Financial Reporting Council

PwC LLP

AUDIT QUALITY INSPECTION

JULY 2019

The FRC

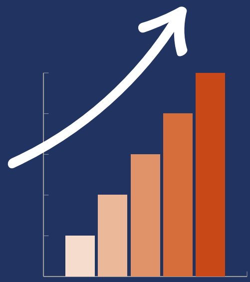
Our mission is to promote transparency and integrity in business.

We have responsibility for the public oversight of statutory auditors.

The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.

AQR

We monitor the quality of UK Public Interest Entity audits.

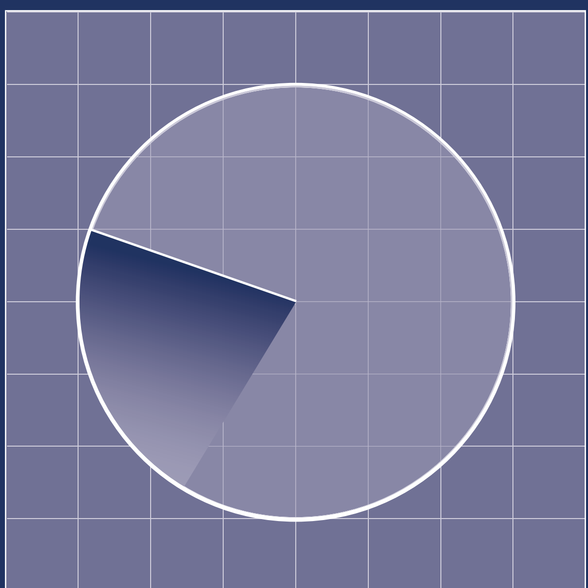


We promote continuous improvement in audit quality.

Our team of over 40 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.

The Firm

PwC has 547 audits within the scope of AQR inspection, including 28 FTSE 100 and 64 FTSE 250 audits.

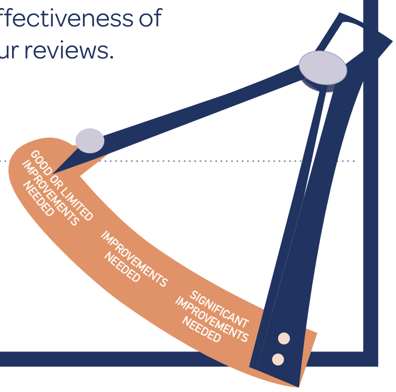


Our inspection process

There are around 2300 audits within the scope of AQR inspection. In total, we inspected 160 individual audits in 2018/19, including 26 at PwC.

We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of the audit work inspected.



Financial Reporting Council

PwC LLP

Audit Quality Inspection

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.

Contents

We consider whether action under the FRC's enforcement procedures is appropriate for all reviews assessed as requiring improvements or significant improvements. In practice, audits assessed as requiring significant improvement, and some of those assessed as requiring improvement, will be referred to the FRC's Case Examiner for consideration of further regulatory action. The Case Examiner will consider the most appropriate action, including Constructive Engagement with the audit firm or referral to the FRC's Conduct Committee for consideration of whether to launch a full investigation. This may result in a sanction being imposed and enforced against a statutory auditor and/or the audit firm in accordance with the FRC Audit Enforcement Procedure.

This report sets out the principal findings arising from the 2018/19 inspection of PricewaterhouseCoopers LLP ("PwC" or "the firm") carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted this inspection in the period from February 2018 to April 2019 ("the time of our inspection"). We inspect PwC, and report publicly on our findings, annually.

