DEVELOPMENTS IN AUDIT 2018

OCTOBER 2018
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Developments in Audit – Executive Summary

This report sets out the work that the FRC has undertaken, in the last year to drive the delivery of consistent, high-quality audit by UK firms, and address the risks that stand in the way of that.

Audit is a public good – it gives stakeholders confidence in the integrity of financial information in the capital markets which forms the basis for investment decisions. Audit also provides valuable assurance to company boards about the integrity of the entity. A well run, transparent and accountable business not only generates a return on capital to fund more investment, but also gives employees confidence that their jobs and pensions are secure, and suppliers confidence they will be paid.

Audit Quality and Our Response

We have already reported publicly this year, on the results of our audit inspection and monitoring work. Although we have identified examples of good practice, our work shows that high quality audit is not being delivered consistently. This year progress towards the FRC’s public target that 90 percent of FTSE 350 audits should require not more than limited improvements has stalled, and the improving picture shown in recent years has been reversed. In particular, we reported a deterioration in the quality of the audits that we inspected to an unacceptable level at one firm, KPMG.

In response, the FRC has developed a new strategic approach, the Audit Firm Monitoring and Supervisory Approach (AFMAS) to the largest audit firms. This adds to our work on individual audits by giving us a greater capacity to monitor their stability and performance by focusing on aspects of their businesses that are critical to the provision of high quality audit. We have also strengthened our enforcement capacity so that we can conclude cases more quickly and revised our sanctions framework to levy penalties that reflect the gravity of the issue. We are also providing stakeholders with greater transparency about our findings and more robust requirements for remedial work. In the case of KPMG, which had the weakest results in our public reports, we are inspecting 25 per cent more audits.

Where we identify poor quality audit that carries a risk that a relevant requirement has not been met and the public interest endangered, we investigate and take enforcement action. We can also take action against accountants in business, where there are reasonable grounds to suspect misconduct and it is in the public interest to do so. This year, we have concluded a number of significant cases as a result of our earlier investment to expand our enforcement team. We have completed our work on a timelier basis and levied over £23 million of financial penalties.

At the same time expectations of audit are changing, partly because of higher expectations of business. In response, we are carrying out a post implementation review of the standards we issued in 2016 in accordance with the new audit regulations.
introduced by the EU, to see if they have been sufficiently effective in supporting high-quality and robust audit work, and whether they go far enough in protecting auditor independence and in preventing conflicts of interest which may exist if an auditor is engaged in providing non-audit services to an audited entity. If auditors cannot demonstrate their independence, they cannot address the perception held by some stakeholders that auditors are sometimes driven more by their commercial considerations, and the sale of non-audit services than they are by acting in the public interest.

We have already commenced work looking at the effectiveness of requirements on auditors in respect of going concern, and the work they do over the information published alongside the financial statements. We expect to adopt a revised standard covering the audit of management estimates and disclosures, which requires auditors to do more work when auditing significant accounting estimates, like the reporting of expected credit losses by banks, by the end of the year.

**Competition in the UK Audit Market**

Although the UK audit market is diverse in certain respects, with some 5,500 registered audit firms undertaking around 100,000 statutory audits a year, at the top end of the audit market the four largest firms – PwC, KPMG, Deloitte and EY – are dominant. For FTSE 350 audits, they have 97 per cent of audit engagements, generate 99 per cent of audit fee income and 98 per cent of non-audit fees. Although there is greater competition in other market segments, those sectors are significantly smaller than the FTSE 350.

The level of concentration at the top end of the market has been the subject of increasing debate and discussion, including a Competition and Markets Authority review. Competition on quality grounds, through mandatory tendering and rotation, introduced in 2012, has not delivered either greater diversification, or the emergence of any new competitors. There is also a risk of companies not finding auditors willing to compete. To address the risks posed by concentration, including the impact of an audit firm failing, we monitor the largest UK audit firms using a new approach focusing on five key pillars of: leadership and governance; firm values and behaviours; business models and financial soundness; risk management; and audit quality.

**The Future of Audit**

To respond to the challenges to the current model for audit in the UK, the FRC is working in two areas. We are launching a major project on the future of corporate reporting, specifically how companies’ provision of information can best serve the needs of investors and other stakeholders. Within this work, as investor needs are established, we will review the need for greater levels of audit and assurance to Boards and the public. We will look at whether audit should go beyond the financial statements and be more forward-looking; and provide greater assurance on areas such as business probity, conduct, compliance and viability.
Section One – Audit Quality

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

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

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

Our assessment of audit quality is drawn from the evidence base provided by our audit inspection work, and that undertaken by the Recognised Supervisory Bodies (RSBs), under delegation. We use this evidence base to report annually against the FRC’s public target that by 2019, 90 per cent of FTSE 350 audits will require no more than limited improvements. We are not confident that the 90 per cent target will be achieved next year.

Inspection work covers a sample of audits in any one year. As that sample is not statistical, we have to be careful in drawing definitive conclusions. The results of the most recent audit inspection results nevertheless require an urgent response, showing a fall in reported quality since last year, both overall (72 per cent vs 78 per cent requiring no more than limited improvements) and for our inspections of FTSE 350 audits (73 per cent vs 81 per cent). Prior to this year, the trend in FRC audit inspection outcomes has been positive, with this being the first decline in FTSE 350 performance since 2013.

1 FRC definition of High Quality Audit
2 Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.
Table 1: Audits assessed by the FRC as either good or only requiring limited improvements

<table>
<thead>
<tr>
<th>Year</th>
<th>FTSE 350</th>
<th>Non-FTSE 350</th>
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<tbody>
<tr>
<td>2017/18</td>
<td>73%</td>
<td>71%</td>
</tr>
<tr>
<td>2016/17</td>
<td>81%</td>
<td>72%</td>
</tr>
<tr>
<td>2015/16</td>
<td>77%</td>
<td>74%</td>
</tr>
<tr>
<td>2014/15</td>
<td>70%</td>
<td>63%</td>
</tr>
<tr>
<td>2013/14</td>
<td>69%</td>
<td>53%</td>
</tr>
<tr>
<td>2012/13</td>
<td>68%</td>
<td>48%</td>
</tr>
<tr>
<td>2011/12</td>
<td>56%</td>
<td></td>
</tr>
</tbody>
</table>

The RSBs have reported a decline in the number of audits inspected achieving their highest grade from 21 per cent to 17 per cent, partially offset by a decrease in audits achieving their lowest grade from 17 per cent to 14 per cent.

FRC audit inspection activity

The FRC’s Audit Quality Review team monitors the quality of audit work of UK Public Interest Entities (PIEs) and other entities, such as Lloyd’s Syndicates and large AIM-listed companies. We also 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 through private contractual arrangements with the relevant regulatory authorities. We also have contractual arrangements in place to inspect the work of auditors of local public bodies and of the National Audit Office.

We have increased the number of inspections we carry out from 126 to around 170. The growth is because of the expansion in the number of financial services and insurance PIEs, the inclusion of local public audit in our inspection regime, the need to cover smaller audit firms carrying out (a limited number) of PIE audits and an increase in the resources we deploy to inspect the work of KPMG. Private companies (other than unlisted banks and insurers) are not PIEs and are therefore no longer within our inspection scope. We do, on occasion, continue to review some large private companies if they have listed debt or as part of joint inspections with other regulators.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total number of audits inspected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014/15</td>
<td>126</td>
</tr>
<tr>
<td>2015/16</td>
<td>137</td>
</tr>
<tr>
<td>2016/17</td>
<td>140</td>
</tr>
<tr>
<td>2017/18</td>
<td>145</td>
</tr>
<tr>
<td>2018/19 [planned]</td>
<td>160-170</td>
</tr>
</tbody>
</table>

This includes audits conducted by UK and Crown Dependency audit firms, Third Country Auditors, Local Public Audit and the National Audit Office.
Our inspections cover FTSE 350 audits over a five-year cycle. We also factor into our work priority sectors of the economy on which we wish to focus. In 2017/18 these were: Property; Travel and Leisure; Financial Services; and Business Support Services.

For each inspection, we focus on certain areas of the audit, based upon: the nature of the business audited; the key audit matters described in the auditor’s report; and the risks listed in the Audit Committee report. Areas involving higher levels of judgement, such as impairment testing and asset valuations, typically feature more frequently in the selection. For each area, we consider the appropriateness of key audit judgments made in support of the audit opinion, and the sufficiency and appropriateness of the supporting audit evidence obtained.

Engagement specific inspections are supplemented by reviews of firm-wide procedures, which include an assessment of the firm’s internal quality assurance programmes. In addition, we undertake two to three thematic inspections a year which entail an in-depth review of particular aspects of audit, such as the use of data analytics.

At the end of each inspection, we grade the audit to reflect the extent to which the audit file complies with the requirements set out in our auditing and ethical standards. Those audits which receive either a 1 or 2A rating are deemed to either be good or need no more than limited improvement. Those audits receiving a grade of 2B and 3 require more than limited improvement. Where an audit requires significant improvement (category 3), we have significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key audit judgements or other matters identified. However, this does not automatically mean that the audit opinion is or was at risk.

In such circumstances we require remedial action by the firm to address our concerns and to confirm that the audit opinion remains appropriate. We will generally review a subsequent year’s audit to confirm that appropriate action has been taken. Audits which receive a grading of 2B or 3 may be referred to our Enforcement Team for investigation.

**Specific Quality Issues**

The most significant issues our 2017 inspections identified are set out below. It is an ongoing concern and frustration for both the FRC and for those who rely on audit, that many of the issues identified are recurring matters which firms have failed to address successfully. We challenge audit firms so that they properly understand underlying root causes, and have the right governance mechanisms, strategies, audit resources and cultural focus to deal with these issues. They included:

- **Lack of professional scepticism and challenge of management**

  We continue to identify problems with insufficient challenge of management and professional scepticism exercised by auditors when auditing key judgement areas (for example, goodwill impairment or long-term contracts). We noted examples where audit teams failed to adequately challenge management’s assumptions in relation to contract costs to complete, environmental provisions and cash flow forecasts. We have again raised this with firms in our public reports and are reviewing their actions to address these findings.
Bank audits

This year we inspected the highest number of banks since our 2014 thematic review of the audit of loan loss provisions and related IT controls in banks and building societies. We identified a partial re-occurrence of some of the issues identified in the 2014 review, including weaknesses in the audit of conduct and loan loss provisions and the assessment of IT general controls. In January 2018 we wrote to all firms within AQR's scope with bank and building society audits, with the objective of focusing their attention on key areas of their audit of banks with December year-ends.

