

Head of audit
ABC LLP

8 November 2019

Dear Sir/ Madam

Achieving high quality audits consistently

Based on recent experience from conducting Audit Quality Reviews (AQR) inspections, I am writing to set out areas on which audit firms should focus in order to achieve high quality audits consistently, particularly where audits have been identified as high risk.

Audit is regulated in the public interest and we seek an audit market in which entities have a choice of auditor and can select based on quality. Some factors in acceptance and continuance decisions are outside the audit firm's control. This letter focuses on matters that are within the control of the audit firm: in particular, how to approach audits identified as high risk in order to achieve high quality.

We would encourage audit firms to consider the resources needed and how they plan and perform audits of different types of entities, including those audits identified as high risk, in a way that delivers high quality. We recognise that the cost of a high-risk audit is likely to be greater, in part reflecting the additional work required.

Results of most recent AQR inspections

The AQR inspections for 2018/19 found that 25% of audits reviewed required improvement. There were consistent findings of insufficient audit evidence and challenge of management in areas based on judgement such as valuations, impairment assessments and provisions. These have been recurring findings over several years, with a factor being inadequate application of professional judgement and scepticism. Other contributory factors have included: inadequate planning, late timing of audit work and insufficient resourcing, leading to increased pressure on obtaining sufficient audit evidence, especially in the face of tight reporting deadlines.

High quality audits

These audits:

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

Achieving high quality audits

The appendix to this letter sets out specific areas on which both audit firms and audit engagement teams need to focus in order to achieve high quality audits consistently. They are largely based on experience from our AQR inspection findings and the results of root cause analyses performed by the audit firms on those findings. They also consider some of the key requirements of the recently revised ISA 540 on Auditing Accounting Estimates and Related Disclosures.

Achieving high quality in audits identified as high-risk

Audits can be high risk for a number of reasons, including the group or entity: being in a high-risk sector or geography; experiencing financial difficulties; having estimation uncertainty and having governance and internal control weaknesses.

Our recent experience of AQR inspections is that high-risk audits are significantly more likely to be of lower audit quality. Some 47% of the audits that we identified as higher risk, on selection, in our 2018/19 inspections were assessed as requiring improvement, compared with 13% of audits not identified as higher risk. The typical issues we identified on high-risk audits also differed from those on other audits. On high-risk audits, we often found insufficient challenge of management judgements and estimates, especially where estimation uncertainty was high. For other audits, the issues more often related to deficiencies in routine audit procedures.

We have seen that audit firms can perform high-risk audits to a high standard of quality. These audits have typically included:

- Significant involvement of partner and other senior team members;
- Good use of specialists;
- Consultation on complex areas;
- Challenge of management leading to changes where assumptions are too optimistic;
- Robust quality control procedures; and
- Clear and timely communication to Audit Committees.

However, this has not been consistent across the audits we have inspected. I have highlighted in the appendix areas where we consider additional focus should be given to high-risk audits.

Yours sincerely

David Rule
FRC Executive Director of Supervision

Appendix - Areas of focus in order to achieve high quality audits
 (Areas requiring increased focus for high-risk entities are shown in bold)