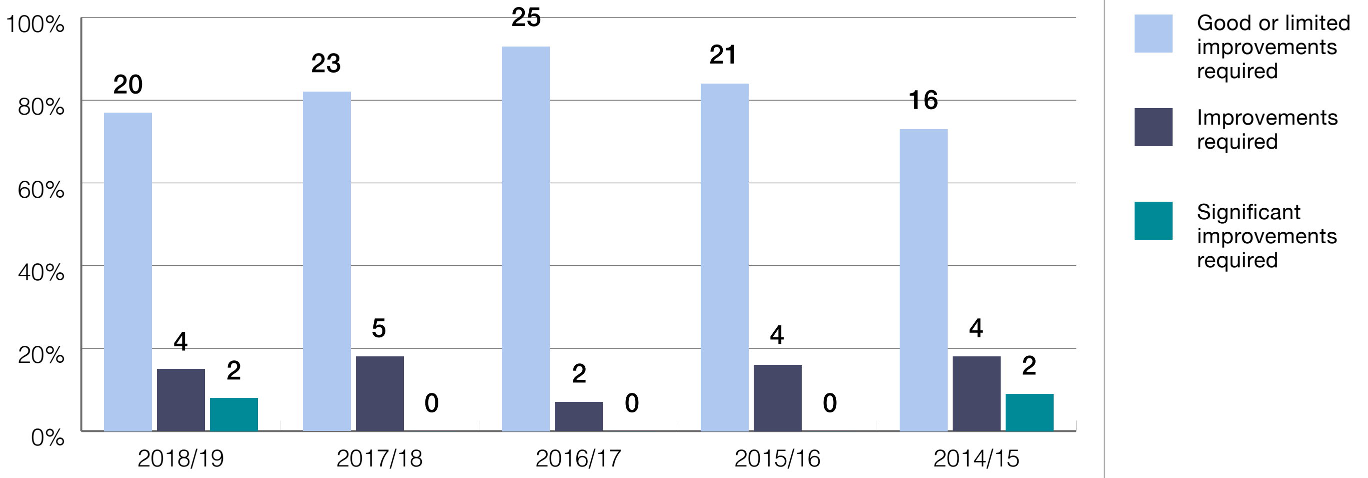
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality. This year, our firm-wide work, performed on a three year cycle, focused on internal quality monitoring, engagement quality control reviews and independence and ethics.

Our priority sectors for inspection in 2018/19 were general retailers; oil and gas producers; support services companies; and financial services. Of the 139 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: General retailers (11); Oil and Gas producers (7); Support services (13); and Financial services (34).

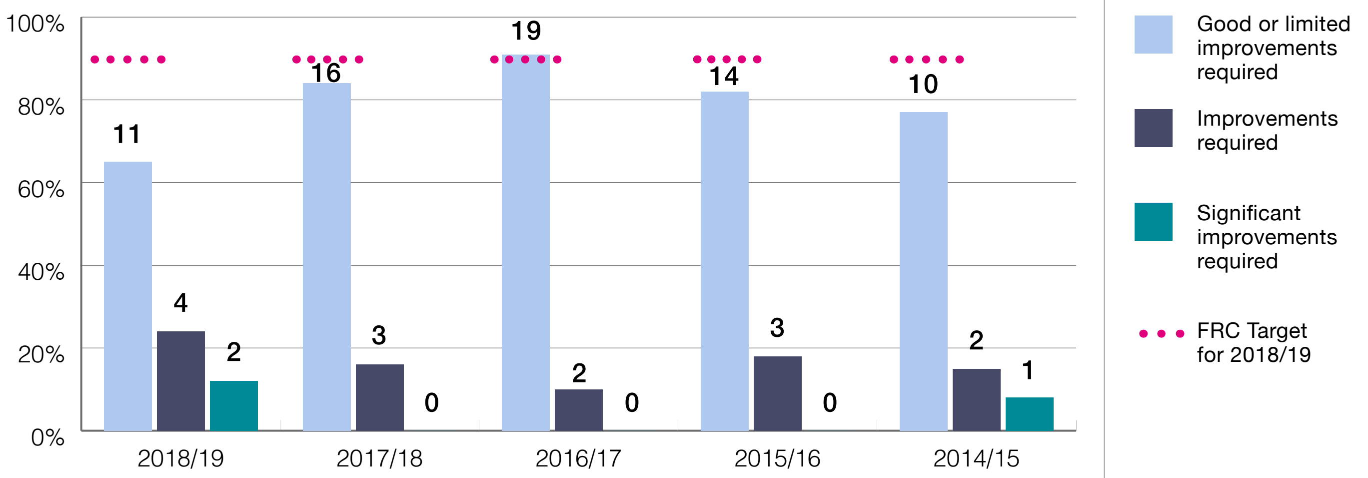
We also paid particular attention to the following areas of focus: changes in auditor appointments; audit of fair value investments (including goodwill impairment); the use of auditor's experts and specialists; and the audit of controls.