Group audit oversight

Appropriate group oversight and direction of the work of component auditors is necessary to achieve a high-quality audit. The group audit partner, supported by the group audit team, is responsible for the direction and supervision of the group audit and therefore needs to demonstrate sufficient involvement throughout the audit process. This is especially important where the audit of significant components involves judgemental areas which may be subject to management bias. We saw instances where the group team did not adequately evaluate the conclusions reached by the component auditors (for example, key assumptions in an impairment model).

We have referred this issue to the FRC’s Technical Advisory Group to determine whether we need to issue further guidance to make clear the requirements of standards, and our expectations in this respect.

Audit of pension balances

Pension scheme assets are significant balances and even small changes can have a material effect on company financial statements. The FRC focused on the quality of audit of pension balances and related disclosures in 51 of its audit inspections in 2017/18 and found that in almost half improvement was required. In many cases the existence of multiple pension arrangements and/or financial and risk management transactions, such as liability-driven investment strategies, partial buy-outs and longevity swaps, have made valuation judgements and their audit complex. We have seen examples where audit teams have provided inadequate challenge to sometimes optimistic management assumptions. As a result, we published a separate report on ‘the audit of defined benefit pension obligations’ setting out areas where quality should be enhanced.

Lack of consistency

Overall, we assessed over 70 per cent of audits inspected as either good or requiring only limited improvements. Firms are, therefore, capable of delivering high quality audits, but they are failing to do so consistently. To ensure greater consistency, we require firms to undertake rigorous Root Cause Analysis (RCA). We first asked the firms to prepare RCA in response to our inspection findings in 2015/16. Effective RCA enables firms to develop appropriate action plans which are likely to result in improvements in audit quality being achieved.

https://www.frc.org.uk/getattachment/4fbf1bb2-930b-4032-a5be-b93aa84f06b0/Audit-of-defined-benefit-pension-obligations_v4.pdf
We require firms to review whether their analyses do identify the real causes of audit shortcomings and therefore whether their action plans will effectively address our concerns. Firms’ work in this area is improving, but we intend to develop further our scrutiny given the recurring nature of some of the findings from our inspections and lack of consistency of execution.

**New Strategic Focus**

Confidence in audit is informed by longer term, recurring and more systemic causes than a single year of poor inspection results. We will continue to carry out individual audit file reviews and examine audit firms’ firm-wide procedures, but we will also focus on the quality and accountability of the leadership of the largest firms and their ability to create the right culture to support consistent high-quality audit. This can be through identifying the right people to consistently deliver high quality work in an environment that rewards or recognises those who do.

In April 2018, we announced an enhanced programme of monitoring (AFMAS) for the largest audit firms in the UK. We took this step to support our expanded responsibilities. 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. Our work in this area requires us to set out our expectations for the firms in respect of five main ‘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.
Leadership

We have set clear expectations for the necessary experience, skills and attributes of candidates for key roles in an audit firm including: Independent Non-Executives; Heads of Audit; and Ethics Partner. We ask firms to demonstrate to us that proposed appointments at this level 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. Those expectations are set out in the table below – the expectations are not an exhaustive list.

<table>
<thead>
<tr>
<th>Role</th>
<th>Expectations</th>
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</thead>
<tbody>
<tr>
<td>Head of a UK firm</td>
<td>We will ask for evidence of involvement in audit quality initiatives within the firm in recent years. If from a non-audit background, then we will ask for evidence about the consideration of how the individual will support audit quality within the firm.</td>
</tr>
<tr>
<td>Chair</td>
<td>We will give consideration of how the individual will support audit quality within the firm as Chair. We expect them to demonstrate an understanding of the public interest and its importance to the activities of an audit firm.</td>
</tr>
<tr>
<td>Head of audit</td>
<td>We will ask for evidence of involvement in audit quality initiatives within the firm in recent years, and a track record of audit quality (from internal and/or external reviews).</td>
</tr>
<tr>
<td>Ethics Partner</td>
<td>Evidence of the candidate’s track record of involvement in ethical matters/issues within the firm; how they have demonstrated an independent attitude of mind; and evidence that they have sufficient standing within the firm to uphold difficult decisions.</td>
</tr>
<tr>
<td>Independent Non-Executive</td>
<td>Knowledge of professional services firms (or an induction plan in place to address gaps); an understanding of the public interest and its importance to the activities of an audit firm; an ability to command the respect of the firm’s partners; sufficient time to devote to the role; and at least one INE should have competence in accounting and/or auditing.</td>
</tr>
</tbody>
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We assess and feed back to senior management of a firm how well we believe their proposed appointees meet these criteria before appointments are made.

To secure improvements in audit quality, we also need to ensure that audit firms’ leadership drives culture in the firms in ways that support quality and consistency. Regulation creates a framework and expectation of leadership in the firm, but it cannot succeed unless the culture of the firm is set and driven by strong leadership.

More detail is provided on our work later in this report.  

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5 https://www.frc.org.uk/auditors/audit-firm-monitoring-approach/our-expectations
6 2018/21 FRC Strategy
Culture

In 2016 the FRC published a report on Corporate Culture and the Role of Boards which showed the actions taken by companies and boards to positively develop and shape their culture. In 2018 we published a thematic review on audit firm culture. Our report provided a ‘snap shot’ of the actions being taken by eight firms to establish, promote and embed a culture that is committed to delivering high quality audits. By comparing and contrasting actions at different firms we identified and reported areas of good practice and, where necessary, encouraged firms to do more.

Our key finding was that whilst the firms are currently investing considerable time and effort on their firm-wide culture, there are a number of key areas where more should be done. The areas for improvement included the following, each of which is explained in greater detail in the report:

- Giving additional prominence to audit specific behaviours and values within the firms’ cultural design, including the fundamental principles of integrity, objectivity, independence and professional scepticism that underpin high quality audit;
- Ensuring that all audit partners and staff appreciate that a good audit is of significant societal value and helps to underpin transparency and integrity in business. This includes having improving audit quality as part of whole-firm strategies;
- Balancing the firms’ robust processes to sanction poor quality work or behaviour with better recognition of positive contributions to high audit quality;
- Further developing the firms’ root cause analysis (“RCA”) techniques to identify the behavioural or cultural factors that contributed to good and poor-quality outcomes;
- Improving the firms’ monitoring of how successful they are at embedding their desired culture. This should include the Independent Non-Executives of the firms being more proactive when performing their assessment of the steps being taken by the firms to embed an appropriate culture; and
- Defining the purpose, behaviours and strategies for global networks and not just the UK firms.

We also encouraged the firms to provide more extensive and transparent public reporting on their cultural assessment to facilitate greater engagement between the firms and stakeholders, such as investors and audit committees.

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8 The eight firms were: BDO LLP (“BDO”) Deloitte LLP (“Deloitte”) Ernst & Young LLP (“EY”) Grant Thornton UK LLP (“GT”) KPMG LLP (“KPMG”) Mazars LLP (“Mazars”) PricewaterhouseCoopers LLP (“PwC”) RSM UK Audit LLP (“RSM”); https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7dfdd7e/Audit-Culture-Thematic-Review.pdf
9 https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7dfdd7e/Audit-Culture-Thematic-Review.pdf
This was the first time we have undertaken a study relating to audit culture. It is a broad, complex subject and requires further exploration in our pursuit of audit quality improvement. We plan to report publicly within the next three years on the actions firms have taken in relation to the findings from the thematic review. We will also regularly follow up on aspects of the review through our audit monitoring and supervisory approach which will include monitoring in relation to audit behaviours and values.

“There are many factors that influence the environment within which auditors make their decisions and act. It is important that firms create an audit culture where delivering high quality work is valued and rewarded, and which emphasises the importance of ‘doing the right thing’ in the public interest.

We found that firms have taken steps to achieving this. However, more should be done by firms to successfully promote and embed their desired culture, so that audit quality can be consistently and sustainably high10.”

Good practice

One of the findings of our Audit Firm Culture thematic, and of IFIAR’s most recent report on the results of international audit inspections, is that good practice should be highlighted as well as things that have gone wrong in an audit. Learning from work performed well can promote improved audit quality, especially where the firms communicate these examples to their audit partners and staff. We have added a separate section in each of our firm public reports to highlight where audit teams have performed high quality or innovative work. We also highlight good practice in the report that we provide to the Audit Committee Chair at the close of each of our individual audit inspections.

We noted the following particular areas of good practice on one or more audits inspected in 2017/18:

– Effective use of data analytics in the audit of revenue and journals;
– Group audit team direction and supervision of component auditors;
– Use of firm specialists in areas of judgement (for example, insurance contract liabilities and investment valuation); and
– On certain audits with IT control deficiencies, we saw good consideration of the deficiencies and testing of compensating controls.

10 FRC news release 10 May 2018
Recognised Supervisory Bodies (RSBs) inspection results

In addition to the audit monitoring that the FRC carries out for PIE audits, the RSBs are responsible for monitoring and inspecting non-PIE audits. The delegation agreements the FRC has with the RSBs require that the activities undertaken by each registered audit firm should be monitored at least once every six years. The RSBs are also required to consider the risks surrounding audit firms and schedule monitoring visits accordingly. The RSBs use various criteria to determine which firms should be visited in a cycle. Factors include the size or complexity of the audit firm and of the bodies it audits; the firm’s regulatory history; past review outcomes; and current circumstances.

In 2017 the RSBs conducted 1,025 audit monitoring visits to firms, and as part of these visits reviewed 1,896 audit files. In reporting their findings, the RSBs highlight that the population of firms, and therefore audit files reviewed by each RSB, differs each year because of the cyclical nature of the selection process. The RSBs therefore find it difficult to draw definitive conclusions on changes in audit quality in respect of the audit firms they monitor.