Areas of focus for audit firms	Areas of focus for audit teams
a) Risk assessment	
Identify and monitor high-risk audits <i>The firm needs to ensure it monitors high-risk audits and that those audit teams respond appropriately to the identified risks.</i>	
<ul style="list-style-type: none"> • Have adequate procedures to identify and monitor high-risk audits • Perform independent reviews of the audit team’s risk assessment and responses to audits identified as high-risk. 	<ul style="list-style-type: none"> • Perform a thorough risk assessment and business understanding of the audited entity. • Focus on management bias in risk assessment. • Ensure the audit approach is appropriately tailored to those risks. • Consult appropriately within the firm on planning for complex areas.
b) Resourcing	
Adequate resourcing <i>Audits need to be resourced adequately in order to ensure appropriate audit procedures can be performed.</i>	
<ul style="list-style-type: none"> • Allocate to audits appropriate resources with sufficient available time to do the work allocated to them, based on the risk profile. • Respond appropriately to resourcing requests. • Consider the level of available resources before committing to taking on new audits. • Plan sufficiently ahead for resourcing needs and recruitment activities. 	<ul style="list-style-type: none"> • Ensure the audit is appropriately resourced at all levels. • Consider both the strength and depth of the available resource. • Allocate higher and more complex risk areas to more senior members of the audit team. • Flag any concerns about resourcing to the appropriate personnel in the firm.
Appropriate competence and capabilities <i>The audit team members should have appropriate competence and capabilities in auditing in the relevant industry sectors.</i>	
<ul style="list-style-type: none"> • Recruit those with the necessary competence and capabilities. • Provide training on a timely basis to maintain the competence and capabilities of partners and staff. 	<ul style="list-style-type: none"> • Ensure work is allocated to those with the necessary competence and capabilities.
Involvement of specialist and experts <i>Specialists and experts are often needed to assist the audit team in complex areas.</i>	
<ul style="list-style-type: none"> • Ensure the audit teams have access to the specialists and experts needed. 	<ul style="list-style-type: none"> • Involve specialists and experts in areas where the audit team has insufficient expertise to assess the risks or to design and perform procedures responsive to the risks, on a timely basis. This would include industry specialists.

Areas of focus for audit firms	Areas of focus for audit teams
<p>Audit engagement led by the partner <i>The audit should be led by the partner, with sufficient personal involvement throughout to ensure the audit approach is effective.</i></p>	
<ul style="list-style-type: none"> Review partner portfolios to ensure they have enough time to lead and participate in the audits to ensure high quality. 	<ul style="list-style-type: none"> Audit engagement partner to lead the planning process at an early stage. Involvement to include regular coaching of audit staff and on-site review of their work. Level of participation to increase for high-risk audits. Review of high-risk areas and material areas of judgement to be phased and not left too late in the process. Timely involvement by the Engagement Quality Control Reviewer (EQCR).
<p>Central support, hot reviews and quality control procedures <i>Providing independent support and real time (“hot”) review of audit work can reduce the risk of insufficient procedures being performed.</i></p>	
<ul style="list-style-type: none"> Provide central support to coach audit teams in complex areas and to review the quality of the audit work on a real time basis (“hot reviews”). Provide adequate technical resources to audit teams across the firm. 	<ul style="list-style-type: none"> Consult on complex areas with technical specialists and other experts in the firm, as needed.
<p>c) Timing of audit work</p>	
<p>Timely planning and project management <i>Timely audit planning helps ensure that audit procedures are not carried out too late in the audit process. Effective project management tools can assist with this.</i></p>	
<ul style="list-style-type: none"> Ensure effective project management tools and procedures are available to audit teams. 	<ul style="list-style-type: none"> Start the planning process at an early stage and phase the audit work to ensure the audit team can identify and address issues on a timely basis.
<p>Early identification of weaknesses in controls that affect financial information <i>Identifying weaknesses in controls or inadequate support for key judgements and estimates early will help ensure sufficient time for the audit to respond appropriately.</i></p>	
<ul style="list-style-type: none"> Encourage early engagement with entities with significant control deficiencies or weaknesses in processes for preparing financial information. Provide adequate tools and guidance for requesting key information from audited entities on time (such as in relation to preparing information requests). 	<ul style="list-style-type: none"> Timely testing of controls to identify and communicate deficiencies. Early engagement with management in obtaining information to support key judgements and estimates and related disclosures. Early discussion of the reporting timetable and any related concerns with management. Consider requesting a delay in reporting deadlines where this is necessary to complete obtaining sufficient appropriate audit evidence. Modify the audit report if this cannot be obtained.

Areas of focus for audit firms	Areas of focus for audit teams
d) Audit evidence and the challenge of management	
Appropriate audit procedures for areas of higher risk	
<i>The audit team needs to design audit procedures that are responsive to the identified risks.</i>	
<ul style="list-style-type: none"> • Provide adequate audit systems, methodologies and procedures to ensure that audits comply with auditing standards. • Develop the use of technology, for example data analytics, to enhance the effectiveness of the audit process. 	<ul style="list-style-type: none"> • Follow the firm’s methodologies and procedures. • Ensure the audit approach is tailored to the identified risks. • Use data analytics where this provides a more effective audit approach. • “Stand back” and evaluate the overall audit evidence obtained.
Challenge management on key assumptions with the right mindset and appropriate scepticism	
<i>The audit team should ensure that the judgements and estimates, and related disclosures, made by management are reasonable. This requires the audit firm to have an appropriate culture to encourage the right mindset and professional scepticism.</i>	
<ul style="list-style-type: none"> • Ensure that the firm has a culture that encourages challenge of management and expects and supports the exercise of professional scepticism throughout the performance of an audit. • Ensure the firm’s guidance includes consideration of contradictory evidence. • Ensure there are appropriate consultation procedures, such as technical panels. • Have a reward system that encourages audit partners and staff to challenge management and demonstrate robust exercise of professional scepticism and to raise matters of concern. 	<ul style="list-style-type: none"> • Exercise professional scepticism appropriately during the audit, in particular when assessing management’s judgements, estimates and related disclosures. • Perform audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. • Consult appropriately on carrying out the audit of complex areas. • Persist in challenging management if they do not address the auditor’s concerns, including through to the decision on signing and the content of the auditor’s report. • Adequately evidence the extent of scepticism and challenge of management.
e) Reporting	
Clear communications to Audit Committees	
<i>The auditors should communicate matters of concern regarding management’s controls, judgements and estimates, and related disclosures, on a timely basis so that the Audit Committees can act accordingly.</i>	
<ul style="list-style-type: none"> • Provide guidance and templates on effective communications to Audit Committees, avoiding “boilerplate” wording. 	<ul style="list-style-type: none"> • Communicate matters of interest to the Audit Committee on a timely basis, including governance concerns, deficiencies in controls, aggressive assumptions and estimates, and insufficient disclosures.

Areas of focus for audit firms	Areas of focus for audit teams
	<ul style="list-style-type: none"> • Ensure communications are clear and concise. • State whether the audit team agrees or not with management's view.
Transparent reporting in the auditor's report <i>The auditor's report should be clear in relation to the audit approach for key audit matters</i>	
<ul style="list-style-type: none"> • Provide adequate support for audit teams in relation to auditor reports. 	<ul style="list-style-type: none"> • Provide clear descriptions of the key audit matters, including the audit procedures to address those matters. • Draw attention to matters of concern where appropriate.
f) Continuous improvement	
Tone at the top and culture <i>The leadership of the firm needs to ensure that audit quality is paramount. The firm's culture needs to support the ability to continuously improve audit quality.</i>	
<ul style="list-style-type: none"> • Drive the right values, ethics and attitudes that support high audit quality throughout the firm. • Ensure remuneration and promotion is linked to audit quality. • Share best practice. 	<ul style="list-style-type: none"> • Embed the values, ethics and attitudes in the audit process.
Audit quality indicators <i>The quality of audits should be monitored at both a firm and engagement level on a real time basis.</i>	
<ul style="list-style-type: none"> • Monitor audit quality indicators at a firmwide level. 	<ul style="list-style-type: none"> • Monitor audit quality indicators at an engagement level.
Root cause analysis and audit quality plans <i>The root causes of audit deficiencies should be investigated, and responses developed to ensure appropriate actions to improve audit quality.</i>	
<ul style="list-style-type: none"> • Perform robust root cause analysis following deficiencies in inspection results (internal and external). • Develop action plans to respond to the identified root causes on a timely basis, so it can positively impact the next audit cycle. 	<ul style="list-style-type: none"> • Implement improvements in procedures arising from the firm's action plans.