Guidance

Financial Reporting Council

December 2019

Audit Quality

Practice aid for audit committees

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

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1 Introduction

Background

1.1 The directors of a company (the Board as a whole) are responsible for ensuring its financial statements are prepared in accordance with the applicable financial reporting framework and for overseeing the company's internal control framework. A 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[1] and provide a reliable and trustworthy basis for taking decisions.

1.2 Audit committees serve the interests of investors and other stakeholders through their independent oversight of the annual corporate reporting process, including the audit of the company's financial statements. The audit committee is responsible for the appointment of the external auditor, approval of their remuneration and any non-audit service work commissioned. The audit committee is also tasked with challenging the auditor over the quality of their work and ensuring that the auditor's independence is not compromised. It reports on the work done, and the conclusions drawn, in the annual report. The audit committee, through its interactions with the auditor and with the other directors and management, can play a key role in facilitating a high-quality audit.

1.3 The first edition of this Practice Aid was issued in May 2015 (the 2015 edition). It responded to requests from many audit committee members who asked the FRC to provide some practical guidance on how they might conduct their assessment of the effectiveness of the external audit. In particular, they often suggested that it is relatively straightforward to assess service levels in the external audit process, but less so to assess audit quality. Quite often, we found that high-quality service becomes a (misleading) proxy for high-quality audit.

1.4 Since May 2015, there have been significant changes in the governance and auditing framework[2] which continues to emphasise the fundamental role of audit committees in effective stewardship. Further changes may be required to respond to recommendations of the Competition and Markets Authority (CMA) study of the statutory audit services market.[3] These changes are likely to include increased regulatory scrutiny of audit committees, including to ensure that they select auditors based on the quality of audit rather than other criteria. Other independent reviews of the quality and effectiveness of audit may also result in new requirements and recommendations and the audit committee should be alert to those.

1.5 Legislation enacted in June 2016 introduced a requirement for all Public Interest Entities (PIEs) to conduct a tender at least every 10 years and rotate auditors after at least 20 years[4]. The legislation includes specific responsibilities for PIE audit committees in respect of tender processes. An effective tender process is a key step in obtaining a high-quality audit. In February 2017, the FRC issued an update of its publication ''Audit Tenders – Notes on Best Practice''[5].

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1 In the UK, the auditor's opinion is on whether the financial statements give a true and fair view in accordance with the framework. ISA (UK) 700 (Revised June 2016), Forming an Opinion and Reporting on Financial Statements, paragraph 25.

2 This includes further revisions to the UK Corporate Governance Code. In April 2016, the Code was revised as a result of the Government's implementation of the EU Audit Directive and as follow up to the report by the Competition Commission on the market for audit services in FTSE 350 companies. In July 2018, the Code was revised again following a comprehensive review that took account of the FRC's work on corporate culture and succession planning, the issues raised in the Government's Green Paper on corporate governance reform, and the report by the Business, Energy and Industrial Strategy (BEIS) Select Committee Inquiry on corporate governance.

3 In July 2019, BEIS issued an Initial Consultation on Recommendations by the Competition and Markets Authority.

4 in 'exceptional circumstances' the audited company can apply to the Competent Authority for an extension of up to two years. The FRC has published instructions for the process for applications to extend the maximum duration of the audit engagement.

5 Audit Tenders – Notes on Best Practice (February 2017).

1.6 The 2018 UK Corporate Governance Code includes a provision requiring the annual report to describe the work of the audit committee, including an explanation of how it has assessed the effectiveness of the external audit process.[6] This assessment should include how the auditor has responded to regulatory oversight, including the results of any audit inspections carried out on the audit of the company.

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

Developing this Practice Aid

1.8 The 2015 edition of this Practice Aid arose out of the feedback from roundtables organised by the FRC where an approach to assessing the effectiveness of the external audit was considered by key market participants[7]; with a focus on audit quality and the financial statement process. It was intended to provide audit committees with some guidance on audit quality and best practice that they can consider as they design or update their own assessment processes. Much of that feedback remains relevant.

1.9 This 2019 update takes account of the developments in the governance and auditing framework and further FRC research since the 2015 edition was issued. New sections have been added on audit tendering and transparency of audit committee reporting. Responding to comments from audit committees, some of the background material has been consolidated and shortened and the illustrative considerations for audit committees have been updated, made more practical in their focus, and more clearly presented in separate appendices.

Applicability

1.10 The audit committee has wide ranging roles and bears significant responsibility in supporting the Board, including overseeing the company's relations with the external auditor and reviewing the effectiveness of the external audit process.

1.11 The 2018 UK Corporate Governance Code requires that members of an audit committee typically have a range of recent and relevant business and financial experience,[8] which provide them with a collective ability to challenge the auditor to demonstrate that they have performed a high-quality audit, and evaluate the auditor's responses through a variety of different lenses.

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

1.13 While the Practice Aid is designed for audit committees of Premium Listed companies it may assist audit committees of other entities, particularly those adopting the Corporate Governance Code voluntarily.

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6 Section 4, provision 26, The UK Corporate Governance Code (July 2018).

7 Participants included audit committee members, investors, financial management and auditors – who gave feedback on the proposed approach, and shared some of their own experiences and expectations.

8 Section 4, provision 24, of the UK Corporate Governance Code (July 2018) requires the Board to satisfy itself that at least one member of the audit committee has recent and relevant financial experience. This provision overlaps with FCA Rule DTR 7.1.1A R which requires that at least one member must have competence in accounting or auditing or both.

How the practice aid is structured

1.14 **Section 2** presents an overview of the audit tender process and the audit committee's role. A good tender process is a key step in ensuring an auditor is appointed who can deliver a high-quality audit. **Section 3** presents an overview of an assessment of the audit**. Section 4** addresses audit committee reporting and transparency of the assessment of the effectiveness of the external audit. The appendices give background information on key audit judgments, illustrative considerations for audit committees undertaking an assessment, and references to other FRC publications that audit committees may find helpful.

2 **Providing for audit quality** – Audit tenders

2.1 The audit committee's assessment of the external audit process is in effect an assessment not just of the auditor but of whether the process as a whole has been successful. A critical factor in ensuring a successful process to achieve a high-quality audit is to ensure that it starts well, appointing an auditor who is able to deliver a high-quality audit.

