Developments in Audit 2020

Summary

November 2020

Key issues for audit

This document highlights the key messages from the Financial Reporting Council's (FRC's) Developments in Audit 2020. It is new this year and is designed for those with an interest in auditing, but who do not need the detail in the main report or who would find a summary helpful. The summary considers the following questions:

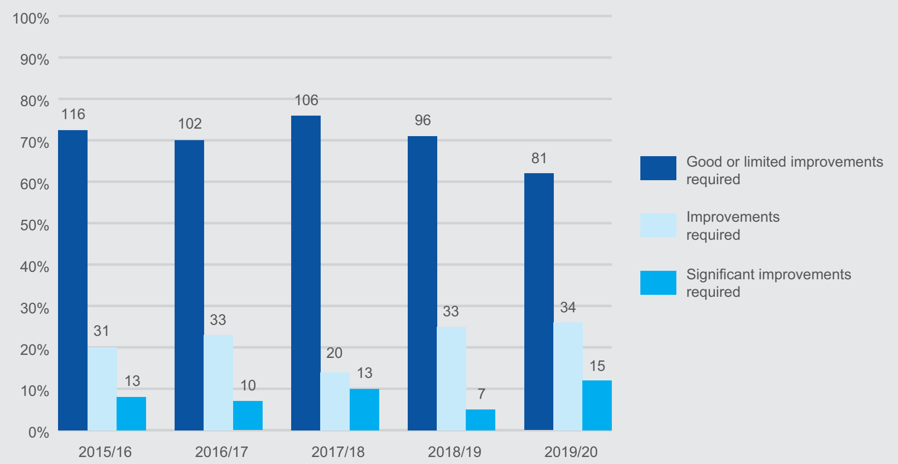
- **What is driving inconsistent audit quality and how are we responding?**
- **What impact is Covid-19 having on audit?**
- **How do we achieve a healthy and resilient audit market?**

- Against the backdrop of the Covid-19 pandemic, which has increased the public's need for reliable financial information, the audit profession needs to achieve consistently higher standards of audit quality and contribute to a more resilient audit market.
- The Government will shortly consult on wide-ranging proposals for audit reform, more effective corporate governance for audit firms, and a regulator with enhanced powers. Developments in Audit 2020 does not cover the proposals subject to the Government's consultation.

What is driving inconsistent audit quality and how are we responding?

- Our 2019/20 audit inspection cycle showed that audit quality is still unacceptably inconsistent. 49 out of the 130 audits inspected (primarily covering audits with year-ends between July 2018 and June 2019), required either improvement or significant improvement.
- Insufficient challenge of the management of audited entities, especially on their forward-looking accounting judgements and estimates, remained our most common finding. An example is goodwill impairment, where auditors need to assess future assumptions, like expected revenue growth and cost savings.
- Heightened economic uncertainty resulting from Covid-19 will make effective challenge of management even more important, but harder to achieve.
- Other common findings in our inspections related to the audit of going concern, group audit oversight, and quality control over the audit.
- Audit firms are investing significantly in programmes to improve audit quality. However we have not yet consistently seen the difference such investment is making.

Assessment of the quality of all audits
inspected by the FRC in the last five inspection cycles



Note: In recent years we have increasingly focused on higher-risk audits because they are where reliable reporting and high-quality auditing matter most. This focus means the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of any individual audit firm. The change in our approach to audit selection over time also means that year-on-year comparisons of results need to be treated with care.

- We also saw examples of good practice, including a willingness to delay and modify audit reports where necessary, the effective use of specialists and some examples of strong challenge of management.

- Within our current powers, we are taking action to drive improved audit quality through:
  - the development of a new supervisory approach to audit firms, including restructuring the current Supervision Division and taking control of the registration of public interest entity (PIE) auditors;
  - continuing to take enforcement action, where it is in the public interest;
  - obtaining agreement of the Big Four firms (Deloitte, EY, KPMG and PwC) to the operational separation of their audit practices from the rest of the firm, so that the audit practice is focused first and foremost on audit quality;
  - performing more audit inspections across all audit firms, including more audits which are higher-risk or require the most complex accounting judgements;
  - increasing the transparency of our work by publishing individual audit inspection findings, starting from our 2020/21 inspection cycle (where we obtain the consent of the audit firm and audited entity); and
  - driving enhancements to key auditing standards, such as going concern, group audit oversight and estimates.