<table>
<thead>
<tr>
<th></th>
<th>Audit files receiving the highest grade</th>
<th>Audit files receiving the lowest grade</th>
</tr>
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<tbody>
<tr>
<td>2014</td>
<td>18%</td>
<td>17%</td>
</tr>
<tr>
<td>2015</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>2016</td>
<td>21%</td>
<td>13%</td>
</tr>
<tr>
<td>2017</td>
<td>17%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Between 2014 and 2016 there had been an improving trend in the quality of audit files, with the percentage of audit files being awarded the highest grade increasing from 18 per cent to 21 per cent. However, in 2017 files achieving the highest grade fell to 17 per cent. Between 2014 and 2017 the percentage of audit files awarded the lowest grade decreased from 17 per cent to 14 per cent. In 2017 the most common findings reported by the RSBs were:

- Audit evidence – ISA (UK) 500: (23 per cent of breaches reported), 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: (19 percent of breaches reported). 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; and

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11 RSBs oversee the statutory regulation of auditors under delegation from the FRC as Competent Authority for audit.

12 Of the 1,025 firm reviews, 170 did not involve the review of an audit file and focused on firm procedures only. An RSB visit may review a single audit file in the case of a small firm/sole practitioner and as many as 12 audit files for a large firm.
Risk assessment – ISA (UK) 315: (8 per cent of breaches reported) and ISA (UK) 330 (4 per cent 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. Several firms also failed to consider the impact of the transition to FRS 102.

**Actions in response to the RSB inspection results**

Firms which receive a poor grade for their overall inspection may be referred to a committee or assessor of the RSB responsible for their audit registration or licensing. The committee or assessor will consider the results of the inspection visit, along with the response from the firm to determine if any action needs to be taken. The committee or assessor can place conditions or restrictions on an audit firm or audit principal. 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.

If the breach is sufficiently serious the committee may refer the matter to the RSB’s investigation department, which may lead to the RSB taking disciplinary action against the firm and/or, audit principal. The committees also can deal with breaches of regulations by imposing a regulatory penalty. In the most serious cases the committee can remove the audit registration or licence from the firm. In 2017 RSBs considered 141 audit firms and placed restrictions or conditions on 102 of those\(^\text{13}\). They also removed seven registrations from firms because of poor audit monitoring visit outcomes.

The RSBs collate the key themes from their audit monitoring activities and use this to inform their training for audit firms and audit personnel. The RSBs use a range of tools to promote audit quality at firms including: publications; training courses, which explore the key themes and results of the audit monitoring visits; and working with training providers to ensure that key messages reach the audit firms.

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\(^{13}\) The RSB committees have the following criteria for selecting audit firms for consideration: those with the lowest grade (D) or where significant issues have been raised; where a review has been specifically requested; and all larger firms.
Section Two – Enforcement

High quality audit, carried out by auditors acting with integrity, and reinforced by enforcement action in significant cases of failure supports justifiable confidence in audit on the part of stakeholders. It also requires those stakeholders to have confidence that audit regulation will result in timely and robust enforcement action to uphold standards and deter misconduct. Our enforcement work covers a broad range of themes, explained in more detail below.

Themes

Our investigations are commonly focused on one or more specific areas, within the context of the overall audit. Areas currently being investigated include:

– Pensions – including the valuation of pension liabilities;
– Impairment – failures to adequately understand and/or test management’s impairment assumptions and estimates, including those relating to goodwill and financial investments;
– Going concern – whether sufficient audit evidence has been obtained on which to conclude that the going concern assumption was appropriate;
– Related party transactions;
– Group audits (including the instruction and supervision of component auditors);
– Reverse factoring;
– Fraud (including bribery);
– Prior year restatements; and
– Independence – whether auditors have taken appropriate steps to deal with threats to their independence and objectivity.

In considering these areas, investigations will often assess:

– Whether sufficient evidence was obtained;
– Whether the objectivity of the auditor is threatened by the nature of the relationship with the audited entity;
– Whether accounting judgements, which often rely on forecasts and estimates provided by management, have been challenged sufficiently;
– Whether the audit team were sufficiently experienced and understood the complexities of the audited entity; and

– Whether the audit team exercised sufficient scepticism in the course of the audit.

The key issue we see is a lack of professional scepticism and failure to challenge management. This leads to breaches of auditing standards which are designed to ensure sufficient and appropriate work is done. We also regularly see investigations into audits which include:

– Failure to obtain sufficient appropriate audit evidence. This can be either not doing enough audit work or relying on poor quality evidence, such as management-generated documentation (rather than documents from third parties);

– Senior audit engagement partners leading the audit may no longer be familiar with the audit technical standards and requirements; and

– Significant work (often in relation to key and complex areas of the audit) is given to junior members of the team, who are insufficiently supervised.

Since April 2017 the FRC has concluded a number of significant audit cases and imposed penalties on auditors of more than £23 million, which represents a marked increase on previous periods, as well as non-financial penalties including deregistration as a statutory auditor. We also commissioned an independent review of our sanctions regime which has resulted in new sanctions guidance which came into effect from June 2018. The FRC has continued to expand the enforcement team and made good progress on cases commenced under the Audit Enforcement Procedure (AEP) which came into effect in June 2016.

Under the AEP, the FRC investigates matters relating to the statutory audits of Public Interest Entities (PIEs), AIM-listed companies with a market capitalisation in excess of €200m and Lloyd’s Syndicates. Other audit-related investigations can be delegated to Recognised Supervisory Bodies such as the ICAEW, although the FRC can choose to retain an investigation, where it is in the public interest to do so. In addition, there are also investigations proceeding under the Accountancy Scheme (which is the disciplinary scheme for the accountancy profession) where the investigation commenced before June 2016, or where it is otherwise appropriate to investigate the conduct of Members of the various professional bodies covered by the Scheme.

Key differences between the AEP and the Scheme are:

– The threshold for conduct capable of attracting sanction is lower under the AEP, being a breach of a relevant requirement. The threshold under the Scheme is the higher one of Misconduct (i.e. a significant falling short of the standards reasonably to be expected);

– Under the AEP, we have the power to compel information and documentation from PIE audited entities whereas under the Scheme we were only able to obtain such material on a voluntary basis.
A case under the AEP and the Scheme will follow a similar path, as shown in the flowchart below.

Sanctions Review

We commissioned an independent review of our sanctions regime chaired by Sir Christopher Clarke, a former Court of Appeal judge. The panel delivered its report in October 2017 which set out a number of recommendations including:

- Greater attention to be given to the use of non-financial penalties, in order to maintain and enhance the quality and reliability of future audit and accountancy work;

- The removal of any requirement for tribunals to consider themselves bound by previous cases when determining the appropriate sanction to impose; and

- The adjustment of settlement discount provisions to encourage timely settlement and reflect the level of cooperation by respondents.

The report concluded that it was not appropriate to set a tariff or range for financial sanctions. However, it noted that in certain circumstances a fine of £10 million or more could be appropriate for cases involving seriously poor audit work, carried out by a Big Four firm. We incorporated the majority of the recommendations in our amended sanctions guidance which took effect from 1 June 2018.

The FRC also recognises the important role that non-financial sanctions can play in upholding the quality of future audits and these have formed part of the sanctions package in the PwC/BHS settlement (see table of concluded cases).
**Faster Case Resolution**

Since 2016 when we introduced the AEP, we have developed measures to improve the speed of investigations. The stronger powers we gained in legislation in that year have also allowed us to make swifter progress on cases. These involve, among other things, a carrot and stick approach with those we investigate: holding early scoping meetings to set out the timetable, approach and expectations of our investigations; discussing formal notices with firms before they are served; but equally setting out the importance of complying with deadlines and taking account of non-cooperation when determining sanctions.

An obvious way of concluding cases early is by individuals and firms making early admissions of failures, settling the case and accepting the imposition of appropriate sanctions. We have increasingly encouraged this over the past two years, and many of our cases have successfully concluded this way (some with significant financial and non-financial penalties). One recommendation from the independent Sanctions Review panel was to incentivise further early admissions of failure by revising the discounts available if admissions are made at an early stage. We have adopted these recommendations.

We have increased the resources deployed on enforcement work. The creation and continued expansion of an internal forensic accounting team (with diverse experience of private and public-sector work) means that investigative work can (and indeed does) start immediately when a case is referred. All new cases now have two lawyers assigned, which leads to efficiency savings, and allows the smaller cases to be progressed at greater speed. Internal milestones introduced recently indicate that these changes are speeding up investigations. We also have learned lessons from some challenging cases – in November 2017, we published a report which included lessons learned from our investigation of KPMG’s audit of HBOS.

When a case is concluded either as a result of settlement or because a Tribunal gives a ruling, the FRC publishes the outcome unless it would not be in the public interest to do so. Where publication would risk prejudicing any other ongoing regulatory action, the FRC may decide to delay publication until those actions have concluded. Publication of outcomes is part of our commitment to operate transparently as a regulator and demonstrates to stakeholders why an enforcement case has been pursued.

**Current investigations**

The FRC opened a number of cases in the period under the AEP including investigations into the audits of Rolls Royce, BT Group, Mitie and Carillion. Several legacy cases which were opened prior to June 2016 continue to be progressed under the terms of the Accountancy Scheme. Nine audit cases under the Scheme concluded in the period, seven of which resulted in the audit partners and firms admitting misconduct and accepting fines and other sanctions, further details of which are set out below. No AEP cases have yet reached the stage of issuance of a Decision Notice, but they are progressing well, measured against internal milestones.

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14 The Independent Sanctions Review, published November 2017
16 Investigations into the audits of HBOS plc and Globo plc were closed during the period.
<table>
<thead>
<tr>
<th>Company</th>
<th>Audit firm / Audit partner</th>
<th>Investigation date</th>
<th>Outcome</th>
<th>Date</th>
<th>Sanction</th>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>RSM Tenon Group plc</td>
<td>PwC</td>
<td>Aug-12</td>
<td>Misconduct admitted</td>
<td>Jun-17</td>
<td>Severe Reprimand</td>
<td>£500,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £6,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Reduced to £5,100,000 after settlement discount</td>
<td></td>
</tr>
<tr>
<td>RSM Tenon Group plc</td>
<td>Nicholas Boden</td>
<td>Aug-12</td>
<td>Misconduct admitted</td>
<td>Jun-17</td>
<td>Severe Reprimand</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £150,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Reduced to £114,750 after adjusting for mitigating factors and a discount for settlement</td>
<td></td>
</tr>
<tr>
<td>Tech Data Limited</td>
<td>EY</td>
<td>May-14</td>
<td>Misconduct admitted</td>
<td>Sep-17</td>
<td>Reprimand</td>
<td>£225,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £2,750,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Adjusted for mitigating factors and discounted for settlement to £1,800,000</td>
<td></td>
</tr>
<tr>
<td>Tech Data Limited</td>
<td>Julian Gray</td>
<td>May-14</td>
<td>Misconduct admitted</td>
<td>Sep-17</td>
<td>Reprimand</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £90,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Adjusted for mitigating factors and discounted for settlement to £59,000</td>
<td></td>
</tr>
<tr>
<td>HBOS plc</td>
<td>KPMG</td>
<td>Jun-16</td>
<td>Case closed</td>
<td>Sep-17</td>
<td>–</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quindell plc</td>
<td>Arrandco Audit Ltd (Formerly RSM Tenon Audit Ltd)</td>
<td>Aug-15</td>
<td>Misconduct admitted</td>
<td>Dec-17</td>
<td>Reprimand</td>
<td>£90,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £1,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Adjusted for mitigating factors and discounted for settlement to £700,000</td>
<td></td>
</tr>
<tr>
<td>Quindell plc</td>
<td>Jeremy Filley</td>
<td>Aug-15</td>
<td>Misconduct admitted</td>
<td>Dec-17</td>
<td>Reprimand</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £90,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Adjusted for mitigating factors and discounted for settlement to £56,000</td>
<td></td>
</tr>
<tr>
<td>Quindell plc</td>
<td>KPMG</td>
<td>Aug-15</td>
<td>Misconduct admitted</td>
<td>May-18</td>
<td>Reprimand</td>
<td>£146,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £4,500,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Discounted for settlement to £3,150,000</td>
<td></td>
</tr>
<tr>
<td>Quindell plc</td>
<td>William Smith</td>
<td>Aug-15</td>
<td>Misconduct admitted</td>
<td>May-18</td>
<td>Reprimand</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £120,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Discounted for settlement to £84,000</td>
<td></td>
</tr>
<tr>
<td>BHS Limited</td>
<td>PwC</td>
<td>Jun-16</td>
<td>Misconduct admitted</td>
<td>May-18</td>
<td>Severe Reprimand</td>
<td>£595,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sanction agreed</td>
<td></td>
<td>Fine £10,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Non-financial sanctions</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Fine reduced to £6,500,000 for early settlement. PwC also agreed to a condition that it monitors and supports its Leeds practice (to include monitoring of compliance with Ethical Standards) and provides annual reports to Executive Counsel setting out the results of such monitoring and support conducted to date on an annual basis for audits with a 2018, 2019 and 2020 year end. PwC further agreed to a signed undertaking to review (and if necessary amend) its policies and procedures with a view to ensuring that audits of all high risk or high-profile entities that are not listed companies are subjected to an to an engagement quality control review.</td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Audit firm / Audit partner</td>
<td>Investigation date</td>
<td>Outcome</td>
<td>Date</td>
<td>Sanction</td>
<td>Costs</td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------</td>
<td>-------------------</td>
<td>----------------------------------</td>
<td>--------</td>
<td>-----------------------------------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>BHS Limited</td>
<td>Steve Denison</td>
<td>Jun-16</td>
<td>Misconduct admitted Sanction agreed</td>
<td>May-18</td>
<td>Severe Reprimand £500,000 Non-financial sanctions Fine reduced to £325,000 for early settlement. Mr Denison also agreed to a condition not to perform any audit work for 15 years and to remove his name from the register for this period.</td>
<td>-</td>
</tr>
<tr>
<td>Globo plc</td>
<td>Grant Thornton</td>
<td>Dec-15</td>
<td>Case closed</td>
<td>Jul-18</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ted Baker plc</td>
<td>KPMG</td>
<td>Jun-16</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Severe Reprimand £3,000,000 Discounted for settlement to £2,100,000</td>
<td>£112,000</td>
</tr>
<tr>
<td>Ted Baker plc</td>
<td>Michael Barradell</td>
<td>Jun-16</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Reprimand £80,000 Reduced to £46,800 after adjustment for mitigating factors and a discount for settlement.</td>
<td>-</td>
</tr>
<tr>
<td>Nichols Plc and the University of Salford</td>
<td>Grant Thornton</td>
<td>Aug-13</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Severe Reprimand £4,000,000 Discounted for settlement to £3,000,000</td>
<td>£165,000</td>
</tr>
<tr>
<td>Nichols Plc</td>
<td>Kevin Engel</td>
<td>Aug-13</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Severe Reprimand £100,000 Discounted for settlement to £75,000</td>
<td>-</td>
</tr>
<tr>
<td>The University of Salford</td>
<td>David Barnes</td>
<td>Aug-13</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Reprimand £70,000 Discounted for settlement to £52,500</td>
<td>-</td>
</tr>
<tr>
<td>Nichols Plc</td>
<td>Joanne Kearns</td>
<td>Aug-13</td>
<td>Misconduct admitted Sanction agreed</td>
<td>Jul-18</td>
<td>Reprimand £60,000 Discounted for settlement to £45,000</td>
<td>-</td>
</tr>
</tbody>
</table>

**Constructive Engagement**

We have considered around a third of cases to be less serious and consequently have been resolved by the FRC’s Case Examiner through constructive engagement.

Constructive engagement is a process introduced in the AEP to provide an efficient mechanism for resolving cases without the need for a full enforcement investigation. It involves a dialogue between the Case Examiner and the relevant audit firm to explore the circumstances underlying the case, the root cause of any potential breaches and to agree appropriate actions to be taken to prevent recurrence.
Section Three – Overview: The UK Audit Market

£3.9 trillion: UK listed companies (Main and AIM market) total market capitalisation (as at 31 March 2018)

5,524: Current number of registered statutory audit firms in UK (29 May 2018) 23,473 Current number of registered statutory auditors (29 May 2018)17

“Competition - or lack of it - at the top end of the audit market remains a serious concern. As a regulator we cannot be content that just four large firms dominate the market for audit services. We believe that this has led to the risk of complacency in the behaviour of those firms. However, there is no easy solution and it is essential that any remedies do not result in further market concentration18.”

Concerns about the level of competition in the UK audit market, and the high levels of concentration, particularly in the main FTSE market have increased since our last report. This has resulted in renewed interest by the Competition and Markets Authority (CMA).

Since the CMA’s reforms, the EU Audit Regulation in 2016 introduced audit rotation to bolster auditor independence. This involved mandatory tendering and rotation for all public interest entity audits at least every 10 years; and imposed a maximum tenure of 20 years for an individual audit firm to continue with an audit engagement. The Regulation also imposed more stringent restrictions on the type and value of non-audit services which auditors of public interest entities can provide to entities they audit, including a financial cap of 70% of the audit fee.19

These reforms were driven in part by the 2008 financial crisis and the potential consequences of having a small number of very large audit firms with a dominant position in the market and very long-term relationships with systemically important companies. Such relationships are perceived to threaten the auditor’s independence and objectivity, given that for a very large and complex entity fees received for audit and non-audit services can exceed £30 million a year. Whilst tendering has resulted in strong competition (usually between big four firms), it has not done anything to dilute the levels of market concentration, and there remains public concern about whether the provision of non-audit services undermines auditor independence.

18 FRC, 2018/21 Strategy.
19 The 70% CAP is calculated on the basis of average audit fees for the previous 3 years.
Our evaluation of the available data leads us to draw the following conclusions about the impact of the reforms on audit tenure, market concentration and fee income from non-audit services:

– Mandatory tendering, and a maximum tenure for auditors, has had a significant impact. Nearly half of FTSE 350 auditors were in place for five or less years in 2017, as compared to fewer than one quarter in 2012;

– There has been no diversification of the UK audit market. Big four firms have increased their market share in the FTSE 350. These firms also dominate fee income in every category of engagement (see graph 1);

– Overall fee income from non-audit services provided to audited bodies fell by nearly nine percent for UK PIE auditors in 2017 (see graph 2);

– Non-big four firms secured proportionately more income growth from services provided to non-audit clients than the big four (nearly seven per cent compared to nearly three per cent). This suggests that non-audit service fees previously supplied by big four auditors are being re-distributed, and that other firms are making inroads into the FTSE 350 and listed markets via a non-audit route;

– Overall, audit firms generate a significant majority of their fee income from non-audit services to non-audit clients (an average of 70 per cent for big four firms in 2017; 60 per cent for non-big four).

**Tenure**

Reforms have had a clear impact on the length of tenure for auditors of the FTSE 350, which is the most important part of the PIE audit market from a fees perspective. The diagrams below illustrate the change since 2012.\(^{20}\)

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\(^{20}\) Source: 2012 data is from a survey of FTSE 350 companies published by Accountancy magazine; for 2017 it is drawn from an amalgam of FRC analysis and the Audit Analytics database.
In 2012, 22 per cent of auditors in the FTSE 350 had been in place for five years or fewer. This increased to 47 per cent by 2017. This trend will continue with some 15 per cent of FTSE 350 auditors with a tenure of twenty years or more in 2017 due to be replaced. (In 2012, 23 per cent of FTSE 350 companies had been in place for over twenty years, many for several decades more than that.)

Limiting the maximum tenure for auditors addresses one of the key concerns which arose in the aftermath of the 2008 financial crisis – the threat to independence from very long-term relationships between auditors and companies. Initial feedback from audit committee chairs has been positive in this respect:

“They have a very good understanding of the business & the risk environment in which it operates. The recent change of audit partner (with the audit tender) has brought a fresh perspective, challenging received wisdom. Quality of the audit team is high.”

Audit committees now have to manage short term risks to audit quality as new auditors ‘get up to speed’. This is an area of focus for our AQR inspection programme. Although the number of audits reviewed is too small to draw definitive conclusions, of the 27 first year audits we reviewed over the past three years, 74 per cent were assessed as good or requiring no more than limited improvements. This is broadly in line with our results across all audits inspected.