2.2 One of the objectives of audit firm rotation is to prevent auditors developing overly close relationships with a company's management. Such relationships can lead, among other things, to an overly familiar or collaborative approach leading to the auditor being insufficiently questioning of management's view, which is detrimental to audit quality. The audit tender process provides the opportunity to identify and appoint the audit firm that will provide the highest quality and most effective audit. That may be determined to be the incumbent auditor, who could continue if the maximum term in office has not been reached, but it may also identify that a change of auditor could be beneficial.

2.3 Legislation enacted in 2016 includes specific responsibilities for PIE audit committees in respect of audit tender processes, including responsibility for the selection procedure. The FRC's publication, "Audit Tenders – Notes on Best Practice" has been updated to take account of the legal requirements, which include:

- Audit committees must submit two possible audit firm options for the engagement to the Board, together with a justified preference for one of them.
- The tender process cannot preclude the participation of challenger audit firms.
- Ensuring that the tender process provides information to the participating firms that allows them to understand the audited company's business.
- Ensuring that the tender process uses transparent and non-discriminatory selection criteria to evaluate the proposals and that a report on the conclusions of the selection procedure is prepared and validated by the audit committee.
- The audit committee should consider the findings and conclusions of the public reports on the quality of audit carried out by UK audit firms published by the FRC.

2.4 The amount of work involved means that management and others in the company may be involved in the tender process, for example in information gathering and research into the different firms and audit partners that might be invited to tender; assisting with the preparation of the invitations to tender; and reviewing the audit firms' proposals. Management may also need to help the audit committee liaise with the audit firms to provide them with the information they need to prepare their tender proposals. However, it is important the audit committee fulfils its overarching responsibility for the selection procedure.

2.5 All members of the audit committee should be involved throughout the tender process, not just attending the audit firms' final presentations. While it may take support and advice from management, the audit committee is responsible for the key decisions including which firms and audit partners are invited to tender and, ultimately, which options are submitted to the Board and the audit committee's justified preference.

2.6 A typical tender process may involve three or four audit firms. In some industries, however, there may be circumstances such as conflicts of interest and limited numbers of firms with the necessary expertise that make it difficult to identify more than two.

2.7 In some cases, the audit committee may find that some eligible audit firms are unwilling to tender for an audit. In such circumstances the audit committee may communicate with those firms to seek to obtain an understanding of why they are unwilling to tender and whether there is anything that could be done that might change that. The audit committee should also consider asking those firms how such action is in the public interest. There may be good reasons for not tendering, like a lack of sufficient resources available to take on certain new engagements. In such circumstances, the audit committee should ensure that it has not excluded other firms from tendering without good reason to believe they would not be able to perform a high-quality audit. It may also be helpful for audit committees to remind eligible firms that refuse to tender that they may as a result be ineligible to bid for non-audit services work.

2.8 The ultimate beneficial clients of a statutory audit are investors and other stakeholders, not companies, and audit committees are acting on their behalf. Companies and audit committees may, therefore, communicate with investors and other stakeholders before the formal tender process commences and seek investor views on matters such as the selection criteria and how audit quality will be assessed to inform their choice of participating firms. For example, companies listed on the London Stock Exchange could issue a Regulatory News Service (RNS) announcement.

2.9 With a focus on audit quality, it is important that audit committees take into account the capabilities of the audit team at each firm, including, in particular, the proposed engagement partner. Audit firms should be asked to put forward two or three partners at the start of the tender process for the audit committee to choose who should lead the tender.

2.10 To enable the audit committee to get the best understanding of the capabilities of the audit teams they are assessing, it is important that the tenders are led by the engagement partners who it is intended will serve in that role for the five years before partner rotation is required. Audit committees may not get the best understanding if tenders are led by "star" audit partners who, if the firm wins the tender, are then rotated off the engagement before the end of the five year term or who, in reality, delegate much of the audit activity to another partner.

2.11 Another important element of the preparation process of the audit committee is to define the critical success factors for the audit proposal, with a focus on high-quality audit. These will be different for each company but, at a high level, may include:

- The overall level of resource (including the seniority and experience of key staff) that will be dedicated to the audit;
- Industry expertise of the firm and audit team;
- The depth of expertise within, or available to the firm – having, or developing, sufficient partners and staff with relevant expertise to allow for unforeseen events (such as illness) and transitions when meeting rotation requirements;
- Experience and audit quality record of the lead partner and the firm;
- Experience of other key members of the audit team;
- The proportion of audit hours that will be carried out by senior members of the audit team compared to the entire audit team;
- The availability and use of specialists where appropriate;
- Planned use of technology in the audit process;
- Use of centralised service centres for the audit (sometimes referred to as 'offshoring') and how quality of that work is controlled;
- Geographical coverage of the firm and its network, especially where the engagement is a group with a diverse global or regional footprint;
- Experience in transitioning similar audits; and

- Results of external and internal audit quality inspections of the audit firm and how any issues have been addressed.

2.12 At a more detailed level, audit committees also obtain, as far as practicable, an understanding of factors they consider when assessing the quality of an ongoing/completed audit, including:

- Mindset and culture.
- Skills, character and knowledge.
- Quality control.
- Judgment.

These are considered further in Section 3 in this Practice Aid. The audit committee should prioritise independence, technical competence and the ability to deliver a high-quality, robust, sceptical and appropriately challenging audit over cultural fit and relationships with management.

2.13 A successful audit tender should have clearly explained how a high-quality audit will be delivered. This will also help provide audit quality indicators that can be used when assessing the effectiveness and quality of the actual audit.

Fees

2.14 The audit committees should conduct the fee negotiation, rather than management. Fees should not be excessive, but it is important that they are sufficient for the firm to be able to provide a high-quality audit and ensure access to any specialised resources that are required. When evaluating the tenders, high audit quality should be the primary criterion - the cheapest tender may not provide a high-quality audit. To ensure that the focus of the evaluation is driven by quality, it may be helpful to carry out a ‘price blind’ evaluation.