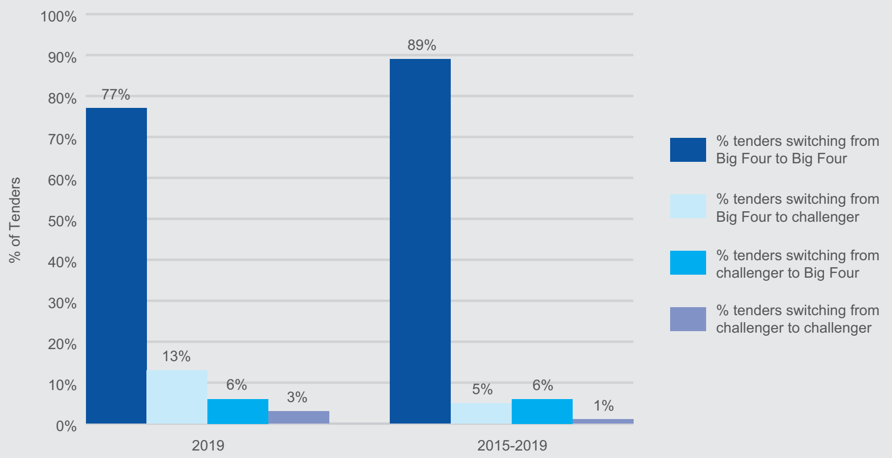
What impact is Covid-19 having on audit?

- The economic impact of the pandemic has increased the complexity of many forward-looking accounting judgements, due to the uncertainty about the prospects of many companies. This makes effective challenge of management more difficult.
- Remote working and travel restrictions have given rise to practical difficulties in obtaining sufficient and appropriate audit evidence, particularly for areas normally tested in person, such as inventory counts, and in relation to group auditor oversight of overseas components.
- Mass home working may have increased control and fraud risks which require enhanced audit consideration.
- We worked with the Financial Conduct Authority and the Prudential Regulation Authority to provide additional guidance to support the provision of high-quality financial information to markets and high-quality audit work, given the new challenges facing the market. This included guidance for companies preparing financial statements and a bulletin for auditors covering factors to be considered when carrying out audits during the Covid-19 pandemic.
- The pandemic has also tested the financial and operational resilience of the audit firms themselves. All firms took early action and, so far, have proven resilient.

How do we achieve a healthy and resilient audit market?

- The Big Four firms continue to dominate the FTSE 350 audit market, particularly for the largest companies by market capitalisation. The failure of any one of these firms would threaten the stability of the overall audit market.
- The introduction of mandatory audit tendering and rotation in 2016 has marginally improved the functioning of the market; and the proportion of audit tenders resulting in FTSE 350 companies switching from a Big Four firm to a challenger firm did increase in 2019, but the Big Four firms continue to audit 96% of FTSE 350 companies. Further increases in participation by firms outside the Big Four are needed in order to increase choice for companies and improve resilience.

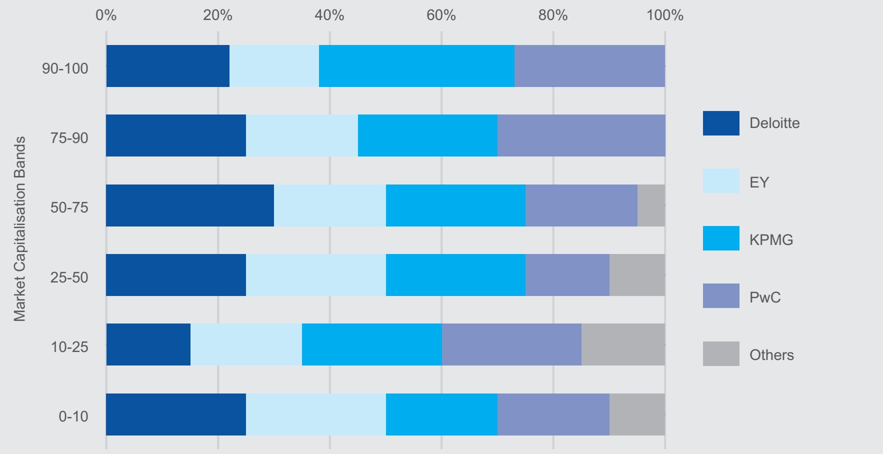
Switching in the FTSE 350 between the Big Four firms and challenger firms



Note: Challenger firms include all auditors other than Deloitte, EY, KPMG, and PwC. This chart includes all switching observed in the period 2015 to 2019 for companies in the FTSE 350 as at 26 June 2020. Because of rounding, the percentages as presented do not always add up to 100%; unrounded percentages do add up to 100%. Source: Audit Analytics Auditor Change data.

- We have assessed the FTSE 350 audit market since our previous Developments in Audit publication and the Competition and Markets Authority's Statutory Audit Services Market Study to provide a starting point of indicators which assess the impact of market-opening measures.
- We will be using audit fees, audit market share, and auditor changes and rotation as key market monitoring indicators.
- The following chart shows audit firm market share of FTSE 350 audits based on the market capitalisation of FTSE 350 companies. Each FTSE 350 company is allocated to one of six percentile bands.

FTSE 350 audit market share by market capitalisation percentile bands and by number of engagements in 2019



Note: 90th percentile corresponds to companies with a market capitalisation above EUR17.4bn, similarly for the 75th, above EUR6.1bn, 50th above EUR2.2bn, 25th above EUR1.3bn, and 10th above EUR0.8bn. "Others" includes non-Big Four firms and unknowns (i.e. observations for which Audit Analytics does not detail the identity of the auditor). Source: Audit Analytics Audit Opinion data.

Financial Reporting Council

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