit Partner	Date opened	Outcome	Date concluded	Sanction
Nichols plc	Grant Thornton	Jul-13	Misconduct admitted Sanction agreed CTC £165,000	Jul-18	A Severe Reprimand and a fine of £4 million (reduced to £3 million after settlement discount)
	Auditor	Apr-14	Misconduct admitted Sanction agreed	Jul-18	A Reprimand and a fine of £70,000 (reduced to £52,500 after settlement discount)
	Auditor	Apr-14	Misconduct admitted Sanction agreed	Jul-18	A Reprimand and a fine of £60,000 (reduced to £45,000 after settlement discount)
	Auditor	Apr-14	Misconduct admitted Sanction agreed	Jul-18	A Severe Reprimand and a fine of £100,000 (reduced to £75,000 after settlement discount)
Equity Syndicate Manage-ment Ltd	KPMG	Feb-12	Misconduct by tribunal Sanction by tribunal CTC £1.35 million	Aug-18	A Severe Reprimand, a fine of £6 million and an agreement to undertake an additional internal review and report to the FRC on certain aspects of its 2018 audits of insurance undertakings (to which Solvency II applies and Lloyds Syndicates)
	Auditor	Feb-12	Misconduct by tribunal Sanction by tribunal	Aug-18	A Severe Reprimand, a fine of £100,000 and agreement to a second partner review of his audits until the end of 2020
	Auditor	Feb-12	Misconduct by tribunal Sanction by tribunal	Aug-18	A Severe Reprimand and a fine of £100,000
Tanfield Group	Baker Tilly	Sep-09	Misconduct by tribunal Sanction by tribunal CTC £827,955	Oct-18	A Reprimand and a fine of £750,000
	Auditor	Sep-09	Misconduct by tribunal Sanction by tribunal	Oct-18	A Reprimand and a fine of £30,000
	Auditor	Sep-09	Misconduct by tribunal Sanction by tribunal	Oct-18	A Reprimand and a fine of £35,000
Serco Geografix Ltd	Deloitte	May-16	Misconduct admitted Sanction agreed CTC £300,000	Jan-19	A Severe Reprimand, a fine of £6.5 million (reduced to £4.225 million after settlement discount) and a Condition that Deloitte arrange for all its audit staff to undergo a training programme (designed to the satisfaction of the FRC) aimed at improving the behaviour that is the subject of the Misconduct
	Auditor	May-16	Misconduct admitted Sanction agreed	Jan-19	A Severe Reprimand and a fine of £150,000 (reduced to £97,500 after settlement discount)

Company	Audit Firm/ Audit Partner	Date opened	Outcome	Date concluded	Sanction
The Co-operative Bank plc	KPMG	Jan-14	Misconduct admitted Sanction agreed CTC £500,000	Feb-19	A Severe Reprimand and a fine of £5 million (reduced to £4 million after settlement discount) In addition, all KPMG's audit engagements with credit institutions for audits with 2019, 2020 and 2021 year-ends to be subjected to an additional review by a separate KPMG Audit Quality team, who will provide reports to the FRC
	Auditor	Jan-14	Misconduct admitted Sanction agreed	Feb-19	A Severe Reprimand and a fine of £125,000 (reduced to £100,000 after settlement discount)
Laura Ashley Holdings plc	Moore Stephens	Feb-18	Misconduct admitted Sanction agreed CTC £85,000	Mar-19	A Severe Reprimand, a fine of £825,000 (reduced to £455,813 after settlement discount), a published severe reprimand, requiring MSR Partners LLP to cease or abstain from repetition of the conduct giving rise to the breaches and a declaration that the 2016 Audit report signed on behalf of Moore Stephens LLP did not satisfy the Relevant Requirements
	Auditor	Feb-18	Misconduct admitted Sanction agreed	Mar-19	A fine of £110,000 (reduced to £60,775 after settlement discount), a declaration that the FY2016 Audit report signed by Mr Corrall did not satisfy the Relevant Requirements and a condition that Mr Corrall shall not act as Statutory Auditor of a Public Interest Entity nor sign a Statutory Audit Report in respect of a Public Interest Entity for a period of at least 18 months

Constructive Engagement

Constructive Engagement is a process introduced by the AEP for resolving cases with an audit firm where the audit quality concerns can be appropriately and satisfactorily addressed without full enforcement action. Nineteen cases, involving a wide range of issues, were resolved through constructive engagement during the year.

Further information on the activities of the FRC's Enforcement Division can be found in the Annual Enforcement Review 2019[12].

[12] https://www.frc.org.uk/getattachment/b8622ccd-5264-41d6-8053-9986fba531c0/2353_Annual-Enforcement-Review-v6-1-Final-Web.pdf

AUDIT FIRM MONITORING AND SUPERVISION (AFMAS)

In April 2018, we announced an enhanced programme of monitoring (AFMAS) for the six largest audit firms in the UK. We took this step to support our expanded responsibilities as the competent authority and to address the risks to the stability of the financial markets by the concentration of the audit market, particularly for FTSE 350 companies. This work is not underpinned by formal statutory powers and requires the active cooperation and engagement with audit firms, all of which have engaged positively. Sir John Kingman's Review of the FRC was supportive of AFMAS and recommended that it be given a statutory basis. The FRC is working closely with BEIS on this.

Our work is structured in five 'pillars', on which we gather evidence to support our monitoring activity. These are:

- Leadership and governance;
- Values and behaviours;
- Business models and financial soundness;
- Risk management and control; and
- Audit quality.

Resource constraints in 2018 limited our ability to deliver on AFMAS, but a more substantial programme of monitoring is planned for 2019/20. Our work in 2018/19 included the following aspects:

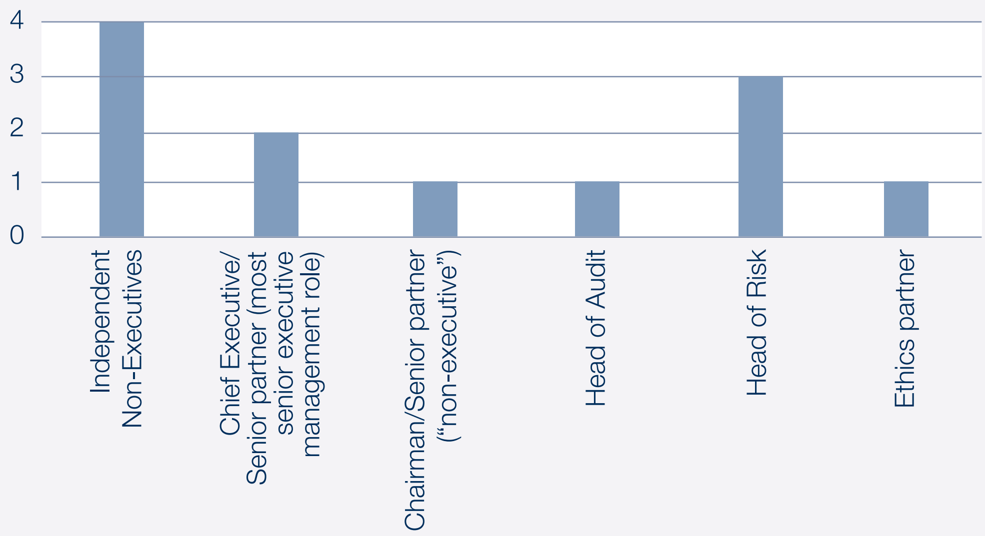
Leadership and governance

We set clear expectations for the necessary experience, skills and attributes of candidates for key roles in an audit firm. We asked firms to demonstrate to us that proposed appointments take proper account of how individuals are competent and capable to carry out the role, as well as their understanding of the firm's values (including audit specific values).

We have met with candidates for several different roles before appointments are made, and assessed and fed back to senior management of the relevant firm how well we believe their proposed appointees meet these criteria.

We also commenced a programme of regular meetings between individuals in key roles at the firms and the FRC leadership. These meetings take place on a six-monthly basis and at the conclusion of each cycle of meetings we draw out common themes and write to the firms setting out areas of good practice and concern.

2.9 Pre-appointment meetings



Risk management and control

In last year's report we described the enhanced monitoring work undertaken in two areas - contingency planning, and information security. The outcomes of these reviews were reported privately to senior management and the independent non-executives of each audit firm. In 2019 we have received progress reports from the firms on the actions they have taken to meet our concerns. In the majority of cases, the key findings from our 2018 reviews had been addressed. Further work is required in some areas for some firms and we will continue to monitor the firms' progress.

We have also established a "risk reporting protocol" with the firms, under which we expect them to report to us incidents occurring either in the UK or across their global networks that could pose a significant threat to the reputation of the UK firm and/or the firm's global network. We also expect reporting on any significant financial or operational (including cyber and information security) risks to the firm.

AUDIT QUALITY MONITORING OF NON-PUBLIC INTEREST ENTITY AUDITS

Audit quality monitoring of non-PIE audits is performed by the Recognised Supervisory Bodies (RSBs)[13] as one of the regulatory tasks[14] delegated by the FRC under Delegation Agreements. ICAEW is the largest RSB in terms of registering audit firms (2,812 firms are registered as at 31 December 2018), registering all except one of the top ten audit firms.

In 2018, the RSBs conducted 1,118 firm monitoring visits, of which the ICAEW's quality assurance department (QAD) was responsible for carrying out over half of the visits to audit firms (567). The sample of firms chosen for inspection is determined both by statutory requirement as well as risk factors specific to the audit portfolio of an audit firm. The RSB's monitoring amounted to a total of 2,189 audit files reviewed in 2018.

ICAEW (QAD) results

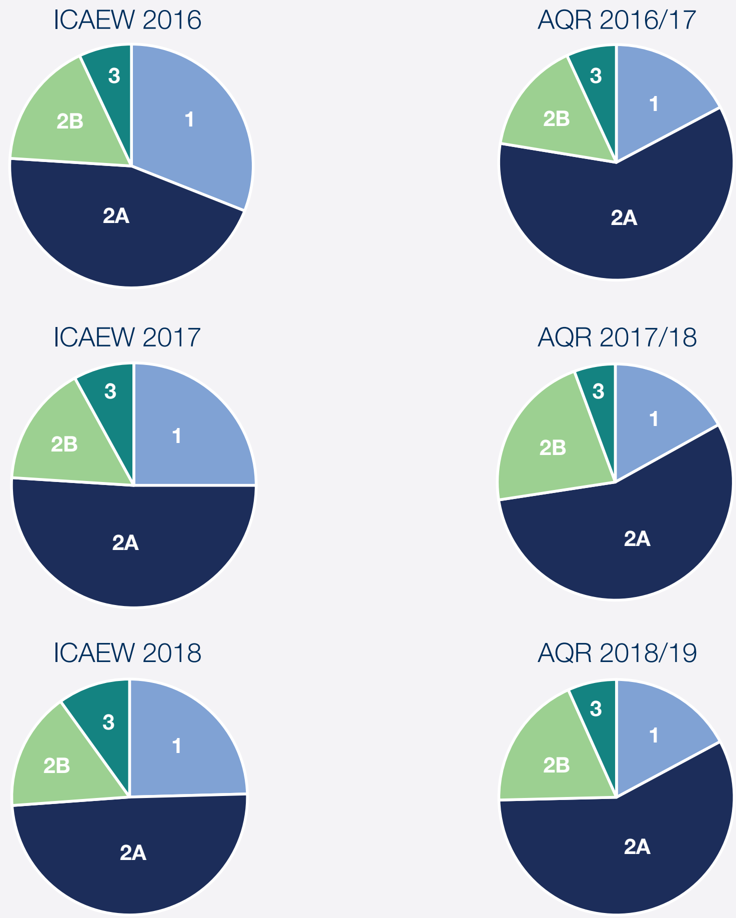
It is interesting to compare the ICAEW's monitoring results to the FRC's (AQR) monitoring results. Of note is that both sets of results show around 75% of files inspected as being of an acceptable quality (being either category 1 or category 2A). This has been broadly the case for the last three years.

The monitoring results of the ICAEW are comparable to the FRC's (AQR) with around 75% of files inspected being of an acceptable quality.

[13] Association of Chartered Certified Accountants (ACCA), Institute of Chartered Accountants in Ireland (ICAI), Institute of Chartered Accountants in England and Wales (ICAEW) and Institute of Chartered Accountants of Scotland (ICAS).

