



Financial Reporting Council

DELOITTE LLP

AUDIT QUALITY INSPECTION

JUNE 2018

The FRC

Our mission is to promote transparency and integrity in business.

transparency



We have responsibility for the public oversight of statutory auditors.

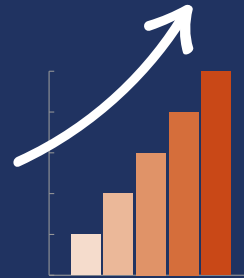
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



AQR

We monitor the quality of UK Public Interest Entity audits.

+1.55	0.20%	+2.27%	-11.48%	POS	-3.2320
+3.20	0.21%	+2.83%	-15.93%	NEG	-3.9993
+3.85	0.14%	+2.42%	-17.67%	POS	-4.2421
+3.38	0.27%	+2.19%	-18.32%	NEG	-4.2083
+3.12	0.20%	+2.28%	-14.73%	NEG	-3.5708
+3.31	0.20%	+2.76%	-20.12%	NEG	-2.8339



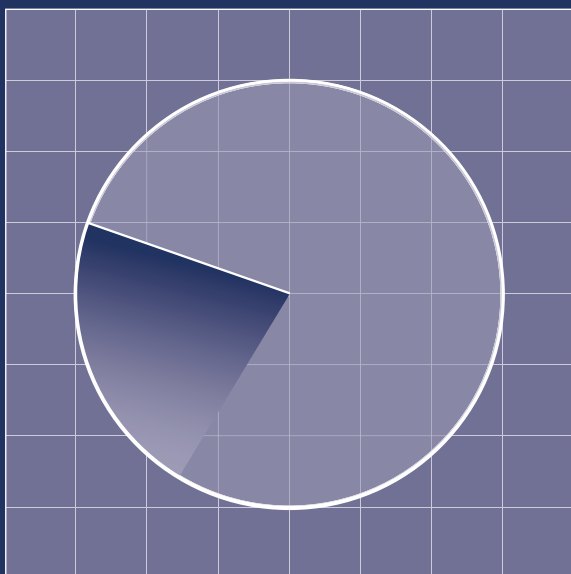
We promote continuous improvement in audit quality.

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



The Firm

Deloitte has 413 audits within the scope of AQR inspection, including 22 FTSE 100 and 66 FTSE 250 audits.



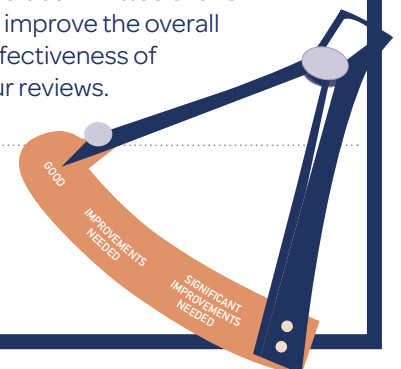
Our inspection process

There are around 2350 audits within the scope of AQR inspection. In total, we inspected 145 individual audits in 2017/18, including 25 at Deloitte.



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

Deloitte LLP

Audit Quality Inspection

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AQR's objective is to monitor and promote improvements in the quality of auditing.

AQR assesses the quality of audit work and policies and procedures supporting audit quality at firms which audit Public Interest Entities.

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 Overview

This report sets out the principal findings arising from the 2017/18 inspection of Deloitte LLP (“Deloitte” 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 March 2017 to February 2018 (“the time of our inspection”). We inspect Deloitte LLP 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, focusing on changes arising from the revised Auditing and Ethical Standards¹.

We plan to implement a new audit firm monitoring approach for the six largest firms from 2018/19². This approach focuses on five key pillars: leadership and governance, firm values and behaviours, business models and financial soundness, risk management, and evidence of audit quality.

We are grateful for the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2017/18 inspection.

Our assessment of the firm’s performance

The overall results of our reviews of the firm’s audits show that 76% were assessed as requiring no more than limited improvements, compared with 78% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 79% as achieving this standard compared with 82% in 2016/17. We are concerned at the lack of improvement in inspection results. The FRC’s target is that at least 90% of these audits should meet this standard by 2018/19.

Where we identified concerns in our inspections, they related principally to aspects of group audit work, audit work on estimates and financial models, and audit work on provisions and contingencies. During the year, the firm has continued to develop the use of “centres of excellence”, increasing the involvement of the firm’s specialists in key areas of the audit. We have no significant issues to report this year in most of the areas we reported on last year.

The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement.

1 The firm was also included within the scope of our thematic review on Audit Firm Culture. The report, published in May 2018, sets out how audit firms are seeking to embed a culture which supports high quality audit: [Audit Culture Thematic Review](#)
2 [AFMA Press Notice](#)

Key findings in the current year requiring action

Our key findings in the current year requiring action by the firm are set out below. Further details are given in section 2, together with the firm's actions to address them.

Individual audit reviews

The firm should:

- Improve the group audit team's oversight and challenge of component auditors.
- Improve the extent of challenge of management's forecasts and the testing of the integrity of financial models supporting key valuations and estimates.
- Strengthen the firm's audit of provisions and contingencies.

Review of firm-wide procedures

The firm should:

- Enhance certain aspects of its independence systems and procedures.

Assessment of the quality of audits reviewed

The bar charts below show the results of our assessment of the quality of the audits we reviewed in 2017/18, with comparatives for our four previous inspections³. The number of audits within each category in each year is shown at the top of each bar.

The first chart shows the results for all audits reviewed. The second chart shows the results for FTSE 350 reviews only.

³ Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Chart 1: All reviews

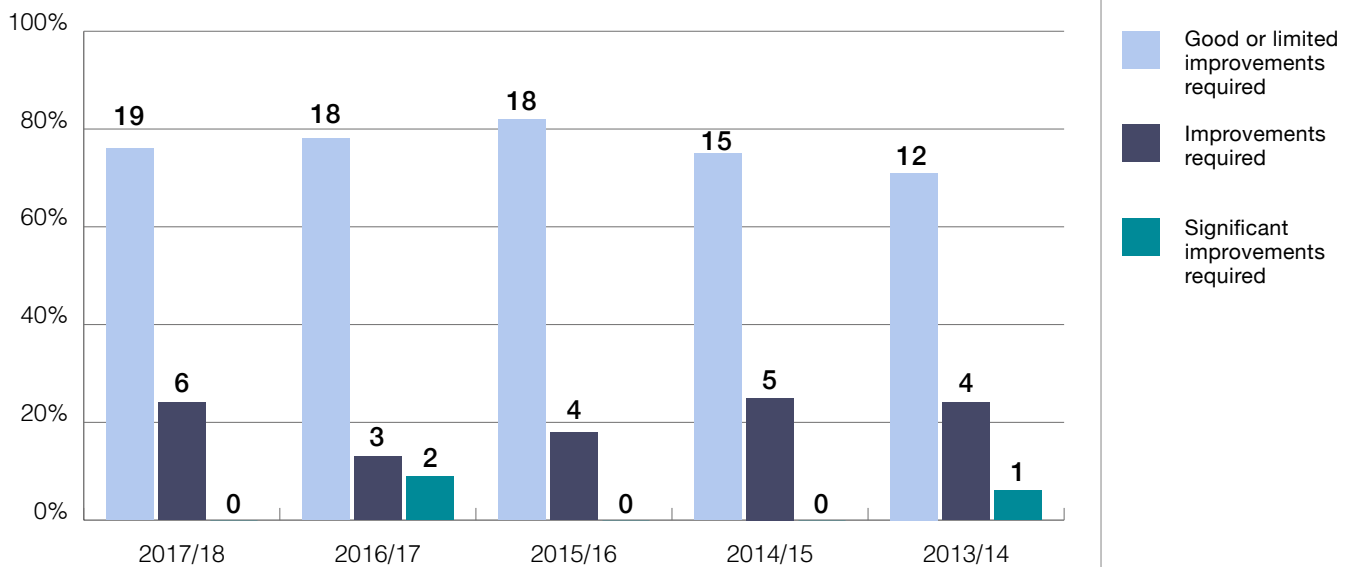
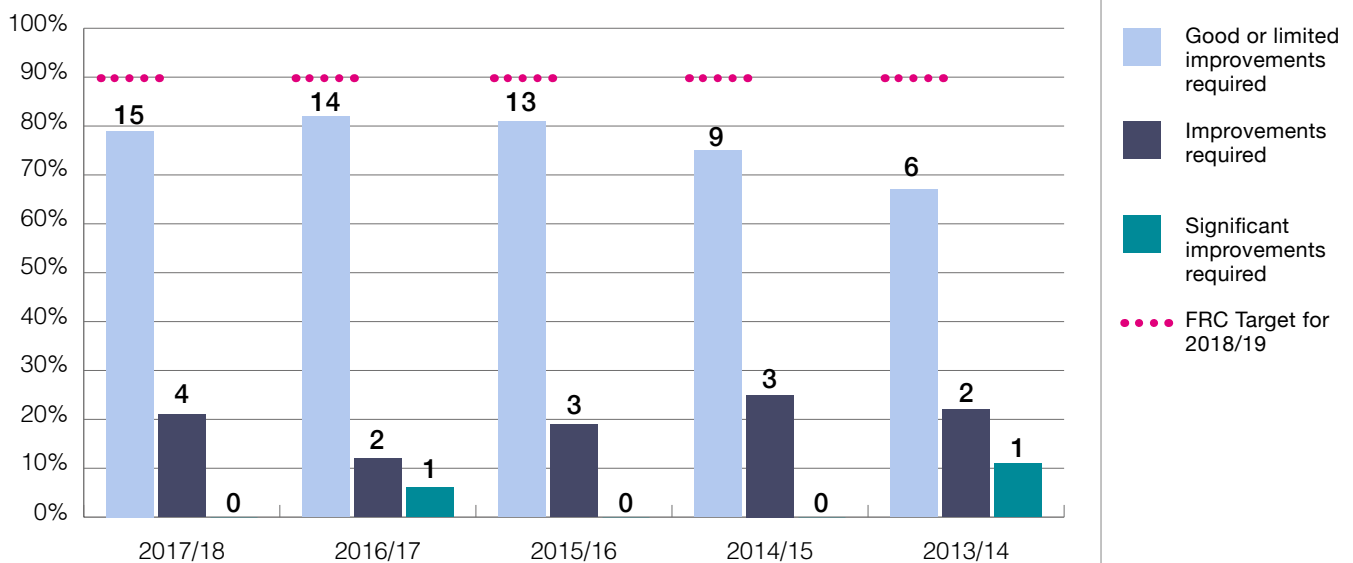


Chart 2: FTSE 350



Good practice identified

Examples of good practice we identified in the course of our work include the following:

Individual audit reviews

- Evidencing of complex revenue systems and controls.
- The use of data analytics for risk assessment and substantive testing purposes.
- The use of the firm's specialists from outside the audit practice, including appropriate integration into the audit team.

Review of firm-wide procedures

- The coverage of the firm’s personal independence compliance testing of partners.
- Certain aspects of the firm’s response to the revised Auditing Standards, relating to training for internal specialists and central oversight and review.

Further details and examples 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.

Our report on Audit Firm Culture stated that, based on RCA undertaken through 2017, all firms covered by that review had improved their RCA since our 2016 thematic review. We also reported that firms should seek to develop their RCA techniques “to identify the behavioural or cultural factors that contributed to either good or poor quality outcomes”.

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.

Firm’s overall response and actions:

We are committed to consistently providing the highest quality audits and seek continuous improvement. We welcome the AQR’s perspective on the quality of our audit work through their engagement and thematic reviews, and we value their external insight.

We take the findings of the AQR seriously and we listen carefully to the views of the AQR and other external audit inspectors. We remediate every finding regardless of its significance and seek to take immediate and effective actions, not just on the individual audits selected but across our entire audit portfolio. We are committed to continuously improving all aspects of audit quality in order to provide consistently high quality audits that underpin the stability of our capital markets.

We have improved the speed by which we communicate potential audit findings, arising from the AQR inspections and our own internal reviews to a wider population, however, we need to do more to ensure these actions are embedded. In order to achieve this we have launched a more detailed risk identification process and our InFlight review programme. This programme is aimed at having a greater impact on the quality of the audit before the audit report is signed. Consistent achievement of quality improvements is our aim as we move towards the AQR’s 90% benchmark.

Our root cause analysis (RCA) is essential in helping us to identify the root causes of findings in both external inspections and our own internal review programme. It also incorporates issues identified by the FRC’s Corporate Reporting review programme. In 2017 we have further enhanced our RCA programme by engaging with a behavioural psychologist who can help our RCA experts dig deeper into root causes by identifying behavioural and wellbeing factors that can drive audit quality (both positively and negatively).

Firm's overall response and actions:

We welcome the AQR's focus on identifying areas of good audit quality, these points as well as areas of good practice identified by other inspectors provide us with valuable insight which helps us to understand 'what good looks like'. This in turn allows us to recreate the positive factors across all our audits.

Through our RCA, we identify whether the findings are specific to the particular audit or whether there is a more thematic issue which could impact our other audits. Findings, comments and root causes are shared with the entire audit practice and are the subject of many different forms of training, guidance and alerts throughout the year. Our internal inspection programme incorporates all findings and comments made by the AQR and other audit inspection programmes throughout the year. We have included more detail in relation to current year key findings within section 2.

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 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 group audit team's oversight and challenge of component auditors

Group auditors are responsible for the overall direction and supervision of the audit and should therefore properly assess the work performed by component auditors, in particular in areas of significant risk.

We reviewed group audit matters on the majority of audits that we inspected. On three audits, we saw examples of good practice regarding the planning and scoping of group audits and the group audit team's oversight of component auditors.

We had concerns with the audit work in this area on five audits, however, particularly where audit procedures were undertaken by component auditors in areas of significant risk.

Issues arising included:

- On four audits we had concerns with the sufficiency of audit work on taxation where audit procedures were largely undertaken at a component level. On three of these audits, there was insufficient evidence of oversight and challenge over the appropriateness of provisions for uncertain tax exposures in foreign jurisdictions. On two of these audits we also had concerns with the sufficiency of audit evidence to support the recoverability of deferred tax assets.
- On one of those audits, there was also insufficient evidence of oversight of the component auditors regarding the corroboration of revenue growth forecasts used in management's goodwill impairment review.
- In another audit, there was a lack of clarity regarding the group team's oversight of the component audit team's work and review of their audit working papers and returns, particularly in relation to testing the operating effectiveness of controls over revenue.

Firm's actions:

We acknowledge the areas for improvement here, and our RCA identified that assumed knowledge was a causal factor, where the audit teams had very deep business understanding of the audited entity and industry knowledge but at times had not included sufficient evidence of that within the audit file. In some cases our RCA also identified a causal factor that audit teams need better guidance on 'what good looks like', in particular in relation to the level of audit evidence required to demonstrate that sufficient group oversight has taken place.

The group audit findings relate primarily to the sufficiency of documentation on the group audit files to fully evidence the group level challenge and oversight of component level areas of judgement.

We have begun to take actions in this area which will flow through the audits under AQR review over time. These include:

- Providing a detailed practice aid July 2017 on group audits which includes details on how to evidence group oversight and challenge;
- Including a session on group audits within our summer technical audit excellence training in 2017;
- A compulsory global training video in December 2017 as part of our monthly technical update to all of audit, focused on key aspects of a group audit and component considerations including risk assessment, common pitfalls, and, key actions and focus areas for 2017 group audits;
- Providing audit team based learning on group audits, and a "getting it right the first time" practice aid in December 2017; and
- Developed specific inflight monitoring health check focused on Group audit planning, evaluating & concluding which has been piloted in early 2018.

Improve the extent of challenge of management's forecasts and the testing of the integrity of financial models supporting key valuations and estimates

Management's forecasts are often used to support key areas of judgement and estimation uncertainty, such as impairment and valuation of intangibles on acquisition. Audit teams need to exercise an appropriate level of professional scepticism when assessing management's assumptions underlying these forecasts, comparing them to available audit evidence and challenging management in relation to their basis. It is also important that sufficient audit evidence is obtained over the integrity of financial models supporting all key valuations and estimates.

Last year we reported concerns with the extent of challenge of management by audit teams, particularly regarding impairment of goodwill. The firm has taken action in response, including mandatory consultation with the firm's impairment specialists on audits of all FTSE 350 entities with material goodwill balances and on other PIE audits with a significant risk in relation to goodwill. In the current inspection cycle, whilst the adequacy of audit work on goodwill impairment was not a key driver this year in relation to any of the

audits we assessed as requiring more than limited improvements, we nevertheless noted concerns on some audits regarding work performed on management's forecasts and/or key assumptions. Details are set out below:

- On two audits, there was insufficient challenge of management over revenue growth assumptions in cash flow forecasts supporting management's goodwill impairment assessment on some cash generating units ("CGUs") and insufficient reporting to the audit committee on sensitivity analysis. On a further audit with a significant number of CGUs, the audit team should have challenged management further to ensure an appropriate allocation of cash flows to partially impaired CGUs.
- On one audit, the firm's mandatory consultation process for goodwill impairment was not held when required. In another case, where goodwill was fully impaired, the consultation process should have been enhanced so that it considered the carrying value of the remaining tangible fixed assets in the CGU.
- On another audit, further audit procedures should have been performed to challenge management's key assumptions underpinning the cash flow forecasts for the going concern period.
- For a group audit with an acquisition in the year, insufficient audit evidence was obtained to assess aspects of the judgements, assumptions and methodologies for acquired technology and customer relationships.

Furthermore, on five audits we had concerns regarding the adequacy of audit work over the integrity of management's models, including their mathematical accuracy and/or verification of key data inputs.

The firm should continue to focus on this area and monitor the effectiveness of the actions taken to date.

Firm's actions:

This area will be a key focus of our summer technical training sessions as part of the preparation for ISA 540 (revised). Our independent RCA identified assumed knowledge as a causal factor in some of these engagements, which had also led to a causal factor 'mind-set' that in certain cases teams had not sufficiently evidenced the professional scepticism they had applied.

We are developing a [global] practice aid for audit teams to provide greater guidance on the extent of audit procedures around management models which will support greater consistency in our approach to such areas.

Whilst we are pleased that the improvements in our approach to the audit of impairment have led to a reduced number of findings, we are not complacent and the audit of impairment is one of our key InFlight review programmes. We will evaluate, through our internal inspections the effectiveness of our policy to require consultation with our impairment centre of excellence to consider whether this will continue to be a mandated process.

We will work with the individual audit teams to ensure the actions identified are implemented. In addition we will seek to drive further adoption of identified best practice data analytics as, together with the practice aid, this is another key route to driving greater consistency in audit quality. We will also continue to encourage our audit teams to consult with specialists in complex areas, which we do via training, coaching and regular communications with the audit practice.

Strengthen the firm's audit of provisions and contingencies

The completeness and accuracy of provisions and disclosures relating to contingencies can be a highly judgemental area. The audit team should address the risk of conscious or unconscious bias and demonstrate sufficient challenge of management to ensure year end balances and financial statement disclosures are appropriate.

We identified the following issues in this area:

- Insufficient evidence obtained over the appropriateness of management's judgement regarding the provision made for an uncertain tax exposure in an overseas jurisdiction.
- Insufficient evidence to support the assumptions used, or justification for the parallels drawn with other sites, to determine the adequacy of a provision for environmental liabilities.
- Insufficient evaluation of contradictory evidence provided by the firm's specialists in the assessment of a restructuring provision for a property portfolio.
- Inadequate challenge of management on the lack of any contingent liability disclosures (two audits).

Firm's actions:

The nature of provisions and contingencies is that the available evidence varies depending on the complexity and materiality of the judgement associated with each. This is a broad area and can result in a range of possible outcomes. Ensuring clarity of challenge and evidence over key assumptions remains important and we will work with the individual teams to ensure the actions agreed have been implemented.

We will include the auditing of provisions and contingencies within our auditing of management estimates practice aid, and our 2018 summer technical audit training will emphasise through the use of cases studies the approaches to auditing and demonstrating professional scepticism in this area.

In addition, we are developing a publication to be shared with audited entities to highlight and provide guidance on the need for sufficiency of supporting documentation which they should gather and assess in forming their own analysis and conclusions ahead of audit challenge of that evidence.

Enhance certain aspects of the firm's independence systems and procedures

A revised Ethical Standard ("ES") became effective during the year with enhanced requirements and stricter prohibitions. The firm therefore needed to ensure its policies and procedures complied with these requirements.

Given the importance of auditor independence and the impact of the revised ES, in March 2017 we reviewed the arrangements for independence and ethics at the six largest firms. This approach allowed us to benchmark arrangements across the firms and share good practice. Our review focused on how the firm's policies and procedures address the revised ES requirements. We have also reviewed compliance with the previous Ethical Standards as part of our inspections of individual audits.

Findings

The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement.

We identified the following concerns:

- The firm's global non-audit services approval system does not include rules and parameters related to the revised ES or require sufficient information to be provided to identify when services are likely to be prohibited.
- The firm has not centrally monitored compliance with audit firm rotation requirements for certain categories of its PIE audits.

Firm's actions:

We have found the benchmarking across firms performed by the AQR to be useful and constructive and it allowed us to focus on specific areas where we needed to improve our systems. It also highlighted areas where we had implemented best practice.

We acknowledge the points raised in respect of our non-audit approval system. This is a global system and we have worked to develop changes which will enhance the system to include a question set in each service request and information required from non-audit engagement teams that is tailored to the requirements and prohibitions of the Revised Ethical Standard. We expect these changes to go live during 2018.

However, it is important to highlight that audit partners and teams are required to gather all the required information to properly assess any proposed non-audit services, regardless of the system constraints. The systems developments will therefore improve the quality and detail of the initial submission to the audit engagement partner through this system.

To date our monitoring approach to audit rotation has been through manual assessment with our analysis updated on a regular but periodic basis. We have been working to enable a systems based solution for full tracking of the relevant data on length of tenure and expect to complete this during 2018. Once these system changes are implemented the monitoring will then be embedded within our central system and processes. We have not identified any instances of non-compliance with rotation requirements.

Other issues driving lower audit quality assessments

Other issues driving lower audit quality assessments on individual audits included the following:

- Lack of evidence that the audit team had performed a proper assessment of the nature of tax advisory services being provided and whether they were permissible under Ethical Standards. As a result, the assessment of threats and safeguards was inadequate.
- Insufficient evidence of audit procedures performed over loan loss impairment and revenue recognition.
- Insufficient audit procedures over inventory, in particular, concerning provisioning, multi-location counts and testing of costs.

3 Good practice examples and developments in the year

Good practice

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

Individual audit reviews

Complex revenue systems and processes

On a number of audits with complex systems, we considered the evidencing of the audit team's understanding of the revenue systems and related controls (including IT controls) to be of a high standard. The audit team made effective use of flow charts which clearly and logically outlined process flows and pinpointed key controls.

Data analytics

We have seen good examples of the use of data analytics by audit teams to obtain audit evidence:

- On a retail group, data analytics were used effectively in a number of areas of the audit. In particular, stores with financial results or key metrics falling outside pre-determined ranges were identified for further investigation. Data analytics were also used effectively to corroborate the level of inventory provisions and to profile populations for sampling purposes.
- On a property company, the audit team designed a bespoke analytic with input from a Deloitte property expert to extract and analyse data from a group database to calculate the expected rental income.
- On another property company, data analytics were used to assist the audit team in the audit of property valuations.

Effective use of specialists

We have seen a number of cases on individual audits where the firm's specialists have been integrated effectively into the audit team to provide an appropriate level of assurance in areas where specialist knowledge is required. Examples include the use of pension specialists to assess the reasonableness of key actuarial assumptions and pension asset valuations; and the use of financial instrument specialists in assessing fair values and hedge effectiveness. We have also seen extensive use of IT specialists on audits.

Firm-wide procedures

Ethics and independence and the firm's response to the revised ES requirements

- The firm's personal independence compliance testing of partners is more comprehensive than at most other firms. It covers investment transactions over a three month period, testing all members of the firm's leadership annually and all new partners in their first year with the firm.
- The firm has revised its employment contracts with non-equity audit partners and other personnel authorised to sign audit reports to embed the legal prohibitions against joining audited entities.

Response to the revised Auditing Standards

The firm has made good progress in addressing the new requirements of the revised Auditing Standards, including updating the firm's policies and procedures. We note the following areas of good practice.

Central oversight

The revised Auditing Standards were effective for all accounting periods starting on or after 16 June 2016. The central compliance team completed a review of which audited entities had short accounting periods to ensure they provided the necessary advice to the relevant audit teams.

Training

The firm has provided training on the revised standards for those internal specialists who are involved in audits.

Extended audit report reviews

All extended audit reports will continue to be reviewed centrally, despite the increased population.

Developments in the year

As mentioned in section 1, the firm continues to place considerable emphasis on audit quality and we have seen continued improvement in relation to most of the key findings we highlighted in last year's report. We set out below key areas of progress that have been made by the firm in the year.

The firm has enhanced its policies and procedures in the following areas:

- Increased use of centres of excellence ("CoE") involving the firm's specialists, including new CoEs focusing on goodwill impairment (established in response to previous inspection findings) and corporate reporting, to address increasing complexity of financial reporting.

-
- Further methodology updates and additional guidance issued to the audit practice including the audit approach to pension balances, internal controls, data analytics, group audits and taxation.
 - A new staff performance and development system was implemented with additional focus on regular timely feedback on performance, including audit quality.
 - Further improvements to the depth and timeliness of root cause analysis on internal and external inspection findings.

Audit Quality Review

FRC Audit and Actuarial Regulation Division

June 2018

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