Auditor independence – forward planning

2.15 Forward planning in anticipation of audit tenders is critical to ensure that those audit firms that might be invited to tender are independent of the company. Firms that currently are not the auditor but that have provided other services to the company may not necessarily become independent immediately simply by ceasing to provide those services. Some services could establish an ongoing threat to a firm’s independence. For example, if they could have a material effect on the financial statements in future periods and thereby create a self-review threat if the firm was to subsequently be appointed auditor. Firms that have provided services to PIEs relating to: designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information; designing and implementing financial information technology systems; and providing internal audit services are prohibited from accepting appointment as auditor for the financial period during which the services were provided and the subsequent financial year.

2.16 It is essential, therefore, that companies that use several firms for advice and services should have a long-term strategy to ensure that firms the audit committee may wish to participate in the audit tender process will satisfy auditor independence requirements. Failure to do this may limit the choice available to the audit committee when tendering for an auditor able to provide the highest quality audit.

3 Overview of an assessment

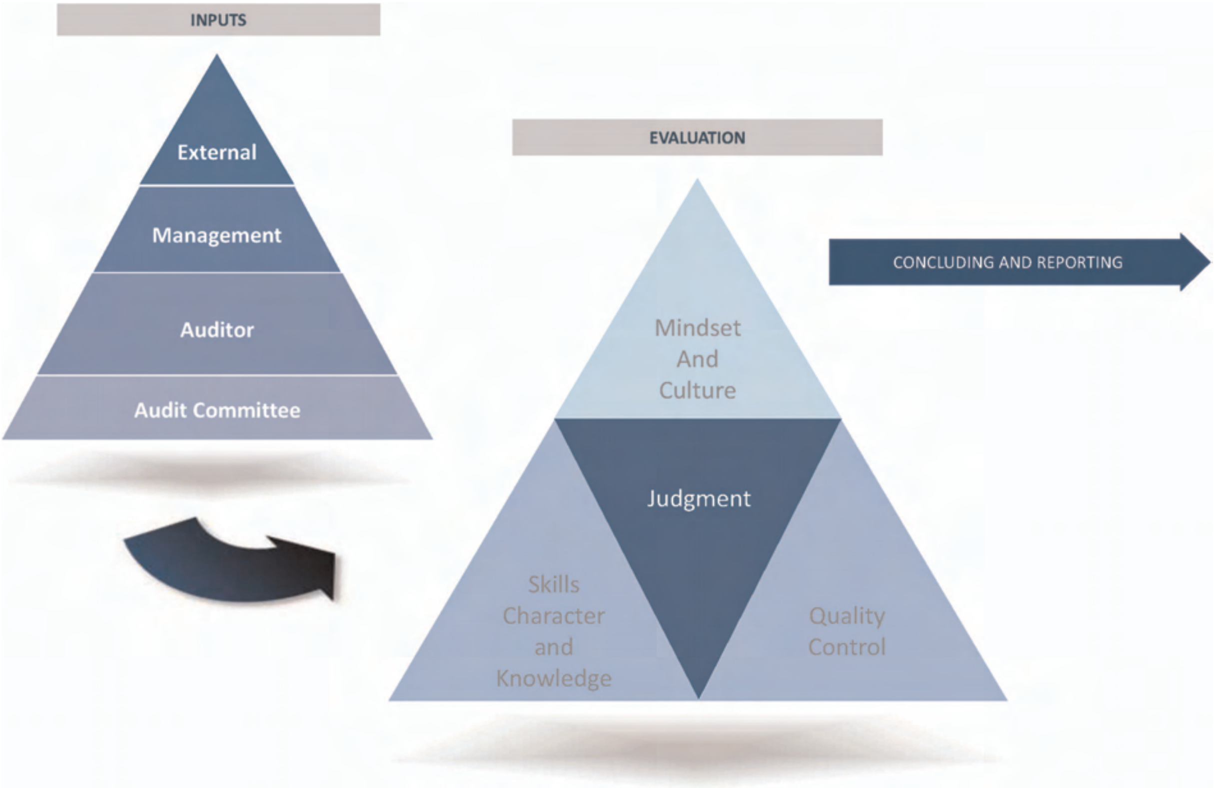

Diagram 1: Overview of an assessment

Introduction

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

3.2 This section highlights factors that audit committees may consider when making the assessment of the quality of the external audit (and hence the effectiveness of the external audit). The assessment is not an 'audit of the audit' and it does not involve the audit committee obtaining access to the auditor's working papers.

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

3.4 A 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[9] and provide a reliable and trustworthy basis for taking decisions (or results in an auditor's

[9] In the UK, the auditor's opinion is on whether the financial statements give a true and fair view in accordance with the framework. ISA (UK) 700 (Revised June 2016), Forming an Opinion and Reporting on Financial Statements, paragraph 25.

report that sets out the basis for any disagreement with management or restriction on the ability of the auditor to give an opinion.

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

Inputs (sources of evidence)

3.6 The audit committee bases its assessment on information obtained in the course of undertaking its activities for oversight of the financial reporting process. A primary source of such evidence is likely to be its observations of, and interactions with, the auditors. However, the quality of relationships between the auditor, management and the audit committee, on its own, should not be taken to be a proxy for the quality of the audit.

3.7 Audit committees can obtain important supplementary evidence through interactions with management and other key company personnel, such as internal auditors, and directly or indirectly, from certain external parties such as regulators.

Auditor inputs

3.8 The auditor's initial communications with the company may include tender documents (see Section 2) and related interviews. During the audit cycle, the most important documents will include the audit plan, the audit findings and the auditor's external report. The auditor should be able to explain to the audit committee at the planning stage how the audit firm addresses audit quality, the criteria it has established and how quality is driven throughout the audit.

3.9 Under extended auditor reporting[10], audit committees have a further opportunity to assess audit quality by reviewing the auditor's external report. The audit committee can assess the auditor's ability to explain in clear terms what work they performed in key areas, and also assess whether the description used is consistent with what they communicated to the audit committee, e.g. in the detailed audit plan.