[14] Audit monitoring, Audit Registration, Continuing Professional Development and Enforcement as set out in Delegation Agreements.

3.0 Three year results comparison: AQR (FRC) vs QAD (ICAEW)



RSBs most common ISA breaches

While it is important to recognise that the population of firms and the audit files reviewed by ICAEW and the other RSBs differ each year because of the cyclical nature of the selection process, of the files reviewed in 2018 the RSBs found that the most common ISAs breached were:

Audit evidence – ISA (UK) 500: (28 percent of breaches reported (23 percent 2017)), with weaknesses in the completeness of revenue, fixed assets, valuation of stock and work in progress, other profit and loss items and other creditors;

Audit documentation – ISA (UK) 230: (18 percent of breaches reported (19 percent 2017)). The RSBs found failures by auditors to adequately record their work, or that the link between the evidence and the conclusion was not clear from the audit file alone;

Risk assessment – ISA (UK) 315: (7 percent of breaches reported (8 percent 2017)) and ISA (UK) 330 (3 percent of breaches reported). In some cases, the RSBs were unable to see from the audit files how well the auditor understood the business and the significant risks; and

Fraud – ISA (UK) 240: (4 percent of breaches reported (3 percent 2017)). There was a lack of evidence that the firms had discussed fraud risk with management or those discussion did not go into sufficient detail. Most firms are aware of the requirement to have a fraud briefing with the engagement team, but often this is not well recorded.

FRC's monitoring of the RSBs

The RSB's work is monitored by the FRC's Professional Oversight Team (POT) against the Delegation Agreements. The Delegation Agreements required the RSBs to agree an audit quality indicator with the FRC that focuses on the improvement of audit quality and annual review activity in respect of audit quality monitoring. In June 2019 the FRC and the RSBs agreed on an audit quality KPI that 75 percent of completed audit file reviews by the registering RSB on a Registered Auditor should require not more than limited improvements, i.e. should be grade 1 (or A) or 2A (or B). Where completed audit file reviews by the registering RSB on a Registered Auditor require more than limited improvements i.e. grade 2B or 3 (ACCA: C), the RSB will apply guidance agreed with the FRC to determine whether a root cause analysis should be conducted by the firm and, where appropriate, should ensure that such analysis is then submitted and considered as part of the relevant visit closedown process, which includes both initial and follow up regulatory action determined by the RSB as appropriate.

The FRC changed the emphasis of its audit quality monitoring inspections from desktop reviews every two to three years, to annual on-site shadowing of the RSBs' monitoring visits to the firms. On-site shadowing of audit files, reviews of RSBs' working papers and reports and attending interactions between the RSBs and audit firms provide a deeper insight into:

- The quality of the audits and the policies and procedures supporting the audit quality at the audit firms;
- The extent to which RSBs incorporate or consider AQR's priority sectors, AQR's area of focus or AQR non-sector specific factors when reviewing an audit;
- The quality of an audit review carried out by the RSBs; and
- The nature and extent of challenge by the RSBs.

This pro-active approach enables POT to require the RSB to take immediate remedial action where necessary. It also means that RSB staff can demonstrate to the FRC how they respond to concerns on a real time basis.

RSB ENFORCEMENT

If the overall review of quality of an audit firm's work is considered insufficient or if a firm has a second or subsequent unsatisfactory visit, regulatory action is considered by the RSBs. Poor file outcomes will usually result in the firm being referred to the RSB's relevant committee responsible for audit registration or licensing. The committee or assessor will consider the result of the inspection visit, along with the firm's response to determine if any action needs to be taken.

The RSBs' committees have the powers to impose conditions and/ or restrictions on the firms. Conditions can include hot and cold files reviews, requiring training to be provided, and requiring the firm to draft an action plan to address the issues found during the inspection. Restrictions can include preventing the firm from taking on new audit engagements without the prior permission of the committee; and preventing the firm from performing audit quality reviews for other firms.

These conditions and restrictions are not lifted until the RSB is satisfied that sufficient progress on audit quality has been made by the audit firm which is assessed during accelerated follow-up visits. In the most serious cases the committee can remove the audit registration from the auditor and audit firm.

In 2018 the RSBs' committees considered such matters for 154 audit firms and placed restrictions and/or conditions on 109 of these firms. The RSBs also removed eight registrations from firms because of poor audit monitoring visit outcomes. Further, where a breach is sufficiently serious, the RSBs' committees may refer the matter to their investigation department, which may lead to the RSB taking disciplinary action against the firm and/or the audit principal.

3. INTERNATIONAL INFLUENCE & FUTURE DEVELOPMENTS

The FRC has a strong track record of international co-operation, on development of standards and sharing experience and good practice with other audit regulators. Audit is a global business, governed by international standards and applied by audit firms and their networks that are often international rather than national in their focus. The adoption of standards, however, is a matter for national jurisdictions, as is audit regulation. We participate in the setting of international standards on auditing, which form the basis of our UK standards. FRC staff actively participate in the work of the International Auditing and Assurance Standards Board (IAASB), and a number of its working groups and task forces. These have worked and are working on revisions to a number of the most important standards covering the audit of accounting estimates, audit risk assessment, quality management and group audits.

The IAASB is not the only way in which the FRC contributes to the development of standards in the public interest. We have recently revised ISA (UK) 570, which sets requirements for the audit of going concern. Following a number of well-publicised audit failures, we used our audit inspection and enforcement work to identify: areas where work was poorly executed; areas where the current standard is not successful in driving the work of the auditor; and opportunities for reporting to be enhanced to provide clearer information to users of the financial statements to help them question and challenge both management of an audited entity and auditors. The FRC has taken action, because the IAASB was not resourced to undertake further projects and hope that the stronger UK requirements will form the basis for change at the international level, in the same way that we led changes to auditor reporting, which saw the development of the extended auditor's report back in 2012.

High quality audit also relies on a strong ethical framework. Although the FRC is not represented on the International Ethics Standards Board for Accountants, we participate actively in all of its consultations, making recommendations to strengthen auditor independence and reduce conflicts of interest. The International Code of Ethics forms the basis of the Codes of Ethics set by the professional accountancy bodies in the UK. However, the FRC continues to show leadership by setting a more rigorous Ethical Standard to govern the work of auditors in the UK, which is currently being revised to strengthen auditor independence by: further limiting the non-audit services that an auditor can provide; requiring auditors to assess their independence against a stronger third party test; and providing greater transparency over fees charged and resources deployed, a wider consideration of the risks to independence posed by giving and receiving gifts and hospitality, and strengthening the role of the ethics partner in an audit firm. As for auditing standards, we share our proposals with fellow audit regulators to further the debate and develop requirements globally. Appendix 5 includes further recent developments regarding specific auditing and ethical standards.

The FRC is also a board member of the International Federation of Independent Audit Regulators (IFIAR). Membership allows us to work with other audit regulators to share best practice, and

FRC staff actively participate in the work of the International Auditing and Assurance Standards Board (IAASB).

to hold the global audit firms to account for the quality of the work they deliver. The FRC is actively involved in all IFIAR working groups, including leading the organisation of the annual inspection workshop, participation in the bi-annual meetings with the audit leadership of the Big 6 audit firms, and involvement in the standards, enforcement and investor working groups. Similarly, the FRC is actively involved in the Committee of European Oversight Audit Bodies "CEAOB", a framework for co-operation between national audit oversight bodies at EU level.

The recent independent review of the FRC by Sir John Kingman, and the reviews by the Competition and Markets Authority and Sir Donald Brydon have increased the focus on and interest in the FRC. Fellow regulators are already considering what the proposals mean for their own powers and responsibilities. It is therefore important that we continue to engage with international stakeholders, lead through example and experience and share information and lessons learned to push for improved audit quality.

EU Exit

The FRC continues to be the central point of contact between the Department of Business, Energy and Industrial Strategy (BEIS), the professional bodies and the audit firms in relation to EU Exit work.

Since the referendum, BEIS and the FRC have made preparations on the basis that there could be a "no-deal" outcome to the EU Exit negotiations. This is because a no-deal scenario presents most additional work for regulators, firms and entities subject to audit. If the UK leaves the EU on 31 January 2020 without any withdrawal agreement, then there will be no transitional period and UK auditors will immediately cease to be EEA auditors and become third-country auditors so far as the EU is concerned. The UK's regulations that put in place the regulatory framework from the date when the UK leaves the EU will continue to allow, on a unilateral basis, the recognition of EEA auditors in the UK. The EU has not put in place any transitional measures covering UK auditors who will therefore need to seek approval as statutory auditors from the competent authorities of member states. Some of the main implications of a no-deal EU Exit are discussed below:

Third Country Auditors

Currently, audit firms in third countries must register with us if they audit an entity traded on a regulated market in the UK. After EU Exit, this will include audit firms in EEA member states. There are around 70 EEA firms that audit around 290 EEA issuers listed in the UK. Such firms will require to register before they sign the audit report for accounting periods beginning after the date of EU Exit. Registered third-country auditors will be subject to UK oversight, audit monitoring, investigation and discipline unless that third country's system of audit assurance has been assessed as equivalent by the UK. In a similar way, UK auditors of entities traded on a regulated market of an EEA member state will need to register with that state's competent authority and will be subject to that state's oversight unless the UK has been assessed as equivalent by the EU.

Equivalence and Adequacy

We have completed preparatory work aimed at ensuring that the UK is ready to submit its applications to the EU for assessment of Equivalence and Adequacy status in relation to audit as soon as possible after the UK has left the EU. We await information from the EU about the timetable and process that it intends to follow. In the event that there are delays in this process, we may decide to seek equivalence and adequacy decisions from individual EEA member states, starting with those states that we consider are the highest priority.

Ireland

EU Exit will bring to an end the long-standing arrangements whereby UK auditors and Irish auditors were able to sign audit reports in each other's jurisdictions. After that date, UK auditors will be third country auditors in Ireland and will need to cease providing audit services to Irish entities unless they pass an aptitude test and are registered as third country auditors. Under Irish legislation, a pre-condition to registration as a third country auditor is that there should be reciprocal arrangements in place whereby one jurisdiction does not place more onerous requirements on the approval of statutory auditors than in the other jurisdiction. In order to demonstrate the reciprocity of the approval arrangements for statutory auditors between the UK and the Republic of Ireland, a Memorandum of Understanding between the FRC and the competent authority in Ireland (IAASA) is being put in place.

Communications

We continue to communicate extensively with audit firms, professional bodies and competent authorities so that they have the information they need to make decisions and so that we become aware of problems that may arise as a result of the process of the UK leaving the EU. This process will continue.

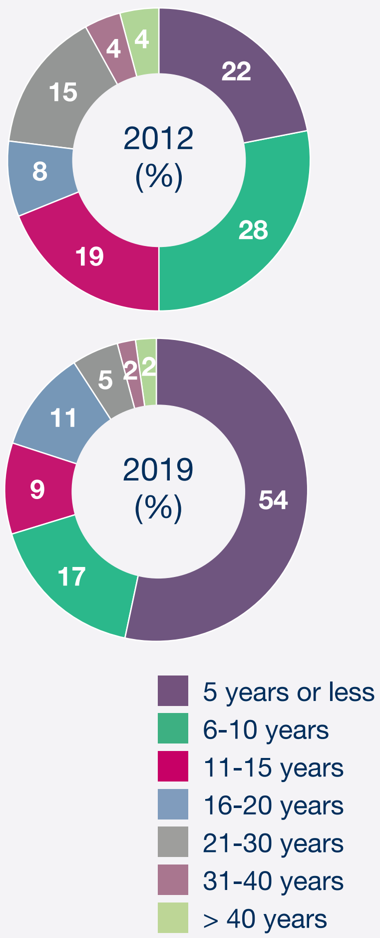
APPENDIX 1
THE CURRENT AUDIT MARKET: OBSERVATIONS

The following provides an update on key trends in the audit sector, namely market concentration, audit tenure, audit fees and cross-subsidy from non-audit services.

The top end of the UK audit market has historically been, and continues to be, heavily concentrated. In the FTSE 350, the four largest firms – PwC, KPMG, Deloitte and EY – dominate. The Big Four audited 97% of the FTSE 350's most recent annual reports and accounts and earned close to 100% of FTSE 350 audit fee revenue (See chart A 1.2). For Alternative Investment Market (AIM) companies, non-Big Four audit firms have a much larger presence, auditing 67% of entities. Nevertheless, as auditors of 33% of AIM entities, the Big Four earn 56% of total AIM audit fees.