**Market Concentration**

In 2017, we reported that 213 (61 per cent) of the FTSE 350 had completed a tendering exercise since 2011. 74 per cent of those tenders resulted in the appointment of a new audit firm. Tendering has largely resulted in a redistribution of audit engagements between the big four firms, rather than diversification (see Graph 1 below).

Only two other firms (BDO and Grant Thornton) have any share in this part of the market, and the introduction of tendering has resulted in a reduction of their combined audits from 16 FTSE 350 engagements in 2011, to 9 in 2017. We predicted that 2015 and 2016 were likely to represent a high tide for FTSE 350 tendering activity in the short term, as the majority of initial tenders have been completed. Assuming no further reforms, it is possible that audited entities will tender more frequently than the 10-year minimum requirement and provide more opportunities for new entrants to the market. However, it is more likely that the current concentration around four main firms will continue for the foreseeable future.
The causes and implications of concentration around four large firms is the subject of ongoing analysis and review, including by the CMA. As we note later in this report, some investor stakeholders are less concerned by this because they believe that the quality of audits being carried out on the UK FTSE 350 compares favourably at an international level. Indeed, some worry that further reform to the market could result in less choice and lower quality, if participants choose not to tender for audits in favour of more lucrative non-audit services work.

Concentration will not be addressed, without dealing with the barriers to entry that exist in the PIE audit market. Audit committee chairs expressed concerns about the willingness of a wider pool of firms outside the big four to participate in the market, and the quality of some tenders when they do. For some particularly complex sectors of the economy, such as banking and insurance, the levels of expertise and resources required to carry out audits of that kind, pose another barrier to entry.

“...We were keen to look at potential auditors outside the big four and had a short list of two big, two medium-sized accountants. The quality of presentation from the two larger candidates was far superior, which was disappointing...”

Non-big four firms have responded, arguing that the matter is more one of perception than a realistic assessment of the quality of their bids. At one extreme, an ‘alumni effect’ may influence the assessment and evaluation of tenders, with ex-big four partners being well represented on audit committees, and members having a conscious or unconscious bias which places other firms at a disadvantage in the process. Given the time and cost involved in participating in the tender process, some firms have become discouraged by their lack of success when competing against the big four.

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Footnotes:
21 FRC Audit Committee Chair Quality Survey - 2018
22 Data source: FRC data drawn from published sources supplemented with the Audit Analytics database. Note that this data was based on published information at a point in time (autumn 2017) and will not take account of changes announced since. This means that the allocation of audits between the firms may change.
The UK audit market is not currently delivering competition in a way that will reduce the levels of concentration at the top of the market. How this impacts on quality is not yet proven, however lack of choice can impact on stakeholder confidence. This is confirmed by our survey of audit committee chairs. Alongside the CMA's review, UK audit firms have recognised that there are urgent issues to address with the heads of nine firms (the Big Four, BDO, Grant Thornton, Mazars, RSM and Moore Stephens) collaborating in a "from four to more" project, considering remedies such as "quotas, the sharing of technology and a transition fund to give smaller firms a leg up".23

**Fees**

The UK PIE audit market is one of the largest in the world in terms of fee income.24 We estimate total fee income for PIE auditors from all sources in 2017 to be £12.6 billion.

<table>
<thead>
<tr>
<th>2017</th>
<th>Total £m</th>
<th>Big Four £m</th>
<th>Big Four %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee Income - Audit</td>
<td>2,662</td>
<td>2,084</td>
<td>78%</td>
</tr>
<tr>
<td>Fee Income - Non-audit services to audited bodies</td>
<td>1,283</td>
<td>1,015</td>
<td>79%</td>
</tr>
<tr>
<td>Fee Income - Non-audit services to non-audit clients</td>
<td>8,641</td>
<td>7,364</td>
<td>85%</td>
</tr>
<tr>
<td>Total Fee Income</td>
<td>12,586</td>
<td>10,463</td>
<td>83%</td>
</tr>
</tbody>
</table>

**Fees for services provided to audited bodies**

In terms of fees generated from audited bodies for all types of services, revenue from FTSE 350 entities is significantly greater than for the rest of the LSE main market and AIM combined. The FTSE 350 audit market pays total fees of £1.175 billion, compared to £641 million for the rest of the LSE Market and £111 million for AIM. This helps illustrate how difficult it might be for a non-big four to break into this market, given the markedly different levels of income.

Outside of the FTSE 350, the share of audit engagements held by big four firms falls to 61 per cent, but this still accounts for 96 per cent of fees, suggesting big four firms are more successful in identifying and winning tenders for larger and more complex audits which generate more revenue. This pattern is repeated in the AIM market, despite a greater diversity of audit firms. BDO and Grant Thornton are two of the biggest three firms by number of engagements and non-big four firms hold 64 per cent of the available engagements. However, these engagements generate only 47 percent of audit fees, and 29 per cent of non-audit fees in the market.

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23 Source: The Times, per FRC daily news bulletin 23/07/18
24 This data does not include audit firms operating solely in other segments of the market.
25 Data source: FRC – information reported to the FRC by UK audit firms auditing PIEs.
### Table 4** FTSE 350

<table>
<thead>
<tr>
<th>Audit Firm or Network</th>
<th>Number of engagements</th>
<th>Audit Fees (£)</th>
<th>Non-Audit Fees (£)</th>
<th>Ratio Non-Audit to Audit Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwC</td>
<td>105</td>
<td>289,261,760</td>
<td>103,607,528</td>
<td>36%</td>
</tr>
<tr>
<td>KPMG</td>
<td>91</td>
<td>198,172,403</td>
<td>79,157,950</td>
<td>40%</td>
</tr>
<tr>
<td>Deloitte</td>
<td>87</td>
<td>171,820,435</td>
<td>103,384,056</td>
<td>60%</td>
</tr>
<tr>
<td>EY</td>
<td>58</td>
<td>177,473,000</td>
<td>43,127,500</td>
<td>24%</td>
</tr>
<tr>
<td>BDO</td>
<td>5</td>
<td>2,985,825</td>
<td>710,363</td>
<td>24%</td>
</tr>
<tr>
<td>Grant Thornton</td>
<td>4</td>
<td>1,473,470</td>
<td>4,321,709</td>
<td>293%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>350</strong></td>
<td><strong>841,186,893</strong></td>
<td><strong>334,309,106</strong></td>
<td><strong>40%</strong></td>
</tr>
<tr>
<td>Big Four</td>
<td>341</td>
<td>836,727,598</td>
<td>329,277,034</td>
<td>39%</td>
</tr>
<tr>
<td>%</td>
<td>97%</td>
<td>99%</td>
<td>98%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>9</td>
<td>4,459,295</td>
<td>5,032,072</td>
<td>113%</td>
</tr>
<tr>
<td>%</td>
<td>3%</td>
<td>1%</td>
<td>2%</td>
<td></td>
</tr>
</tbody>
</table>

### Table 5** AIM Market

<table>
<thead>
<tr>
<th>Audit Firm or Network</th>
<th>Number of engagements</th>
<th>Audit Fees</th>
<th>Non-Audit Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>BDO</td>
<td>138</td>
<td>10,005,793</td>
<td>3,496,475</td>
</tr>
<tr>
<td>KPMG</td>
<td>132</td>
<td>14,494,610</td>
<td>13,202,901</td>
</tr>
<tr>
<td>Grant Thornton</td>
<td>115</td>
<td>8,052,906</td>
<td>3,780,787</td>
</tr>
<tr>
<td>PwC</td>
<td>86</td>
<td>11,928,916</td>
<td>7,350,331</td>
</tr>
<tr>
<td>Deloitte</td>
<td>66</td>
<td>8,352,327</td>
<td>3,196,629</td>
</tr>
<tr>
<td>RSM</td>
<td>50</td>
<td>3,526,397</td>
<td>1,242,625</td>
</tr>
<tr>
<td>EY</td>
<td>43</td>
<td>6,587,556</td>
<td>3,399,919</td>
</tr>
<tr>
<td>Other</td>
<td>280</td>
<td>9,924,288</td>
<td>2,774,358</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>910</strong></td>
<td><strong>72,872,792</strong></td>
<td><strong>38,444,025</strong></td>
</tr>
<tr>
<td>Big Four</td>
<td>327</td>
<td>41,363,409</td>
<td>27,149,780</td>
</tr>
<tr>
<td>%</td>
<td>36%</td>
<td>57%</td>
<td>71%</td>
</tr>
<tr>
<td>Non-Big Four</td>
<td>583</td>
<td>31,509,383</td>
<td>11,294,245</td>
</tr>
<tr>
<td>%</td>
<td>64%</td>
<td>43%</td>
<td>29%</td>
</tr>
</tbody>
</table>

---

26 UK FTSE 350 Audited bodies, FRC data combined with Audit Analytics Database  
27 UK AIM Audited bodies, FRC data combined with Audit Analytics Database
Fee data for PIE audits in 2017, the first year of the application of the Audit Regulation [graph 2] illustrates the likely impact of the new 70 per cent cap on non-audit services provided to audited bodies. The current data is a reflection of preparations for full implementation of the cap, including changes to company policies on tendering for those services. Reported income for these non-audit services fell for the big four (8.9 per cent) and non-big four firms (8.7 per cent) compared to the previous year. At the same time, fee income from non-audit services provided to non-audit clients increased by 2.8 per cent for big-four and 6.8 per cent for non-big four firms.

This suggests that some non-audit service work is being transferred away from external auditors, confirming feedback we have had from some firms that they are having greater success in winning this type of work. Over time, the relationships these firms develop with FTSE 350 companies might begin to have an impact on the outcome of audit tenders.

Non-audit services have nevertheless been seen as a potential threat to auditor independence because of concerns that auditors may be more favourable to management in order to retain non-audit income. If this trend continues as the cap is fully implemented, then it is possible that the threat may reduce over time.

**Graph 2: Growth Rate**

<table>
<thead>
<tr>
<th></th>
<th>2015-16</th>
<th>2016-17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Fee Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Fee Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Audit Work to Audit Clients Fee Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Audit Work to Non-Audit Clients Fee Income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Analysis of Fee Income**

Big four firms dominate every category of fee income in the PIE market. Our analysis reveals that even in sectors of the market when the big four are less dominant in terms of the numbers of engagements held, they continue to generate higher levels of fees. It also reveals the importance of non-audit services fees to audit firms, with fee income from non-audit clients for all UK firms being larger than total fees from audited bodies. This is set out in more detail in the following paragraphs.
- Big 4 firms generate around 70% of their revenue from services provided to non-audit clients, as compared with 60% for other UK PIE firms.28

- Given the growth in these revenues for non-big four firms in 2017, it is possible that the 60% figure will continue to increase. [see graphs 3 and 4 below]

- Fees generated from audit have increased between 2015-17, but at a rate of 9% compared to 18% for non-audit services provided to entities not audited by a firm.

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**Graph 3:** Big four firms - proportion of fee income derived from audit fees, non-audit services and fees from non-audit clients.

**Graph 4:** Non-big four firms: proportion of fee income derived from audit fees, non-audit services and fees from non-audit clients.29

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28 Data source: FRC – Key Facts and Trends: information reported to the FRC by UK audit firms with PIE audits.

29 Data source: FRC – Key Facts and Trends
International Context

Market concentration around four dominant firms is not unique or restricted to the UK. This is an important contextual factor when considering further potential market remedies since major firms operate across international boundaries. For instance, in Germany, big four firms have 94 per cent of the 130 largest listed company audits and almost 100 per cent of audit fee income. In the USA they have 79 per cent of the 3,000 largest public company audits and earn 96 per cent of audit fees.

In France, although many entities are required to have a joint audit, big four firms nevertheless continue to dominate in terms of both audit fee and non-audit fee income (74 per cent of engagements and 85 per cent of audit fee income). Nearly half of joint audits have two big four auditors, and only 3 per cent have two audit firms who are non-big four. Where a big four and non-big four firm combine to deliver the audit, in 73 per cent of cases the big four firm earns the larger audit fee.

Our response - ‘Too Big to Fail’ – Responding to Concentration

The FRC has responsibility for the regular monitoring and mitigation of risks in the audit market.30 These include the risks of systemic deficiencies within an audit firm network which could lead to the demise of that firm and impact on the overall stability of the financial sector. In 2010 we issued the Audit Firm Governance Code in order to secure enhancements to the quality of governance and ensure that risks to the firms are managed in the public interest.31

The Code applies to firms that audit 20 or more listed companies but may also be adopted on a voluntary basis by firms auditing fewer than that. It provides a benchmark of good governance practice against which firms can report, and for dialogue between the firms and investors in listed companies. In 2016 we enhanced the provisions in order to:

- Sharpen the Code’s purpose to ensure that a focus on high audit quality is at its core;
- Introduce a minimum number of Independent Non-Executives (INEs) for firms and a provision that at least one should have experience in audit or another relevant sector; and,
- Maximise transparency in reporting by the firms and their INEs.

However, the level of concentration in the UK market, and the reliance on big-four firms, requires us to develop and strengthen our regulatory approach because, if realised, the risks of a UK firm failing would have a grave impact on the market should a firm be unable to provide audit services. Although our powers fall far short of those of a supervisory regulatory authority, such as the Prudential Regulation Authority, we have responded with an enhanced monitoring approach for the largest audit firms - AFMAS, the pillars of which are set out earlier in this report. What this means is that we will be asking the firms to demonstrate to us the actions that they are taking in the public interest, to satisfy both themselves and policy makers that they are doing enough to ensure stability in the financial markets, through the provision of high quality and consistent audit, supported by enhanced levels of choice and competition.

30 See the analyses of the extent of market concentration in the UK audit market.
31 The Code was updated and enhanced in 2016.
Our work in this respect has already started with greater focus on the leadership of UK audit firms, as reported in Section 1 of this report. We have also undertaken enhanced monitoring work in two areas - contingency planning, and information security.

**Contingency Planning and Information Security**

For contingency planning, we focused on how the firms’ audit practices would respond to extreme and challenging scenarios. We used their contingency plans to assess their preparedness to recover from an event or events that might threaten their ability to deliver audit services. We also discussed with each firm how this fitted with their existing approaches to wider risk management and business continuity management.

In an extreme scenario, we examined firms’ plans where recovery is not achievable, to determine the impact this might have on financial markets, and how this might be minimised. This area of ‘resolution’ planning is one where more work is required. We expect firms to consider how audit services can be delivered to entities that they audit where a firm’s existence in the UK is under threat. Planning for the continuance of audit services is necessary to avoid disruption to capital markets, and ‘resolution’ plans are crucial in this respect.

Information security, including IT and cyber risks, is an increasingly important topic for audit firms, and one which carries significant reputational risk. Audit firms process large volumes of client data and are therefore vulnerable to data breaches or external cyber-attacks. Such incidents could carry with them significant operational and reputational risks. A confirmed vulnerability to external cyber-attack was highlighted in late 2017 by a data breach affecting an audit firm in the US where hackers gained access to a server containing information from bodies audited by the firm. Although the FRC’s remit is limited to UK audit firms, we recognise that damage to a global brand’s reputation could have consequences in the UK, particularly taking account of the extent of market concentration around a few large firms.

We reviewed UK firms’ risk management policies and procedures over information security, using a maturity framework based on recognised standards, to benchmark the firms. We provided feedback based on the information security risks affecting the firms, including areas for improvement.

The outcome of the contingency planning and information security reviews were reported privately to senior management and the independent non-executives of each audit firm, with the expectation that areas of weakness will be addressed. We have asked for progress reports from the firms on the actions they have taken to meet our concerns.
Section Four – Stakeholder Confidence in Audit

Our strategic objective is to promote justifiable confidence in UK audit. High quality audit promotes transparency and integrity and provides investors and other stakeholders with a significant level of assurance that financial statements give a true and fair view and provide a reliable and trustworthy basis for taking investment decisions.32

Since we last reported in 2017, stakeholders have raised increasing concerns about both the quality of UK audit and its effectiveness. There has also been increased Parliamentary scrutiny of audit quality including the structure of the UK audit market, and its implications for quality and choice.

The joint Business, Energy and Industrial Strategy and Work and Pensions Parliamentary Select Committee inquiry has sought explanations for the causes of high-profile corporate failures. Members of Parliament individually have increased their scrutiny of audit. In part, this has reopened the debate about whether what audit is currently designed to do is sufficiently responsive to the needs and expectations of stakeholders. Increased scrutiny has also raised more questions about whether auditors are sufficiently independent of the management of the companies that they audit and are able to demonstrate this effectively. The results of our audit inspections suggest that recent progress in improving audit quality has not been maintained, and in some areas has reversed in the last twelve months.

We have engaged with two key stakeholder groups, investors and audit committee chairs, to seek their current assessment of confidence in audit. We believe that audit, as a public good has a societal importance, and our views and our regulatory approach is determined by the wider public interest. However, these two stakeholder groups have a particularly direct relationship with auditors: investors as the primary consumers of independent assurance (the beneficial clients); and audit committee chairs as those responsible in law for ensuring the effectiveness and independence of their external auditors.

Investors have reported that they are more concerned about audit quality than they were a year ago; whilst feedback from audit committee chairs shows they are more concerned about the level of choice within the UK audit market currently, with a more favourable view of audit quality, and greater confidence in audit as a result.

The feedback from audit committee chairs is more favourable than the results of our own inspection work, a position consistent with the results from previous surveys. However, this may be due to respondents making their assessment based on both their views on the quality of the audit they have received, and the quality of the service received from the audit firm in delivering it.

32 FRC 2018/21 strategy
Investors

“Shareholders rely on auditors to ask tough questions and provide a thorough analysis of the company’s books. Auditors must ensure that the information ultimately provided to shareholders is accurate, fair and a reasonable representation of the company’s financial position. The only way shareholders can make rational investment decisions is if the market is equipped with accurate information about the fiscal health of the company.

Shareholders should demand the services of objective and well-qualified auditors at every company in which they hold an interest. Similar to directors, auditors should be free from conflicts of interest and should assiduously avoid situations that require them to make choices between their own interests and those of the shareholders they serve.”

We sought direct feedback from a diverse range of investors, from large institutional investors through to retail investors. Generally, the message was that the quality of audits being conducted for UK FTSE 350 companies remained high when compared internationally. Some told us that they did not believe market concentration between four large audit firms was impacting on quality – notwithstanding some individual, high profile failures. Investors also continue to focus more than other stakeholders on the underlying objectives of auditors – to provide independent assurance on financial statements and wider corporate reporting.

However, high-profile failure has taken its toll, with a majority of those we spoke to telling us that they were more concerned about audit quality than they were a year ago. Many also expressed frustration that issues impacting on audit quality and confidence in audit continually recur. A common example of this was the extent to which auditors were seen to be focused on a commercial business relationship rather than demonstrating that they are independent from the companies they audit.

Other areas of concerns raised with us included whether users of the financial statements are provided with the information they need to understand the work the auditor has done and the extent of the challenge to management that they have provided. This has increased stakeholder interest in audit firm culture, governance and leadership and whether it is sufficiently focused on the societal value of audit. Do auditors have the right incentives to act in the public interest, and do they understand their duties to investors?

Having a truly granular understanding of the audit process is only possible for those directly involved in an audit. This creates a barrier to others to understanding what is being done, and to whether it is delivering against the expectations of those who ultimately rely on it. The UK became the first major capital market to introduce extended auditor reporting, requiring auditors to report on their audit risk assessment, materiality and audit scope in a way which is accessible to and understandable to the users of financial statements.

UK Investors have welcomed the increased information but have also told us that it could be further enhanced by the inclusion of more specific information. This could cover how auditors challenged management – for example the tolerances used to test management estimates rather than generic references to management being within the ‘upper’ or ‘lower’ part of an undisclosed range; or more detail of areas where management and auditors took a different view, but the auditors were ultimately prepared to accept management’s judgement as reasonable.

Developments in international auditing standards, based on the FRC’s example have introduced new reporting requirements. Auditors now report on management’s use of the going concern basis of accounting, and on the information in the Viability Statement. Auditors also report on the extent to which their audit is capable of detecting irregularities, including fraud.

When confidence in audit is shaken, investors are concerned that they lack full transparency over critical aspects of the work that is being done on their behalf. Extended auditor reporting provides users with greater insight, however, to have trust in the information provided, investors need to have assurance that what is reported is both a fair reflection of the work being done, and that work is being carried out to a high standard. Where they feel that assurance is lacking, as a result of corporate failure, or poor inspection quality results this confidence is undermined.

**Audit Committee Chairs**

Audit Committees are responsible for the appointment of external auditors, challenging them to ensure that high quality work is delivered, and also evaluating auditor independence (including policies for the approval of the provision of non-audit services). The FRC undertakes an annual survey of Audit Committee Chairs, to gather feedback on audit quality. In 2018 we also included questions about audit tendering and the nature of competition in the UK audit market.

The results of the 2018 survey are shown in graphs 5 and 6 below. They show a slight drop in audit committee chairs’ satisfaction with the focus, approach, risk assessment, mind-set, culture and professional scepticism of their auditor. However, the overall message continues to be a positive one, with 86 per cent of Audit Committee Chairs rating their external auditor as either ‘excellent’ or ‘above average’ in 2018, compared to 90 per cent in 2017.

“We have seen a real commitment to continuous improvement and comprehensively addressing any issues raised from previous audits.”

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34 In 2018 we sent invitations to 800 Committee Chairs, with 248 responding (31%). The fieldwork was conducted on our behalf by YouGov between May and June 2018. Fieldwork would have been conducted before publication of our 2017 audit inspection findings.
“Audits are performed by people not robots. Therefore, as the customer we need to ensure quality of partner and depth of resources, quality methodology, adequate senior time commitment, as well as technical know-how.”

“Perhaps a strange measure but I tend to regard complaints from the execs as a healthy indicator of audit scepticism.”

“Slight concern that audit partner’s closeness with management affects robustness of challenge.”

“Dialogue was positive as we built internal processes to satisfy ourselves over auditor independence...[the auditors]... were objective and rigorous in calling out potential challenges to independence.”
On tendering, we asked respondents to rate their satisfaction with the quality and choice of candidates available. Only 42 per cent told us they were ‘highly’ satisfied.

**Graph 7: Satisfaction of Audit Committee Chairs with the quality and choice of candidates available when tendering.**

Audit Committee Chairs of larger listed entities told us that they believe only big-four firms have the resources and reach, expertise and experience to deliver a high-quality audit of a complex, global organisation. Many also told us that they were disappointed by the quality of the tender documentation and presentations they received from non-big four firms.

“Audit quality generally good, but difficult for a firm below the Big 4 to have the breadth of experience of a Big 4 firm.”

“Given technical nature can only really be from Big 4.”

“Outside the Big 4 there are not enough industry specialists.”

“Very difficult to find firms interested and with comparable depth of experience. The ‘law of unforeseen consequences’ seems to be in play in that we are in danger of ending up with a weaker external audit partner.”

“Even on AIM, there are no more than 2-3 credible non-Big 4 alternatives.”

“Disappointed that there is little reason not to go with a Big 4 firm. We did approach a smaller firm, but they did not come across as well and were no cheaper.”

However, the same audit committee chairs were also frustrated by limited choice, when tendering, because of independence conflicts for big-four firms, which make them ineligible for appointment. Often other, smaller firms are reluctant to participate in tenders.

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35 Note this is based on the responses of approximately 50% of our respondents who had either recently conducted a tender or were considering one.

36 2018 FRC survey of PIE Audit Committee Chairs
“The size of the company has restricted the number of non-big four firms prepared to tender. Some of the big four are conflicted through partners being shareholders in the company.”

“Several firms (including several below the big four) declined to tender, either due to conflicts or because they were not confident about their prospects.”

“It was a big issue. Two members of the Big 4 where conflicted because of non-audit work being carried out for the company. None of the second-tier firms remotely had the industry expertise or the regulatory knowledge.”

“I think it likely that some firms will not bid for audit work because being auditor restricts the other services they may provide. Audit fees, margins and risks make the audit unattractive.”

Our survey of audit committee chairs indicates a more positive assessment of confidence in audit. However, their comments about the lack of competition and choice point to systemic challenges in the UK audit market, and which continue to be the subject of significant debate.
Section Five – Future of Audit

The current UK context and the Kingman review

Responding to stakeholder concerns about declining confidence in audit requires a response not just designed to improve its quality. As we have already noted, we are enhancing our oversight of the major audit firms through our AFMAS work. We will shortly launch a post implementation review of the impact of the 2016 changes to our Auditing and Ethical Standards, and particularly those changes which sought to address threats to independence from non-audit work and prevent conflicts of interest from arising, in order to determine whether more needs to be done.

Concerns about whether the regulation of companies, accountants and auditors is sufficiently robust and pro-active to meet changing public expectations has also led the government to commission an independent review of the FRC by Sir John Kingman. The Kingman review is expected to reach conclusions and make relevant recommendations by the end of the 2018 calendar year.

For our part, our review of Audit Firm Culture identified areas where firms need to refocus on the public interest aspects of their work, including making sure that their staff have a clear understanding of the wider societal importance of what they do, in the public interest.

… we should be trying to close the expectation gap between what investors are looking for from quality reporting and auditing and what may be provided practically.38

We continue to think about how audit could evolve to better meet stakeholder needs and expectations and to better serve the public interest, over the medium and longer term.

The Future of Audit

We stated in our 2018/19 Strategy document that it is time to review the current statutory audit model and ask whether it can be made more effective. We also announced a review of the future of corporate reporting. We now believe it is sensible to take these projects forward together.

This will be a major and wide-ranging review, drawing on input from a wide range of sources. It will consider how corporate reporting should evolve in the future to meet increased demands for information and the need for audit or assurance of that information. Key areas to be considered in relation to audit include the scope of audit; its relationship with future risk, viability and going concern; the impact of new technology.

38 Investor feedback from FRC roundtable
**Going Concern**

The use of the Going Concern basis of accounting has been an area of concern, with wider confidence in audit affected by high profile collapses of companies a matter of months after unqualified audit opinions were given on financial statements. Our work builds on a series of earlier actions where the FRC has been proactive in its consideration of going concern, and where we have sought to lead a debate about the best way in which users’ needs and expectations in this area can be met. The FRC commissioned the Sharman Inquiry in 2011 to identify lessons for companies and auditors addressing going concern and liquidity risks. The recommendations arising from Lord Sharman’s Inquiry 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. Lord Sharman also made recommendations for international standard setters, given that standards are developed at a global level.

We are also currently undertaking a Thematic Review looking at the work that auditors do when reviewing the front half of the annual report (the ‘other information’) to ensure that the auditor has obtained evidence to allow them to report by exception that information is not materially misstated. We have now launched a project to determine whether, in the absence of plans at the international level, we can take actions in the UK to strengthen the framework of requirements auditors are subject to in this respect.

Our project focuses on the auditor’s work effort when undertaking an assessment of going concern, to determine whether the current auditing requirements are sufficient, and whether auditors need more detailed guidance to ensure that they meet the expectations of users of financial statements. We aim to complete this work to support a public consultation on any revisions to the existing standard and associated guidance material at the start of 2019.

**The International Dimension**

The nature of capital markets means that audit in the UK cannot and does not operate in isolation from international developments – whether through the existence of multinational companies requiring audit; global audit firms; the development of auditing standards; or cooperation between international regulators.

There have been important developments at the international level since our last report, which have the potential to significantly influence the future development of the audit profession. These include proposals to fundamentally reform international standard setting bodies, and ongoing revisions to foundational auditing standards. In addition, issues at a global level have highlighted the need for effective cooperation between regulators, and the potential reputational damage which can impact the other firms in a network.

The FRC is fortunate in being able to work with other independent audit regulators through IFIAR, which coordinates regulator approaches from different national regulators, and which is taking forward a project examining audit quality indicators, in response to the pending revision of ISQC 1 (covered in more detail later in this report).
**Monitoring Group**

The Monitoring Group is a group of international financial institutions and regulatory bodies committed to advancing the public interest in areas related to international audit standard setting and audit quality. In November 2017 it began a formal consultation on measures to strengthen the governance and oversight of the international audit-related standard setting bodies.

In addition to the public interest, the Monitoring Group has recognised a legitimate concern among many stakeholders that the influence of the accountancy and auditing professions over the standard setting process is at least perceived to be too strong, relying heavily on IFAC and large audit firms for resources. It also felt that a renewed focus is needed on whether the development or revision of standards is carried out in a sufficiently timely way. Some of the key areas consulted on by the Monitoring Group were:

- Reform of the standard setting boards, including whether the option of a single board with responsibility for the development and adoption of international auditing, assurance and ethical standards, or a dual board structure would best respond to the public interest;

- Potential changes to the membership of any such board, ensuring that it is representative of stakeholders, demonstrates appropriate diversity, with a remit to be more strategic and less operational in focus, as compared with the current model;

- Over time, nominations to the board(s) to become the responsibility of the Public Interest Oversight Board (PIOB) rather than the Nominating Committee of IFAC;

- Enhancing the role and remit of the PIOB, including a clearer articulation of how to assess whether a standard has been developed in the public interest; and

- Seeking a sustainable funding model in the medium-term to remove the current risk that those who fund standard setting are perceived to have an undue influence over the process.

The Monitoring Group is currently working on a series of formal proposals for reform based on the outcome and feedback from the consultation. It issued a feedback statement and identified next steps to be undertaken at the end of May 2018, with work aiming for completion by the end of 2018.

**Current IAASB Projects**

As the UK’s auditing standards setter, we work closely with the IAASB to ensure that our professional standards reflect the latest developments internationally. Our Director of Audit Policy is an independent public interest IAASB Board member, and we participate in a range of key IAASB task forces. This allows us to share our experiences, help drive innovation and enhance the UK’s interests and influence at a global level.

The IAASB continues to prioritise work on those standards which are fundamental to the audit process, in the context of the many new challenges the profession is facing. This includes revisions to two of the auditing standards relevant to quality control (ISQC1 and ISA 220), to the auditing standard which includes requirements addressing the identification and assessment of risks of material error in the financial statements (ISA 315), and to the auditing standard that deals with the audit of accounting estimates (ISA 540).
ISA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Developments in accounting frameworks have led to calls for enhanced auditing requirements and guidance to enable auditors to deal with increasingly complex accounting estimates and related disclosures. Audit inspections also identify that common areas of weakness when dealing with estimates are a failure by auditors to challenge assumptions made by management with a sufficient level of professional scepticism, and insufficient attention to disclosures. IFIAR publishes an annual summary of member regulators’ inspection findings for the six largest audit firm networks. Their most recent report found that accounting estimates was the area with the highest rate and greatest number of audit findings.

…most findings related to failure to assess the reasonableness of assumptions, including consideration of contrary or inconsistent evidence.39

The IAASB has responded to this by revising ISA 540, with key objectives including:

(a) Modernising the ISA for an evolving business environment by recognising the increased use of modelling, forward-looking assumptions, and external information sources; and

(b) Reinforcing professional scepticism through enhanced risk assessment requirements, more granular work effort requirements, and the requirement to “stand back” and evaluate the audit evidence obtained.

The Board has now finalised the standard, and the FRC is considering whether there are issues we need to address ahead of adoption in the UK. The FRC is also now updating our own Practice Note 19 (The Audit of Banks in the United Kingdom), which will contain worked Expected Credit Loss (ECL) audit examples. We are proposing to consult on the revised Practice Note in early 2019.

ISA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

The IAASB established a task force to consider potential revisions to ISA 315. It has now issued a consultation on proposed revisions to this standard. The IAASB’s work has focused on:

– Reflecting the 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 of the entity and its internal controls;

– Setting an enhanced risk assessment foundation, including for other standards (such as ISA 540 and ISA 600) and sharpen the auditors focus on the risk assessment in order to drive the most appropriate audit work; and

– Emphasising the importance of the appropriately Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

The IAASB consultation runs through to November 2018 and once finalised, the FRC will consult on adoption in the UK.

**International Standard on Quality Control 1: Quality Control for Firms that Perform Audits and Reviews of Financial Statements & ISA 220: Quality Control for an Audit of Financial Statements**

The IAASB’s work to revise ISQC1 deals with the audit firms management of quality, including governance, leadership and culture. The FRC is part of the ISQC1 task force which has the objective of enhancing audit quality through:

– The introduction of a Quality Management Approach, both at the firm level and at the level of the engagement. The QMA is a more pro-active approach to managing quality through the identification, assessment and response to quality risks in a broad range of circumstances; and

– Improvements in monitoring and remediation activities, including a greater focus on causal analysis.

This links closely to the conclusions from our audit inspection results and thematic reviews, where we believe the UK firms should continue to evolve their approaches to root cause analysis when things go wrong, as well as doing more to highlight good practice. These include:

– Enhancements to the firm’s activities when using the work of the network or a network firm;

– Reflecting evolving environmental influences (such as more advanced technology being utilised by audit firms, and evolution in audit delivery models); and

– Strengthening the auditor’s approach to planning and performing an audit, including a group audit. This includes enhancements to the standard in relation to engagement leadership, including greater specificity in the standard regarding engagement partners responsibility (e.g. for direction, supervision, and review on each audit engagement).

These enhancements should help address the areas of weakness we report in the section on audit quality in respect of group audits. ISQC1 will also strongly encourage firms to communicate, with external stakeholders about the firm’s system of quality management.

The revised ISA 220 focuses on strengthening individual engagement quality through better articulating the relationship between the firm’s system of quality management and quality management at the engagement level, with application material to highlight that blind reliance on the firm’s policies and procedures is not appropriate. The revision of the standard has also driven an amendment to the Objective of ISQC1 – to make it
less compliance focused and ‘require’ firm’s to “fulfil their responsibilities in relation to professional standards” as opposed to “comply with professional standards”.

The revised standard focuses on the leadership of an audit engagement, given the importance of the Engagement Partner’s (EPs) overall responsibility for achieving quality on the audit engagement, and for the EP to set the right tone. The standard also clarifies the requirements and application material in respect of the audit team’s responsibilities in relation to relevant ethical requirements, and a new “stand-back” in relation to the required statement on independence in paragraph 28(c) of ISA 700 (Revised).

The IAASB will consult on these revised standards in late 2018 or early 2019. Once finalised, the FRC will then consult on adoption in the UK.

**Advances in Technology**

Developing technologies such as Blockchain and Artificial Intelligence, as well as enhanced data analytics capabilities have the potential to profoundly change the way in which companies operate, and the way in which audit and assurance activity is carried out. These opportunities and threats are not restricted to the UK, and have an important international context.

Audit firms have invested heavily in technology in recent years. In smaller firms this has seen investment in support tools which allow the testing of journals, or the selection of sample items with greater rigour, sometimes using off the shelf packages. One of the drivers for this investment is to enhance audit quality through the consistent application of an audit methodology, and to draw conclusions based on an approach that has tested a far greater proportion of the transactions that are contained in the financial statements of an entity than would be the case through a ‘traditional’ approach based on sampling. Technology also permits the auditor to undertake a risk assessment which draws on a much broader insight that sophisticated analysis of the underlying data allows for.

In addition, audited entities increasingly have access to their own ‘audit’ software for use as part of a new approach to internal control. If management makes use of sophisticated analysis to support its own decision making, and has invested in the capability, then they may well question a more ‘traditional’ audit approach, and also the auditor’s assessment of significant risks in an entity, based, for instance on the results of their own continuous monitoring. The internal control environment of audited entities may be transformed from the current model of checks and balances towards greater reliance on technology. Audited entities may also be reluctant to accept and address the auditor’s findings and recommendations if they are contrary to management’s own understanding. The auditor may have ethical concerns about the extent to which they can place reliance on management’s own systems and processes – as well as the work effort required to earn the right to place that reliance.

The FRC has held an ongoing dialogue with audit firms about the consequences of greater use of technology. That dialogue has not identified any failings in the current suite of auditing standards, which we believe remain fit for purpose. However, there are clearly areas of uncertainty that have emerged from applying new technologies to address the requirements of the auditing standards, and in dealing with some of the challenges there are areas of inconsistent market practice. We are also contributing to dialogue and debate at the international level through our involvement with the IAASB’s Data Analytics Working Group.
Appendix One – Big Six Firms’ Audit Quality Performance

The results of our reviews of the KPMG’s audits over the past five years have been disappointing. The firm’s 2017/18 inspection results show further deterioration, with only 50% of the FTSE 350 audits inspection being assessed as good or requiring no more than limited improvements.

Our key concern is the lack of consistent execution of audits within the firm. Whilst we have seen improvements in certain areas where we have raised findings in previous years (for example, the audit of revenue), it is clear that previous changes to the firm’s policies and procedures have not, to date, brought about the improvements required to the overall quality of audits we have reviewed.

KPMG’s senior UK management changed in July 2017. The new leadership shares our concerns and have responded positively and with urgency by developing a range of short and longer-term actions. We are reviewing the firm’s Audit Quality Plan and related processes in detail and increasing our engagement with senior staff and the firm’s Independent Non-Executives. In the light of our 2017/18 inspection results, and the trend of disappointing results, we will also increase by 25% the number of KPMG audits that we inspect in 2018/19.
The overall results of our reviews of the firm’s audits show that 67% were assessed as requiring no more than limited improvements, compared with 88% in 2016/17. This is a disappointing outcome in comparison to the progress made in the previous two years. Of the FTSE 350 audits we reviewed this year, we assessed 82% as achieving this standard compared with 92% in 2016/17.

Where we identified concerns in our inspections, they related principally to the audit of aspects of provisions in financial services entities and the audit of pension scheme assets and liabilities. The firm continues to take action to improve audit quality. It has continued to implement its Audit Quality Programme, including a focus on audit team behaviours, the firm’s Audit Quality Support Team, coaching and project management. We have seen improvements in all areas where we had key findings last year, in particular the audit of revenue, including the use of revenue data analytics, and communications to audit committees.
The overall results of our reviews of the firm’s audits show that 76% were assessed as requiring no more than limited improvements, compared with 78% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 79% as achieving this standard compared with 82% in 2016/17. We are concerned at the lack of improvement in inspection results.

Where we identified concerns in our inspections, they related principally to aspects of group audit work, audit work on estimates and financial models, and audit work on provisions and contingencies. During the year Deloitte has continued to develop the use of “centres of excellence”, increasing the involvement of the firm’s specialists in key areas of the audit. We have no significant issues to report this year in most of the areas we reported on last year.
The overall results of our reviews of the firm’s audits show that 82% were assessed as requiring no more than limited improvements, compared with 93% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 84% as achieving this standard compared with 90% in 2016/17. We are concerned at the decline in inspection results by comparison with the previous year.

Where we identified concerns in our inspections, they related principally to the challenge of management’s estimates and certain aspects of group audits. The firm has focused on further improving its procedures relating to coaching, supervision and review. We have seen an improvement in relation to most, but not all of the key findings we highlighted in last year’s report.
The results of our reviews of individual audits show a continued improvement in recent years, with seven of the eight audits reviewed requiring no more than limited improvements. We have seen an improvement in relation to some of the key findings highlighted in last year’s report, although we continue to identify shortcomings in certain areas (for example, the quality of communications with Audit Committees on significant findings).

The firm had revised most its policies and procedures in response to the revised Ethical and Auditing standards. At the time of our review, however, the firm’s systems and procedures for the monitoring of personal financial interests and implementing certain other requirements of the revised Ethical Standard, required improvement.
Grant Thornton (all audits inspected)

The results of our reviews of individual audits show some improvement from 2016/17, with six out of eight audits requiring no more than limited improvement. We also identified more instances of good practice arising from our reviews. We did, however, continue to identify findings in relation to the extent of challenge of management in relation to areas involving judgement and the consideration of independence and ethics matters. These two areas individually contributed to two audits being assessed as requiring significant improvement.

At the time of our review, the firm had made progress in revising its policies and procedures in response to the revised Ethical and Auditing Standards. Further improvements were, however, required to the firm’s systems and procedures in certain areas, including non-audit services approvals and the monitoring of personal financial interests. Since our last public report, which highlighted a number of findings related to auditor independence, the firm has recruited further resource into its ethics function and has maintained a strong focus on improving procedures in this area.