Audit committee and auditor interaction

3.10 The most direct evidence to support the committee's assessment can be obtained by the audit committee asking open questions of the auditor, management and others. The committee can challenge where it needs further explanations or where it identifies apparent inconsistencies with its own knowledge. The level of engagement of the audit committee with the auditor, management and others, and the tone of the audit committee, can be very influential on the effectiveness of the external audit process. The auditor has legal right of access at all times to the company's books and to require certain persons, including any officer or employee of the company, to provide such information or explanations as the auditor thinks necessary for the performance of the

[10] ISA (UK) 701, Communicating Key Audit Matters in the Independent Auditor's Report, requires auditors reporting on companies which apply the UK Corporate Governance Code to explain more about their work, particularly with regard to audit scope, risks of material misstatement and materiality.

auditor's duties. The audit committee should review and monitor management's responsiveness to the auditor's requests for information, and the auditor's findings and recommendations, and should support the auditor in appropriate challenge of management.

3.11 The auditor's procedures should be designed and performed in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (see paragraph 3.38). Where, after challenging management, the auditor has accepted management's position, the auditor should be able to demonstrate that there is sufficient appropriate evidence to justify that position, and that the auditor has not compromised their challenge, nor ignored contradictory evidence, because of an overly close relationship with management or succumbed to pressure from management.

3.12 The audit committee should consider, where applicable, how the auditor has responded to its previous assessments of the audit quality and whether any concerns expressed by the audit committee have been addressed satisfactorily. The committee might also ask the auditor about the firm's own internal control processes including any hot review and cold review processes, issues arising from the engagement quality control (second partner) review, and how any such issues were addressed,

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

3.14 The frequency of communication is important, but communication is also likely to be of more value to the audit committee if it is open and frank, constructive and informative and not littered with technical terms or boiler plate. Audit committees should challenge their auditor where the communications they are provided with are not clear and do not help the committee in its understanding of the audit and challenge of the auditor.

Evidence from management and others

3.15 Audit committees might also seek input from those subject to the audit. For example, they might use tailored surveys to help with their assessment of audit quality, taking appropriate account of the risks of incentives to bias from these sources. Asking for demonstrable evidence and examples of effective auditor challenge is one way of reducing these risks. The audit committee should support the auditor in appropriate challenge of management and feedback from management should be assessed in that context, especially where the auditor raised significant concerns. The auditor, and audit committee, should be robust in ensuring concerns raised with management are addressed satisfactorily and that agreed positions are appropriate and justifiable.

3.16 The inputs the audit committee receive are likely to be more credible the more evidence-based they are. If the audit committee seeks input from management and others through the use of an assessment checklist, the audit committee may wish to discuss the completed checklists with selected respondents and ask specific questions to identify why the respondent believes that the auditor has demonstrated certain characteristics, such as technical competence, appropriate scepticism and challenge and understanding of the company's business and circumstances, and the risks relevant to its financial reporting. This can avoid the completion of checklists becoming a "tick box" exercise.

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

External evidence

3.18 Obtaining external inputs from investors and other stakeholders who are willing to provide it could also help to inform the audit committee's views as it considers matters of audit quality. Audit committees could, for example, seek input by writing to, or meeting with, investors and other stakeholders.

3.19 Audit quality inspection reports are a key source of external evidence on aspects of audit quality. The FRC's Audit Quality Review team (AQR) writes a report on each individual audit it reviews and sends a copy directly to the audit committee chair of the company concerned. These reports are specifically designed to assist audit committees in undertaking their assessment of the effectiveness of the external audit, and also provide a basis for the committee to challenge the auditor over the actions that they propose to take to address any identified weakness in audit work or audit quality.[11]

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

3.21 The AQR also issues individual annual public reports on its audit quality inspection findings, together with thematic inspections reports. Included in the AQR reports are the results of Third Country Auditor inspections. The AQR also issues each year an overview report[12] focused on assessing justifiable confidence in UK audit and also summarises the current 'state of play' as seen by the FRC and its stakeholders. It is supplemented by a more detailed report of the FRC's audit related activities and evidence gathering.

3.22 Audit committees should discuss the issues raised in the company's external audit inspection report with the auditor to ensure they fully understand the potential implications for the quality of the audit. Audit committees should also discuss remedial actions taken or planned by the audit engagement partner and the audit firm to address these issues and how they will enhance the quality score rating given by the AQR. If they have not already had one, audit committees may also seek a meeting with the audit inspectors in connection with the auditor's inspection report. Such a meeting with the inspectors may be bilateral, without company management attending.

3.23 Audit firms operate monitoring policies for audit quality and, as part of that, particular audits will be subject to review by inspection teams organised by the firm who are independent of the audit team. These are required to include, on a cyclical basis, at least one completed engagement for each engagement partner.

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[11] Where a company's audit has been reviewed by the AQR, the FRC expects audit committees to discuss findings with their auditors and consider whether any of those findings are significant for disclosure in the Report of the Audit Committee on the effectiveness of the audit process.

[12] Report on Developments in Audit.

3.24 The audit committee should discuss with the audit engagement partner the audit quality indicators used by the firm and the results of the firm's own monitoring processes for the audit business, including for the engagement partner. The engagement partner should be asked to explain how the current audit rates in relation to those quality indicators. If the company has been included in the monitoring cycle the results of that inspection should be considered. The audit committee should also discuss remedial actions taken or planned by the audit engagement partner and the audit firm to address issues identified and how they will enhance audit quality.

3.25 The FRC Corporate Reporting Review team (FRC CRR) aims to review the FTSE 350's report and accounts in full at least once every five years. Other companies are also within the CRR remit[13], although they may be reviewed less frequently.

3.26 Where there has been interaction with the FRC CRR, the audit committee should consider how that feeds into the assessment of audit effectiveness – for example, how do matters raised by the auditor compare with those raised by the FRC CRR?

Evaluation

3.27 Evaluation of audit quality entails assessing four key elements:

- Mindset and culture.
- Skills, character and knowledge.
- Quality control.
- Judgment.

Mindset and culture

3.28 The auditor should adhere to high professional and ethical principles, to protect their integrity and independence. The auditor should not have any personal or commercial interests that would (or would be seen to) conflict with the responsibilities of their role. The audit firm should support both an appropriate personal mindset for auditors and an appropriate audit firm culture[14].

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

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

[13] Companies within CRR remit include listed companies, UK AIM quoted companies, large private companies and limited liability partnerships.