Our assessment of the quality of audits reviewed

PwC



FTSE 350



Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our selections, which are primarily risk-focused, are also informed by the priority sectors and areas of focus referred to above. For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

1 Overview

The FRC set a target for the firms that at least 90% of FTSE 350 audits should be assessed as requiring no more than limited improvements by the end of the 2018/19 inspection cycle. Regrettably, no firm inspected this year achieved the target.

As a result, we will, for 2019/20:

- Continue to measure firms' audit quality against the 90% FTSE 350 target and expect all firms to meet that target.
- Extend the 90% target to all other audits within the scope of our inspection.

Stakeholders rightly demand high quality work on all audits and they would expect, we believe, that all audits subject to our review should require no more than limited improvements. We will therefore, for 2020/21 onwards, set a new target for audit firms that 100% of audits should require no more than limited improvements.

All the firms reviewed have performed root cause analysis and identified a number of themes relating to why the audits we inspected did not always meet the required standard and why certain findings recur over a number of years. These themes, across the firms inspected, include insufficient scepticism and weaknesses in project management or resourcing. In addition, the analysis also highlighted inconsistent execution of firms' audit methodologies and quality control procedures. Firms' actions should be targeted and responsive to the findings from their root cause analysis to achieve the required improvements in audit quality.

We will continue to take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past two inspection cycles, we have referred 16 audits, across all firms inspected, to the Case Examiner for consideration of further enforcement action. In these cases, we further scrutinise the root cause analysis undertaken by the firm and the actions taken by the firm in response to our findings and consider what additional action we can take to ensure audit quality.

Key findings for PwC

We assessed 77% of the firms' audits that we reviewed as requiring no more than limited improvements, compared with 82% in 2017/18. Of the FTSE 350 audits we reviewed this year, we assessed 65% as achieving this standard compared with 84% in 2017/18. We consider the notable decline in inspection results, particularly for FTSE 350 audits, by comparison to prior years to be unsatisfactory and have required the firm to take prompt and targeted action to address this decline.

Our key individual review findings related principally to the need to:

- Improve the audit team's challenge and supporting evidence in relation to the audit of long-term contracts.
- Improve the consideration and challenge of growth assumptions in relation to the impairment of goodwill and other assets.
- Strengthen the consideration and challenge in relation to management's estimation of certain provisions.
- Enhance the audit work performed for aspects of revenue and inventory for retailers.

We had no significant findings arising from our firm-wide work on internal quality monitoring and engagement quality control reviews.

The firm-wide issues we identified concerned the need to:

- Strengthen the firm's systems and procedures relating to non-audit services approval.

Given our key individual review findings noted above, this would indicate that the firm's quality control procedures have not been sufficiently effective to achieve the necessary improvement in audit quality.

Further details of our key findings are given in section 2, together with the firm's actions to address them.

We will monitor closely the promptness and effectiveness of the firm's actions. Should the firm's response not address our concerns adequately, we will take further action.

Good practice identified and developments in the year

We identified examples of good practice in the course of our work, including group audits and the use of specialists and experts. These, together with firm developments in the year, are set out in section 3.

Root cause analysis

Thorough and robust root cause analysis ("RCA") is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

The firm has performed RCA in respect of our key findings and considered the outcome in developing the actions included in this report. We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques further.

Given that no firm this year has met the FTSE 350 target, firms need to re-appraise whether their RCA accurately identifies the causes of our inspection findings and whether their actions are properly linked to those causes. In particular, the firms should increase their focus on systemic issues behind the findings as well as the findings on each individual audit.

Firm's overall response and actions:

We set very high standards and are proud of the quality of our audits. We are therefore disappointed with the results of the latest AQR inspection and regard the issues raised in this cycle to fall below the high standards we aim to achieve on all our audits. In order to ensure that we deliver high quality audits consistently we have recently announced a significant investment in audit quality over the next three years.

We have undertaken root cause analysis (RCA) on the inspection results, identifying causal factors and actions relating to the identified specific areas for improvement. Broader causal factors, including those relating to audit culture, and auditor behaviours have helped inform the need for this investment.