Attempts have been made to reduce this concentration, most notably through regulatory change prohibiting long tenure. But, to date, this has had little impact. While audit rotation has notably increased and length of tenure reduced (see chart A.1.1), Big Four audits have almost exclusively moved to other Big Four firms. This has had a levelling effect on the number of engagements across the Big Four, with EY notably increasing its FTSE 350 engagements since 2012 (see chart A 1.6). From 2012 to August 2019, across the current FTSE 350, only seven audits have moved away from a Big Four firm – six to a mid-tier firm and only one from a Big Four firm to a smaller firm (see chart A 1.4).

A 1.1 Audit Tenure FTSE 350



Footnote: 2012 data is from a survey of FTSE 350 companies published by Accountancy Magazine in 2013. The 2019 data is from Audit Analytics, Audit Engagements as of 30/08/2019.

Percentage of entities with the same auditors for five years or less has increased from 22% in 2012 to 54% in 2019. At the same time, the average length of audit relationship for the FTSE 350 has fallen from 14 years in 2012 to 9 years in 2019.

A 1.2 Audit and non-audit fees of auditors of FTSE 350 audits

Audit Firm or Network	Number of engagements	Audit Fees (£)	Non-audit Fees (£)	Ratio of Audit Fees to Non-audit Fees
PwC	102	276,160,424	78,883,898	78:22
KPMG	91	250,891,634	80,006,686	76:24
Deloitte	82	214,105,788	75,614,863	74:26
EY	62	171,748,920	42,140,702	80:20
Grant Thornton	6	1,809,000	443,000	80:20
BDO[15]	5	1,716,812	2,780,426	38:62
Total	348	916,432,578	279,869,575	77:23
Big Four	337	912,906,766	276,646,149	77:23
%	96.8	99.6	98.8	
Other	11	3,525,812	3,223,426	52:48
%	3.2	0.4	1.2	

Footnote: Audit Analytics as of 30/08/2019. Audit fees are from FTSE 350 companies' most recent annual report and accounts. Non-audit fees in this chart are defined as audit related fees, tax fees, and other fees included in the annual report and accounts, provided to entities that were also audited by the respective firm. Data is shown for 348 companies in the FTSE 350 as two companies (Network International Holdings Plc and Smithson Investment Trust Plc) are yet to issue an Annual Report as a FTSE company and report audit fees. Data shown is from FTSE entities' most recent report and accounts, 2018-19.

[15] Only one of the five audits had any non-audit services and those fees relate entirely to Playtech.

A 1.3 Audit and non-audit fees of auditors of AIM audits

Audit Firm or Network	Number of engagements	Audit Fees (£)	Non-audit Fees (£)	Ratio of Audit Fees to Non-audit Fees
BDO	154	13,292,544	5,161,428	72:28
Grant Thornton	107	9,452,266	6,243,374	60:40
KPMG	98	14,969,827	5,951,197	72:28
PwC	88	16,484,725	9,306,886	64:36
RSM	55	3,683,316	1,949,819	65:35
Deloitte	54	9,278,515	2,158,487	81:19
EY	36	7,984,676	3,463,691	70:30
Other	254	11,362,075	4,468,712	72:28
Total	**846**	**86,507,944**	**38,703,594**	**69:31**
Big Four	276	48,717,743	20,880,261	70:30
%	32.6	56.3	53.9	
Other	570	37,790,201	17,823,333	68:32
%	67.4	43.7	46.1	

Footnote: Audit Analytics as of 30/08/2019 and annual reports from Companies House for AIM entities not on the Audit Analytics database. Non-audit fees in this chart are defined as audit related fees, tax fees, and other fees included in the annual report and accounts, provided to entities that were also audited by the respective firm. Audit Analytics held data on 822 AIM companies out of the current 886 AIM entities (as of 30/08/2019). Of the remaining 64 entities, only 24 had reported on audit fees and non-audit fees in their most recent annual report and accounts, 2018-19. Therefore, the audit and non-audit fees of 846 AIM entities have been stated.

A 1.4 FTSE 350 – Auditor movement

Footnote: This graph captures any changes in auditor for FTSE 350 companies from 2012 to August 2019

A 1.5 Big four to next three largest firms

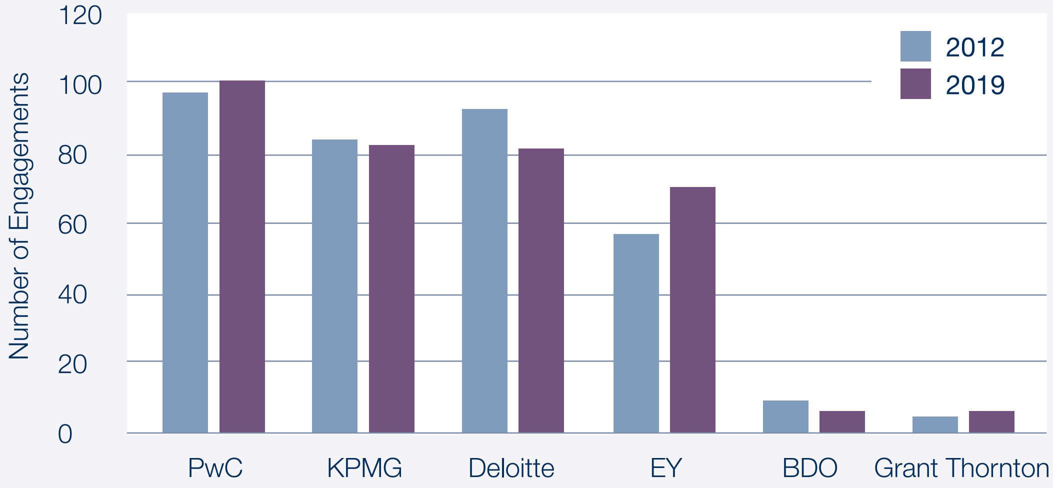
Entity Name	Previous Auditor	Engaged Auditor	Engaged Effective Date
Bankers Investment Trust PLC	PwC	Grant Thornton	18/06/2014
Witan Investment Trust PLC	Deloitte	Grant Thornton	22/08/2016
HgCapital Trust PLC	Deloitte	Grant Thornton	10/05/2017
Wetherspoon (JD) PLC	PwC	Grant Thornton	09/11/2017
Galliford Try PLC	PwC	BDO	01/07/2019
BMO Global Smaller Companies PLC	PwC	BDO	25/07/2019

Big four to smaller firms

Entity Name	Previous Auditor	Engaged Auditor	Engaged Effective Date
Ferrexpo PLC	Deloitte	MHA MacIntyre Hudson	03/07/2019

Footnote: Audit Analytics, Auditor Changes in the current FTSE 350 from 2012 to 2019 – data taken as at 30/8/2019.

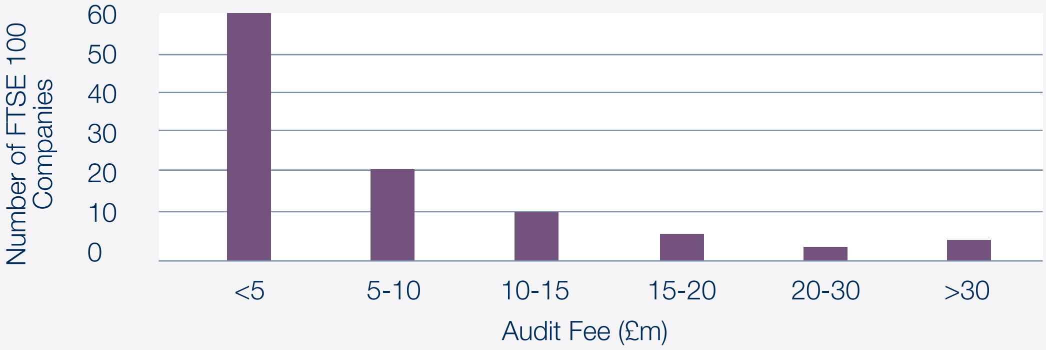
A 1.6 Changes in big six FTSE 350 audit engagements, 2012-2019



Footnote: 2012 data is from a survey of FTSE 350 companies published by Accountancy Magazine in 2013. The 2019 data is from Audit Analytics, Audit Engagements as of 30/08/2019. The Big Six audit firms undertook 349 of the FTSE 350's audits in both 2012 and 2019. In 2012, Telecom Plus plc's auditor was PKF LLP and in 2019 Ferrexpo plc's current auditor is MHA MacIntyre Hudson, the UK member of Baker Tilly International Ltd.

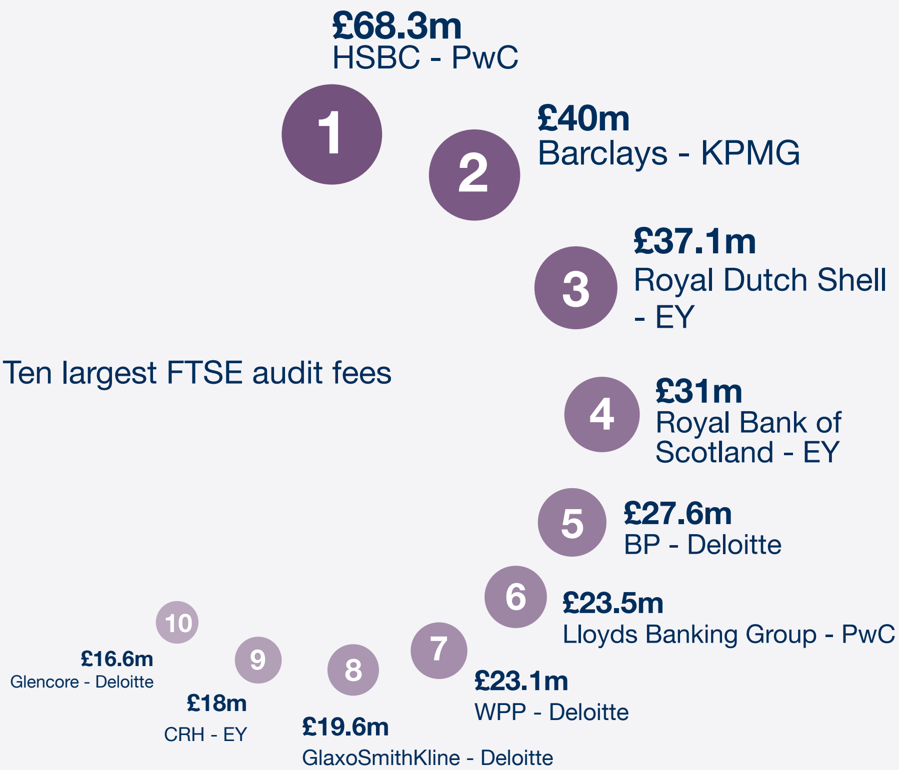
Audit fees, commensurate with the risk and work required, are essential for the delivery of high-quality audits. Setting such fee levels is a complex process. It requires a detailed understanding of the entity and a reasonable forecast of any significant events or issues that could affect audit hours.