[14] Audit Culture Thematic Review: Firms' activities to establish, promote and embed a culture that is committed to delivering consistently high quality audits (May 2018)

Skills, character and knowledge

3.31 Auditors should have strong auditing skills (investigative, analytical and judgmental) developed through effective training and relevant experience.

3.32 Auditors also need to be knowledgeable about business, the industry and the environment in which the company operates, and about the legal and regulatory frameworks that underpin both their responsibilities as a statutory auditor and the company's financial reporting process and outputs. Auditors also need to understand those issues which are of greatest importance to users of the financial statements and consider how they address these matters in their audit and their report on the audit.

3.33 Auditors should demonstrate strong personal attributes in performing their work, such as effective communication skills (clarity and brevity), and rigour, perseverance and robustness. These attributes enable auditors to undertake their role with professional scepticism and exercise an appropriate degree of challenge to management, whilst maintaining effective working relationships with management and other employees.

Quality control

3.34 Effective quality control of an audit engagement involves identifying the risks to audit quality and establishing adequate controls at the engagement level to address these, taking account of controls at the audit firm level. In a group audit, this includes establishing controls over risks to audit quality relating to component auditors' work. Quality control, including firm level controls, can also help auditors improve their application of professional judgment by setting a tone that emphasises the need to apply professional scepticism and an appropriate degree of challenge to management.

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

Judgment

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

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

3.38 In the **planning stage**, the auditor:

- Develops an understanding of the company, its business and the environment in which it is operating, including the company's financial reporting process and the applicable financial reporting framework;
- Makes judgments about materiality (i.e. what would influence the economic decisions of users based on the financial statements);

- Identifies risks of material misstatement in the financial statements whether inherent or control related, and assesses their likelihood and impact;
- Resources the audit in a way that will provide sufficient resource and skill to carry out a high-quality audit; and
- Designs procedures that are both appropriate by their nature for the assertions[15] to be tested, and sufficient in extent, to enable the auditor to conclude with a high level of assurance whether the financial statements contain material misstatements. These procedures are focused most intensely on addressing the risks judged most significant and are designed and performed in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

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

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

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

3.40 The auditor's key communications with the audit committee include the audit plan[16] and their audit findings. The former deals with the auditor's planning judgments and the latter with their judgments about the key issues arising. The auditor has ample opportunity, therefore, to demonstrate that they have applied sound judgment in both the planning stage and in the performance and evaluation stage of the audit. The auditor can also demonstrate that they have the necessary skills, character and knowledge, mindset and culture and have exercised effective quality control over the audit.

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

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

3.42 Further material that provides context to an understanding of the auditor's judgments is given in Appendix 1.

[15] Assertions - Representations by management, explicit or otherwise, about financial information in the financial statements, used by the auditor to consider different types of errors that may occur.

[16] Guidance on Audit Committees (April 2016), paragraph 75: At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit. The committee should consider whether the auditor's overall work plan, including planned levels of materiality, and the proposed resources to execute the audit plan, appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team.

Carrying out the evaluation

3.43 Audit committees should obtain evidence of quality throughout the audit and particularly at the planning stage, not just focus on the outputs of the audit. For example, audit committees could:

- **Hold an initial audit committee discussion without the auditor** (perhaps shortly after the completion of the previous year's audit) to 'brainstorm' factors that could affect audit quality for the current year audit. This exercise can draw on: past experience of the audit, the audit engagement team and the audit firm; dealing with changes to the engagement team or to the audit firm as a result of auditor rotation; anticipated changes in the business and the business environment; and the financial reporting framework. This discussion might be primed by asking the auditor to provide relevant inputs and by obtaining, through company resources, relevant inputs from other public sources (such as inspection reports). It would also be informed by audit committee members' own experience and knowledge, including any previous assessment of the auditor.
- **Ask the auditor**, when presenting the audit strategy and plan for the current year, to explain the **risks to audit quality** that they identified.
- **Probe and challenge the auditor's strategy and plan** in light of the outcome of the audit committee's initial audit quality discussion. The audit committee may wish to do so with some broader challenges but could also 'deep dive' in one or more areas of particular significance identified in the initial discussion. Doing so may provide the audit committee with greater insight into the topic of discussion, including activities of the auditor, as well as giving the auditor an opportunity to demonstrate their mindset and culture, and their skills, character and knowledge.

3.44 A **greater focus on challenging audit quality at the planning stage** could then be linked to steps the audit committee may take later in the audit. This could include **an audit committee discussion to reflect on their views on audit quality** based on the earlier steps in the process and weigh the evidence they have received in relation to each of the judgment areas and supporting elements.

3.45 Examples of matters for the audit committee to consider in relation to key areas of audit judgment are given in Appendix 2. Illustrative audit committee considerations in evaluating the auditor's supporting competencies (mindset and culture, skills, character and knowledge, and quality control) are given in Appendix 3).

3.46 The audit committee should consider how well the auditor has contributed to enhancing the quality of the company's financial reporting, including whether they have exercised professional scepticism, made appropriate challenges of management and discussed issues with the audit committee. When assessing the auditor's external report (see paragraph 3.9) the audit committee should consider how well the 'key audit matters' are addressed, including in particular the auditor's risk assessment, consistency with what has been communicated to the audit committee and with the audit committee's own views. The audit committee also considers how well written is the auditor's report and whether it gives helpful information to readers, specific to the company and avoids 'boiler plate'.

3.47 The audit committee may also benefit from asking the auditor for their perception of the external audit, to provide constructive feedback on their interactions with senior management and other members of the finance team, as well as with the audit committee. This should include the auditor's interaction with component management, component auditors and component audit committees where they exist.

3.48 The auditor could also be asked for their own assessment of whether they met their criteria for a high-quality audit, and to explain what went well and what didn't go well and how audit quality could be improved in the future.

Audit committee conclusions

3.49 Before concluding and reporting on its assessment in the annual report (see Section 4), the audit committee should consider whether the evidence it has obtained is sufficient for it to draw reasonable conclusions about the quality and the effectiveness of the external audit. The audit committee makes further inquiries if it does not believe it has a sufficient basis to conclude. For example, if the audit committee has not already done so, it should understand if the auditor has met the agreed audit plan and obtain reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditors to address those risks.

3.50 In the FRC report: Audit Committee Reporting (December 2017), we reported that some investors believe there is too much description of process in the Audit Committee Report which is often boiler plate and uninformative. Audit committees may find it helpful to add more colour and insight to their reports by tailoring the assessment model to the specific circumstances of their company and its external audit and the audit committee's areas of particular emphasis. Investors and other stakeholders want to be able to easily discern the key messages and important issues.

4 **Transparency** – Audit committee reporting

4.1 The UK Corporate Governance Code requires the audit committee to report to the Board on how it has discharged its responsibilities. The annual report of the company should describe the work of the audit committee, including:

- An explanation of how it has assessed the independence and effectiveness of the external audit process;
- An explanation of its approach to the approval of any non-audit services provided by the auditor, and how the committee considered any impact on the auditor's independence arising from the provision of such services; and
- The approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans.

4.2 In respect of auditor appointment and tendering, the FRC's Audit Committee Reporting (ACR) project identified that investors and other stakeholders want:

- Confirmation in the ACR that quality is paramount and are more concerned with that than the amount paid for the audit. They look for evidence in the ACR that a robust process is in place to deliver high-quality audit.
- To understand the criteria against which the audit firms are being assessed and the rationale for the selection of the preferred firm.
- An explanation of how any conflicts of interest have been mitigated to offset any impact on auditor independence and to understand the safeguards put in place when there is a change in role.

4.3 The ACR needs to strike the right balance between giving sufficient information to enable an understanding, while excluding overly detailed descriptions of processes that will not add value. Disclosures should focus on the key judgments.

4.4 With respect to assessing auditor independence and objectivity, The ACR should explain how the audit committee assessed characteristics such as mindset and culture of the auditor. For example:

- How was the exercise of professional scepticism and an appropriate degree of challenge to management demonstrated?
- Were contentious issues communicated and, if applicable, an explanation why extra audit work has been performed?

4.5 With respect to the assessment of the effectiveness of the audit, the ACR project identified that investors other stakeholders want the ACR to:

- Set out the factors considered in the assessment of the effectiveness of the audit process.
- Focus more on the auditor's relationship with the audit committee rather than with management.
- For a newly appointed auditor, provide an understanding of whether the auditor's first audit has met the expectations established in the tender.
- Explain what the audit committee has done to obtain external evidence of the auditor's effectiveness. For example, how have they responded to the FRC's AQR team report on the audit firm and, if applicable, the results of individual inspection reports where the audit has been reviewed by the AQR? Also, if applicable, where there has been interaction with the FRC's CRR team, how has this fed into the

assessment of audit effectiveness – how do matters raised by the auditor compare with those raised by the CRR?

4.6 The audit committee should, where relevant explain how it has driven any changes in the audit process. This may include, for example, whether the audit committee requested more work is undertaken in relation to particular matters.

4.7 Something that may be a challenge for the audit committee when assessing the effectiveness of the audit is to distinguish between audit quality – including how effective was it at identifying and addressing matters that could compromise the quality of the company's reporting – and quality of service which relates more to relationships. When addressing the points above in the ACR the audit committee should consider how they could help make the distinction evident.

Appendix 1

Key areas of audit judgment

Materiality

1. Judgments about materiality are critical to the audit. The auditor is required, to consider the perspective of users (investors and other stakeholders) when determining materiality i.e. Information is material when, if misstated, it could influence the economic decisions of users taken on the basis of the financial statements.

2. The auditor has to determine an 'overall' level of materiality for the financial statements as a whole. This is essentially a judgment the auditor makes about the level of misstatements (whether due to error or fraud) that would render the financial statements misleading. In planning the audit, materiality, taken together with the risk assessment, drives the extent and nature of the audit work.

3. Other aspects of materiality also require judgment. The auditor may also disclose performance materiality – performance materiality is set at a lower level than materiality, to ensure that the auditor carries out sufficient work to ensure that the financial statements do not contain material error made up of smaller errors or omissions. The 'discount' applied to materiality by the auditor provides an indication of the auditor's assessment of the quality of internal control in the entity. A larger 'discount' indicates a weaker internal control system.

4. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence users, the auditor is required to also determine the lower materiality level or levels to be applied to those. These might apply, for example, to the measurement or disclosure of related party transactions, remuneration of directors, or other key disclosures that users' attention might be particularly focussed on.

5. Misstatements identified by the auditor are evaluated from a qualitative perspective and are not automatically immaterial if they fall below the quantitative materiality levels the auditor judges appropriate. The auditor should accumulate all misstatements identified during the audit other than those that are ''clearly trivial''.

6. Failure to make appropriate materiality judgments, or to update materiality during the audit if information is identified that would have caused a different amount to be determined initially, reduces audit quality by driving an inappropriate work effort, even if the auditor's risk assessment is valid.

Risk assessment

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

8. Risks of misstatement may arise, for example, because: (a) particular elements of the financial information required to be reported are difficult to prepare (e.g. accounting estimates with high levels of uncertainty, complexity or subjectivity); or (b) because of

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

Nature and extent of audit work

9. The auditor has to make judgments about the nature and extent of audit work that needs to be performed, so that it is responsive to the risks identified, and takes account of the materiality levels set. The higher the assessed risks of material misstatement, the more persuasive the audit evidence needs to be.

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

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

12. The auditor's procedures should be designed and performed in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

Audit conclusions and auditor reporting

13. In considering the issues arising in their work, the auditor makes judgments about whether the evidence they have found is sufficient and appropriate for them to conclude that the financial statements as a whole are not materially misstated. The auditor will discuss with the audit committee significant issues that remain unresolved (but they also may wish to discuss those that arose during the course of the audit and were subsequently resolved directly with management). For serious matters, the auditor will engage with the audit committee as and when the matters arise. The auditor is required to communicate any uncorrected misstatements identified during the audit, and explain the implications for their audit. The audit committee may also find it helpful for reviewing the effectiveness of the audit process, and the company's internal financial controls and internal control and risk management systems, if they are also informed of misstatements identified that have been corrected.

Appendix 2

Matters for the audit committee to consider in relation to key areas of audit judgment

The FRC is keen to encourage audit committees to develop their own approach that is relevant in the circumstances of the particular company, rather than to provide definitive guidance. Accordingly, it is not intended that audit committees need to consider all the matters in the examples below. The audit committee may also identify other matters to consider.

Materiality

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

- What is the basis for the overall materiality level set, and how appropriate is the benchmark used by the auditor in determining that overall materiality level? Is the auditor applying their informed judgment or adopting a guideline in the audit firm's methodology with little or no judgment? How does this reflect the needs and expectations of users? "5% of net profit" is the most common threshold used by auditors for overall materiality, but how did the auditor assess the relevance of this, or other benchmarks if applicable, to the users of the financial statements for this type of business[17]? What qualitative factors were considered?
- Were lower materiality levels set for any specific items and, if so, on what basis? Has the auditor identified all items that users' attention might be particularly focussed on?
- What is the performance materiality level(s) and what factors were taken into account in determining it?
- What is the auditor's approach to qualitative aspects of materiality, for example, how does the auditor evaluate misstatements in narrative disclosures?
- In a group audit, how has the auditor evaluated the appropriateness of materiality levels applied to group subsidiaries? Has the auditor explained the allocation of materiality across the parent company and its subsidiaries?
- How do the materiality levels affect the scope and level of audit work, particularly in significant areas?
- What are the reasons for any change in materiality levels during the audit, and how does this affect the level of auditor's work?
- Have materiality levels been adjusted in the light of significant events arising near the year end and/or actual results that are very different from plan?
- At what level are identified misstatements reported to the audit committee and why?

Risk assessment

The audit committee could ask the auditor at an early stage how they intend to address the **risks to audit quality** in developing the audit strategy and plan, including asking the auditor to:

- Explain the risks to audit quality by reference to the specific circumstances of the company's audit.
- Explain if there are any are new risks and the reason for them, and which risks previously identified have been assessed as less significant and why.

[17] The FRC Audit Quality Thematic Review "Materiality" (December 2017) includes matters audit committees could consider in relation to materiality. It identifies common benchmarks used by audit firms and variations between them, including for different industries.

- Explain the proportion of audit hours that will be carried out by senior members of the audit team, particularly in higher risk areas.
- Identify key audit firm and network level controls the auditor expects to rely on to address the identified risks to audit quality. The auditor should also explain the basis on which they are satisfied it is reasonable to do so. For example, in a group audit, the group audit engagement team and the component auditor(s) may be subject to common policies and procedures for performing the work (i.e. common audit methodologies).
- Explain how the auditor is addressing any issues raised in previous assessments by the audit committee of the quality and effectiveness of previous audits.
- Explain what inputs they have received from internal and external inspections of their audit and their audit firm, and of network firms performing audit work on significant components in the case of a group audit.
- When discussing the auditor's findings later in the audit, explain how they addressed the risks to audit quality (identified and discussed at the planning stage) in performing their audit work and concluding and reporting on the issues that arose in the audit.

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

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

Nature and extent of audit work

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

- Has the auditor been able to articulate their testing strategy in a manner that is understandable? Is the auditor able to articulate their choice of testing strategy in particular areas and why alternatives were not appropriate?
- Are there specific areas of risk that are of greater concern to the audit committee, where they might want to probe the auditor's judgments more deeply?
- Does the amount to time spent on areas of risk that are of greater concern to audit committee appear sufficient?
- In what areas and to what extent is the auditor making use of specialists?
- What audit work is 'offshored' / covered by centralised service centres and how is the quality of the work controlled?
- Are there specific areas of the testing strategy that are not clear? For example, can the auditor explain clearly how they are applying data analytics techniques?
- To what extent does the auditor intend to rely on the effectiveness of internal controls? Is this consistent with the audit committee's understanding of the reliability of the company's relevant internal controls?
- To what extent are the risks to the quality and the effectiveness of the financial reporting process addressed in the audit plan?
- Can the auditor clearly explain their testing strategy in relation to fraud, revenue recognition, laws and regulation, and management override of controls?
- What areas has the auditor identified relating to amounts or disclosures in the financial statements, where special audit consideration is necessary? (For example, related party disclosures).
- In group audits, can the auditor clearly articulate how the size, resources and geographical coverage of the audit are appropriate in the circumstances? How is evidence drawn out across the different components to enable the auditor to reach conclusions at the group level?
- To what extent are the audit quality issues identified by the FRC AQR in their public reports related to the testing strategy and what remedial action has the auditor considered? Has the auditor considered recent guidance from regulators on testing strategies and how has this been incorporated into the audit plan[18]?

Audit committees can also ask questions about the auditor's intended response to financial statement level risks (e.g. if the company has effective internal control, the auditor may choose to conduct more audit procedures at an interim date rather than focusing all effort at the year-end).

Audit conclusions and auditor reporting

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

- Has the auditor communicated key accounting and audit judgments, and conclusions, to the audit committee in a way that is understandable? Does the communication clearly demonstrate that they have exercised professional scepticism and an appropriate degree

[18] For example, The Basel Committee on Banking Supervision Supervisory Guidance on the External Audit of Banks.

of challenge to management? Has the auditor been robust and perceptive in the handling of questions from the audit committee on the key accounting and audit judgments?