In June 2019 we announced our "Programme to enhance audit quality", a package of Board approved measures with the primary objective of improvement in delivering consistently high quality audits. In addition to our response to the current year inspection results, we have been listening to a wide range of stakeholders about the future of audit - exploring how it needs to change to meet society's evolving expectations.

Our programme targets four key areas: organisational design, audit culture and behaviours, audit governance and oversight, and audit quality. It underpins our audit vision to "deliver the highest quality audits, combining passionate people with leading technology to build trust in society". This significant investment over the next three years, aims to not only address inspection findings from the AQR and other regulators, but also to meet future market expectations of an audit, continue to reinforce our quality-first culture, and drive cultural and behavioural changes in our auditors.

1) **Organisational design** - From 1 July 2019, our Audit and Risk Assurance practices have operated as separate lines of service, focusing our audit specialists on the delivery of high quality audit and audit related services. We have developed national teams in our financial services practice, and brought together our technology specialists into a single digital audit team, which will support all of our audit teams to deliver effective technology enabled audits in increasingly complex environments.

2) **Audit culture** - Our people are key to performing high quality audits, and we must support them with an environment that has a culture of challenge at its heart. A high quality audit relies on an auditor's ability to ask the right questions, take an independent view, challenge management when necessary and not rationalise away things that look wrong. We are working in collaboration with Karthik Ramanna, Professor of Business and Public Policy at the University of Oxford's Blavatnik School of Government to bring a fresh perspective to the question of what is a healthy culture of challenge.

3) **Audit governance and oversight** - In conjunction with our Independent Non-Executives, we are exploring ways of strengthening the independent oversight of our audit practice, with a clear-sighted focus on quality and our public interest responsibilities. We are increasing the independent oversight of auditor reward and remuneration, and enhancing the performance assessment of audit specialists to include even more emphasis on aligning their remuneration with the delivery of audit quality.

4) Audit quality - The Audit Quality Plan (AQP) underpins the significant investment that we are making in the audit practice over the next three years. There are three pillars of action under the AQP:

- **Investment in our people** - As a people-based business, behaviours of our audit specialists are critical to the consistent delivery of high-quality audits. Increasing the capacity in the audit practice will further support our engagement teams to deliver well-planned, well-managed and well-executed audits more consistently. It will facilitate additional investment in coaching, support and supervision of our teams, as well as continue to support the development of high quality, sceptical, minds required to undertake audit work. Accordingly, we plan to increase capacity in our front line delivery teams by recruiting 500 additional experienced auditors over the next two years whilst at the same time reviewing our audit portfolio. The combination of these actions will help ensure a greater degree of consistency is achieved.

- **Investment in our training programmes** - There have been many changes to our audit programmes and methodology over the past few years, and in the past 18 months we have invested significantly in evolving our audit delivery model to improve consistency in specific areas of audit. Our RCA concluded it is necessary to reinforce some of the key elements underpinning the issues raised by the AQR, and therefore our extended training programme will cover topics that have been highlighted in regulatory reviews such as challenges with 'auditing the future' in estimates and judgements, and auditor behaviours including scepticism and challenge of management.

  However, just delivering more training is not enough. We have therefore changed the way in which we are delivering our core training programme throughout 2019. All our qualified staff will attend three days of mandatory classroom training, a deliberate doubling of classroom time from previous years. The training has been intentionally re-designed to bring our staff together, and facilitate the sharing of experiences in a simulated team environment. The programme covers a broad range of topics including auditor behaviours and mindset, technical accounting developments, and auditor skills including strategic planning and project management. The programmes overarching objective is to reinforce how to deliver high quality audits consistently.

- **Investment in central monitoring and support** - Recognising that investment in front line staff is not enough, we are also increasing our investment in central monitoring and support through increasing the scale of our central quality support functions. As our RCA showed some correlation of the benefits of our real-time review programme with regulatory inspection results, we will be expanding this programme in both scale and depth, concentrating on those audits and engagement teams that are the most high profile or in higher risk industries. Furthermore, we will be establishing a Chief Auditor Network (CAN) of audit quality specialists based within our network of offices, to provide real time support on the application of audit methodology and support engagement leaders in complex auditor judgments.