A 1.7 FTSE 100 audit fee distribution



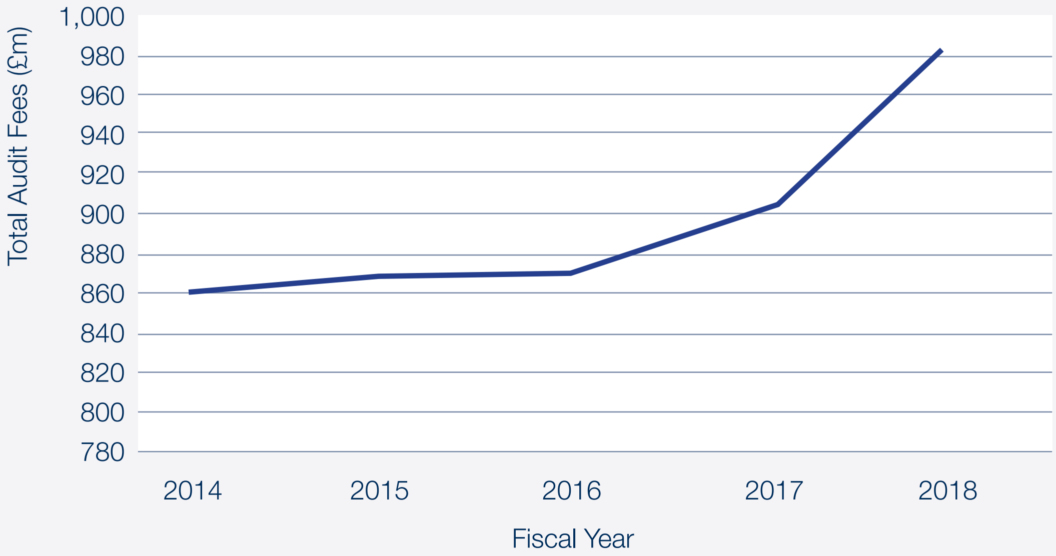
Footnote: Audit Analytics, Audit Fees FTSE 100 as of 30/08/2019

A 1.8 Ten largest FTSE audit fees



Footnote: Data taken from most recent published annual reports as at 30 August 2019.

A 1.9 Total FTSE 350 audit fees 2014-18



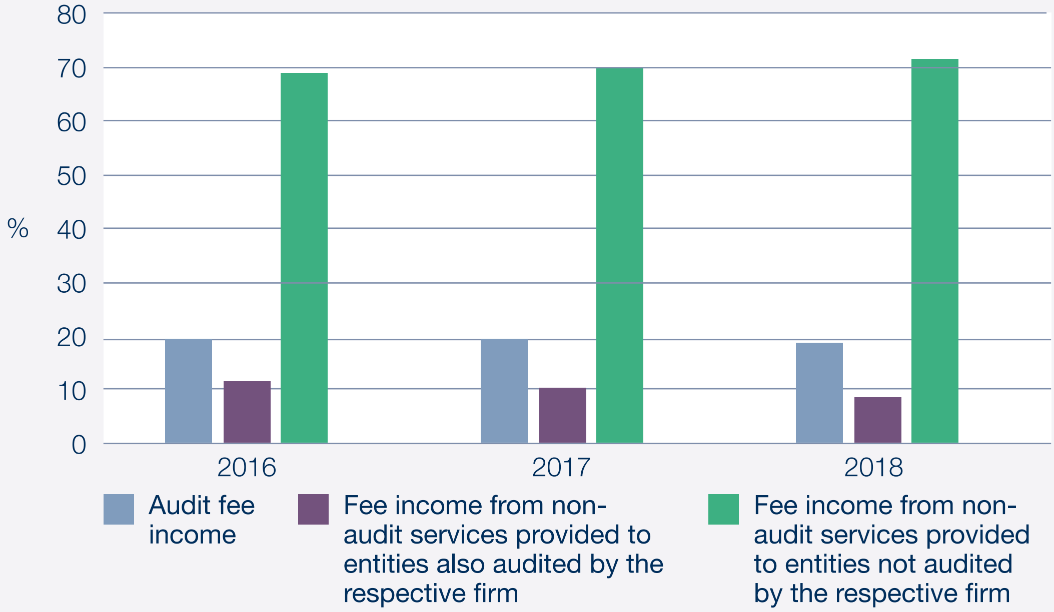
Footnote: Audit Analytics 2019, Audit Fees FTSE 350 as of 30/08/2019

Chart A 1.9 tracks total audit fees, over five years, of a subset of 318 companies that are currently in the FTSE 350 and that have reported audit fees since 2014. Fees increased most sharply (by 9%) between 2017 and 2018. This is consistent with anecdotal evidence from our discussions with audit committee chairs, who noted an overall increase in audit fees and firms explicitly pricing in risk to a greater extent.

Changes in regulation have also imposed more stringent restrictions on the type and value of non-audit services that auditors of public interest entities can provide to entities they audit, including a 70% rolling cap over 3 years of historic audit fees. For the Big Four firms, non-audit fee income from entities they also audit has fallen slightly over the past four years to 8% of total fee income in 2018 (Chart A 1.10). Analysis of the revenue of Big Four firms highlights the predominant and growing share of revenues arising from non-audit services provided to entities they do not audit. The split is marginally less marked for non-Big Four firms, although income from non-audit services to entities they do not audit is still the largest component of their total revenue.

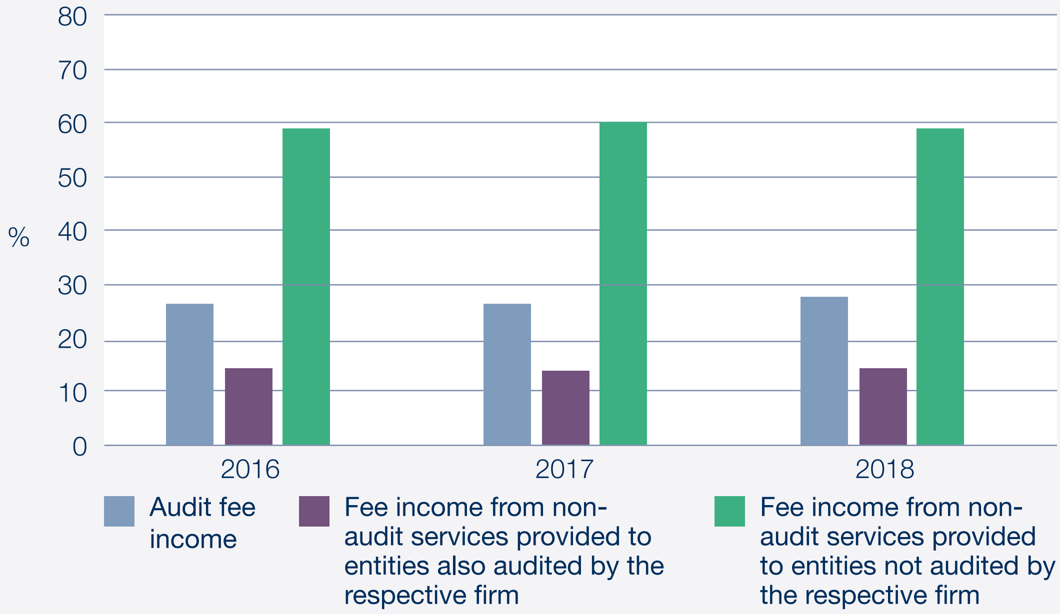
Non-audit fees continue to be the main source of income for audit firms

A 1.10 Big four firms: Overview of fee income, 2016 - 2018



Footnote: This graph shows the revenue split for all engagements including the provision of audit and non-audit services

A 1.11 Non-big four firms with PIE audit engagements: Overview of fee income, 2016 - 2018



Footnote: FRC, Key Facts and Trends: Information reported voluntarily to the FRC by UK audit firms with PIE audits. 2016 and 2017 figures from KFAT (Key Facts and Trends) 2018, and 2018 figures from KFAT 2019 (forthcoming). Non-Audit fees are defined as "any engagement in which a firm, or a member of its network, provides professional services to (1) an audited entity; (2) an audited entity's affiliates; or (3) another entity, where the subject matter of the engagement includes the audited entity and/or its significant affiliates, other than the audit of financial statements of the audited entity" as taken from paragraph 5.8 of the FRC's Ethical Standard (June 2016).

APPENDIX 2
OVERVIEW OF AUDIT QUALITY MONITORING APPROACH

In the UK the responsibility for monitoring of audit quality lies with the FRC in its role as Competent Authority for audit regulation, but it does not perform all monitoring activities itself. The FRC directly monitors the audit quality of PIEs and certain other entities (currently large AIM/ Lloyd's Syndicates/Listed Non-EEA), while the monitoring of other statutory audits is undertaken by Recognised Supervisory Bodies under a series of Delegation Agreements. The FRC is also responsible for the monitoring of TCAs.

In addition, we undertake some monitoring activity not in our capacity as Competent Authority. We, together with the ICAEW, inspect audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area by contractual arrangements with the relevant regulatory authorities in the Crown Dependencies.

This inspection work includes the audits of a number of major companies which are listed in the UK and are included in the FTSE 100 or FTSE 250 indices. Crown Dependency companies listed on AIM are, however, not included within these inspection arrangements.

Under transitional statutory duties under the Local Audit and Accountability Act 2014 ("LAAA"), the FRC is also responsible for the oversight of Major Local health body audits (excluding Foundation Trusts) for 2018/19, which are those with either revenue or expenditure in excess of £500m. From 2019/20, local government bodies will also be subject to audit oversight monitoring by the FRC, transitioning from Public Sector Audit Appointments Limited ("PSAA"). RSBs are responsible for the monitoring of non-major local audits.

The FRC is also the independent supervisor of Companies Act audits undertaken by the National Audit Office.

In addition we have contractual arrangements in place to inspect other audit work performed by the National Audit Office.

Summary of UK audit quality monitoring arrangements

Entity type	Monitoring body	Monitoring capacity/ arrangement
UK PIE audits Large AIM listed entities Lloyds Syndicates	FRC	Competent Authority
Crown dependency incorporated entities with securities traded on regulated EEA market	FRC/ ICAEW	Private contractual arrangement
Third country audits	FRC	Competent Authority
Local Audits	FRC/ RSBs	Local Audit and Accountability Act 2014
Other (non-FRC scope) audits	RSBs	Delegation agreement
National Audit Office audits	FRC	Independent supervisor/ Private contractual arrangement

AQR – Audit monitoring approach

AQR's audit monitoring activity is based on the review of a sample of audits each year, supported by related audit quality (firm-wide) procedures at individual audit firms, which this year, focused on internal quality monitoring, engagement quality control reviews and independence and ethics. In addition, we periodically undertake thematic inspections which focus on particular aspects of audit across a sample of audits and firms. The frequency of AQR inspections varies with larger firms inspected annually while other firms less frequently, typically once every three years. In cases where the PIE's audited by the firm are all SME's the inspection cycle can be extended to six years.

The sample of individual audits we inspect each year has continued to increase. In the last inspection cycle we reviewed 160 audits, a 10% increase over the previous year. We expect to review in the range of 130 to 140 audit files in the 2019/20 cycle, due to resource constraints and consideration of changes to our approach in respect of Sir John Kingman's Review of the FRC and other recommendations.

For the last three years we have published the names of the entities we review. A list of those reviewed in 2018/19 is included in appendix 4.

Total number of audits inspected:

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20 (estimated)
Total inspected	126	137	140	145	160	130-140

The selection of audits for review is an iterative process, responsive to developments within sectors, entities and audit firms. The selections are under constant review and changes are made in response to developments we observe. Selections are based on a number of factors, such as the type of business and sector, the significance of the entity (e.g. FTSE 350 in particular), media coverage, financial performance and share short-selling. They are also influenced by the priority sectors set each year. These are deemed to be the highest risk sectors of the economy based on an in-house economic analysis.

Going forward, we expect, resource permitting, to increase both the overall number of reviews performed, and for the reviews to be more in depth, including overseas components in some instances. The number of higher risk entities subject to reviews is also likely to increase.

In the current inspection cycle the priority sectors were:

- Financial services, with emphasis on banks, other lenders and insurers;
- General retailers and retail property;
- Business support services; and
- Oil and gas.

The table below shows the priority sectors for the past four years.

Priority Sector	2018/19	2017/18	2016/17	2015/16
Insurance				●
Financial Services	●	●		
Property		●		
Natural resources/extractive industries			●	
Companies servicing the extractive industries			●	●
Food, drink, consumer goods manufacturers and retailers				●
Business support services including public sector	●	●	●	●
Media			●	
Travel & leisure		●		
General retail	●			
Oil & gas	●			

Of the 139 audits that we reviewed in the year across all firms (excluding public sector), the number in priority sectors was:

- General retailers (11);
- Oil and gas (7);
- Business support services (13); and
- Financial services (34).

The review of each audit is carefully scoped to identify key areas for consideration. These are based on the nature of the business, the key audit matters listed in the audit report as well as any risks highlighted by the Audit Committee or other regulators. Typically, areas requiring most judgement such as impairment testing of goodwill and other intangibles, asset valuations and revenue recognition are some of those most frequently chosen, but we may not necessarily cover all significant risks identified by audit teams on each inspection.