- Reviewing and monitoring the content of the auditor's management letter, in order to assess whether it is based on a good understanding of the company's business. Establish whether auditor recommendations have been acted upon and, if not, the reasons why they have not been acted upon. Review and monitor management's responsiveness to the auditor's findings and recommendations.
- Has the auditor been able to explain why uncorrected misstatements, if any, have not been corrected by management? The audit committee may also want to address this matter directly with management, in particular, to establish whether management's reasoning was appropriate and whether the auditor provided sufficient challenge.
- Where there have been differences of view and debates about alternative treatments of an item in the financial statements (e.g. different valuation bases), does it appear to the audit committee that the auditor's conclusion on a particular option reflects an appropriate mindset? The auditor should be able to demonstrate that their conclusion and rationale are related to the nature of the challenges raised in the underlying work, the strength of the evidence obtained and the perspective of investors and other stakeholders.
- Has the auditor been able to explain how major issues that arose during the course of the audit have subsequently been resolved, or if relevant, why those issues have been left unresolved?
- For group audits, how was the auditor satisfied that they had received sufficient appropriate evidence on components audited by component auditors?
- Reviewing whether the auditor has met the agreed audit plan and obtaining reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditors to address those risks.
- Reviewing whether the proportion of audit hours carried out by senior members of the audit team compared to the entire audit team, particularly in relation to significant risks, was in line with that in the audit plan or, if not, the reasons for the variation. Which areas did the senior members of the audit team spend most of their time on?
- Consistency of the auditor's risk assessment and the key audit matters communicated in the auditor's report with risks reported in the audit committee's report. Whilst the auditor's report and audit committee report are not required to mirror one another, if there are differences the audit committee and the auditor might discuss those differences and consider the need to articulate reasons for those differences within either the auditor's report or the audit committee report.
- Reviewing the written representation letters, giving particular consideration to matters where representation has been requested that relate to non-standard issues. Consider whether the representations requested and information provided is complete and appropriate based on the audit committee's own knowledge.
- Confirmation that any changes made to the materiality levels initially advised upon have been reported to the audit committee.

Appendix 3

Illustrative audit committee considerations in evaluating the auditor's competencies

The auditor's mindset and culture

In discussions with the audit committee and with company management, the auditor should be able to demonstrate to the audit committee's satisfaction that they approach their work with an appropriate mindset and operate an appropriate audit firm culture. Matters the audit committee may consider include whether the auditor:

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

Supplementary sources of evidence may include, for example:

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

The auditor's skills, character and knowledge

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

- Actively engaged with the audit committee about the circumstances surrounding misstatements in the financial statements, including disclosures, whether due to fraud, unintentional bias or error and internal control deficiencies.
- Demonstrated an ability to develop their knowledge of the business and the challenges and opportunities it is facing beyond the finance function, (e.g. by meeting senior employees of the company outside of the finance function and visiting key operational sites).
- Described how they have challenged information that appears to contradict their understanding of the company, its operations or activities.

- Provided concise, easy to understand explanations of the issues they presented, particularly when the issues are difficult or contentious.
- Demonstrated a thorough understanding of, and rationale for, the audit strategy presented, particularly when challenged. For example, the auditor should be able to explain the circumstances giving rise to new risks and explain why risks in the prior year are no longer valid. They should be able to articulate clearly how they obtain audit evidence on components.
- Exercised strong personal attributes to ensure effective interviews of management and others in the company and applied appropriate scepticism in challenging the evidence obtained.
- Articulated how the strategic decisions of the company, changes in its environment and current or developing accounting standards might impact future financial statements.

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

- Observing the business and technical expertise of the audit firm that may be available to support the audit engagement team through audit committee members attendance at industry and technical forums organised by the audit firm.
- Reviewing FRC AQR reports on the relevant firm and its competitors. Some inspection reports may specifically address concerns about the auditor's skills in applying the auditing standards based on the evidence in the audit files. Where such matters are raised, the auditor can be asked to explain the remedial actions the audit firm and the auditor are taking that will improve the firm's audits.
- Asking the audit engagement partner whether they have been subject to review by the FRC AQR and/or internal firm processes, and what the results were (see paragraphs 3.18-3.24).
- Checking publicly available regulatory action, professional body disciplinary action and any other press releases relating to the audit engagement partner and the audit firm.
- Obtaining feedback on auditor competencies (e.g. through surveys and discussion).

The auditor's quality control

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

- Communicating in their audit plan how they assess risks to the quality of their audit, the key risks they have identified and the quality controls they have put in place to ensure they deliver a high-quality audit.
- Communicating information about the quality of communications between the auditor and their teams in other countries; discussing judgments being made there that impact the group financial statements and how the auditor will be sure that those judgments are sound.
- Explaining how the auditor is satisfied that other audit firms in the group audit are demonstrating high standards of audit quality. In particular, how the audit firm supports the group audit engagement partner and what evidence there is of that support (e.g. to what extent are there common methodologies and software, or shared results from network firm internal quality reviews).
- Communicating certain aspects of inspection reports that are of importance to their engagement including, when appropriate, about overseas audit quality inspection findings and the auditor's response to those findings. Explaining how the auditor is taking action to enhance their audit quality rating(s).

- Communicating their activity in remedying any deficiencies identified in internal or external audit quality inspections and the impact of those deficiencies on the company's audit. Audit committees can ask for the latest results of the audit firm's internal monitoring reports, particularly with regards to the engagement partner and whether or not their particular audit was reviewed as part of that internal monitoring process.
- Explaining what resources they used to support audit quality in addressing contentious issues and key judgments, for example did they use an independent review partner, partner panel, technical consultations, etc.
- Explaining how the auditor's overall work plan, and the proposed resources to execute it, appear consistent with the scope of the audit engagement.
- Demonstrating that more senior members of the audit engagement team were actively involved in risk assessment, planning meetings, key audit judgments and conclusions. This would include demonstrating that the proportion of audit hours carried out by senior members of the audit team was reflective of an appropriate level of involvement.
- At the end of the annual audit cycle, demonstrating that they met the agreed audit plan, and discussing with the audit committee the reasons for any changes to the audit plan or delays in completion.

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

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

Appendix 4

Other FRC publications

The UK Corporate Governance Code (July 2018)

Guidance on Audit Committees (April 2016)

Audit Committee Reporting (December 2017) – exploring how investors' confidence in audit is enhanced by, and audit quality promoted through, external reporting by audit committees in the annual report and accounts. The publication focuses on good practice elements of existing audit committee reporting and encourages audit committees to consider adopting these good practices.

Audit Tenders – Notes on Best Practice (February 2017)

FRC AQR thematic reviews:

> Audit Quality Thematic Review 'Fraud Risks and Laws and Regulations' (January 2014)
>
> Audit Quality Thematic Review 'Firms' Audit Quality Control Procedures and Other Audit Quality Initiatives' (March 2017)
>
> Audit Culture Thematic Review (May 2018) – covering audit firms' activities to establish, promote and embed a culture that is committed to delivering consistently high-quality audits

FRC AQR report on Developments in Audit (2019).

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