Within our response to the AQR's key findings are specific root causes and responsive actions relating to aspects of audit methodology and guidance as well as enhancements to specific policies and procedures that support audit quality. Further details of these are explained in the other response sections in this report.

2 Key findings requiring action and the firm's response

We set out below the key areas where we believe improvements are required to enhance audit quality and, where relevant, safeguard auditor independence. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Improve the audit team's challenge and supporting evidence in relation to the audit of long term contracts

Accounting for long-term contracts, including revenue and profit recognition and the estimate of claims and variations, is highly judgemental and can be susceptible to management bias. Audit teams should apply an appropriate level of challenge and obtain sufficient and appropriate audit evidence in relation to the significant judgements in management's estimates.

Findings

Given the level of audit risk and the potential impact on the financial statements, we reviewed the audit of long-term contracts on all applicable audits. We identified insufficient challenge, or insufficient evidence of such, in relation to long-term contracts on several audits, including the following:

- In relation to estimated future costs and margins, inadequate testing or insufficient evidence of assessment of whether costs to complete and profit margins had been appropriately estimated by management.
- For recognised contract claims and variations receivable, and contracts where late profit adjustments were made, the audit team had not sufficiently challenged management's explanations (including claims which were not at an advanced stage of negotiation) or obtained sufficient corroborating evidence (for example, where they were informed that an oral offer had been made).
- In relation to contracts that had been identified as potentially onerous (or could have been), insufficient evidence of adequate audit procedures to assess whether the key assumptions were appropriate or that there had been adequate challenge of forecast revenues.
- For the accounting for multiple-element and complex contracts that impacted the amount of revenue recognised, insufficient evidence of the audit team's consideration and challenge relating to the recognition of revenue.

The firm should consider whether assistance could be obtained from the firm's experts in relation to the audit of long-term contracts.

Firm's actions:

Auditing entities in industries with significant, bespoke and complex long term contracts is challenging. The nature of the evidence available to support key assumptions and judgements, or to support accounting standard requirements, varies significantly dependent on individual circumstances. Given the regulatory focus and emerging findings over the past 18 months, in 2018 we implemented a programme which included developing better, practical, guidance for our auditors and delivering specific training modules for relevant engagement teams. This focus will continue for relevant engagement teams during 2019 as part of our AQP investment in training.

Our RCA also identified variability in the quality of evidence available to support specific contractual elements, such as forecast revenue and variations/claims. These, by their nature, cannot be easily validated to 'hard' or 'third party' audit evidence. Our best practice examples retained the relevant supporting evidence, clearly evaluated the balance of corroborative and contradictory evidence obtained, and directly linked both to their conclusion. We have enhanced our standard work programme to require engagement teams to obtain and retain management's supporting evidence for significant assumptions, and to ensure the relative balance of evidence supports the auditor conclusion. Our analysis also identified that the phasing of audit work in relation to long term contracts is particularly important. The AQP includes actions to assist engagement teams in planning and project managing their audits more effectively in this regard.

We do not mandate the use of an auditor expert, when management employ experts. However, our standard work programmes now require engagement teams to formally evidence their consideration of whether the audit of complex accounting/judgements necessitated expert or specialist input.

Improve the consideration and challenge of growth assumptions in relation to the impairment of goodwill and other assets

Management's decisions on whether to impair goodwill and other assets rely on them making key assumptions which involve judgement. This includes assumptions relating to future levels of profitability, where the level of impairments can be sensitive to small changes in future growth. Audit teams should obtain sufficient and appropriate evidence to assess the reasonableness of those assumptions and provide an appropriate level of challenge to management.

Findings

We reviewed the audit of impairment of goodwill and other assets on all audits that we inspected where this was identified as an area of significant risk. While the audit work on other key assumptions was generally performed to an acceptable standard, we identified findings relating to the consideration of the future short-term growth estimates, including the following:

- In relation to goodwill impairment, while cash flows were agreed to Board-approved plans, additional audit procedures were largely based on discussions with management. There was insufficient evidence of the audit team's challenge or corroboration of the estimated short-term cash flow forecasts in management's plans or that the historical business levels were sustainable. In addition, there was insufficient evidence that management's historical cash flow forecasting accuracy had been adequately assessed and/or that the impact of recent market and business changes had been sufficiently considered.