For each of these areas, we assess the appropriateness of the key audit judgements made and the sufficiency and appropriateness of the supporting audit evidence obtained. In addition to these, in the last inspection cycle, we paid particular attention to the following areas of focus: changes in auditor appointments; audit of fair value investments (including goodwill impairment); the use of auditor's experts and specialists; and the audit of controls.

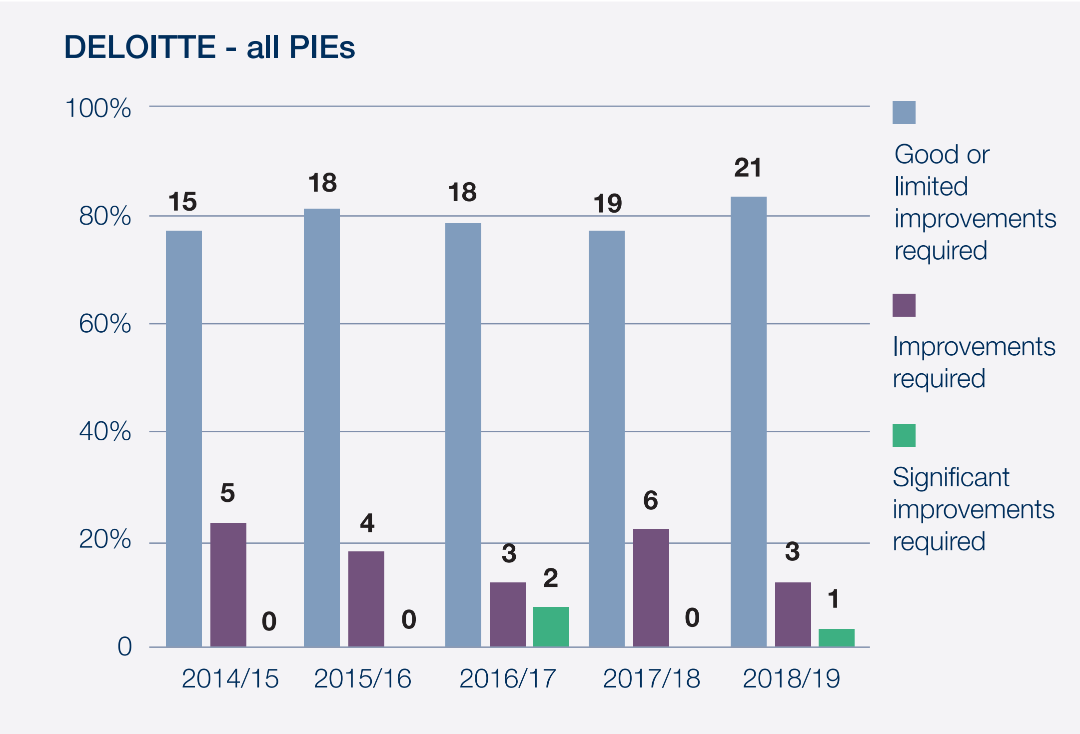
On completion of each inspection the quality of the audit is assessed. This involves an extensive internal moderation process involving a panel of skilled professionals. During the process the severity of concerns are considered and compared to similar audits. Account is taken of the materiality of the area or matters raised and the level of risk associated with these, the pervasiveness of the concerns noted, any potential impact on reported profits as well as any implications on the ongoing appropriateness of the audit opinion.

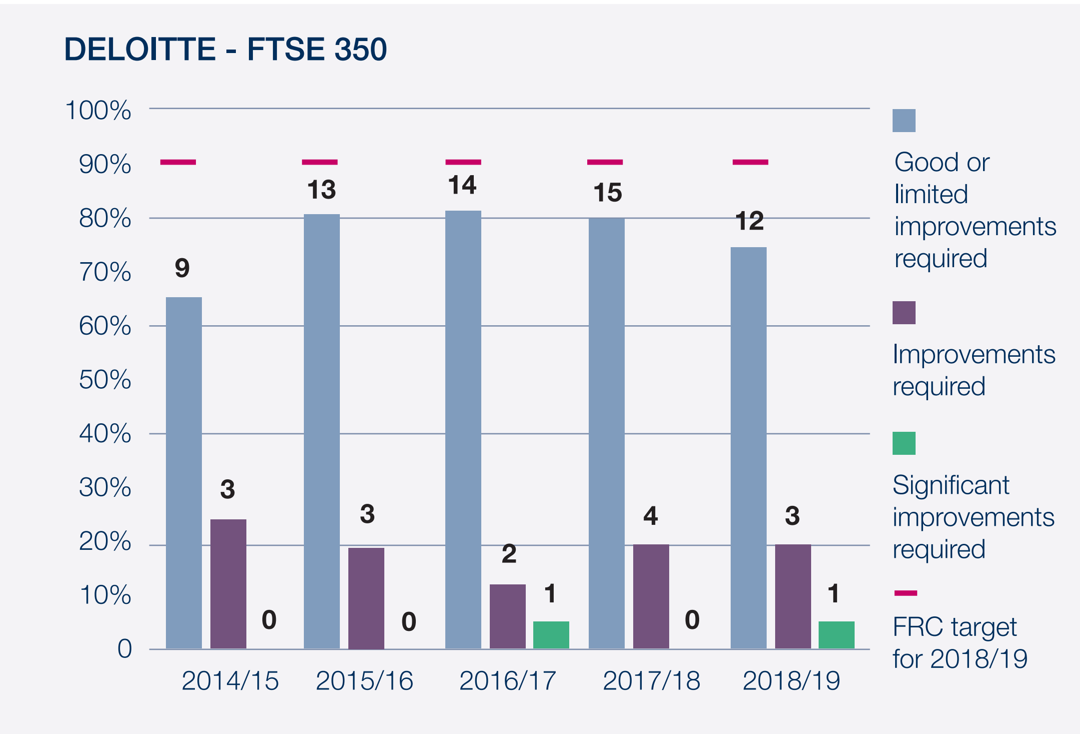
A confidential report with our overall assessment and details of concerns noted is shared with the audit firm and relevant audit committee chair. We assess each audit file using a four-category scale as follows:

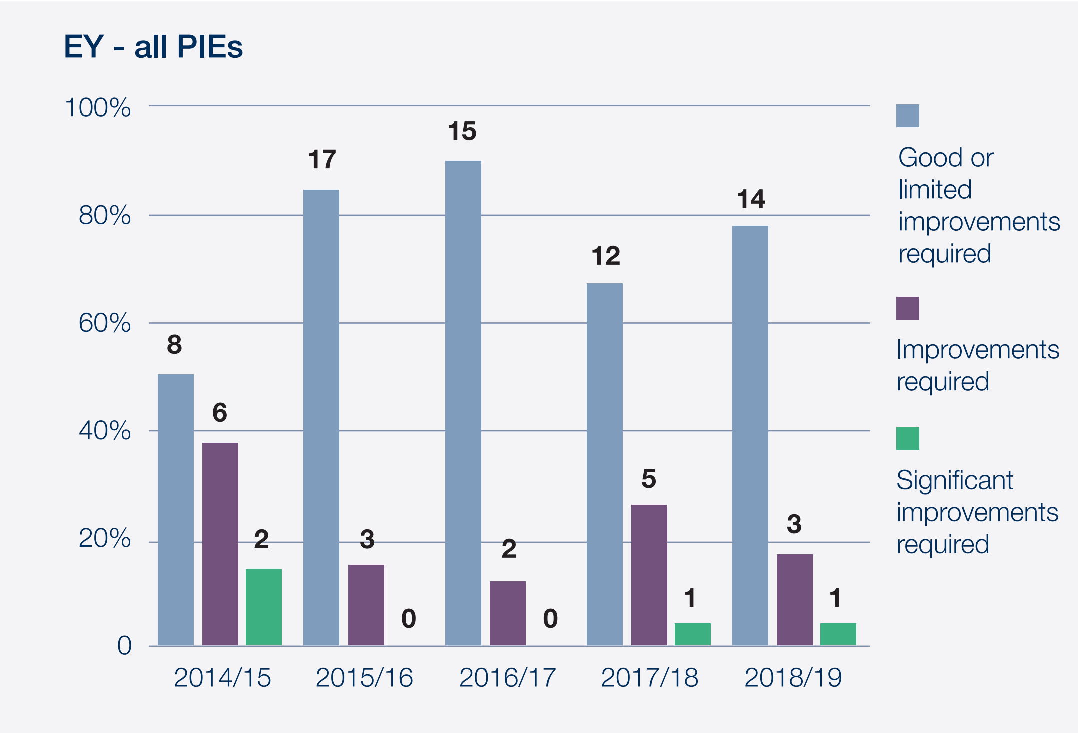
- Good (category 1)
- Limited improvements required (category 2A)
- Improvements required (category 2B)
- Significant improvements required (category 3)

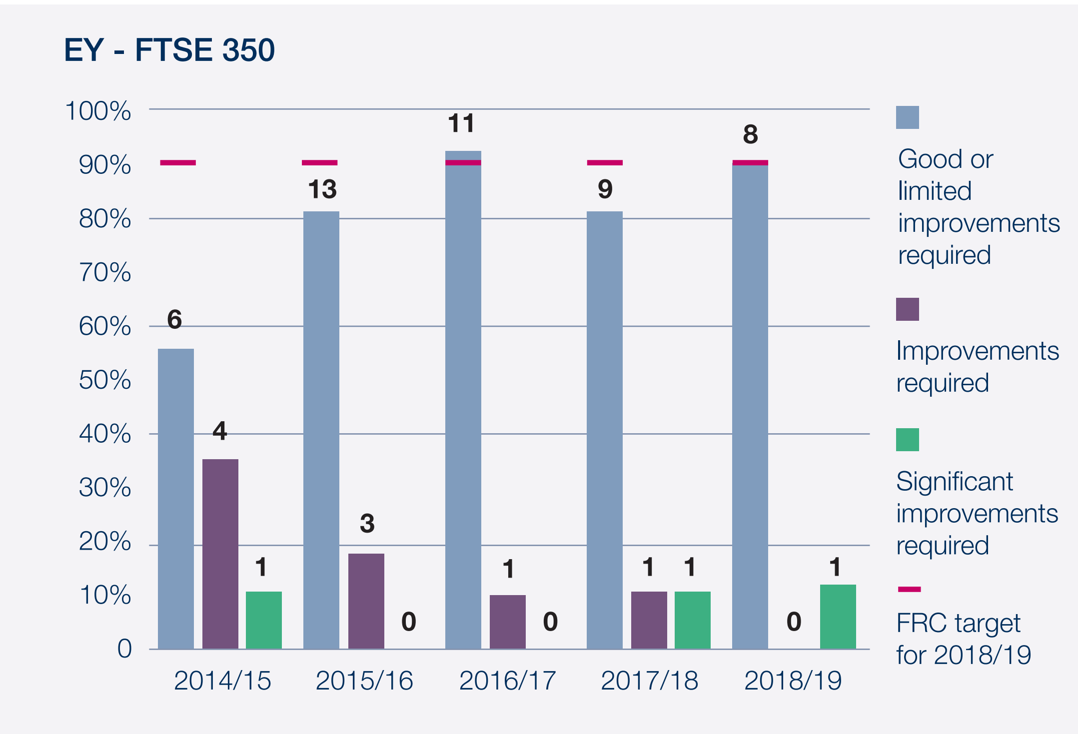
For our public reports on the individual firms, we combine audits classified as category 1 and 2A and refer to these as 'Good, requiring limited improvements'. This is the threshold required for our 90% target. For any category 2B or 3 reviews, we consider the need for any action under the FRC's enforcement procedures. On the whole, this means that any audits classified as a category 3, requiring significant improvement, are referred to the FRC's Case Examiner to determine if further regulatory action is required. This can take the form of Constructive Engagement with the audit firm or for more severe cases, referral to the FRC's Conduct Committee, which decides whether a full investigation is warranted. This may result in an enforcement sanction being imposed and enforced against a statutory auditor and/or the audit firm in accordance with the FRC Audit Enforcement Procedure.

APPENDIX 3
INDIVIDUAL FIRM RESULTS - BIGGEST SEVEN FIRMS

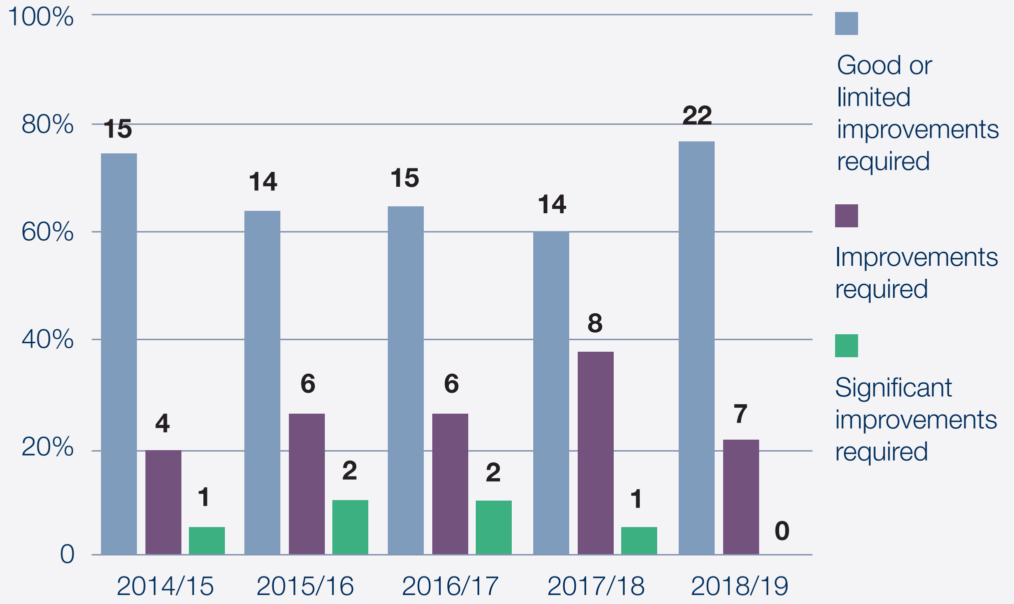




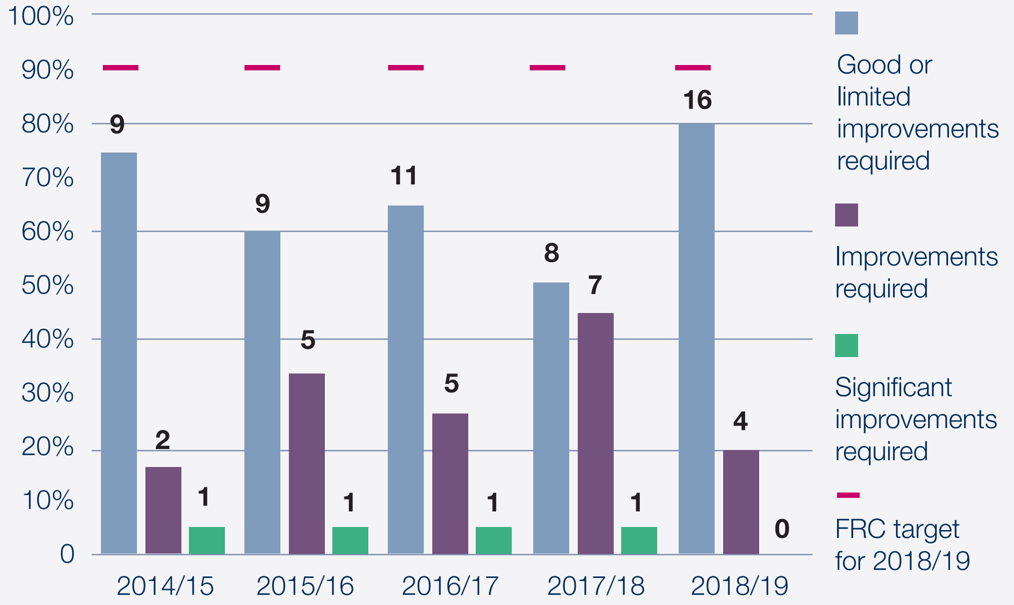

EY - all PIEs
100%
80%
60%
40%
20%
0
8
6
2
17
3
0
15
2
0
12
5
1
14
3
1
2014/15
2015/16
2016/17
2017/18
2018/19
Good or limited improvements required
Improvements required
Significant improvements required


EY - FTSE 350
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0
6
4
1
13
3
0
11
1
0
9
1
1
8
0
1
2014/15
2015/16
2016/17
2017/18
2018/19
Good or limited improvements required
Improvements required
Significant improvements required
FRC target for 2018/19

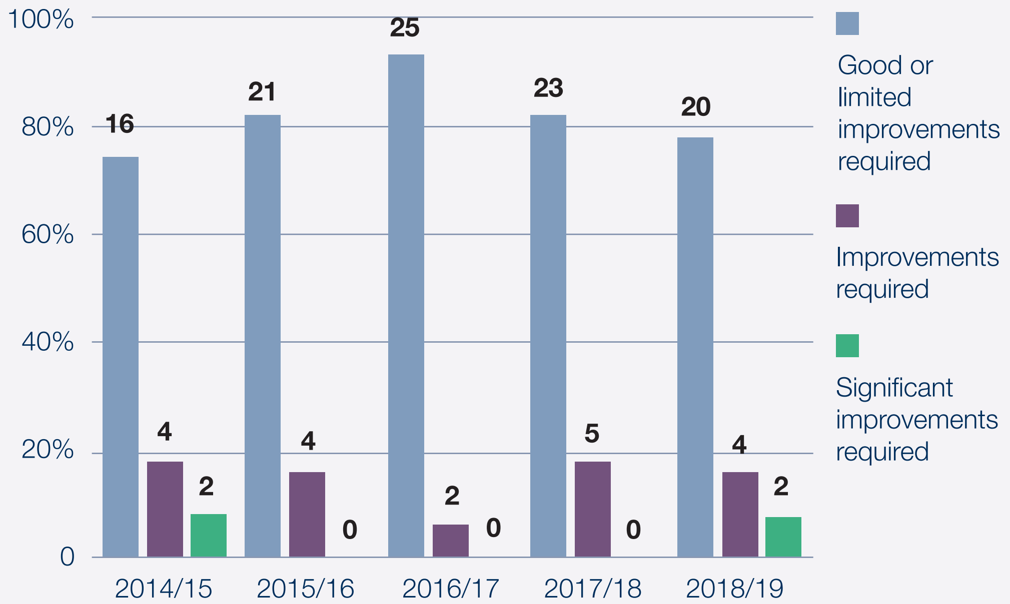
KPMG - all PIEs



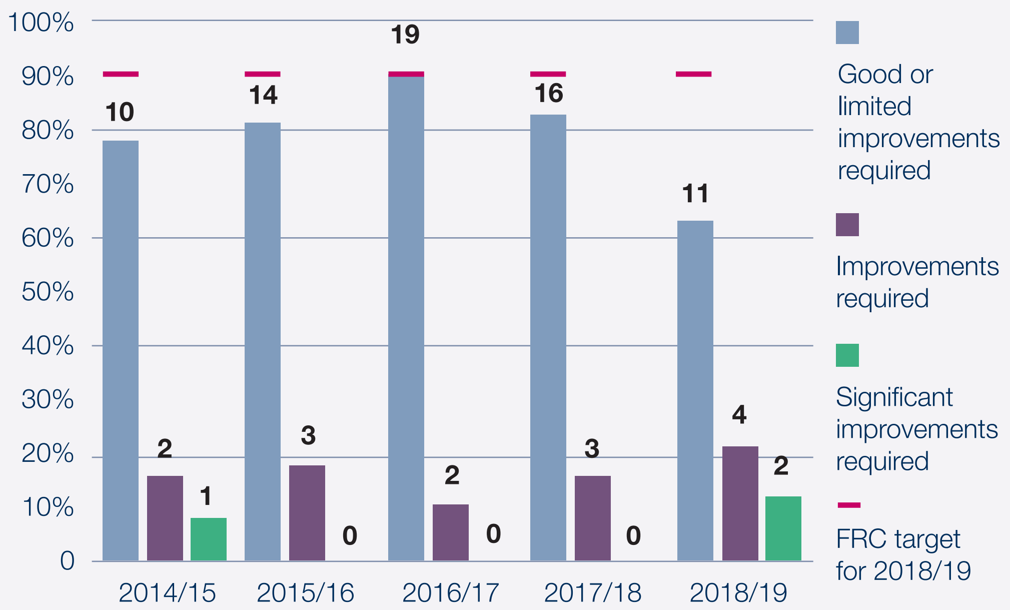
KPMG - FTSE 350

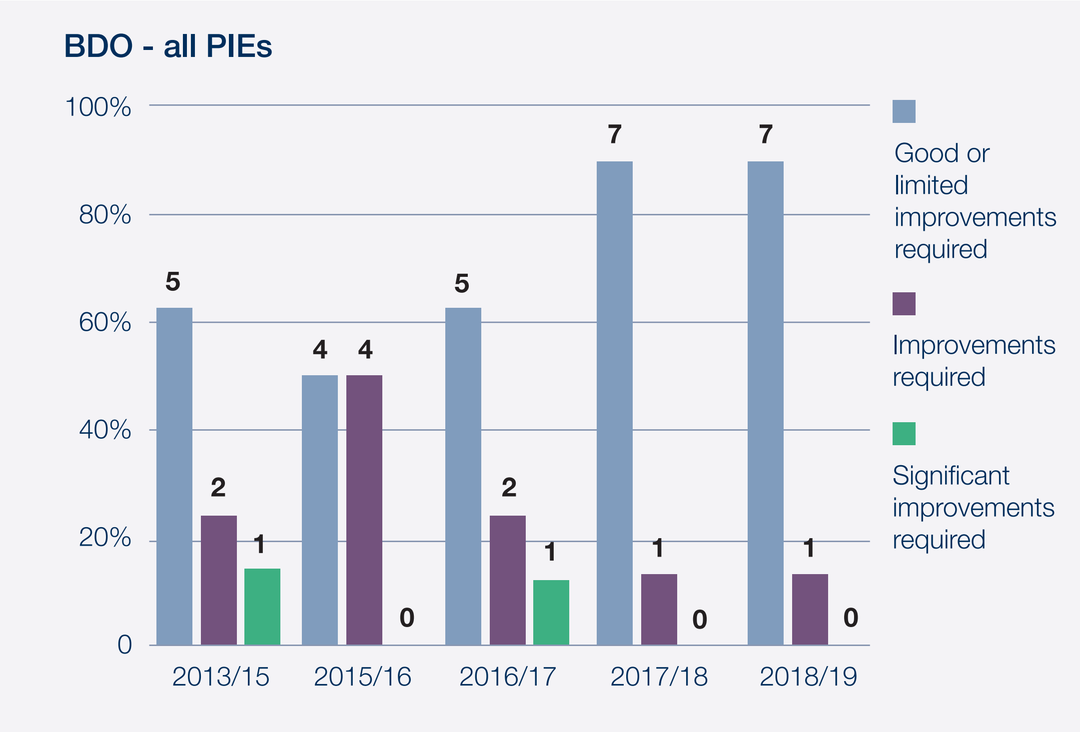


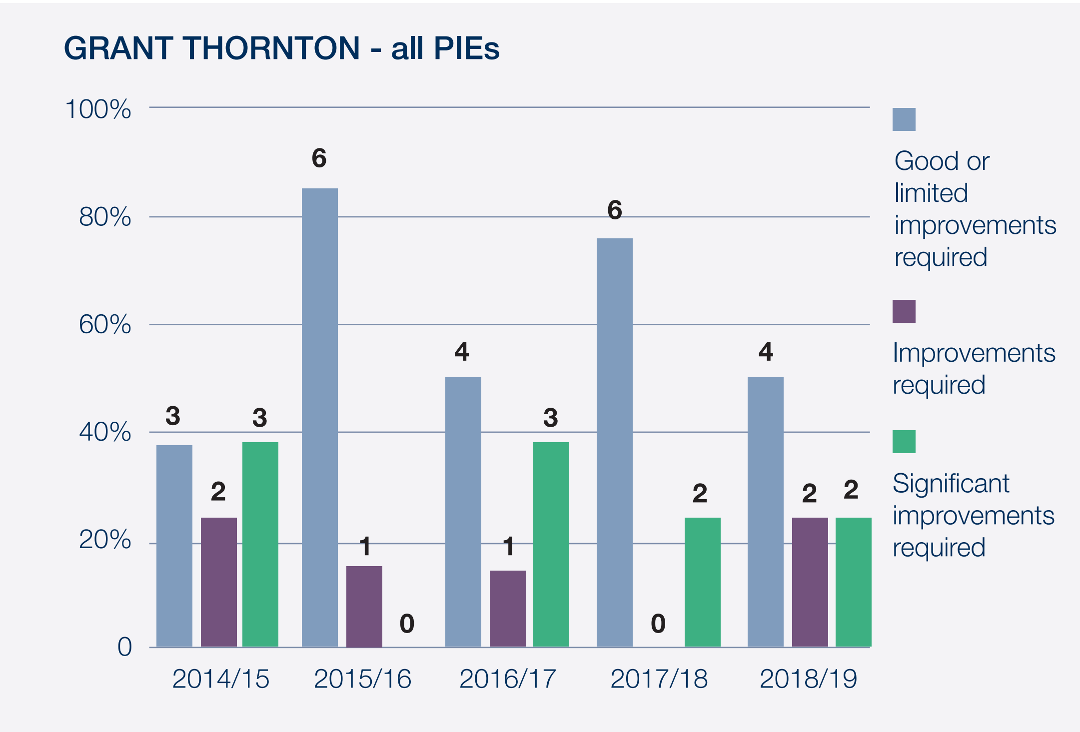
PwC - all PIEs



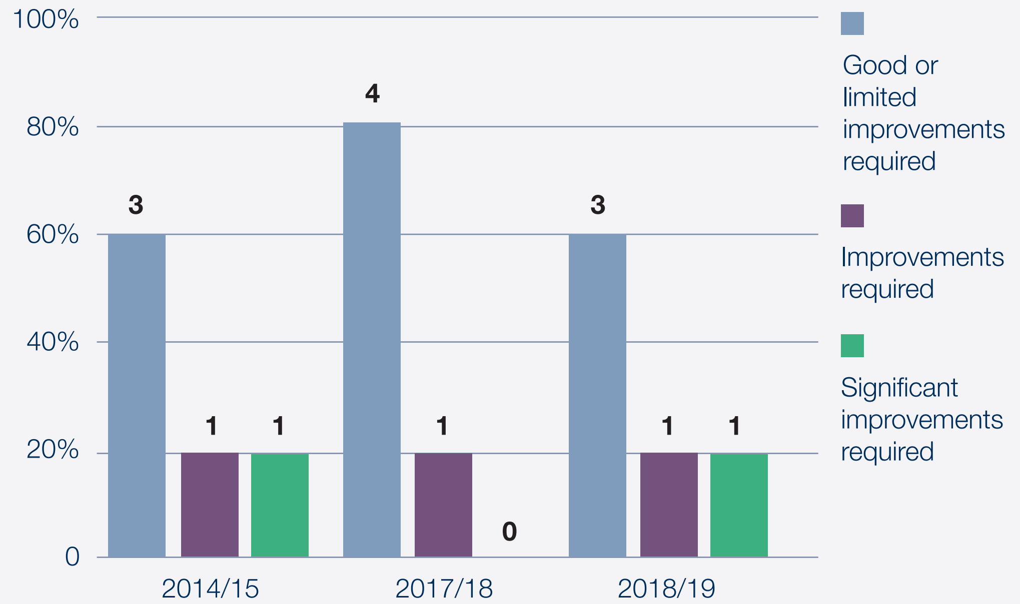
PwC - FTSE 350




BDO - all PIEs
100%
80%
60%
40%
20%
0
5
2
1
4
4
0
5
2
1
7
1
0
7
1
0
2013/15
2015/16
2016/17
2017/18
2018/19
Good or limited improvements required
Improvements required
Significant improvements required


GRANT THORNTON - all PIEs
100%
80%
60%
40%
20%
0
3
2
3
6
1
0
4
1
3
6
0
2
4
2
2
2014/15
2015/16
2016/17
2017/18
2018/19
Good or limited improvements required
Improvements required
Significant improvements required

MAZARS - all PIEs



APPENDIX 4
LIST OF AUDITS REVIEWED BY AQR IN 2018/19 INSPECTION CYCLE

Firm	Review
Deloitte	Amedeo Air Four Plus Limited (YE 03/2018)
Deloitte	Centrica plc (YE 12/2017)
Deloitte	CLS Holdings plc (YE 12/2017)
Deloitte	ConvaTec Group plc (YE 12/2017)
Deloitte	Ecclesiastical Insurance Office plc (YE 12/2017)
Deloitte	Electra Private Equity PLC (YE 09/2017)
Deloitte	FirstGroup plc (YE 03/2018)
Deloitte	GKN plc (YE 12/2017)
Deloitte	Go-Ahead Group plc (YE 07/2017)
Deloitte	Gulf Keystone Petroleum Limited (YE 12/2017)
Deloitte	HomeServe plc (YE 03/2018)
Deloitte	Inmarsat plc (YE 12/2017)
Deloitte	Just Eat plc (YE 12/2017)
Deloitte	Melrose Industries plc (YE 12/2017)
Deloitte	Morgan Sindall Group plc (YE 12/2017)
Deloitte	Mothercare plc (YE 03/2018)
Deloitte	National Grid plc (YE 03/2018)
Deloitte	Sanne Group plc (YE 12/2017)
Deloitte	Syncona Limited (YE 03/2018)
Deloitte	Syndicate 435 (YE 12/2017)
Deloitte	Taylor Wimpey plc (YE 12/2017)
Deloitte	Tullow Oil plc (YE 12/2017)
Deloitte	U K Insurance Limited (YE 12/2017)
Deloitte	Ultra Electronics Holdings plc (YE 12/2017)
Deloitte	Yorkshire Building Society (YE 12/2017)
EY	3i Group plc (YE 03/2018)
EY	888 Holdings plc (YE 12/2017)
EY	BP plc (YE 12/2017)
EY	Co-operative Group Limited (YE 01/2018)
EY	CYBG plc (YE 09/2017)
EY	De La Rue plc (YE 03/2018)
EY	Exillon Energy plc (YE 12/2017)
EY	FM Insurance Company Limited (YE 12/2017)
EY	Fresnillo plc (YE 12/2017)
EY	Hochschild Mining plc (YE 12/2017)
EY	InterContinental Hotels Group PLC (YE 12/2017)
EY	PageGroup plc (YE12/17)

Firm	Review
EY	Premier Oil plc (YE 12/2017)
EY	Shaftesbury PLC (YE 09/2017)
EY	Syndicate 4444 (YE 12/2017)
EY	Telit Communications plc (YE 12/2017)
EY	Unum Limited (YE 12/2017)
EY	VTB Capital Plc (YE 12/2017)
KPMG	AO World plc (YE 03/2018)
KPMG	Balfour Beatty plc (YE 12/2017)
KPMG	Barclays PLC (YE 12/2017)
KPMG	British American Tobacco p.l.c. (YE 12/2017)
KPMG	Caledonia Investments plc (YE 03/2018)
KPMG	Capita plc (YE 12/2017)
KPMG	Computacenter plc (YE 12/2017)
KPMG	Experian plc (YE 03/2018)
KPMG	Halfords Group plc (YE 03/2018)
KPMG	Hill & Smith Holdings PLC (YE 12/2017)
KPMG	ICBC Standard Bank Plc (YE 12/2017)
KPMG	James Fisher and Sons plc (YE 12/2017)
KPMG	Lancashire Holdings Limited (FY 12/2017)
KPMG	Lonmin Plc (YE 09/2017)
KPMG	Morgan Advanced Materials plc (YE 12/2017)
KPMG	National Counties Building Society (YE 12/2017)
KPMG	Paddy Power Betfair plc (YE 12/2017)
KPMG	Paragon Banking Group (YE 09/2017)
KPMG	Pendragon PLC (YE 12/2017)
KPMG	Pension Insurance Corporation PLC (YE 12/2017)
KPMG	Redde plc (YE 06/2017)
KPMG	Rolls-Royce Holdings plc (YE 12/2017)
KPMG	Saga plc (YE 01/2018)
KPMG	Senior plc (YE 12/2017)
KPMG	Serco Group plc (YE 12/2017)
KPMG	Smith & Nephew Plc (YE 12/2017)
KPMG	Standard Life Aberdeen plc (YE 12/2017)
KPMG	The British United Provident Association Limited (YE 12/2017)
KPMG	West Bromwich Building Society (YE 03/2018)
PwC	Babcock International Group PLC (YE 03/18)
PwC	BT Group plc (YE 03/2018)
PwC	Cairn Energy PLC (YE 12/2017)
PwC	Carnival plc (YE 11/2017)
PwC	Clinigen Group plc (YE 06/2017)
PwC	Costain Group PLC (YE 12/2017)
PwC	Daily Mail and General Trust plc (YE 09/2017)

Firm	Review
PwC	Debenhams plc (YE 09/2017)
PwC	Derwent London plc (YE 12/2017)
PwC	Dunelm Group plc (YE 07/2017)
PwC	Hiscox Insurance Company Limited (YE 12/2017)
PwC	Indivior PLC (YE 12/2017)
PwC	J.P. Morgan Securities plc (YE 12/2017)
PwC	John Wood Group PLC (YE 12/2017)
PwC	Kier Group plc (YE 06/2017)
PwC	Ladbrokes Coral Group Limited (YE 12/2017)
PwC	Legal & General Group Plc (YE 12/2017)
PwC	Lloyds Banking Group plc (YE 12/2017)
PwC	Mondi plc (YE 12/2017)
PwC	NEXT plc (YE 01/2018)
PwC	Renewi plc (YE 03/2018)
PwC	Society of Lloyd's group (YE 12/2017)
PwC	The Mercantile Investment Trust plc (YE 01/2018)
PwC	The Royal London Mutual Insurance Society Limited (YE 12/2017)
PwC	TSB Banking Group plc (YE 12/2017)
PwC	Wm Morrison Supermarkets PLC (YE 02/2018)
BDO	Blue Prism Group plc (YE 10/2017)
BDO	Genesis Housing Association Limited (YE 03/2018)
BDO	HSS Hire Group plc (12/2017)
BDO	James Halstead plc (YE 06/2017)
BDO	Mitie Group plc (YE 03/2018)
BDO	Petra Diamonds Limited (YE 06/2017)
BDO	River and Mercantile Group PLC (YE 06/2017)
BDO	XPS Pensions Group plc (YE 03/2018)
Grant Thornton	Allianz Technology Trust plc (YE 11/2017)
Grant Thornton	GlobalData Plc (YE 12/2017)
Grant Thornton	Interserve Plc (YE 12/2017)
Grant Thornton	Medica Group Plc (YE 12/2017)
Grant Thornton	Patisserie Holdings plc (YE 09/2017)
Grant Thornton	Sports Direct International plc (YE 04/2018)
Grant Thornton	Woodford Patient Capital Trust plc (YE 12/2017)
Grant Thornton	Yorkshire Housing Limited (YE 03/2018)
Mazars	Financial Insurance Company Limited (YE 12/2017)
Mazars	Metropolitan Police Friendly Society Limited (YE 12/2017)
Mazars	Persia International Bank Plc (YE 03/2018)
Mazars	Taliesin Property Fund Limited (YE 12/2017)
Mazars	Thrive Homes Limited (YE 03/2018)
Moore Stephens	Dentists' Provident Society Limited (YE 12/2017)
Moore Stephens	Omnilife Insurance Company Limited (YE 12/2017)

Firm	Review
Moore Stephens	TOC Property Backed Lending Trust plc (YE 11/2017)
KPMG CI	Apax Global Alpha Limited (YE 12/2017)
KPMG CI	Bluefield Solar Income Fund Limited (YE 06/2017)
KPMG CI	ETFS Foreign Exchange Limited (YE 12/2017)
KPMG CI	Sequoia Economic Infrastructure Income Fund Limited (YE 03/2018)
KPMG CI	Tetragon Financial Group Limited (YE 12/2017)
Beever & Struthers	Longhurst Group Limited (YE 03/2018)
Beever & Struthers	Monarch Assurance Plc (YE 12/2017)
Crowe	Hardy Oil and Gas plc (YE 03/2018)
Crowe	Laura Ashley Holdings plc (YE 06/2017)
Haysmactintyre	Associated British Engineering plc (YE 03/2018)
Haysmactintyre	The Salvation Army General Insurance Corporation Limited (YE 03/2018)
Scott-Moncrieff	SVM UK Emerging Fund plc (Y/E 03/2018)
Third Country	bank muscat SAOG (YE 12/2017)
Third Country	Great Eastern Energy Corporation Limited (YE 03/2017)
Third Country	KCell JSC (YE 12/2017)
Third Country	Seplat Petroleum Development Company Plc (YE 12/2017)
Third Country	Vietnam Enterprise Investments Limited (YE 12/2017)

APPENDIX 5
AUDITING & ETHICAL STANDARD DEVELOPMENTS

Work has been going on both in the UK and internationally to enhance auditing standards to reflect an increasingly complex environment for financial reporting and accounting, including changes to technology. Similarly, in the world of professional ethics for accountants and auditors, the UK Ethical Standard and the IESBA Code have both been revised.

In 2018 the FRC began a Post Implementation Review (PIR) of the UK Ethical and Auditing Standards, which had been revised following the 2016 EU Audit Regulation and Directive (ARD). On one level, our objective was simply to assess how effective those changes had been, and whether they had had a measurable and positive impact on confidence in audit. However, our review also had to take account of the very fundamental concerns expressed about audit quality in the UK since those revisions were conceived.

Taken in isolation from the outcome of the other reviews underway, the changes that we have proposed to UK standards, and the changes put forward by the IAASB to the international standards (on which the UK versions are based), already represent a step change which we would expect to result in a significant improvement in audit quality. That is because these changes are based on lessons learned from our recent experience and will result in a fundamental improvement to the way auditors:

- Approach quality management at firm level (ISQM1 and ISQM2) and in individual engagements (ISA 220);
- Identify and assess material risks of misstatement through understanding the nature of the entities they audit (ISA 315);
- Achieve and demonstrate independence and objectivity (UK Ethical Standard 2019);
- Undertake group audits (ISA (UK) 600)
- Report the results of their audits in a transparent and information-rich way (ISA (UK) 701);
- Assess the risks of material misstatement in the ‘other information’ published alongside company financial statements (ISA (UK) 720), clarify and simplify reporting to better meet user expectations and make the auditor’s report clearer;
- Discharge their responsibilities in respect of material misstatements (errors) arising from non-compliance with laws and regulations, including fraud (ISAs (UK) 250A & 250B); and
- Audit key areas of management judgement and estimation (ISA 540).

Quality management ISQM1, ISQM2, ISA 220

In 2019 the IAASB carried out a public consultation on revisions to the international standards which deal with quality control in audit firms (currently ISQC1) and individual audits (ISA 220). Two of the key objectives of these revisions were the introduction of a more robust and consistent approach to quality management, whilst ensuring that the requirements were proportionate and scalable.

In summary, the proposed changes will:

- Modernise the standards for an evolving and increasingly complex environment, including addressing the impact of technology, networks and use of external service providers;
- Increase firm leadership responsibilities and accountability and improve firm governance;
- Lead to more rigorous monitoring of quality management systems and remediation of deficiencies;
- Enhance the engagement partner's responsibility for audit engagement leadership and audit quality; and
- Address the robustness of engagement quality reviews, including engagement selection, documentation and performance.

Specifically:

- ISQM1 introduces a new 'quality management' approach for firms which is more proactive through the identification, assessment and response to quality risks in a broad range of circumstances and introduces improvements in monitoring and remediation activities, including a greater focus on causal factor analysis and issues from across the firm networks;
- ISQM2 is a new stand-alone standard enhancing and consolidating requirements for Engagement Quality Control Reviews (EQCRs); and
- ISA 220 has been revised to embed the principles of quality management into the engagement level requirements, with material relevant to EQCR moved to the new ISQM2.

Having been an influential part of the project team responsible for these changes, the FRC strongly supports these proposals. It is expected that the standards will be finalised in early Summer 2020.

ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment (ISA 315)

In 2016 the IAASB established a task force to consider potential revisions to ISA 315, the standard which deals with the auditor's risk assessment and understanding of the entity and the environment in which it operates. This standard is a critical part of the design of an effective audit and requires the exercise of professional scepticism in the identification and assessment of risks.

In July 2018 an exposure draft of the revised standard was issued for consultation and in last year's Developments in Audit report we set out the key areas of focus:

- Reflecting evolving environmental influences (such as more advanced technology being utilised, changing internal control frameworks, increased complexity in business activities and resulting evolution in financial reporting requirements);
- Facilitating improvements in the application of the standard, particularly in relation to the auditors understanding the entity's internal controls; and
- Sharpening the auditors' focus on an enhanced risk assessment in order to drive the most appropriate audit work.

The FRC has been strongly supportive of these changes.

Since the consultation closed in November 2018 the IAASB has been considering the responses and implications for the exposure draft. As well as support for the proposals, some broad concerns were identified in relation to the length and complexity of the revised standard. The Board has therefore been considering how to simplify and streamline the presentation of requirements, including greater use of application material, as well as clarifications on controls relevant to the audit and information system and control activities components.

Current expectations are for final IAASB Board approval of ISA 315 in autumn 2019, with a further consultation by the FRC prior to approving adoption in the UK.

Independence and objectivity (UK Ethical Standard)

The more stringent ethical rules which were introduced in 2016 for auditors of PIEs were, at the time, generally welcomed, but were also seen by some to be at the more stringent end of the desirable range of prohibitions. Many felt that UK audit firms could manage risks to their independence without further restrictions on, for example, the kinds of non-audit services they could provide to the companies they were auditing. The introduction of a 70% fee cap for PIE auditors, limiting the upper value of non-audit services to a proportion of the annual audit fee, was seen to be an effective mechanism to reinforce the principle of independence.

However, consultation and outreach conducted as part of our 2018/19 post-implementation review, persuaded us of the need for further changes, including some strengthening of prohibitions. The critical factor was the need to ensure that auditors remain independent of the entities they audit and, just as importantly, are seen to be independent. In addition, we identified areas where the 2016 standard was seen to be overly complex, making it more difficult to ensure high levels of compliance by practitioners. Our changes therefore:

- Simplified and restructured the Ethical Standard in order to achieve higher levels of understanding and compliance with the requirements and principles;
- Re-defined the objective, reasonable and informed third party test, which is a core element of the Ethical Standard. Our proposal is to set a new definition which has greater focus on the perspective of stakeholders who are the ultimate beneficiaries of assurance and also to provide more application guidance that firms should use when making an assessment:

  "Such a person is informed about the respective roles and responsibilities of an auditor, those charged with governance and management of an entity, and is not another practitioner. The perspective offered by an informed investor, shareholder or other public interest stakeholder best supports an effective evaluation required by the third-party test, with diversity of thought being an important consideration."
- Introduced a list of permitted services that auditors of PIEs can provide, limiting these to those which are closely related to the audit and/or required by law and regulation. This reflects the commitments made by some of the largest audit firms in their evidence to the BEIS Select Committee in January 2019. The existing list of prohibited services continues to be enshrined in law;
- Expanded the scope of certain ethical requirements to cover entities which may not be formally designated as PIEs, but are clearly of significant public interest (drawing on lessons learned from the BHS enforcement case); and
- Strengthened certain ethical prohibitions and requirements which relate to auditor independence, including the provision of non-audit services, for the auditors of all listed entities.

Going concern

Our review of the UK standards identified the need for some specific detailed improvements to ISA (UK) 570 Going Concern, with wider confidence in audit having been affected by high profile collapses of companies a matter of months after the auditor issued a clean opinion which failed to highlight concerns about the company's prospects. The significance of this standard, and the changes to the auditor's work effort we are proposing, meant that we launched a separate consultation on ISA (UK) 570 Going Concern, proposing to increase the work required of auditors when assessing whether an entity is a going concern for audits commencing on or after 15 December 2019.

The revised ISA (UK) 570 builds on a series of earlier actions where the FRC has been proactive in its consideration of going concern: the recommendations arising from Lord Sharman's Inquiry in 2011 were incorporated into the FRC's response to the financial crisis, which included the revision of the UK Corporate Governance Code; the development of viability statements; guidance for company directors and revisions to both accounting and auditing standards.

The going concern assumption is a fundamental principle in the preparation of financial statements. The auditor must obtain sufficient appropriate audit evidence about whether a material uncertainty related to going concern exists and whether management's use of the going concern assumption is appropriate. Our revisions to ISA (UK) 570 mean that UK auditors will follow significantly stronger requirements than those required by current international standards with:

- Greater work on the part of the auditor to more robustly challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement;
- Improved transparency with a new reporting requirement for the auditor of public interest entities, listed and large private companies to provide a clear, positive conclusion on whether management's assessment is appropriate, and to set out the work they have done in this respect; and
- A stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when the auditor draws their conclusions on going concern.

Other UK auditing standards

Similar to the Ethical Standard, changes in 2016 to the auditing standards which increased the auditor's work effort in areas such as group audit procedures, 'other information' included in annual reports and reporting to regulators, were broadly welcomed, but alongside consultation responses which warned of the dangers of 'gold plating' regulation.

It would not have been appropriate, in our post implementation review, to anticipate the outcome of the Brydon Review into the quality and effectiveness of audit, or to anticipate Government consideration of the independent reviews and subsequent public consultations. However, where we identified audit weaknesses or failings as a result of the FRC's own inspection and enforcement work, we proposed some revisions to address these urgently.

We proposed:

- Clarifying group audit procedures in ISA (UK) 600;
- Enhancing auditor reporting in ISA (UK) 701, including more explanation about the auditor's approach to materiality, and more information about what auditors found when testing Key Audit Matters;

The FRC's recently revised Auditing Standard on going concern extends significantly beyond the requirements of current international standards.

- Enhancing work effort in respect of irregularities in law and regulation, including fraud; and
- Greater clarity over the auditor's work effort and reporting on 'other information' included within annual financial reports. This is partly in response to an AQR thematic review which identified an inconsistent approach to other information by auditors and areas where they were not doing enough work to meet current requirements.

Auditing accounting estimates, including fair value accounting estimates, and related disclosures (ISA 540)

Following consultation, in December 2018, we issued a revision of ISA (UK) 540 for audits of financial statements for periods commencing on or after 15 December 2019 (early adoption permitted). This adopted the revised ISA 540 issued by the IAASB, while also retaining a small amount of supplementary material that reflected specific UK legal requirements. Taking account of views of UK stakeholders obtained through outreach activities, the FRC had strongly supported the changes made by the IAASB. Those changes were designed to help auditors deal with increasingly complex accounting treatments and related disclosures, including by:

- Modernising the ISA for an evolving business environment by recognising the increased use of modelling, forward-looking assumptions, and external information sources;
- Enhanced risk assessment requirements, more granular work effort requirements, and the requirement to "stand back" and evaluate the audit evidence obtained; and
- Reinforcing professional scepticism.

Formal adoption of the standard has allowed us to support IAASB plans for implementation, as well as updating key supplementary guidance for the UK.

Practice Note 19

Standard setters in the UK and internationally have been focused on driving a step change in audit quality through a programme of enhancements to the auditing and ethical standards. Those standards are intended to provide a structure within which professional judgement is exercised by auditors. In the UK, further work is done in the form of practitioner guidance, where additional contextual material and best practice in specific technical areas or specialised sectors is published in the form of Practice Notes. Whilst 'persuasive' rather than 'prescriptive' in nature, auditors are expected to take account of this best practice guidance when performing their audits or be prepared to explain why not. In the light of disappointing inspection results for audits of financial institutions (see AQR public reports June 2018 & 2019), and with significant revisions to relevant accounting and auditing standards, we consulted on a revised Practice Note 19: The audit of banks and building societies in the United Kingdom which reflected:

- Revisions to ISA 540 noted above;
- The need identified for additional guidance relevant to the audit of estimates for expected credit losses (ECL), which are expected to be very complex and require significant judgement. Our aim is to identify and encourage best practice in the area; and
- Changes in relevant legislation and regulation.

A final revised version of Practice Note 19 was published in July 2019. It includes guidance relevant to the audit of estimates for expected credit losses (ECL) which auditors may find helpful for the audits of periods ending before 15 December 2019 even if they have not early adopted ISA (UK) 540 (Revised December 2018).

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