- In relation to retail stores (based in the UK), where impairment reviews had been undertaken for individual stores, the audit team did not challenge the appropriateness of using a standard growth rate across all stores. In addition, there were cases where the audit team did not sufficiently challenge the forecast short-term growth rates, even though they were in excess of recent actual growth rates.

Firm's actions:

Our engagement teams typically default to a fully substantive approach to auditing impairment reviews, without considering whether to obtain evidence to support the effectiveness of management's controls in this area. As a consequence, relevant support for assumptions, including short term growth rates, is not always directly obtained from the client. Engagement teams instead consider the assumptions in the light of other available sources of evidence. In response, we are strongly encouraging audit teams to undertake walkthroughs and operational effectiveness testing of management controls for significant risks relating to goodwill and intangible impairment and asset valuations, in addition to appropriate substantive audit tests. Our AQP includes actions to support engagement teams in robustly re-phasing and project managing their audits accordingly.

Our RCA also identified that demonstrating our challenge of assumptions requires improved clarity, particularly when evidence adequately supports management's position, or where there is no change to an assumption or overall outcome as a consequence of our work. We have made a number of enhancements to our working papers to assist our teams in evidencing their challenge and conclusions, and have included sessions in our 2018 and 2019 technical training programmes to continue to focus our engagement teams on these judgemental areas.

Strengthen the consideration and challenge in relation to management's estimation of certain provisions

Provisions can involve significant judgement. Audit teams should ensure they apply an appropriate level of challenge and adequately consider the appropriateness of the accounting policy and whether the provisions are appropriate.

Findings

We raised findings relating to the evidence of appropriate consideration or challenge of certain provisions including tax, conduct, regulatory and loan loss provisions on some audits.

In particular, for onerous lease provisions, in one case the audit team's consideration of the appropriateness of management's policy only to provide for stores that had closed was inadequate. In another case, there was insufficient evidence to explain why a provision was not required for leases of loss-making stores. In both cases, there was also insufficient evidence that the appropriateness of excluding central costs from the onerous lease provisions had been considered, including to what extent central costs may have been attributable to the loss-making stores.

Firm's actions:

Underpinning these findings is a need for improved consistency in the evidencing of our work. To help address this, we have enhanced our work plan requirements for consideration of accounting policies throughout the audit phases and will deliver a further 2019 mandatory training module to recalibrate sufficiency of evidence expectations when auditing judgements and estimates. Our AQP's investment in capacity will increase the time spent by our senior team members in coaching and sharing best practice examples with their engagement teams.

Adoption of IFRS16 will almost entirely remove the need for onerous lease provisions. Our 2018 training programme included an introduction to IFRS16, which will be reinforced in our 2019 training programme, alongside mandatory modules to align expectations over sufficiency of evidence, and share examples of how to demonstrate professional scepticism. Our IFRS16 work-programme includes procedures to ensure consideration of the right of use assets for impairment.

Enhance the audit work performed for aspects of revenue and inventory for retailers

Revenue and inventory measures are used as key performance indicators for retailers. Audit teams should ensure that they have a clear and appropriate audit approach and have undertaken adequate procedures in these areas.

Findings

As one of our priority sectors this year, we reviewed the audits of several retailers, including consideration of the audit of revenue and inventory given the significance of these areas to the financial statements. We identified findings relating to aspects of revenue and recurring findings relating to inventory counts, including the following:

- The audit team did not perform sufficient procedures over aspects of revenue, in one case, in relation to the testing of key reconciliations and, in another case, in relation to the need to obtain additional evidence over the occurrence of the transactions.

- The audit approach to inventory counts for multi-location stores was not adequately considered in relation to the stores attended, the timing of the attendance or the nature of the count testing on some audits. There were also cases where audit teams relied on management's information to support the calculation of the stock provision without adequately verifying the basis of the underlying methodology.

Firm's actions:

Our inventory counting guidance has evolved, and been refined, over the past four years to assist engagement teams in more complex inventory situations. Our RCA identified that the planning for certain inventory cycles needs to be undertaken on a timelier basis during the client's financial year. In response to these factors, we have updated the planning requirements for inventory counting to enhance the clarity of our inventory counting approach, and included certain post-signing procedures to ensure engagement teams on continuing audits consider the inventory counting requirements for the next year's audit early. This will be supported by a 2019 training module for relevant engagement teams as part of our AQP investment in training.

Our analysis concluded that the matters raised in relation to revenue required specific action by the individual audit teams. Nevertheless, we recognise the ongoing challenges with auditing aspects of retail companies and have recently held a roundtable of internal industry practitioners to discuss the issues raised, and the challenges of auditing retail entities in the current environment more generally, with a view to issuing new, practical, guidance during autumn 2019.

Strengthen the firm's systems and procedures relating to non-audit services approval

Timely approval of non-audit services by the audit engagement partner reduces the risk of a non-permissible service commencing on an audit.

Findings

As stated last year, the firm's systems do not require audit engagement partner approval before service teams obtain engagement codes to charge their time. The systems also do not incorporate the Ethical Standard changes or functionality to help engagement teams identify non-permitted services. The firm is reliant on changes to global systems to address this, although we understand that these systems will not be fully implemented in 2019.

Firm's actions:

Our existing systems cannot be configured to prevent finance codes being created for non-audit services where approval is yet to be received from the audit engagement leader. We have a number of effective monitoring controls in place, at both a UK and global level, to mitigate breach risk.

All partners and staff will complete further mandatory training during 2019, with additional training provided at relevant trigger points such as joining, re-joining, promotion, and other career milestones. The 2019 training will reinforce the requirements and confirmations required when providing non-audit services to audit clients.

Notwithstanding the above, we understand the concerns that any perceived deficiency in our control processes can create. As such, we are continually seeking to improve our own systems and IT based controls, with the network currently in the early design stages of a new global client and finance system. Additional controls will also be added to the new global AFS system (targeted for launch Summer 2019) and into our proposed central client and engagement acceptance team - to be rolled out across the firm (targeted to be completed by June 2020).

We will enhance our existing central monitoring control over the small number of clients where the delegation of audit engagement partner responsibility for approving non-audit services policy is applied.

3 Good practice examples and developments in the year

Good practice

We set out below the key areas where we noted good practice, either in audit work on individual engagements or firm-wide procedures.

Individual audit reviews

The extent of the group audit team's oversight and interaction with the component audit teams

We identified examples of good group audit team involvement in the direction and review of the work of component auditors and good evidence of that involvement. This included ongoing interaction and involvement with the component audit teams in respect of significant risk areas.

The quality of the firm's summaries of audit responses to significant risks and related findings

Audit teams prepare significant matter summaries to provide an overview of the audit responses to significant risks and related findings. These are required to be reviewed by the audit partner and engagement control quality reviewer. The significant matter summaries prepared for most audits we reviewed were of a good standard.

The use of and interaction with the firm's internal specialists and experts

Audit teams often use the firm's specialists (working as part of the audit team) or experts (reporting to the audit team) in areas such as property valuations and tax. Examples of good practice included their involvement in benchmarking key assumptions and the extent and clarity of the scope of their work.

Effective use of data analytic techniques in the audit of revenue and journals

The effective use of data analytic techniques in the audit of revenue and journals enhanced the quality of audit work in a number of cases. For example, data analytic techniques were used on one audit to provide a high level of coverage on the audit of investment income and the valuation of investments.

Firm-wide procedures

The enhanced approach to the firm-wide testing and internal quality monitoring procedures

The firm has updated its approach and the extent of its testing for firm-wide procedures.

Developments in the year

It is clear from the outcome of this year's inspection cycle that the firm has more to do to deliver consistently high quality audits. However, most of the key findings that we highlighted in last year's report have largely been addressed.

The firm has enhanced its policies and procedures during the year in a number of areas, including initiatives in the following areas:

- Effective coaching, supervision and review procedures: there has been continued focus on how audit teams embed effective coaching in the audit.

- Increased involvement from audit engagement leaders at the planning stage and throughout the audit.

- Improved articulation of audit conclusions: training and increased focus on the narrative and detail supporting audit conclusions.

We note the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2018/19 inspection.

Audit Quality Review
FRC Audit and Actuarial Regulation Division
July 2019

Financial Reporting Council

FINANCIAL REPORTING COUNCIL
8TH FLOOR
125 LONDON WALL
LONDON EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk