Developments in Audit 2021

Financial Reporting Council

November 2021

Contents

Foreword

Welcome to this year's Developments in Audit. This report is not just an assessment of the UK audit market as a whole but also sets out the FRC's high expectations of how audit firms should deliver audit quality improvements so that the market works more effectively and in the public interest. During the year the Government's Consultation 'Restoring trust in audit and corporate reform' (the 'Government's Consultation') resulted in high levels of engagement with a wide range of stakeholders on the proposals and over 600 responses submitted.[1] This keen level of engagement and interest indicates not only the importance of the need for reform but also a desire to see a new regulator, the Audit, Reporting and Governance Authority (ARGA), established as soon as possible with the statutory powers to deliver better outcomes for all stakeholders – companies, investors, employees, pension holders, suppliers, customers and taxpayers.

This report emphasises that high quality audit remains vital to ensure users of financial statements can confidently rely on the information published by companies in relation to their financial health, their operational performance and their prospects. This will become even more important as listed companies will, from next year, be required to report against the Task Force on Climate-Related Financial Disclosures. While there is emerging evidence to suggest some of the audit firms are successfully implementing improvement measures, audit quality remains mixed and inconsistent across the firms and in some instances, between audits at the same firms. During the year we have revamped our approach to supervising the largest firms, consulted on revising the Audit Firm Governance Code, advanced the operational separation of the Big Four and significantly enhanced a number of key auditing standards. The report also outlines some key initiatives for the future as we await the Government's Feedback Statement on the consultation (the 'Consultation response') which will set out next steps and timing.

As we continue to lay the groundwork for establishing ARGA and improve ourselves, our continued objective will be to drive all firms to deliver consistent, high quality audit to the benefit of all stakeholders and the wider public. We have set the bar high for what we expect from the firms and rightly so given the importance of audit at the centre of the corporate ecosystem.

1 Consultation on the UK Government's proposals on "Restoring trust in audit and corporate governance" published in March 2021: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

Key issues for audit

This report sets out the FRC's work in the past year to support its objectives of improving audit quality and maintaining resilience in the UK audit services market. In working towards these twin aims, we have set out the key issues for the audit market and have reported on what is being done well – and what can still be improved.

The results of our Audit Quality Reviews and recent enforcement cases once again highlight deficiencies relating to lack of professional scepticism by auditors, including failures to sufficiently challenge management's assumptions, as well as evidence of the poor application of professional judgement. The persistence of these issues over time is disappointing given that they are fundamental to the mindset required to deliver effective audits. Similar concerns have been expressed by international audit inspectors,[2] and a focus on auditor scepticism and auditor independence were key themes in Sir Donald Brydon's report on improving audit quality and effectiveness (the 'Brydon Review')[3] and the Government's Consultation on audit reform.

The pandemic has had a significant impact on the conduct of an audit in the UK and has affected audited entities, audit firms as well as the operational activities at the FRC. Despite these challenges, opportunities also arose as firms adopted more agile ways of working and leveraged the capability of newer technologies. Likewise, the FRC rose to these challenges by regulating the wider audit market whilst continuing to navigate a period of significant internal change, to support the creation of a new regulator ARGA. Our transformation will deliver a strong and 'fit for-purpose' regulator and provide increased confidence in the UK market.

The 2021 year began with continued uncertainty and further restrictive lockdowns resulting from new strains of Covid-19. However, the market has adapted and rebounded with agility and cautious optimism.

Having established the resilience of the firms' own business models in light of the pandemic, our attention turned to how firms set about resolving the resultant accounting and auditing challenges for their own service delivery responsibilities. In this context, our regulatory aim was clear – how could we best preserve, and even improve upon, the quality of UK audit services in an environment marred by uncertainty and the increased complexity in making judgements and forward-looking estimates? In 2020 we had asked ourselves the following questions.

- **What is driving inconsistent audit quality?**
- **How do we achieve a healthy and resilient audit market?**
- **What are we doing to address these issues?**

We have revisited these questions in 2021 to help us measure our progress in driving improvements to achieve consistently high standards of audit quality, in the context of our current powers to achieve our statutory objectives.

Our review of audits once again highlight deficiencies relating to lack of professional scepticism by auditors.

2 IFIAR, Survey of Inspection Findings 2020 (March 2021): https://www.ifiar.org/?wpdmdl=12436
3 Sir Donald Brydon CBE, Assess, Assure and Inform (December 2019): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

In responding to these key challenges for audit, our approach is underpinned by our continued work to develop and improve the auditing, assurance and ethical standards and, where necessary, apply transparent and visible enforcement procedures in response to poor conduct. Sections 1 and 2 below set out respectively our response to dealing with the key issues for audit and how these respond to the audit quality results for the 2020/21 inspection cycle.

Regulatory reform and resilience

On 18 March 2021 the Government published its white paper, *'Restoring Trust in Audit and Corporate Governance'* (the Government's Consultation) paving the way for legislation to be introduced that will implement the reforms recommended in the three independent reviews published in 2018 and 2019: the Kingman Review[4], the Brydon Review and CMA's market study[5] (together 'the Reviews'). The white paper includes far-reaching proposals affecting the FRC's purpose and objectives, and the roles and responsibilities of those we regulate. The Government's Consultation has the potential to significantly alter and enhance the FRC's supervisory and enforcement powers.

The Government is expected to publish its Consultation response shortly, which will include the proposed next steps in the process. Covid-19 and the UK's exit from the EU have heavily affected the available Parliamentary time, and we are awaiting the Government's update on the timetable for tabling legislation.

The FRC's regulation of the audit market includes measures designed to drive improvement in the auditor's mindset. Our principles for operational separation of the audit practices of the Big Four audit firms in the UK include the objective to strengthen professional scepticism and judgement through a greater focus on audit and audit quality. The FRC's 2021 culture conference, described in Section 1 under 'Values and Culture', was specifically intended to develop an enhanced mindset of professional scepticism and challenge by auditors. We are also launching a project to design a new framework for the exercise of professional judgement, partly in response to a specific recommendation in the Brydon review. Alongside these and other initiatives we continue to influence the design of auditing standards internationally to deliver better and more consistent performance, providing additional UK specific requirements where we feel an international standard does not go far enough. This includes working closely with the International Auditing and Assurance Standards Board which has a professional scepticism working group which contributes to the development of international standards[6] as well as producing stand-alone guidance.[7]

Our regulation of the audit market includes measures to drive improvement in the auditor's mindset.

Improving audit quality

We have revamped our approach to the way we supervise the largest audit firms through the creation of three teams – Audit Firm Supervision, Audit Market Supervision and Audit Quality Review (within the Supervision Division). Further details are set out in our publication 'Our Approach to Audit Supervision'[8] and throughout this report (in particular Section 4).

Our audit inspection programme has always been risk-based and focused primarily on those firms carrying out audits in which the public interest is greatest; our so-called 'higher-risk' audits.

We have revamped our approach to supervising the largest audit firms.

4 Independent Review of the Financial Reporting Council published in December 2018: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf
5 Statutory audit services market study final summary report by the Competition & Markets Authority published in April 2019: https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final_summary_report.pdf
6 Details of the IAASB professional scepticism working group, please refer to: https://www.iaasb.org/consultations-projects/professional-skepticism
7 For example guidance on professional scepticism: https://www.ifac.org/system/files/publications/files/PS-Communique-201910-FINAL-Edited.pdf
8 Our Approach to Audit Supervision published by the FRC in March 2021: https://www.frc.org.uk/getattachment/db4ef2e0-72f6-4449-bda0-c8679137d1b1/FRC-Approach-to-Audit-Supervision-FINAL.pdf

Higher-risk audits

We define audits as higher-risk where the group or entity:

- is in a high-risk sector or geography;
- is experiencing financial difficulties;
- has balances with high estimation uncertainty; or
- where the auditor has identified governance or internal control weaknesses.

Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues, for example:

- materiality becomes a key factor in determining the significance of audit judgements for entities that have low profitability;
- headroom on impairment assessments may be lower and the entity's balance sheet may be more sensitive to changes in key assumptions; and
- going concern assessments are less clear cut.

Taking a similar, proportionate approach, we vary the intensity of our forward-looking supervisory work across these three tiers of audit firms that audit public interest entities (PIE audit firms).

The 2020/21 audit quality results show that challenges remain within the wider audit market in achieving and improving quality in audits undertaken. This observation holds true for both larger and smaller audits and audit firms, as well as for the sample of National Audit Office audits we reviewed. The results for the local audits have improved, however the timeliness of auditor reporting is disappointing. Overall, nearly one third of audits inspected by the FRC still require improvement.

- Of the 147 audits reviewed, 33% required improvement or significant improvement, compared with 38% for 2019/20;
- Quality across firms was more mixed than in 2019/20, with evidence that some firms had successfully implemented improvement measures since our last review.

The FRC has observed and identified examples of good practice in the audits inspected during the 2020/21 cycle, such as:

- the effective use of internal and external specialists to review and challenge management's methodology and assumptions;
- the delaying of audit opinion sign-offs to ensure that sufficient time is available to deliver quality output;
- the rigorous assessment of the risks related to the carrying value of assets which could be impaired;
- the use of corporate finance and modelling specialists to challenge assumptions and modelling techniques used in going concern assessments; and
- in group audit oversight work, the robust challenge of the component auditor's work.

We recently published a document on what makes a good audit, based on our recent file inspections.[9]

We have also published measures that individual firms will be required to implement in response to individual inspection findings. The most significant thematic weaknesses identified by us in the 2020/21 inspection cycle related to:

- inconsistency in audit quality across different firms, across different audits within the same firm, and even within different parts of the same audit;
- the lack of professional scepticism, including the failure to adopt an attitude to sufficiently challenge management's assumptions;
- the poor application of audit judgements or estimates (e.g. around going concern or impairments);
- the poor assessment of internal controls – including their effectiveness in mitigating fraud risk;
- good practice not always being applied on a sufficiently consistent basis; and
- the tendency for some smaller firms to apply capped or limited sample sizes despite the significant risk area audited, or key judgements required.

9 What Makes A Good Audit: https://www.frc.org.uk/getattachment/117a5689-057a-4591-b646-32cd6cd5a70a/What-Makes-a-Good-Audit-15-11-21.pdf

Covid-19 and Beyond

All of our teams considered the impact of Covid-19 on the audit firms during the period. We responded to the emerging Covid situation by providing firms with additional flexibility in carrying out their engagements, whilst requiring the same basic benchmark of quality from auditors and preparers.

A bulletin was issued to auditors reminding them of the requirement to obtain sufficient, appropriate audit evidence to support their audit opinions. While the pandemic did not reduce the extent of audit evidence required to support an audit opinion, we updated our guidance on auditors' use of alternative procedures, including remote working and technology, to obtain sufficient appropriate evidence.

We adjusted elements of our 2020/21 cycle inspection activity to specifically assess if auditors were appropriately responding to the audit risks posed by Covid-19. This included:

- undertaking and publishing two thematic briefings on the audits of going concern;
- considering which industries and entities had been more significantly impacted by Covid-19; and
- identifying whether the entity had a year-end before or after March 2020, and adjusting our inspection's focus accordingly.

Similarly, our cross-firm supervision teams maintained a close oversight of the Tier 1 firms' Covid risk management and responsiveness through our regular engagement meetings and the work conducted as part of our risk-based monitoring plan. Further information on these measures is set out in Section 1.

Developments in auditing, assurance, and ethical standards

A number of key UK auditing standards have either recently become effective, or will become effective in the near future, creating new requirements for auditors. We have set out these developments in Section 4 and Appendix 2.

ISA (UK) 540 Auditing Accounting Estimates and Related Disclosures became effective for audits of financial statements beginning on or after 15 December 2019 and includes two key requirements which we have since incorporated into other standards – a requirement for the auditor to make a 'stand back' overall evaluation of audit evidence obtained, including indicators of management bias, as well as considering evidence that is contradictory to management's assumptions and estimates.

Similar requirements have been included in recent revisions to ISA (UK) 570 Going Concern (also effective for audits of financial statements commencing on or after 15 December 2019), and ISA (UK) 240 The auditor's responsibilities relating to fraud in an audit of financial statements.

Alongside these changes a revised ISA (UK) 315 becomes effective for audits of financial statements for periods beginning on or after 15 December 2021, which will significantly enhance auditor risk assessment.

In implementing these standards, we expect auditors to deliver significant measurable improvements in their exercise of professional scepticism and challenge of management, including much greater consistency.

In response to Covid, we updated our guidance on auditors' use of alternative procedures to obtain sufficient appropriate evidence.

Enforcement

The Enforcement regime is an important route to improving audit quality. Financial sanctions have important deterrent effect, but in many ways the non-financial sanctions have a more direct impact on audit quality. Furthermore, the work undertaken by our Supervision Division on constructive engagement with audit firms on matters that are not passed through the investigation procedures have more timely impact on the way audits are undertaken at firms and therefore improve audit quality.

During the 2020/21 financial year the Enforcement regime resolved:

- **48** cases (45% increase compared to last year) through Constructive Engagement;
- **6** cases with settlement;
- **1** case through Tribunal; and
- **3** cases with no further action.

Further information on Enforcement is set out in our Annual Enforcement Review published in July 2021.[10]

10 For details, please refer to the Annual Enforcement Review published by the FRC in July 2021: https://www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

Section 1: Our work

Our work

How is the FRC responding to the audit monitoring results?

The FRC continues to move forward with strengthening its regulatory approach to drive improvements in audit quality and resilience.

Change to a supervisory approach

In March 2021, we published 'Our Approach to Audit Supervision', setting out what we expect from firms subject to our oversight and how we are developing a 'fair, evidence-based and comprehensive view of these firms, to judge whether they are being run in a manner that enhances audit quality and supports the resilience of individual firms and the wider audit market.'.

To help improve audit quality, we have introduced a forward-looking supervisory approach, with proportionate monitoring across three tiers of PIE audit firms. Tier 1 firms are already on an annual Audit Quality Review (AQR) inspection and firm-wide review cycle. Tier 2 firms either have several public interest entity (PIE) audits (e.g. ten or more) and/or other risk factors, and are typically on a three-year cycle for individual audit inspection and firm-wide work. Tier 3 firms are the remainder of the PIE audit firms which are usually on a six-year cycle of individual audit inspection and firm-wide work. All firms that audit PIEs have been allocated a Supervisor and we have written to each firm setting out our new approach and our expectations of them.

Further details are set out in Section 4.

Changes in AQR audit inspections

In line with recent years, we continue to select an increasing number of 'higher-risk' audits for review (as defined on page 5). Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues.

Each year we identify priority industry sectors, which are typically those subject to greater stress in the current economic climate, or those undergoing financial reporting changes. Entities in these sectors will feature more heavily in our selection. We identify a number of areas of focus, which we prioritise covering on the audits that we inspect.

Our supervisory approach entails a fair, evidence-based and comprehensive view of firms.

For 2020/21, our priority sectors were:

- Financial services;
- Construction and materials;
- Retail, including retail property;
- Travel and leisure; and
- Manufacturing.

Our 2020/21 areas of audit inspection focus were:

- Going concern and the viability statement;
- The Other Information in the Annual Report;
- Long-term contracts;
- The impairment of non-financial assets;
- Fraud risk; and
- Application of new accounting standards, specifically IFRS 15 for revenue and IFRS 16 for lease accounting.

In the current year, we:

- reviewed a higher number of audits at BDO LLP and Mazars LLP, with a focus on first year and complex audits. These firms have taken on more and higher-risk PIE audits and we wanted to provide appropriate oversight to monitor and support their growth;
- increased the number of inspections performed at smaller firms (see page 18);
- performed more inspections in respect of local government and health bodies as part of our efforts to drive improvements in audit quality in this sector; and
- reviewed the audits of several large and significant private companies that do not meet the definition of public interest entities (PIEs) (see page 22). We intend to continue this into the 2021/22 cycle and beyond.

In 2021/22 we plan to continue increasing our engagement with the smaller firms that have growth plans in the PIE market. We propose to further increase audit inspections in 2021/22 for these firms and set out improvements they need to make in order to lay foundations for growth with quality.

Response to Covid-19

In 2020 we issued a bulletin to auditors reminding them that they must obtain sufficient, appropriate audit evidence to support their audit opinion as the existence of Covid-19 did not change the requirements around the nature or extent of audit evidence required to support the audit opinion. The consequences of Covid-19 did, however, require auditors to consider the use of alternative procedures, including remote working and technology, to obtain that evidence. Covid-19 also changed the nature and extent of the risks that auditors needed to consider when determining the procedures to be performed to obtain audit evidence.

During the 2020/21 cycle we adjusted some elements of our inspection activity to specifically assess if auditors were appropriately responding to the audit risks posed by Covid-19. This included:

- undertaking and publishing two thematic briefings on the audit of going concern.[11] The first was a review of the firms' policies and procedures in relation to the audit of going concern and the second was a review of a sample of completed audits to assess how the revised going concern policies and procedures were being applied in practice;
- adding the audit of going concern on more AQR inspections, except where we could demonstrate that this was not an area of risk;
- when identifying higher-risk audits for inspection, considering which industries and entities had been more significantly impacted by Covid-19; and

We adjusted our inspection activities to assess if auditors were appropriately responding to the audit risks posed by Covid-19.

11 FRC's review of firms' going concern policies and procedures: https://www.frc.org.uk/news/july-2020/audit-firms-implement-%E2%80%98additional-measures%E2%80%99-to-enh published in June 2020; and a letter addressed to Heads of Audit at firms on FRC's review of firms' audit of going concern assessments on a sample of eleven audits: https://www.frc.org.uk/getattachment/c1ec4c8f-0eb3-44b9-a4c7-5fe5e4c0e0f1/FRC-going-concern-review-letter-(phase-2).pdf published in November 2020.

- identifying audit areas of focus for our inspections, based on whether the entity had a year-end before or after March 2020, for specific consideration. This included impairment of intangible assets, valuation of non-current assets including property, inventory with a focus on stock counts and stock provisions, group audit oversight, and expected credit losses for receivables. We have added these areas to the scope of inspections as appropriate, based on the nature of the audited entity. The findings identified have been included in our summary in Section 2, with more detail in Appendix 1.

For the 2021/22 inspection cycle, the impact of Covid-19 has continued to be identified as an audit inspection focus area. This will include, where appropriate, consideration of going concern, impairment of assets, inventory, the audit of estimates with regard to the implementation of the revised ISA 540 and group audits. We have also commenced a review of the firms' policies and procedures in relation to auditing the risk of fraud, with a focus on how these policies and procedures have been updated to reflect the changes to risk due to Covid-19. The audit of fraud risks will also be an area of focus for all 2021/22 audit inspections.

Transparent reporting of individual AQR inspections

To provide enhanced transparency for the 2020/21 cycle, we intend to publish a summary of the key findings and good practice of all corporate inspections, with the audited entities and the audit firm kept anonymous. We expect this will provide a further level of detail on our findings and examples of good practice, beyond the themes included in our public reports on firms and the detailed audit quality results of the inspection cycle 2020/21 in Section 2 of this document.

Root Cause Analysis review

Effective root cause analysis (RCA) is crucial for an audit firm to understand the underlying causes of audit weaknesses, to learn from experience, and to develop appropriate actions to prevent repetition. Where audit firms do not perform RCA in detail or with sufficient rigour, it is likely that any responses will only target the symptoms, rather than the causes, of the problem, increasing the likelihood of issues recurring.

Key underlying themes identified by audit firms through their RCAs include:

- audit teams using a corroborating mindset rather than a challenging mindset;
- a lack of resourcing to allow the audit to be completed in a timely manner using an appropriate staff mix;
- insufficient levels of training and guidance for audit teams that performed detailed testing on key risks;
- ineffective project management to ensure that high-risk audit work was being performed in a timely manner to allow for full consideration of key risks; and
- an inconsistent level of supervision and review from senior members of the audit team.

We have reviewed the progress of the audit firms' RCA processes over recent years and requested that they routinely perform RCA reviews as part of their development of actions to address our findings. This year, we have not conducted a detailed benchmarking of all firms' RCA review processes, but we have made necessary enquiries to inform our views on progress. Overall, we have noted that audit firms continue to enhance the methodology and reporting of RCA and how RCAs can be used to promote continuous improvement. The Big Four firms' RCA processes and outputs have reached a higher standard than that of other firms, so there is an opportunity for the smaller firms to learn from these developments, particularly as RCA will become mandatory for all audit firms under ISQM 1.

Effective root cause analysis is crucial for an audit firm to understand the underlying causes of audit weaknesses.

Root cause analysis will become mandatory for all audit firms under ISQM 1.

We have summarised our observations, key findings and good practice for RCA in our individual inspection finding reports for each of the Tier 1 firms, published in July 2021.[12]

Audit quality plans review

Audit quality plans (AQPs) are used by audit firms to drive measurable improvements in audit quality. These plans should include initiatives which respond to identified quality deficiencies as well as forward-looking measures which contribute directly or indirectly to audit quality.

We made enquiries to inform our views on the firms' progress in implementing these plans and observed key underlying themes that strengthen their AQPs including:

- frameworks and tools to embed a culture of challenge in the audit process;
- initiatives to improve resourcing, training, project management and overall audit quality;
- responding to RCA matters; and
- enhancements to governance, scope monitoring and reporting of AQPs.

The Big Four firms' AQPs are more progressed than those of other firms so there is also an opportunity for the smaller firms to learn from these developments. We have summarised our observations, key findings and good practice for AQPs in our individual inspection findings reports for each of the Tier 1 firms, published in July 2021.

Clear reporting of our regulatory concerns

In addition to the annual public reports on Tier 1 audit firms, starting in 2021 we plan to send a private annual supervisory letter to each Tier 1 firm in the autumn, clearly outlining our view of relevant risks to audit quality and the resilience of the audit firm, with prioritised actions the firm should take to address them. The letter also describes the supervisory work we plan to carry out in the following year. This will reinforce the messages in the public report on the firm, but also convey messages relating to our private supervisory work. These letters are tailored to each firm. We ask firms to reply setting out the actions they will take in response to our letter.

Similarly, we send a private annual supervisory letter to each Tier 2 firm, by the end of each calendar year, focused on the work we have done in respect of that firm in the year and any areas of particular concern where we want leadership at the firm to focus on in the future. Our private annual supervisory letter to Tier 3 firms, also sent by the end of each calendar year, will be generic unless the firm has been subject to an inspection in that year. In all cases, we assess the actions a firm has taken in response to our letters through subsequent supervision and inspection activities.

Cross-firm review of key supervisory pillars – Tier 1 firms

As part of our wider role under the revamped supervisory approach, we have undertaken cross-firm projects to assess the effectiveness of the firms' arrangements in the areas listed below. These projects focused on the Tier 1 firms and are reported privately to them, with anonymised, peer-benchmarking data to promote improvements that support audit quality and resilience. If we see risks emerging in the next tier of firms then this work is extended to those firms. In the current year, we undertook the following cross-firm supervisory activities in each pillar:

We will issue individual private annual supervisory letters to reinforce our messages in the public report on the Tier 1 firms.

12 FRC Annual Audit Quality Inspection and Supervision Results 2020/21 covering the Tier 1 firms, published in July 2021: https://www.frc.org.uk/news/july-2021/frc-annual-audit-quality-inspection-results-2020-2

Governance & Leadership

Audit Firms auditing 20 or more listed companies are required to publish an annual Transparency Report in accordance with the Audit Firm Governance Code (2016). Effective transparency reporting by audit firms should enable stakeholders to better assess the suitability of firms to undertake statutory audits and to assist them in holding the firm's leadership to account for key governance and performance matters.

We published a thematic review on 'Transparency Reporting' in September 2019.[13] As part of our statutory role in performing an annual review of Transparency Reports and our wider responsibility for audit market monitoring, we performed a follow-up internal review of Tier 1 firms' Transparency Reports for their financial years ended in 2020. All firms showed improvements to their transparency reporting compared to two years ago. While most firms largely complied with the relevant transparency reporting provisions and had adequate transparency reporting in place, certain firms' transparency reports were not sufficiently fair, balanced and understandable.

Values & Culture

A healthy culture is a critical component of an audit firm's ability to deliver high-quality audits in the public interest. One critical attribute of audit culture is the ability for auditors to exercise professional scepticism and challenge when performing audits. We oversee how audit firms establish a culture that supports high-quality audits performed in the public interest. We set expectations around desired behaviours and drivers of behaviour but do not prescribe a 'one size fits all' culture. Our focus is to ensure a firm's desired culture is designed to achieve high standards of audit quality and that this culture is embedded in the day-to-day behaviours within the firm.

In June 2021 we held an international conference entitled: 'Audit Firm Culture: Challenge. Trust. Transformation.' The conference brought together leading academics, directors, regulators, and standard setters to explore the overall theme of creating a culture of challenge within audit firms to restore trust as part of the wider cultural transformation journey in the audit profession. The topics discussed included the link between audit quality and audit firm culture, developing an auditor's mindset of professional scepticism and challenge, the role of the audit committee and other stakeholders in promoting and assessing culture, embedding and measuring organisational culture, and the role of the regulator in supervising culture.[14] Following the conference, we will be publishing a 'Collection of Perspectives' in early December 2021, exploring the topics discussed at the conference in more detail.

Since November 2020, we have been performing an ongoing assessment of audit firm culture. This work firstly looks at the design of the desired culture at each audit firm and the behaviours that are most directly correlated to performing high-quality audit in the public interest. We then look at how the firms are embedding their desired culture and the drivers of behaviour that either support or inhibit attempts to establish, promote, and embed an appropriate audit culture. We are also monitoring how firms assess their culture through surveys, management information, and qualitative measures.

Our ongoing quality review data, including the AQR 2020/21 audit inspection results, highlights ineffective challenge of management as a key driver of poor quality audits and re-emphasises the need for a culture of scepticism and challenge in the audit profession. In response to this finding, we are performing a thematic review to assess both the culture and the processes that the firms have in place in order to effectively challenge management. The work on this specific aspect of audit firm culture will look at drivers of behaviour that either promote or inhibit the ability of an auditor to exercise professional scepticism and effectively challenge management.

A healthy culture is a critical component of an audit firm's ability to deliver high-quality audits in the public interest.

Risk Management & Resilience

In September 2020 we issued our private reports on the internal audit practices at Tier 1 firms. Practices were assessed against the International Standards for the Professional Practice of Internal Auditing (IIA standards). The reports allowed firms to identify areas of strengths and areas for improvement within their individual operations, and included anonymised

13 Transparency Reporting AQR thematic review published in September 2019: https://www.frc.org.uk/getattachment/3c124043-70b7-428a-af03-9359b32652e2/Transparency-Reporting-Final.pdf
14 Audit Firm Culture: Challenge. Trust. Transformation conference summary published in August 2021: https://www.frc.org.uk/getattachment/c9ba16de-ea3b-4578-b166-76ca0d8662ab/Culture-Conference-Event.pdf

thematic observations that allowed the firms to compare themselves with peers and learn from each other. While the resources devoted to internal audit and the breadth of reviews carried out varied, we did not find significant departures from the broad requirements of the IIA standards and codes of practice.

Our annual monitoring of the firms' compliance with the Institute of Chartered Accountants in England and Wales (ICAEW) Professional Indemnity Insurance (PII) Regulations was carried out from July to September. The scope of work was expanded to consider the broader risk and resilience implications of the firms' insurance arrangements. The review outputs were not published for reasons of confidentiality, however, in general, we noted that processes in place within Tier 1 firms to manage their PII arrangements were satisfactory.

In December 2020, we turned our attention to monitoring the firms' enterprise risk management arrangements based on guidelines for risk management. Individual private reports were issued to the firms in June 2021. Our review identified that firms generally have adequate risk management governance structures in place and that all firms' risk registers include the key challenges of managing audit quality and delivery risk, people and talent risk, the operational resilience of critical IT/systems, and business model (strategic) risk. Moreover, we found evidence that all firms had identified the threats associated with emerging risks such as the UK's exit from the EU market and Covid-19 in 2020. While we identified areas of good practice, we felt that firms could do more in relation to checking and challenging the design and operation of critical controls in mitigating key risks. We also noted a significant variation in dedicated risk management resourcing levels across firms. All firms have agreed action plans in place to deal with the recommendations we made, which we are monitoring to completion.

Between March and July 2021 we undertook a thematic review of the firms' cyber security arrangements using industry benchmarks such as ISO 27001 and Cyber Essentials Plus[15], and found that all Tier 1 firms take cyber threat management seriously. This is an area where the threats are constantly evolving and the firms are able to leverage advice and experience from their own consultancy businesses.

Business models & financial soundness

We monitor changes in the Tier 1 firms' business models as a result of their strategic decision-making, which is often shaped by changes in the external environment. We undertake this work by regularly reviewing the firms' management and financial information.

During the past year, we have reviewed the firms' financial positions with a forward-looking lens to ensure they remain resilient despite the challenges posed by the pandemic and the UK's exit from the EU market.

During the year, we completed a review of assessing the quality and completeness of firms' management information made available internally to their respective executive and governance bodies, including on audit quality. Relevant, timely and regular information is essential for management to be able to monitor performance, make informed decisions and identify emerging risks and issues. Good management information can also be utilised by the firms' governance bodies to exercise independent and effective challenge of firms' leadership. We have communicated our observations to firms, including examples of good management practices. We will continue reviewing firms' management information on a regular basis as part of our ongoing monitoring work.

ISQC 1 firm-wide review

We review firm-wide procedures based on those areas set out in the International Standard on Quality Control (UK) 1 (ISQC1), in some areas on an annual basis and others on a three-year rotational basis. We set out below our key findings and good practice identified in the current year's review of the Tier 1 firms' audit methodologies and training.

We encourage firms to check and challenge the design and operation of critical controls more in mitigating key risks.

15 Assessment was performed based on ISO 31000:2018 Risk management – Guidelines https://www.iso.org/standard/65694.html and Institute of Risk Management guidance documents https://www.theirm.org/media/4709/arms_2002_irm.pdf.

Audit methodology and the guidance provided to auditors on how to apply it are important elements of a firm's overall system of quality control. Our inspections primarily evaluated key changes to a firm's methodology and guidance including how it had been updated to incorporate recent changes to auditing and accounting standards, including:

- ISA 540 revised (Auditing accounting estimates and related disclosures);
- ISA 570 revised (Going concern);
- IFRS 9 (Financial instruments) with a focus on the audits of banks, building societies and other credit institutions (banking audits); and
- IFRS 16 (Leases).

We also considered other key topics such as policies for using specialists and experts on audits and updates to audit software. We performed the majority of this work on methodology and guidance in place on 31 March 2020, including a consideration of firms' initial response to the impact of Covid-19.

Good practice

We identified the following areas of good practice at one or more firms:

- detailed guidance on the controls that are common to banking entities, and how those controls (if tested appropriately) can provide audit evidence for particular risks identified;
- the use of an economics tool to compare management forecasts against independent forecasts on certain banking audits to inform the audit teams' assessment of economic and macro-economic assumptions;
- good guidance on illustrative audit procedures, including examples of questions that can be used to challenge audited entities on the allowance for expected credit losses;
- the mandatory use of a centre of excellence team, specialising in experted credit losses models under IFRS 9, at each state of a banking audit to encourage consistent application of the firm's methodology and guidance;
- the mandatory use of experts when auditing multiple economic scenarios on banking audits; and
- frequent and high-quality ongoing communications to partners and staff in relation to methodology and guidance on new auditing and accounting standards and refreshers on existing standards.

Key findings

We have also identified the following key findings on audit methodologies:

- For certain firms we identified issues with the quality and extent of IFRS 9 methodology and guidance relating to banking audits. Improvements needed include issuing a comprehensive IFRS 9 methodology including clear baseline expectations of the procedures audit teams are required to perform on banking audits and/or by developing additional comprehensive methodology and guidance on how to audit the various elements of IFRS 9, in particular relating to classification and measurement of financial instruments and expected credit losses; and

- We also found that for certain firms the guidance issued to audit teams in relation to auditing lease accounting and financial instruments accounting (non-banking entities) under IFRS 16 and IFRS 9 required improvements or targeted enhancements for specific aspects of the standards.

Firms' training arrangements must provide auditors with the knowledge and skills necessary to fulfil their role effectively and, as such, are also an important element of the firm's overall system of quality control. Our inspection included an evaluation of the amount of training provided by firms in the year ended 31 March 2020, the subjects covered, and how the training was delivered. We also considered firms' processes for monitoring course attendance and evaluating whether participants had met the learning objectives by conducting post-course assessments.

Good practice

We identified the following areas of good practice at one or more firms:

- ensuring timely completion of mandatory training by establishing clear consequences for individuals who do not do so, including a process for identifying and managing the issue of repeat offenders;
- analysis of post-course assessment results to identify residual knowledge gaps by analysing how often individual questions are answered incorrectly to identify topics that training attendees found difficult;
- monitoring the number of attempts an individual takes to pass a post-course assessment and, when the number exceeds a pre-set threshold, set and monitor an action plan for the individuals involved; and
- mandating training at the milestone of becoming a manager and on completion of one year in the role in addition to the annual update training provided to all qualified auditors.

Key findings

We have also identified the following key findings on training:

- completion of certain required aspects of audit training was not mandatory for audit practitioners and there was no audit specific training for specialists who assist on audits. We also identified instances of a lack of appropriate post-course assessments on technical training to evaluate whether learning objectives have been met; and
- instances where firms did not ensure that audit practitioners completed their mandatory training on a timely basis with clear and enforced consequences for any non-compliance.

ISQM 1 firm-wide work

International Standard on Quality Management (UK) 1 (ISQM (UK) 1) ('ISQM 1') is the new UK auditing standard that sets out the firm's responsibility to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements. ISQM 1 replaces the extant standard of quality control (ISQC 1) with effect from 15 December 2022. By the effective date, firms should have established their quality objectives, identified and assessed the risks to meeting those objectives, and designed and implemented their responses to address such risks. Firms are also expected to have designed and implemented their monitoring and remediation activities to identify any deficiencies in the design or operation of their quality system and take appropriate action on a timely basis.

During the first half of 2021, we performed a pre-implementation review of ISQM 1 to assess the preparedness of the Tier 1 firms to meet the deadline for ISQM 1. We found that all firms have established clear governance arrangements to monitor the implementation of ISQM 1 and have project management initiatives with milestones and phases leading to their implementation dates. Firms are broadly on track against plans and have achieved the milestones set to date, however we identified that implementation teams at a minority of firms appear to be under-resourced to achieve the next phase of their projects.

All firms have established clear governance arrangements to monitor the implementation of ISQM 1.

In the UK, early adoption of ISQM 1 is strongly encouraged. Several firms are planning to fully implement it well in advance of the implementation date, which is a positive development. We will continue to monitor implementation progress for the remainder of 2021 and into 2022 while planning our own monitoring and evaluation procedures on the effectiveness of the firms' quality management systems once they become operational.

Audit thematic reviews; Thematic briefings; Dear Head of Audit letters

We publish various types of information and findings arising from our supervision and inspection work. Although much of the evidence for these publications derives from our work at the Tier 1 firms, the audience for them is wider and the findings and recommendations should be considered by all audit firms, particularly PIE audit firms.

We also write to the Heads of Audit of the Tier 1 firms when we wish to highlight matters of emerging risk to audit quality. These letters are published on our website to enable all audit firms to access the information.

We published thematic reviews and briefings, and issued the following letters to firms' Heads of Audit in the year with key messages summarised in the table on the right:

Output	Key messages
FRC's review of firms' going concern policies and procedures (June 2020)	Auditors enhanced their audit policies and procedures relating to going concern when the impact of Covid-19 began to increase the risk of material uncertainties to going concern for many companies. The review found that audit firms have taken sensible steps to increase required consultations and offer more central support to audit teams. Audit procedures also need to be proportionate to the risks facing companies, which vary considerably depending on the impact of the pandemic on their businesses.
FRC's review of firms' audit of going concern assessments (November 2020)	Auditors have enhanced their procedures when auditing management's going concern assessment. The audit procedures were proportionate to the risks facing the companies, which varied depending on the impact of Covid-19 on their businesses.
Heads of Audit letter: Challenge of Management (December 2020)	Effective challenge of management is one of the critical responses to the requirements in a number of International Standards on Auditing. The letter sets out our own analysis of the factors which have given rise to both favourable and unfavourable audit review findings and each firm's RCA in this critical area.
Thematic Briefing: The audit of cash flow statements (May 2021)	Errors in cash flow statements remain a recurring issue in Constructive Engagement cases. The briefing document highlights the results of the FRC's Constructive Engagement key findings and the steps taken by audit firms to strengthen the audit of cash flow statements.

Findings and recommendations should be considered by all audit firms, particularly PIE audit firms.

Section 2: Audit quality results

Overview of audit quality results

In the 2020/21 FRC audit inspection cycle we reviewed 147 audits. The number of audits that we have assessed as 'improvements required' and 'significant improvements required' remains unacceptably high. This year, audit quality varied to a greater degree between different firms. We always find inconsistencies within the same firm, such as good or deficient practices being observed within some audits but not in others.

Across the 147 audits inspected directly by the FRC's AQR team, we assessed 99 audits as requiring no more than 'limited improvements'. This was a small increase from 62% in 2019/20 to 67% in 2020/21. Audit quality results for non-Tier 1 firms, except for the National Audit Office audits, were poorer overall than for the Tier 1 firms. As a result, our combined results across all 147 audits inspected are slightly worse than those for the 103 audits inspected at the Tier 1 firms.

Inspection Cycle	Good or limited improvements required	Improvements required	Significant improvements required	Total
2016/17	102	33	10	145
2017/18	106	20	13	139
2018/19	96	33	7	136
2019/20	81	34	15	130
2020/21	99	41	7	147

Changes to the proportion of audits falling within each grading category continue to reflect a wide range of factors, including the size, complexity and risk of the audits selected for review, the scope of individual reviews, and the impacts of broader economic and operational factors on audit risk. Many of the audits reviewed in the current cycle were carried out wholly or partially following the onset of the pandemic. The resulting challenges included economic uncertainty, uncertainty over the timing, extent and impact of restrictions, and the difficulties of remote working for auditors and management of audited entities.

The AQR results are also driven by our inspection selections, which are informed by the priority sectors referred to in Appendix 1. We are also cognisant, when making our selections, of the recommendation by the CMA that FTSE 350 company audits should be subject to inspection approximately every five years on average. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across a firm's entire audit portfolio. As such, small year-on-year changes in AQR results will not necessarily indicate any overall change in audit quality at a firm. Nonetheless, any inspection cycle identifying 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.

In 2020/21 we requested legal waivers from audited entities where audit documentation contained legally privileged information. In five instances we did not receive such waivers and so reviewed redacted audit documentation and limited the scope of our review. Limiting the scope of our reviews in such a way is undesirable, as it prevents a fulsome assessment of audit quality on these individual audits and limits our oversight of audit quality at the firm as a whole.

One-third of audits inspected still require improvements.

What is high audit quality?

The FRC defines high-quality audits as those that:

- 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 and audit evidence, avoid conflicts of interest, have strong audit quality processes, and involve the robust exercise of 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.

Audit quality is not directly visible to stakeholders and can be defined in different ways depending upon what different stakeholders expect from an audit. The results of our audit quality inspections are a key measure of audit quality and are designed to provide an indicator of audit quality for a broad range of stakeholders.

We recently published a document called 'What Makes a Good Audit?', setting out our experience of what a 'good audit' looks like, based on our recent file inspections.

Overview of key audit monitoring activities in the UK

While the AQR inspection results are a key measure of audit quality for a broad range of stakeholders in the UK, other mechanisms for monitoring audit quality are also important. This is particularly the case for audits of smaller entities – the monitoring of which is delegated to the Recognised Supervisory Bodies (RSBs), such as the ICAEW. The table on the right outlines the suite of external regulatory monitoring arrangements in the UK. The results of each of these monitoring activities are set out in this report. In addition, audit firms perform their own quality monitoring of completed audits.

Entity type	Monitoring body	Monitoring capacity/ arrangement
UK Public Interest Entity (PIE) audits; Large private companies; UK incorporated Alternative Investment Market (AIM) listed entities; and Lloyd's Syndicates	FRC	Competent Authority
Crown dependency incorporated entities with securities traded on regulated European Economic Area market	FRC/ICAEW	Private contractual arrangements
Third country audits	FRC	Competent Authority
Local Audits	FRC/RSBs	Local Audit and Accountability Act 2014
Other (non-FRC scope) audits	RSBs	Delegation agreement
National Audit Office audits	FRC	Independent supervisor /private contractual arrangements

For the 2020/21 inspection cycle, we increased the number of audits reviewed from 130 last year to 147. This is still below the 160 audits reviewed in 2018/19 as we have broadened the scope of our inspections in areas such as the auditor's response to fraud and going concern risks, and the review of some overseas component audit work. We also increased the scope of our focus areas for 2020/21 to include going concern assessments, inventory, and asset valuations and impairment, in response to the challenges posed by Covid-19.

We plan to inspect around 150 audits in 2021/22 and we will continue to focus on selecting more complex and higher-risk audits.

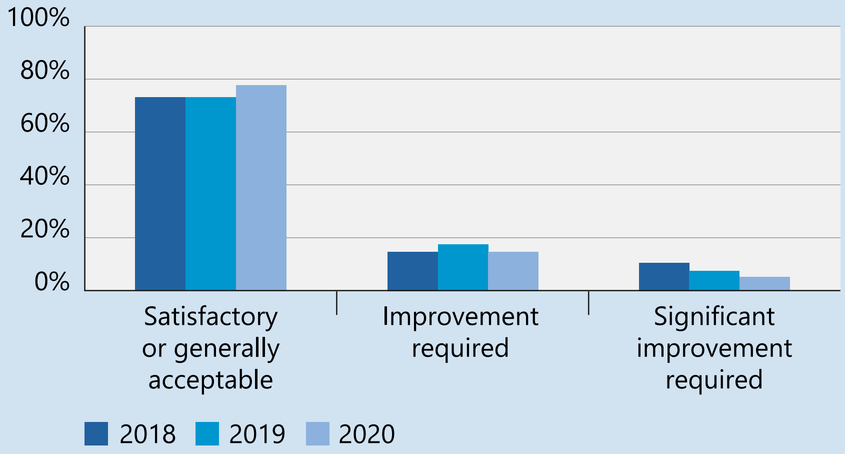
Audit Quality Monitoring of companies that are not Public Interest Entities

Monitoring the quality of audits of non-PIEs is performed by the RSBs under delegation agreements with the FRC and subject to our oversight. This excluded the nine audits that the FRC has reclaimed from the RSBs during the year. The largest of these RSBs is the ICAEW, which had registered 2,561 statutory audit firms as of December 2020.

ICAEW monitoring results

The ICAEW will shortly publish a report outlining the results and findings from its inspection activities. The chart opposite shows the results of ICAEW's audit file reviews for the calendar year 2020, indicating that 78% of the audits were either satisfactory or generally acceptable and 22% required improvement or significant improvement. The results have improved slightly compared to recent years, although the different populations of audit firms reviewed each year mean that the proportion of audits falling into each category cannot be relied upon to provide an overall picture of audit quality across all ICAEW regulated firms. The majority of audit weaknesses identified relate to audit evidence, documentation and risk assessment. As with the FRC's inspections, the most common aspects of audit evidence that need improvement are work on revenue, and more judgemental areas such as valuations, which require more auditor scepticism and challenge of management.

Quality of audit files – 2018 to 2020 visits



FRC's monitoring of RSBs

The FRC's Professional Oversight Team (POT) monitors the RSBs' work in fulfilling their regulatory tasks under the FRC's delegation agreements. During the year, POT continued its in-depth review of the RSBs' audit quality monitoring processes, including planning, fieldwork, reporting and finalisation to assess how each RSB applies its policies and procedures in practice. The pandemic meant that some of the RSBs were unable to complete their monitoring of all UK audit registered firms within the statutory six-yearly timescale in 2020. These RSBs have prepared a catch-up plan to enable them to complete the outstanding 2020 statutory visits in 2021 and have since confirmed to the FRC that they have caught up on these visits.

We require RSBs to report on three Key Performance Indicators (KPIs) each year, two of which focus on the RSBs' annual review activity and one on audit quality. All RSBs met the requirements for KPIs except for one body that did not meet one annual review activity KPI due to a combination of matters some of which were within its control while others were outside of its control.

In response to Covid-19, going concern assessments, inventory, asset valuations and impairment, were scoped in for 2020/21.

Last year we required one RSB to adopt a top-down risk-based approach to its file selection. This RSB has since developed its approach, which has been agreed by the FRC. As a follow up from last year, we observed that all RSBs included the quality review grades given to each audit file inspected in their final reports to the firms.

Under the International Education Standards (IES7 and IES8), statutory auditors are required to identify their development needs and ensure that they undertake sufficient Continuing Professional Development (CPD) to maintain their professional competence. The RSBs are responsible for monitoring CPD of all their statutory auditors, which is achieved by reviewing CPD declarations and by audit quality monitoring visits. During 2019/20 POT examined the systems and processes used, the basis for selecting the CPD to be monitored, how the review was documented, and the feedback where the CPD was found to be inadequate. We will follow up on all findings during future monitoring visits.

Spread of audits inspected by AQR:

During the 2020/21 inspection cycle, we significantly increased the number of reviews of local government and health body audits, including those relating to local government pension schemes, as part of our increased oversight of this sector.

We also significantly increased the number of reviews of smaller firms' audits due to:

- an additional firm coming into our scope;
- follow-up reviews at one firm where significant quality issues had previously been noted; and
- the progression of our six-year cycle, as per the revamped tiered supervisory framework described in Section 3.

The audits selected for review this year included nine large non-PIE companies that FRC reclaimed from the RSBs (previously delegated to the RSBs under the agreements with the FRC) as part of our work to monitor and improve audit quality across the market. These entities were selected based on our assessment of both risk and public significance.

AQR inspections	2020/21	2019/20
Tier 1 firms	103	88
Crown Dependency firms[16]	0	5
Tier 2 & Tier 3 firms that audit PIEs	16	8
Other firms	0	2
National Audit Office	7	7
Firms auditing local government and health bodies	20	15
Third country audit firms[17]	1	5
Total AQR inspections	**147**	**130**

16 No Crown Dependency audits were reviewed in 2020/21 as these firms are reviewed on a three-year cycle with none falling due in the current year.
17 Partly due to the travel restrictions imposed by Covid-19, only one third country audit was reviewed in 2020/21 using remote methods.

AQR inspection analysis – Key observations

In the course of our inspections, we have seen examples of both poor and good practice in the below key areas, reflecting the inconsistency in audit quality:

- **Sufficiency of challenge of management's assumptions;**
- **Impairment of tangible and intangible assets;**
- **Assessment of going concern;**
- **Audit of revenue;**
- **Group audit oversight; and**
- **Banking and expected credit losses.**

In the assessment of going concern we saw many examples of good practice which reflects the efforts the firms have made in light of Covid-19.

Some of these areas were identified in previous years. The recurrence of these findings indicates that auditors finding it difficult to fully address the complex and challenging nature of these issues. The impact of Covid-19 has increased the risks in these areas for companies and audit firms, affecting audits signed from March 2020 onwards. These areas remain a key focus for AQR.

Sufficiency of challenge of management's assumptions

Effective challenge of management requires auditors to adopt a mindset of professional scepticism to be alert to the possibility that management may be consciously or unconsciously biased towards optimistic assumptions. Auditors also need to be aware of their own potential biases towards corroborating management's assumptions. Challenge of management is even more important in times of economic uncertainty when making assumptions about the future is more difficult and there may be less reliable evidence available. Auditors must challenge management's assumptions through procedures such as consultation with experts and specialists, independent research, and benchmarking to competitors and industry expectations. Auditors must also ensure they consider management's assumptions in aggregate to look for overall indicators of bias.

Particular care is needed where forward-looking judgements and estimates are involved, including the impairment reviews of goodwill and intangibles, future revenue (including from long-term contracts), valuation of assets (including pension and property assets), recoverability of debtors, and provisions.

In the 2020/21 cycle, issues have continued to arise in respect of auditors failing to corroborate assumptions to robust, supporting evidence, consider available contradictory evidence, or critically challenge the reasonableness of forecasts used.

Good practice

In the 2020/21 inspections we have seen examples of good practice in the way auditors have challenged management, demonstrating that it is possible for this to be done well. Observed instances of robust challenge included:

- challenge of key management assumptions in judgemental areas such as property valuations, including through the use of independent research;
- effective use of internal and external specialists to review and challenge management's methodology and assumptions for performing valuations;
- consultation with technical specialists to challenge management's application of accounting policies when alternatives are available; and
- challenging the extent and quality of disclosures relating to key areas of estimation and uncertainty, such as goodwill and intangibles.

The recurrence of findings indicates that auditors are finding it difficult to fully address complex and challenging issues.

We also saw instances of auditors delaying the signing of audit opinions to ensure they had sufficient time to complete their audit. This is an important example of prioritising audit quality and setting the tone of challenge. Audit firms should support auditors in setting and maintaining audit timetables that provide adequate time to obtain and evaluate sufficient audit evidence.

Timely and informed audit planning and a healthy audit culture are critical to effective challenge of management. We have observed that audit firms' action plans to address these issues focus on senior team involvement, understanding the audited entity's system of internal control, and requiring management to improve their own assessment process. We will continue to check that action plans have been implemented.

Impairment of tangible and intangible assets

Auditors are required to obtain sufficient evidence to confirm that management have performed appropriate impairment assessments for all intangible assets with indefinite lives, such as goodwill, and all intangible and tangible assets where impairment indicators have been identified in the year. Impairment assessments are usually driven by the value in use of a company's assets or cash generating units, which is calculated using discounted forecast cashflows.

Covid-19 raised indicators of impairment for many assets and increased the risks and challenges around the audit of the cashflow forecasts used in impairment assessments.

Key findings

We found instances where auditors had not challenged enough the sufficiency and robustness of management's impairment assessments for tangible and intangible assets. Issues we found included:

- insufficient consideration and challenge of certain key cashflow assumptions, including forecast increases to sales and the success of future improvement plans;
- auditors not adequately analysing the sufficiency of impairment indicators identified to ensure that all relevant assets had been assessed for impairment;
- insufficient evaluation of how assets, including relevant shares of corporate assets, were grouped into cash generating units to be assessed for impairment, to ensure that sufficiently granular assessments were performed; and
- auditors not adequately assessing management's historical forecasting accuracy with, in most cases, the 'look back' period being limited to one year.

Good practice

Examples of good practice around the audit of impairment assessments included auditors rigorously assessing the risks related to the carrying value of a cash generating unit, in particular by means of sensitivity and reverse stress analysis and detailed consideration of the key assumptions and their link to historical results.

Assessment of going concern

Auditors are required to obtain audit evidence about whether a material uncertainty related to going concern exists and the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements They are also required to consider the adequacy of management's disclosures if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, even if the auditor concludes that no material uncertainty exists.

While assessing going concern is the responsibility of the directors, auditors play a vital role by providing independent challenge. Boards and their Audit Committees should accept and facilitate this challenge.

Timely and informed audit planning and a healthy audit culture are critical to effective challenge of management.

Auditors and Audit Committees should provide and facilitate independent challenge of directors' going concern assessments.

Covid-19 increased the likelihood that such events or conditions would arise, thereby increasing the risk that directors do not identify and disclose material uncertainties relating to these events and conditions, or that they make inappropriate assumptions about whether a company is a going concern. A company's ability to continue as a going concern may have been dependent on assumptions about the timing of public health restrictions being lifted in different countries, the speed of economic recovery, and the company's ability to raise additional finance, refinance existing debt, or obtain waivers for financial covenants.

Key findings

We identified instances where auditors did not adequately assess and evaluate management's going concern assumptions. Issues we found included:

- auditors not obtaining sufficient evidence to support the entity's ability to raise additional financing or performing insufficient procedures over covenant compliance;
- where auditors had used the work of specialists to assess management's forecasts and likely ability to raise finance, insufficient evaluation of the extent and limitation of their work and identification of where further audit work and consultation was needed; and
- auditors insufficiently considering and challenging management's forecasts and assumptions, or the adequacy of the sensitivity testing performed over these assumptions in light of the prevalent levels of economic uncertainty.

We also found examples where the auditors did not evidence whether:

- the extent and detail of management's going concern disclosures were sufficient; and
- disclosures would allow users of the accounts to understand the going concern assumptions used and the sensitivity of these assumptions.

While the revised International Standard on Auditing (ISA) (UK) 570 Going Concern did not become effective for the audits we inspected in this cycle, the standard was available for consideration by audit firms as a way of enhancing audit procedures in this area.

We have identified numerous examples of good practice in this area, across the audit firms, from our inspections and our two thematic briefings published in 2020/21 on the audit of going concern (as reported on page 14).[18] We saw that firms had enhanced their audit policies and procedures relating to going concern from the end of March 2020 and that these enhancements had been substantially applied in practice.

Good practice

Examples of good practice observed in the area of going concern included:

- a good level of consultation on audits, including the use of technical panels within the audit firm to ensure appropriate debate about and scrutiny of going concern conclusions;
- use of economic scenarios tailored to audited entities' circumstances and use of reverse stress testing and other severe but plausible scenarios to challenge the economic assumptions made;
- use of corporate finance and modelling specialists to review and challenge the assumptions and modelling techniques used in going concern assessments;
- use of analytics to test the integrity of management's going concern model;
- extensive challenge of management's going concern assessments and assumptions, including use of a 'traffic light system' to assist with the assessment of key assumptions;
- challenge of management's going concern disclosures to improve transparency; and
- rigorous assessment of management's historical budgeting accuracy.

18 Covid-19 Thematic Review: Review of financial reporting effects of Covid-19: https://www.frc.org.uk/getattachment/03838acd-facc-4a06-879c-a4682672a6d7/CRR-COVID-19-Thematic-Review-Jul-2020.pdf published in July 2020; and a letter addressed to Heads of Audit at firms on FRC's review of firms' audit of going concern assessments on a sample of eleven audits: https://www.frc.org.uk/getattachment/c1ec4c8f-0eb3-44b9-a4c7-5fe5e4c0e0f1/FRC-going-concern-review-letter-(phase-2).pdf published in November 2020.

Audit of revenue

Auditors should undertake sufficient procedures and obtain supporting evidence to confirm that revenue is not materially misstated. These procedures also need to be appropriate to respond to any fraud risks identified in respect of revenue recognition, given management's incentives to manipulate revenue.

Auditors need to gain an understanding of the processes by which revenue is initiated, recognised, and recorded to ensure that they have appropriately identified where risks of fraud and error arise.

Key findings

We found instances where auditors did not design and perform procedures to obtain sufficient, appropriate evidence over the accuracy and completeness of recorded revenue, or ensure that revenue was recognised in the correct period. This included:

- auditors not demonstrating adequate evaluation of the revenue process (including the IT systems used) and how revenue could arise and be recorded within the entity's systems;
- auditors not assessing whether the scope and extent of controls testing were adequate to allow the auditor to rely upon these controls when planning the substantive audit procedures required;
- inadequate evidence of analysis of customer contracts to assess the performance obligations and when revenue should be recognised;
- insufficient challenge of the significant judgements and accounting treatments for long-term contracts;
- where auditors used data analytics to test revenue based on cash receipts, performing insufficient procedures to reconcile cash receipts to revenue for a material revenue stream, and to evaluate and test material reconciling items between revenue and cash; and
- when performing substantive analytical reviews procedures on revenue, not obtaining sufficient evidence to support inputs used to develop the revenue expectation.

Good practice

We also saw some examples of good practice in respect of the audit of revenue. These included the effective use of data analytics in several firms to test unbilled revenue and understand how revenue recognised related to the recognition of cash and debtors, and instances of robust challenge and corroboration of the assumptions used for long-term contracts.

Group audit oversight

Group auditors are responsible for the direction, supervision, and co-ordination of the work performed by overseas and domestic auditors at the component level,[19] ensuring their audit documentation supports the conclusions reached on the group audit.

In the current year, travel restrictions have prevented many group auditors from conducting visits to component auditors, making group oversight more difficult. These difficulties were compounded where component auditors were based in jurisdictions that do not permit audit workpapers to be transmitted cross-border.[20]

Under auditing standards, the group audit team remains responsible for the global audit and is required to ensure there is adequate challenge of group and component management, and of component auditors. Group auditors should be sufficiently involved in their component audits, understand the key judgements made by component auditors, and challenge these as if they were making the judgements themselves.

19 According to International Standard on Auditing (ISA) (UK) 600 (Revised June 2016) para. 9(a), a 'component' is defined as an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

20 According to International Standard on Auditing (ISA) (UK) 600 (Revised in June 2016) para. 9(b), a 'component auditor' is defined as an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Key findings

Our reviews identified several instances where the group audit team were unable to demonstrate how they had assessed and ensured the adequacy of the component auditors' procedures in key audit areas. This included the following examples:

- insufficient evidence of oversight and evaluation of the procedures performed by component auditors in respect of judgemental areas;
- insufficient evidence of the oversight of component procedures over revenue testing, including around ensuring revenue is recognised in the correct period and the consideration of the appropriateness of the different component auditor approaches; and
- where component auditors were instructed to perform testing over specific risks and balances, failing to set out in sufficient detail the work undertaken by the component auditors.

We found examples where the group auditors had not evidenced sufficient involvement of the Engagement Quality Control Reviewer (EQCR) in the work of component auditors. The EQCR should discuss matters arising with key audit partners of all significant components. Finally, we saw instances where group auditors had not sufficiently ensured that component auditors adequately understood and complied with UK ethical standards.

Despite these deficiencies, the group oversight role was performed well across several audit firms, with audit teams evidencing their oversight in each phase of the component audit.

Good practice

Examples of good practice included holding a conference to brief all component auditors on the group audit approach, providing clear oversight of component auditors over key IT systems and controls, evidencing robust challenge of specific elements of the component auditor's work, and clearly evidencing involvement of the EQCR, including the EQCR's discussions with the key audit partners for significant components.

Banking audits and expected credit losses

The audits of banks and similar entities are often very complex as they involve numerous areas of estimation and judgement, and often require the auditing of complex and significant loan loss provisioning and valuation models. The level of difficulty was increased by the introduction of IFRS 9 in the prior year, which required entities to account for expected credit losses on financial assets not held at fair value. The audit of expected credit loss provisions is technically challenging due to the extent of economic assumptions involved and the complexity of the modelling processes. The increased uncertainty resulting from Covid-19 added to these challenges.

Key findings

Our reviews identified weaknesses in the audits of banking and similar entities. These included the following examples:

- insufficient audit procedures being performed on key aspects of expected credit losses, notably around the procedures relating to the assessment of significant increases in credit risk and related testing, individually assessed exposure credit file review procedures, and the testing of models and related data elements;

- deficiencies in the testing of financial instrument valuations, including in respect of testing over model risk management; and
- weaknesses in the audit procedures designed and performed to respond to the risk of unauthorised and unconfirmed trading and significant deficiencies in the work of IT specialists over privileged user access (refer to Appendix 1 'Information Technology' for details).

We also performed a firm-wide review of the Tier 1 firms' IFRS 9 methodology and guidance, as reported on page 12, which identified instances where improvements were needed to the quality and extent of the guidance provided to auditors.

Good practice

We observed good practice in respect of the audit of expected credit losses, with an example of a high-quality review of model code and independent model rebuilding of the entity's loan loss provisioning model.

Audit quality review inspection analysis – Good practice

Through our inspections we also identified areas of good practice, with 154 good practice points identified across 85 of the audits inspected. It is important to recognise and share these as a mechanism for improving audit quality and showing how it is achievable. We have already highlighted examples of good practice in the sections above, but want to draw out further the following additional examples:

- use of internal specialists to support the audit team's knowledge of the industry, technical knowledge and challenge of management. Examples include a clear demonstration of their integration into the audit team, timely involvement, and clear evidence of how the points they raised were resolved;
- robust procedures on first year audits resulting in the identification of prior year adjustments. The auditors evidenced a thorough challenge of the root cause of each matter to understand if there could be a pervasive impact;
- robust procedures over the existence of inventory, considering the challenges posed by Covid-19, including using more senior members of the audit team to attend post year-end inventory counts to ensure adequate challenge and scrutiny of management's process;
- timely performance of continuance procedures to identify significant concerns that could impact the auditors' ability to continue in role and early communication of these concerns, with related requests for improvement, to management and those charged with governance; and
- evidencing significant involvement and review of the detailed audit procedures by the audit partner to ensure effective oversight and review on a timely basis and preparing high-quality summaries of audit response to significant risks to facilitate the review process.

We identified instances of good practice across areas where we also found key findings, highlighting that audits are unique and audit approaches must be tailored to the risks of each audited entity and the events and challenges faced in the year. It also highlights the struggle that the audit firms have in achieving consistency in audit quality across individual audits.

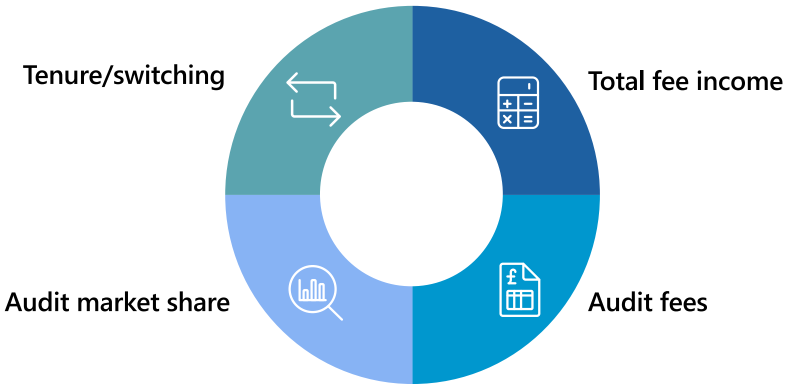
More information on what 'good audit' looks like is included in our recent publication 'What Makes a Good Audit?'

Section 3: Audit market developments

Audit market overview

This section provides details of the latest developments in the FTSE 350 and wider PIE audit market.

In last year's publication, Developments in Audit 2020, we focused on the FTSE 350 and outlined the need to track the data on indicators of competition in the audit market. This year, we are broadening our analysis to the whole of the PIE audit market (to the extent that data is available). By highlighting trends in audit fees, audit market share, and audit tenure and switching, we want to understand the impact of measures we are putting in place to improve audit quality and strengthen market resilience, and whether the outcomes we are seeking from a well-functioning market are being achieved.



Our review of indicators for this year has found that:

- Audit firms continue to derive most of their fee income from the provision of non-audit services to entities which they do not audit. For the Big Four this was 73.7% of their total fee income in 2020, for the non-Big Four it was 56.6%. However, in both the FTSE 350 and the wider market for PIE audits, fees derived from non-audit services to audit clients saw declines of 4.7% and 27.0% from 2019 to 2020 respectively (noting that the large decline for PIEs may be partly indicative of a less complete data set). This is the second year of decline in the FTSE 350 due to regulatory action to limit non-audit fees.
- The value of the FTSE 350 audit market continues to grow but at a declining rate. In 2020, FTSE 350 companies paid in total approximately £1 billion for audit services, a 3.6% increase on 2019. The previous increases were 9.4% in 2019, and 10.5% in 2018 respectively; well above inflation. In contrast there was a small fall of 2% in total audit fees for the PIE market. There has been little change in the top 10 FTSE 350 companies by audit fee, with banks, and oil, gas and coal companies continuing to pay the largest share of fees in both this index and the wider PIE market.
- While the Big Four continue to audit all FTSE 100 companies, the non-Big Four audit firms increased their market share of FTSE 250 audits. In 2019, two non-Big Four firms audited 10 of the FTSE 250 companies; in 2020 four non-Big Four firms audited 22 of these entities. The PIE audit market has a higher number of audit firms relative to the FTSE 350 audit market, with between 37 and 39 firms providing audit services to PIEs over the last four years.

We broadened our analysis from the FTSE 350 market to the whole PIE audit market this year.

Total fee income

Data collected from audit firms and published in the FRC's Key Facts and Trends in the Accountancy Profession shows the overall fee breakdown from all clients of UK audit firms with PIE clients (of those audit firms which responded to our survey) and suggests that whilst non-audit fees remain dominant, audit fees continue to grow.[21]

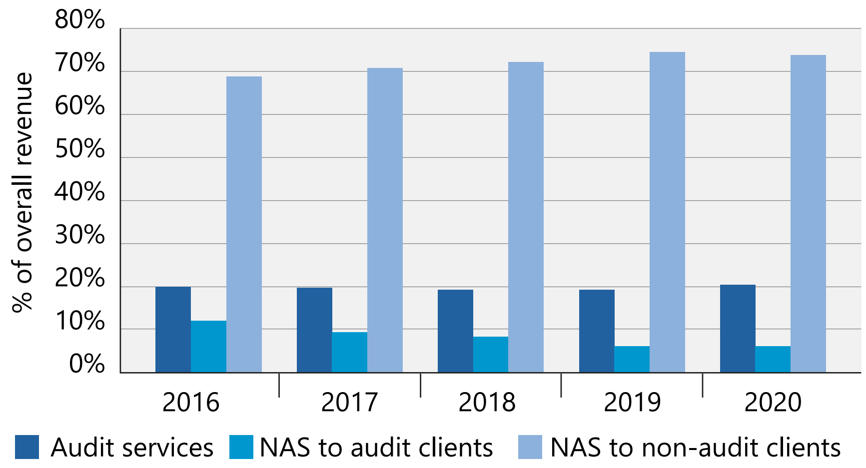
Figure 1 shows Big Four fees from audit services rose slightly as a share of total fees in 2020, representing 20.3% of the total services provided by these firms, compared to 19.3% in 2019.

Big Four fees from non-audit services supplied to companies that the firms did not audit, remained steady at 73.7% of total fees in 2020, compared to 74.4% in 2019. This varied from 65.6% for KPMG LLP (66.0% in 2019) to 80.2% for Deloitte LLP (80.6% in 2019). The remaining 6.0% of Big Four

21 Key Facts and Trends in the Accountancy Profession published by the FRC in July 2021: https://www.frc.org.uk/getattachment/669f6196-5a08-4a0b-aad3-b1915d4a6e4e/FRC-Key-Facts-Trends-2021.pdf

fees generated in 2020 came from non-audit services provided to companies the firms also audited, down slightly from 6.3% in 2019.

Figure 1: Total Big Four fees from audit and non-audit services

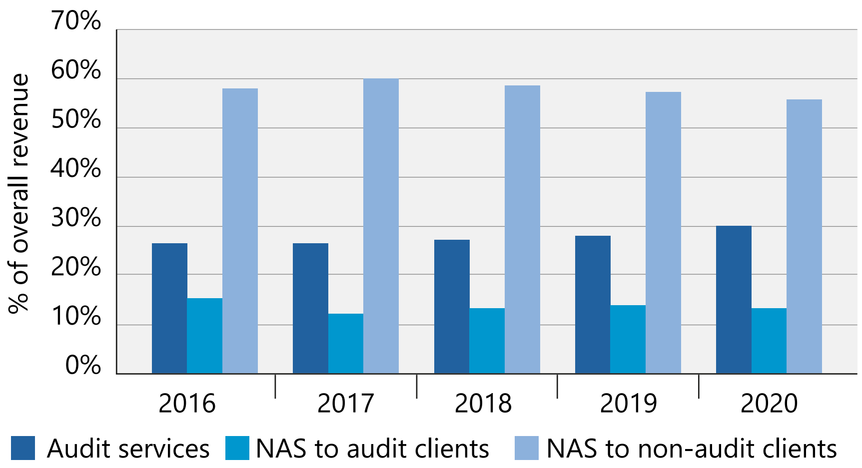


Source: FRC Key Facts and Trends in the Accountancy Profession 2021, 2020, 2019, 2018, 2017; audit firms with PIE clients.

Figure 2 shows that non-Big Four fees from audit services also rose slightly as a share of total fees in 2020, representing 30.2% of the total services provided by these firms (this proportion was 28.3% in 2019).

For the non-Big Four firms, fees from non-audit services provided to companies that the firms did not audit accounted for 56.6% of total fees in 2020, compared to 57.7% in 2019. This varied from 48.7% for BDO LLP (49.4% in 2019) to 58.7% for RSM UK Audit LLP (60.0% in 2019). The remaining 13.2% of non-Big Four fees generated in 2020 came from non-audit services provided to companies the firms were also auditing, down slightly from 14.1% in 2019.

Figure 2: Total Non-Big Four fees from audit and non-audit services



Source: FRC Key Facts and Trends in the Accountancy Profession 2021, 2020, 2019, 2018, 2017; audit firms with PIE clients.

Audit fees

FTSE 350

In 2020, FTSE 350 companies paid approximately £1 billion in total for audit services. This represents a 3.6% increase on 2019, considerably slower growth than the 9.4% increase in 2019 and the 10.5% increase in 2018, all well above inflation. The largest sector by audit fees in the FTSE 350 was banks (representing 20.2% of the total audit fees paid in the FTSE 350), followed by oil, gas and coal (7.6%) and industrial metals and mining (5.5%).[22]

Table 1 on the next page shows the top ten FTSE 350 companies by audit fee in 2020 and the relevant auditor for that financial year. As for 2019, the banking, and oil, gas and coal sector companies top this table, paying the highest fees in the FTSE 350. For this top ten group, total audit fees paid decreased by 0.5% compared to 2019. In 2020, the audit fees paid by

Non-audit services to non-audit clients contributes the majority of firms' total fee income.

22 Based on Audit Analytics fees data and London Stock Exchange sector classifications.

these top 10 companies still accounted for 33.3% of audit fees for the entire FTSE 350 index, down slightly from 34.6% in 2019. The highest audit fee is more than three times the tenth highest audit fee. The ten largest FTSE 350 companies by audit fee in the UK are also the ten largest PIEs by audit fee in the UK.

Table 1: Top 10 FTSE 350 companies by audit fee - 2020

Company Name	Auditor	Audit Fees (£m)	LSE Sector
HSBC Holdings PLC	PwC	67.2	Banks
Barclays PLC	KPMG	46.3	Banks
Royal Dutch Shell PLC	EY	38.3	Oil, Gas & Coal
NatWest Group PLC	EY	34.8	Banks
BP PLC	Deloitte	29.6	Oil, Gas & Coal
GlaxoSmithKline PLC	Deloitte	27.9	Pharma & Biotechnology
Lloyds Banking Group PLC	PwC	27.4	Banks
WPP PLC	Deloitte	24.4	Media
Vodafone Group PLC	EY	19.5	Telecommun-ications
British American Tobacco PLC	KPMG	18.3	Tobacco

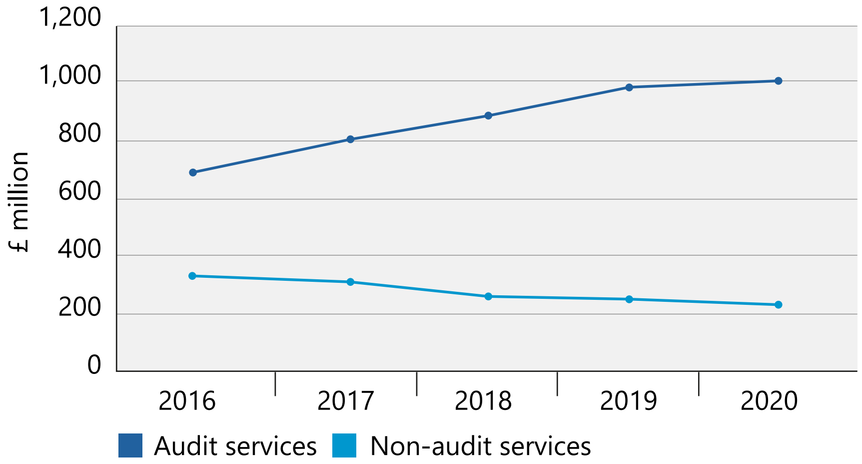
Source: Audit Fee data from Audit Analytics' Audit Opinion Database; FTSE 350 constituents as at 30 June 2021.

The largest audit firms are multi-disciplinary and provide a range of services beyond audit. There have been diverging trends in the total fees derived from audit and non-audit services supplied to those FTSE 350 companies the firms also audit, highlighting the declining importance of non-audit fees received from companies the firms audit relative to audit fees.

This reflects both voluntary moves by audit firms to restrict the types of non-audit services they provide to FTSE 350 companies that they audit and, more recently, changes to the UK's Ethical Standard that further restricted the non-audit services that could be provided to PIEs audited by the firms.

Figure 3 shows fees earned by the audit firms from both audit and non-audit services to FTSE 350 companies the firms also audit. While total fees from audit services increased by 3.6% from £969m in 2019 to £1,003m in 2020, total fees from non-audit services from companies the firms also audit decreased by 4.6% from £260m in 2019 to £248m in 2020.

Figure 3: Fees from audit and non-audit services to FTSE 350 companies audited by the firms



Source: Source: Audit Fee data from Audit Analytics' Audit Opinion Database; FTSE 350 constituents as at 30 June 2021.

Non-audit fees from companies the firms audit continue to decline in importance relative to audit fees.

Public Interest Entities (PIEs)

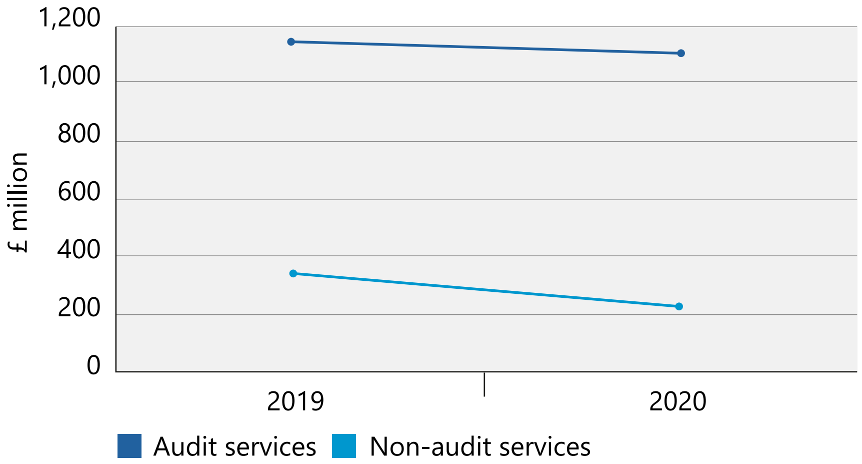
Being much broader, the data on PIEs is less well developed. We do have some data on audit firms and their PIE clients, but that does not extend to *all* the work done by those audit firms for *all* PIEs. However, within the data presented here, we have separated out fees for both audit services and non-audit services.

Figure 4 sets out total fees received by audit firms from audit and non-audit services provided to those PIEs which they audit between 2019 and 2020. It shows that fees received from these entities, for both audit and non-audit services have declined during the period.

Figure 5 shows the split between audit fees for both audit and non-audit services to PIEs that the Big Four audited between 2017 and 2020.

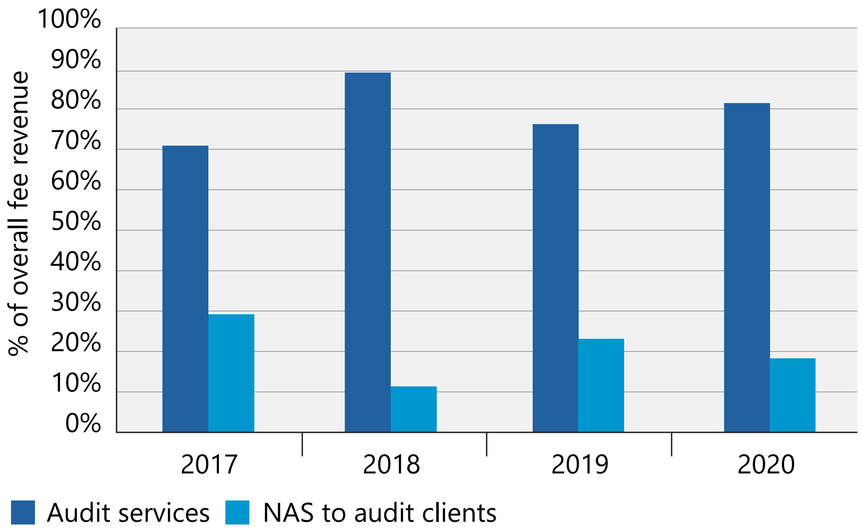
Similar to the total fees breakdown in Figure 1, fees from audit services to PIEs continue to dominate over fees from non-audit services to PIEs. For 2020, fees from audit services to PIEs comprised 81.9% of total fees, compared to an average of 79.3% for the three prior years. The large fluctuations from 2017 to 2019 show no clear trend and exposes a less reliable historical data set. Nevertheless, the proportion of fees from PIE non-audit services to PIEs has decreased over time from 28.9% in 2017 to 18.1% in 2020.

Figure 4: Fees from audit and non-audit services to PIE audit clients



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021. Audit Fees and Non-Audit Fees from Audited Entities are based on the 'Audit Fee' and 'Non-Audit Fee' fields provided by audit firms in the 2016-2020 AQR Inspection Scope Surveys.

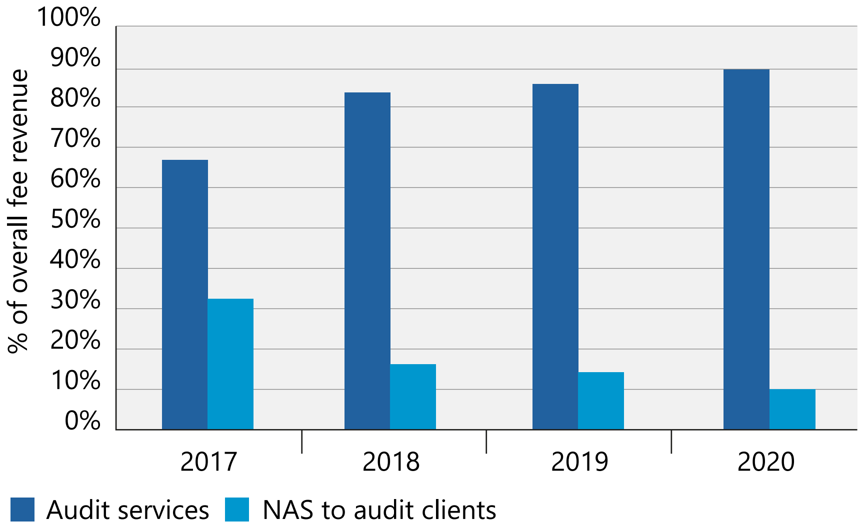
Figure 5: Big Four firms' fees from audit and non-audit services to PIE audit clients



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021.

Figure 6 shows non-Big Four fees generated from both audit and non-audit services to PIE audit clients between 2017 and 2020. Overall, the fees for audit services to PIE audit clients as a proportion of total PIE audit client fees has increased steadily over the last four years. Audit fees from PIEs increased from 86.5% in 2019 to 89.8% of total in 2020, while revenue from non-audit services decreased from 13.5% in 2019 to 10.2% of total.

Figure 6: Non-Big Four firms' fees from audit and non-audit services to PIE audit clients



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021.

Audit market share

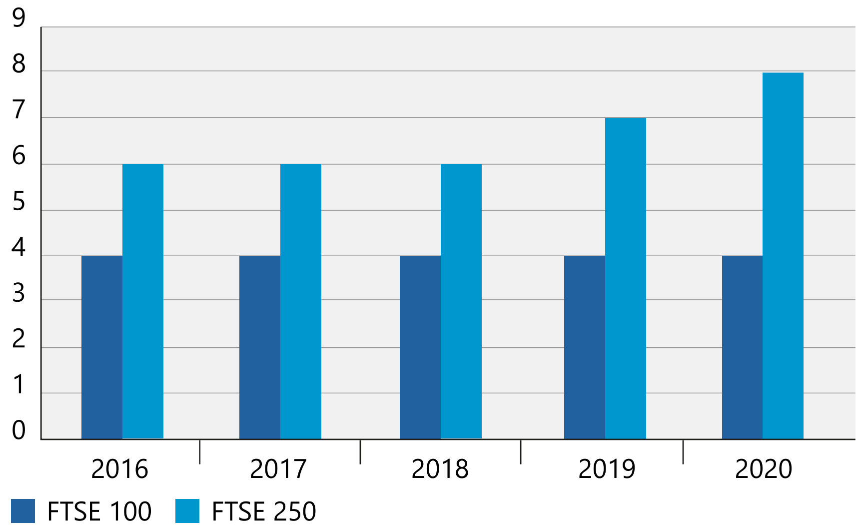
FTSE 350

The Big Four were the statutory auditors of 93.7% of FTSE 350 companies in 2020. This is slightly lower than the 95.7% share they held in 2019. This represents a small shift of FTSE 350 market share from the Big Four to non-Big Four firms. However, the Big Four firms are still taking a larger share of the larger, more lucrative, audits accounting for just over 98.8% of audit fees earned from the FTSE 350 in 2020, again a small decrease compared to 2019, when they accounted for 99.3%.

The non-Big Four firms that audited FTSE 350 companies in 2020 were BDO LLP (15 audits), Grant Thornton LLP (4 audits), MHA Macintyre Hudson LLP (2 audits) and RSM LLP (1 audit), with BDO's LLP market share increasing significantly in the past year as they grew their FTSE 350 audits from 5 to 15.

Figure 7 shows the number of firms providing audit services to FTSE 100 and FTSE 250 companies in each year between 2016 and 2020. While only the Big Four have provided audit services to FTSE 100 companies in the past five years, the number of audit firms serving the FTSE 250 has increased from 6 to 8 over the period.

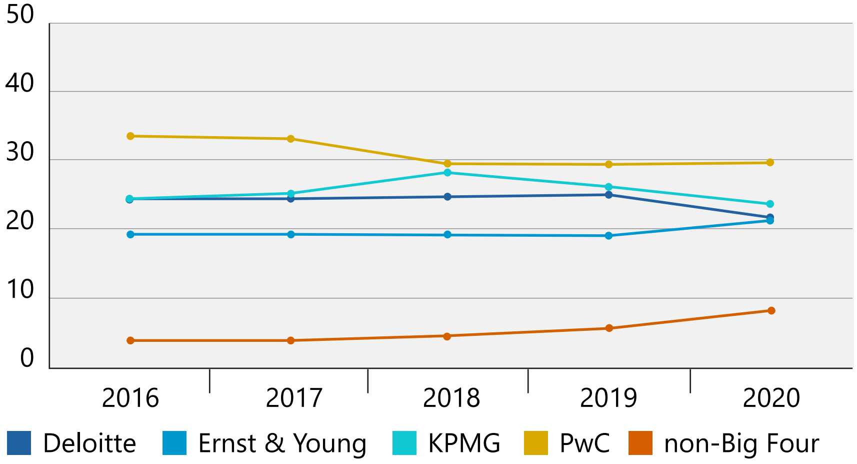
Figure 7: Number of audit firms signing the audit opinions of FTSE 100 and FTSE 250 companies



Source: Audit Fee data from Audit Analytics' Audit Opinion Database; FTSE 350 constituents as at 30 June 2021.

Figure 8 shows the FTSE 350 audit market share of each of the Big Four and non-Big Four firms between 2016 and 2020. In 2020, each Big Four firm had a much larger share of the FTSE 350 audit market than the non-Big Four firms put together.

Figure 8: FTSE 350 audit market share by number of entities audited



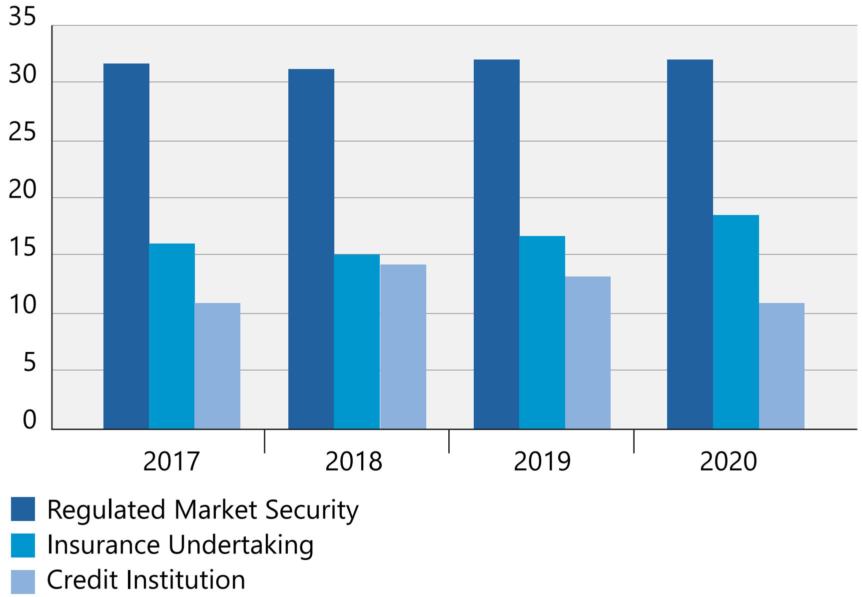
Source: Audit Analytics' Audit Opinion Database; FTSE 350 constituents as at 30 June 2021.

Public Interest Entities (PIEs)

In contrast to the FTSE 350 market, more audit firms operate in the wider PIE market. In total there were 38 audit firms auditing PIEs in 2020 compared to 37 in 2019.

Figure 9 shows the number of audit firms signing the audit opinions of PIEs between 2017 and 2020, broken down by the three PIE qualifying categories of Regulated Market Security, Insurance Undertaking and Credit Institution. Some firms audited one or more entities within these qualifying categories; 11 firms audited credit institutions, 16 audited insurers and 32 audited entities with transferable securities in a UK regulated market in 2020.

Figure 9: Number of audit firms signing the audit opinions of PIEs



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021.

The non-Big Four firms have increased their total PIE market share from

21%

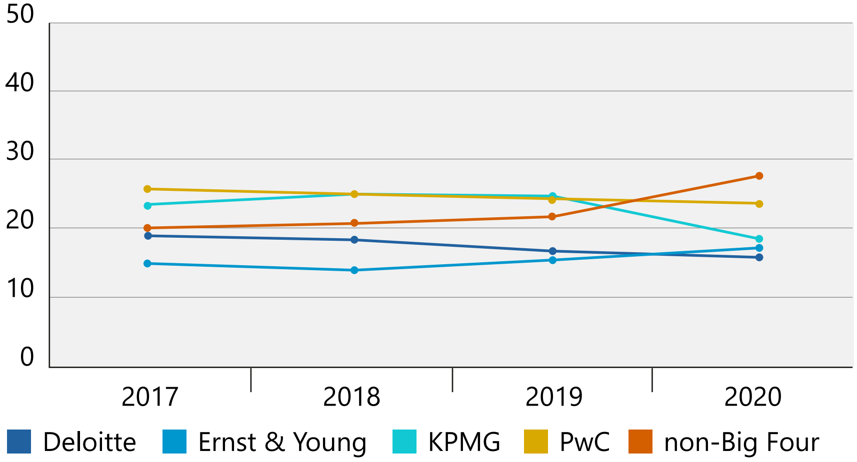
in 2019 to

27.4%

in 2020.

The Big Four's share in the PIE market has declined slightly in the last two years from 79.0% in 2019 to 72.6% in 2020. Figure 10 shows the audit market share for PIE audits split by number of entities audited by the Big Four and non-Big Four firms. As a result, the orange trend line shows non-Big Four firms have increased their market share over the years and now audit 27.4% of the total PIE market in terms of number of entities audited, compared to 21.0% in 2019.

Figure 10: PIE audit market share by number of entities audited



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021

Auditor changes and auditor tenure

FTSE 350

The proportion of FTSE 350 companies switching auditors averaged 8.7% per year between 2016 and 2020. The highest proportion of companies switching in this period was 11.7% in 2017, while the lowest was 6.6% in 2018. Among the switches that occurred, there is recent evidence of more FTSE 350 companies switching their audits from Big Four firms to non-Big Four firms, as shown in Figure 11.

- Switching from Big Four to Big Four has remained the largest of the four switching categories, particularly in 2018 where it represented 100% of the tender switches. In the last two years however, the proportion of switches from Big Four to Big Four has been falling, from 77.4% in 2019 to 69.2% in 2020.

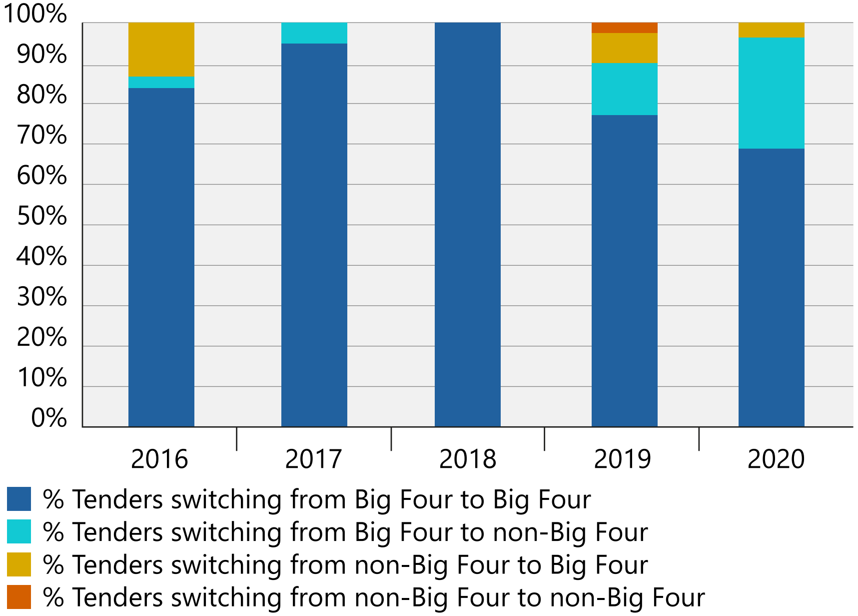
- Switching from Big Four to non-Big Four has seen a correspondingly upwards trend. In 2016, 3.1% of switches were from a Big Four firm to a non-Big Four firm and this has increased to 26.9% in 2020. In between, rates of switching away from the Big Four firms have fluctuated from 0% to 12.9%.

- Switching from non-Big Four to Big Four has also trended downwards, from 12.5% in 2016 to 3.8% in 2020, with the three years in between averaging at 2.2%.

- Switching between non-Big Four firms has been minimal in the last 5 years, with switching in this category occurring only once in 2019 (3.2% of tenders).

Figure 11 shows all the auditor switches of FTSE 350 companies (FTSE 350 as at June 2021) occurring between 2016 and 2020. The number of switches in each year varied from 23 in 2018 to 41 in 2017, but averaging 31 over the five year period. The chart clearly illustrates the recent downward trend in the proportion of switches from Big Four to Big Four.

Figure 11: Auditor switching in the FTSE 350 2016 - 2020

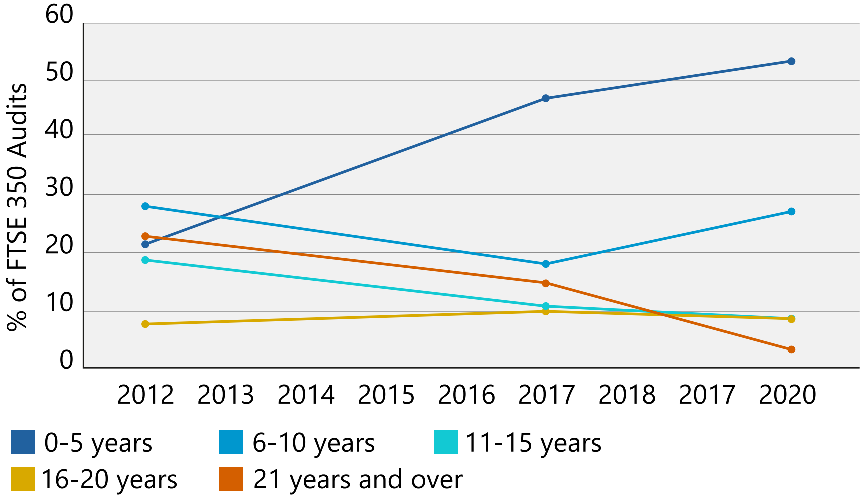


Source: Auditor data from Audit Analytics' Auditor Changes Database; FTSE 350 constituents as at 30 June 2021.

Figure 12 sets out the distribution of current auditor tenures for FTSE 350 companies since 2012. This shows that the proportion of FTSE 350 companies with audit tenures of five years or less has increased over time.

Conversely, the proportion of FTSE 350 companies whose current auditor's tenure is over five years has decreased over time, from 78.0% in 2012, to 53.0% in 2017, and to 46.3% in 2020. At the other extreme, 2% of companies still have a current audit relationship extending for over 20 years. These companies fall within different sectors such as retail, insurance, beverages, and media, and most have reappointed the same audit firms for the coming financial year but anticipated the audit to be re-tendered in the next two to four years in compliance with the transitional arrangements allowed and requirements under mandatory audit firm rotation for PIE audits.

Figure 12: Distribution of audit tenures for the FTSE 350: 2012, 2017 and 2020



Source: Auditor data from Audit Analytics' Auditor Changes Database; FTSE 350 constituents as at 30 June 2021.

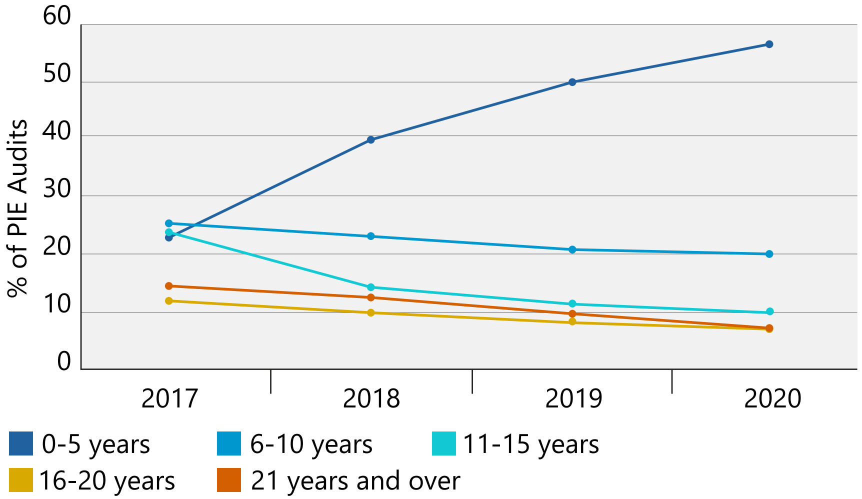
The proportion of FTSE 350 companies with audit tenures of five years or less has increased over time.

Public Interest Entities (PIEs)

For the PIE market, there have been similar increases in the proportion of entities with current audit tenures of five years or less. Figure 13 shows that 55.8% of all PIEs had audit tenures of five years or less in 2020 compared to 23.1% in 2017. The proportion of PIEs whose current audit tenure is over five years has generally decreased over time, from 76.9% in 2017, to 44.1% in 2020.

We have shown an earlier starting point for FTSE 350 entities because the UK implemented a requirement under the UK Corporate Governance Code in 2012 for FTSE 350 companies to retender their audits every ten years. While not all audit tenders under this requirement resulted in a change of auditor, switching did increase for FTSE 350 companies from this point. The UK implementation of the Statutory Auditors and Third Country Auditors Regulations[23] in 2016 required a ten-year retendering period for all PIEs, not just the FTSE 350, and introduced mandatory rotation of auditors, after a maximum term of twenty years.

Figure 13: Distribution of audit tenures for PIEs: 2017 - 2020



Source: 2020 AQR Inspection Scope Survey – PIEs as at 30 June 2021.

Looking Ahead

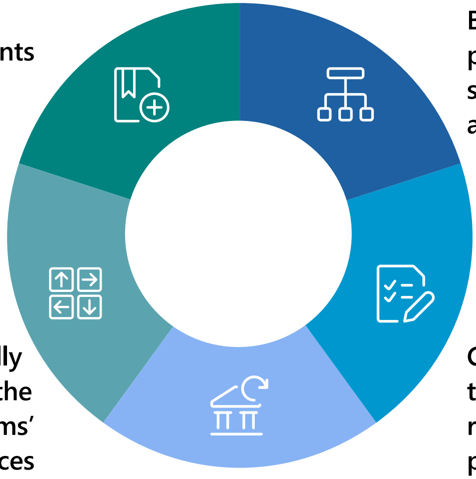
Many aspects of the current proposed programme of corporate governance and audit reform are expected to impact upon the audit market for both FTSE 350 entities and PIEs. This includes the Government's proposals for regulatory oversight of Audit Committees and managed shared audit. In addition, increased transparency of AQR results, both good practice and findings, should enable auditors to improve audit quality across the market. The FRC (and then ARGA) will continue to monitor developments in the audit market and report findings in future publications.

23 The Statutory Auditors and Third Country Auditors Regulations 2016: https://www.legislation.gov.uk/uksi/2016/649/regulation/11

Section 4: Restoring trust in the audit market

Restoring trust in the audit market

Pending the Government's response to the Consultation issued in March 2021, the FRC has lost no time in addressing recommendations which are not fully reliant on legislation to implement, including:



Building a proportionate supervisory approach

We have divided PIE firms into three Tiers to ensure proportionality and fairness in our new approach. Further details are set out in the table on the right and the next page, together with how the degree of supervision activity currently affects firms in the relevant Tiers. Our approach to audit supervision will continue to evolve and respond to developments, such as any additional powers gained as we transition to ARGA.

Appendix 3 sets out the audit firms which have been allocated to each tier as at 1 September 2021.

Our revamped tiering supervisory approach:

	Tier 1 firms	Tier 2 firms	Tier 3 firms
Effective date	1 October 2020	1 April 2021	1 April 2021
Current allocation of firms (subject to change as the market evolves)	Largest seven firms	A further five to seven firms, based on our risk assessment. Firms with more than ten PIE audits are likely to be in this tier	Remaining PIE audit firms
Supervisory activity			
Engagement Framework of regular meetings	Full	Independent non-executives (INEs), senior partner and head of audit meetings only	No
Audit inspections	Usually annual (typically at least five audits)	Typically a three-year cycle (two or three audits) Annual risk-based sample of firms	Three or six-year cycle plus ad hoc to address risks (one or two audits)
Firm-wide work on audit quality controls (ISQC1)	Annual (topics addressed in rotation over a three-year cycle)	Smaller firms programme as part of AQR audit inspection; may be extended at our discretion	Smaller firms programme as part of AQR audit inspection

Continued	Tier 1 firms	Tier 2 firms	Tier 3 firms
Supervisory activity			
Review of root cause analysis (RCA) and action plans	Yes	In depth in year of AQR audit inspection plus annual updates	Three-year cycle – yes Six-year cycle – no
Supervisory pillars	Full scope	At our discretion	No
Pre-appointment meetings	Yes	Head of audit only	No
Risk reporting protocol	Yes	Yes	No
Conveying supervisory messages			
Annual supervisory letter	Tailored, annual, September 2021 onwards	Tailored, annual, end 2021 onwards	Generic, annual, end 2021 onwards. Risk-based additional tailored elements based on monitoring activity
Firm-level reporting	Public	Private	Private
Individual audit inspection reports	Yes	Yes	Yes

Continued	Tier 1 firms	Tier 2 firms	Tier 3 firms
PIE auditor registration			
PIE audit firm and auditor registration (planned from 2022)	Yes	Yes	Yes

Changes to the PIE auditor registration process

The Kingman Review considered the delegation of approval and registration of PIE audits to the RSBs to be a deficiency in the functions and powers of the regulator. Kingman argued that this delegation left the regulator without sufficient power to act where systemic quality issues are identified.

Currently there is no distinction between PIE and non-PIE approval and registration, and an audit firm and Responsible Individuals authorised by RSBs to undertake audits, can conduct any audit. The Government's Consultation considers that in order to improve the quality of PIE statutory audits, it is important that the regulator directly approves both the individuals and firms which carry out PIE audits. The Government considers that the task of entering approved individuals and firms onto the register of statutory auditors should fall to the RSBs, which are better placed to carry it out.

At present the regulatory tasks to approve and register statutory auditors (including PIE audits) are delegated to the RSBs through a direction from the Secretary of State. If the current Ministerial Direction is revoked, the FRC may reclaim these delegated powers. It is expected that any revocation of the Ministerial Direction would occur well in advance of any legislation establishing ARGA being finalised.

The FRC is working with the Government and the RSBs to plan for the changes set out above. During the year, we extended the team to plan for the introduction of a system and processes to respond to the requirements of PIE auditor approval and registration, which is expected to go live in 2022.

Revising the Audit Firm Governance Code

We are revising the Audit Firm Governance Code (the 'Code') to ensure that it is consistent with the regulatory requirements for audit firm governance, including operational separation, to take account of the findings of our 2020 implementation assessment and promotes good governance practice in the largest audit firms.

Our 2020 review of the implementation of the Code at the Tier 1 firms found that the flexibility in the Code had enabled each firm to implement it differently. This has led to significant differences in the approach to partner oversight of the activities of management and to the positioning and activities of INEs. The extent of the differences in the governance arrangements makes comparability and assessment of effectiveness difficult and hinders communication about how the largest audit firms are run.

In reviewing the Code, we have undertaken outreach with a broad range of stakeholders, including INEs from all seven Tier 1 firms, and members of management from these firms. We set up a Stakeholder Advisory Group comprised of audit committee chairs, finance directors, an academic, and investors to provide an external perspective on audit firm governance. Their feedback has helped inform the proposals we are consulting on this autumn.

We propose to align the Code with the rest of the regulatory framework around audit. Firms that audit 20 or more public interest entities or that audit any listed companies will be expected to apply the revised Code when it takes effect from 2023.

In developing our proposals, we have sought to:

- strengthen the Code in those areas where we have identified gaps in the current Code or weaknesses in firm implementation;
- provide greater clarity in areas where stakeholders tell us the Code is insufficiently precise or detailed;
- reflect recent developments in good governance practice;
- eliminate or reduce overlap with requirements based in law, regulation or standards;
- align the Code with the language and intent of the new International Standards on Quality Management (UK); and
- establish the boundaries between the responsibilities of INEs and Audit Non-Executives (ANEs) in firms with operationally separate audit practices (the Big Four).

The 12-week consultation was published in August 2021.

Operationally separating the Big Four firms' audit practices

Following the publication of the Operational Separation Principles (the 'Principles') in July 2020, the four largest audit firms agreed to implement the principles on a voluntary basis. The four firms submitted their initial implementation proposals in October 2020, which we reviewed and on which we provided feedback. Following our discussion with the firms, we issued a revised version of the Principles, published in February 2021.[24] We are monitoring how firms are implementing their plans on an ongoing basis and will be providing formal feedback on progress on a regular basis in the run-up to publicly reporting on the firms' compliance with the principles in respect of their financial years ending in 2024 (end of transition period).

In respect of governance requirements, firms have now appointed ANEs to sit on their Audit Boards. At some of the firms Audit Board meetings have already commenced. We have been in regular discussion with the firms during this set-up phase to ensure that the proposed remit and

24 Updated principles for operational separation of the audit practices of the Big Four firms published in February 2021: https://www.frc.org.uk/news/february-2021/operational-separation-of-audit-practices

responsibilities of the Audit Boards are compatible with the Principles and that there is consistency across the firms in what the Audit Boards are empowered to do. Terms of reference will be published in due course by each firm.

The firms have defined which of their assurance services they intend to place within the same ring-fence as their audit businesses, with some firms having wider definitions than others. Firms are in the process of moving staff between the audit practice and other lines of services to create their ring-fences.

We have confirmed that quality will be a key element in the performance appraisals of audit partners and staff. We are comfortable that the firms have established appropriate and acceptable governance structures and that there will be suitable oversight of the policies and procedures for audit partner promotion and audit partners' remuneration in accordance with the Principles.

The firms are finalising their approaches to transfer pricing and cost allocation between the audit and non-audit practices, which we will review when completed. We have also presented the firms with our proposed template for their financial reporting, and we are considering the best approach to obtaining assurance on these numbers.

Ongoing enhancements to auditing standards

The FRC works closely with the International Auditing and Assurance Standards Board (IAASB), and a member of FRC staff is also an IAASB Board member. This ensures that the UK can exercise significant influence in the development of international standards, as well adding any material when adopting them that we believe is appropriate in a UK-specific context. The IAASB has revised a series of core standards in recent years, many of which have been adopted in the UK since Developments in Audit 2020.

In addition to new standards and guidance, we have had to deal with the ongoing challenges presented by the pandemic, and have issued clarifications and guidance on a variety of issues – for example independence considerations where auditors were asked to help companies with applications for government support, and on the use of technology to complete audit procedures such as stock counts.[25]

This section of the report sets out those auditing standards which the UK adopted in previous periods which have now become effective. It also sets out the major new standards we have adopted in the UK since the previous Developments in Audit Report, and the work we have done to enhance the UK version of the auditing standard on fraud.

Major developments during the year included:

- **the auditing standards ISA (UK) 540 Auditing Estimates and Related Disclosures and ISA (UK) 570 Going Concern:** these standards, issued in previous periods become effective for financial reporting periods beginning on or after 15 December 2019, and therefore for the first time the audits that came into our inspection cycle 2020/21. Auditors will be required to consider evidence that contradicts management's judgements and estimates, as well as that which corroborates them. They also include new 'stand back' requirements where before forming their opinion, an auditor explicitly considers all of the evidence gathered in the course of an audit in a more holistic way, and in the context of their understanding of the audited entity;

- **the revisions to the FRC's Ethical Standard for auditors:** issued in December 2019 and became effective for most entities from 15 March 2020. The revisions focus on enhancing the reality and perception of auditor independence. We also strengthened the role and authority of Ethics Partners in the firms, and expanded our definition of the crucial 'third party test' against which auditors must make judgements about matters of ethics and independence;

25 Guidance For Auditors and Matters to Consider where Engagements are Affected by Coronavirus (Covid-19) updated by the FRC in December 2020: https://www.frc.org.uk/getattachment/ae0044e3-a7bf-4b75-8aa2-4e39e20f525b/Bulletin-Coronavirus-Guidance-December-2020.pdf

- **the Government's Consultation:** published in March 2021 with the consultation period concluded in July 2021. As the reform agenda continues, we will implement necessary changes to standards and guidance, with the key objective of helping deliver consistently high-quality audit. There are potentially profound implications for standards setting, including how the scope of audit is defined and the way in which auditors report the outcome of their work;

- **the revised ISA (UK) 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements:** issued in May 2021, the revision aims to clarify that the auditors have an obligation to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud;

- **the issuing of new Quality Management Standards (ISQM (UK) 1, ISQM (UK) 2 and ISA (UK) 220):** these new standards issued in July 2021 are designed to introduce a new quality management system approach that is focused on proactively identifying and responding to risks to audit quality; and

- **the IAASB activities:** The FRC contributes to the enhancement and development of the international auditing standards, with active participation in key projects represented by our Director of International Auditing and Assurance Standards as one of the IAASB board members.

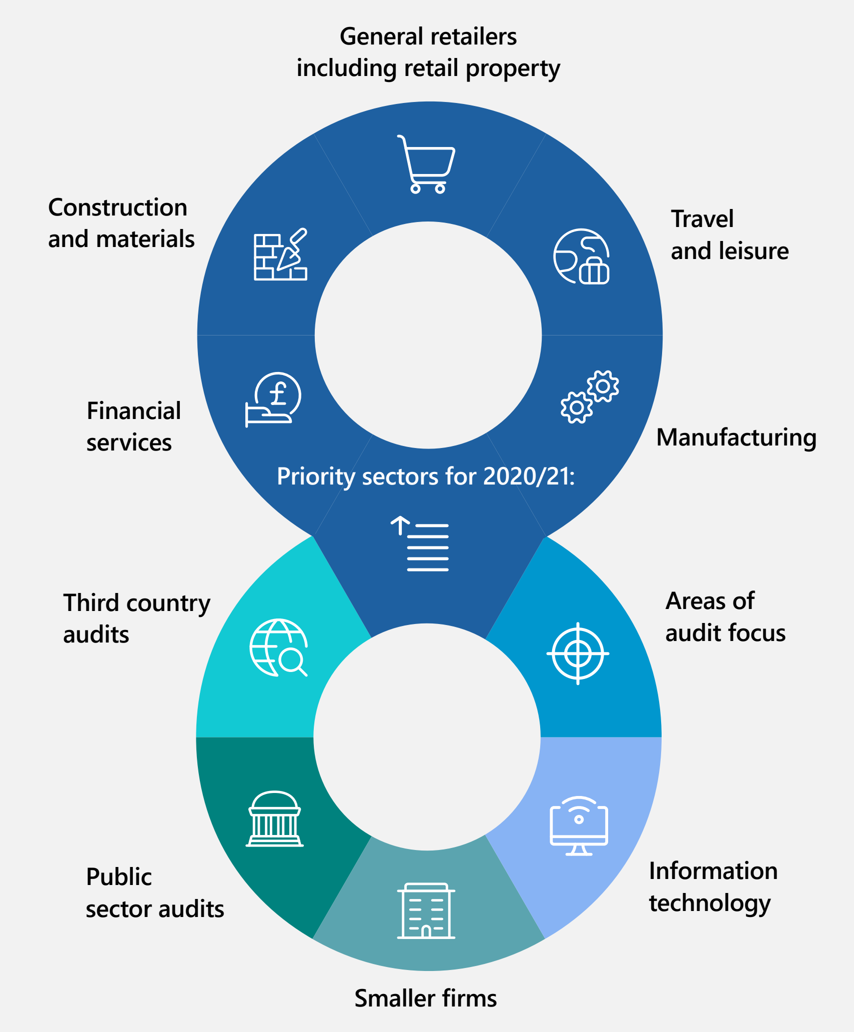
Appendix 2 sets out these changes in more detail.

Appendix 1: Detailed audit monitoring analysis

Appendix 1: Detailed audit monitoring analysis

In this Appendix, we take a closer look at various aspects of our audit quality monitoring results, such as findings emerging from inspections in our priority sectors, as well as the results of our inspections of smaller firms.

Areas subject to detailed analysis:



Financial services (28 inspections)

Financial services audits, including insurance audits and banking and building society audits, remain an important component of our review programme. The sector has been deemed a priority sector since the 2017/18 inspection cycle.

Insurance entity inspections

In 2020/21, we inspected 12 insurance audits (six life and six non-life across seven audit firms). Since 2015/16, when insurance entities were categorised as PIEs, we have completed the inspection of 76 insurance audits (33 life and 43 non-life, across 11 audit firms). Last year, we reported on the challenge that the completeness and accuracy of data represented to auditors and their actuaries on account of the continued use of legacy systems by many insurers. We see this as a long-term challenge which should reduce as insurers upgrade their systems.

Key findings

Key findings in this sector included:

- instances in which component audit teams provided insufficient evidence of their evaluation of the effectiveness of aspects of IT control environments which were managed at group level in other countries; and
- weaknesses in audit of the valuation of financial investments that cannot be valued using readily observable inputs, and in audit of revenue recognition (particularly management's estimates of premium income). In a few cases, audit teams obtained insufficient audit evidence to support the carrying value of intangible assets or gave insufficient attention to the quality of financial statement disclosures and audit finalisation procedures.

Good practice

We also identified good practice points that included aspects of group oversight, technical provisions and use of actuarial specialists, Covid-19 and going concern, service organisations, and first year audit procedures. Most audit teams identified the 'valuation of technical provisions' and 'Covid-19 and going concern' as significant audit risks and reported on them as Key Audit Matters. We inspected the underlying audit work in all such cases and found it was generally carried out to an acceptable standard.

Banks and similar entity inspections

We reviewed 15 bank, credit institution and building society audits. Similar to the previous inspection cycle, we continued to see significant differences in the audit approach used and the quality of audit work inspected.

The most notable area of polarisation continued to be the valuation of financial instruments and certain aspects of IFRS 9 testing, where we observed instances of both very high- and low-quality audit work. One of the root causes of these differences appears to be variations in firms' methodologies and other ancillary guidance and training. The FRC reviewed methodology and training in these areas in the 2020/21 cycle (as reported on page 12) and will continue this focus into our 2021/22 inspection cycle.

Key findings

Key findings in this sector included:

- notable variation in key aspects of audit approaches to allowance for expected credit losses within the scope of IFRS 9, including how audit teams understand, challenge and test banks' methodologies used in estimating key assumptions. The most significant findings in this area related to the assessment of Significant Increase in Credit Risk (SICR) and related testing, individually assessed exposure credit file review procedures, the testing of models and related data elements, and the sufficiency of work and challenge over modelled Multiple Economic Scenarios and forward-looking considerations within individually assessed exposures. We have also seen strong work performed over key areas of IFRS 9, in particular where firms integrated technical experts with the audit team, the use of data tools, and where strong challenge was evident throughout the audit;
- valuation of financial instruments within the scope of IFRS 13 remains a key area of risk and involves management bias and estimation uncertainty. We continue to identify issues with auditors not performing appropriate risk assessments associated with complex valuations leading to findings over the control and substantive testing performed; in particular with respect to model risk management. We also noted instances of insufficient audit procedures performed over the risk of unauthorised trading, including related IT testing;
- audit of settlement / clearing accounts: (a) inadequacies in the audit team's understanding of the bank's processes to determine the nature and extent of procedures to be performed; (b) insufficient testing by the IT specialist teams; and (c) insufficient evidence retained to support the IT-dependent control and substantive testing performed throughout the year, including testing of report logic. Due to the pervasive risk associated with this area for banks, audit teams should consider enhancing the work performed, including more oversight by more experienced team members;
- user access management remains a key area of risk and we have recently identified significant deficiencies in IT specialist teams' related testing, and audit teams' overall assessment and response to the risk identified; and
- deficiencies in quality control on banking audits, which primarily related to lack of evidence supporting key judgements, untimely

review of key working papers, insufficient remediation of previous AQR inspection findings, and lack of challenge by the firms' quality control procedures, including EQCR review. A clear and detailed quality review should be performed to enable audit teams to conclude that they have performed an appropriate level of audit work to support their conclusions. Audit teams should clearly evidence the audit procedures performed, the key judgements made, and conclusions reached.

Good practice

We also observed good practice in respect of the audit of expected credit losses, with an example of a high-quality review of model code and independent model rebuilding of the entity's loan loss provisioning model.

Construction and Materials Entity Inspections (2 inspections)

We have seen several poorer quality audits of construction and materials entities over recent years. This trend continued for 2020/21, with both audits in this area graded as requiring more than limited improvements. The construction and materials sector has faced a downturn in profitability and reduced margins on large infrastructure contracts as well as the operational and economic pressures arising from Covid-19. The introduction of IFRS 15 for revenue from contracts with customers has rightly increased the level of tangible evidence needed before revenue can be recognised on contract receivables.

Construction projects typically take several years to complete, and profit on these projects is based on both an estimation of the future costs and profit margin, and assumptions about the claims that can be made to increase revenue where overruns and variations have occurred.

Key findings

We found instances of auditors not challenging the significant judgements and accounting treatments for long-term contracts. Examples included insufficient challenge of whether claims would be recoverable from customers and the completeness of future, forecast costs. Where auditors relied on management's controls over forecasts, they did not always adequately test the robustness of these controls.

General retailers including retail property (14 inspections)

We saw varying quality in the results of general retailer and retail property audits, with only six of the 14 audits graded as limited improvements required and none graded as good. Many retailers are under significant financial pressure and have been significantly affected by the restrictions imposed due to Covid-19, reduced consumer confidence, and the increased popularity of online shopping. Many retailers have increased their debt levels and high-profile businesses have collapsed.

Key findings

Key findings in this sector included:

- audit teams did not sufficiently challenge the key assumptions, such as forecasting growth or decline in sales and profits used in the audited entity's impairment models, or ensuring that sufficient sensitivity testing was performed over these assumptions, with due consideration of market forces and shifts. We also found instances where auditors had not sufficiently challenged the recoverability of debtors to consider if further impairments to working capital balances were needed; and

- We found instances where auditors had not sufficiently tested the accuracy, completeness, and cut-off of revenue, despite attempted use of revenue analytics to test the full balance of transactions. We also found instances where audit teams had not performed sufficient procedures to challenge the valuation of and provision for inventory. Other findings were around the extent of inventory count procedures and the lack of clear rationale and justification for the inventory count approaches taken.

Travel and leisure inspections (9 inspections)

We saw inconsistent quality in the audits of travel and leisure entities. Of the nine inspections, two audits were graded as good, four as requiring limited improvements, and three requiring improvements. Many travel and leisure entities faced severe financial pressure and uncertainty as a result of Covid-19. Some also have a significant high-street presence and so were affected by falling property valuations.

Key findings

Key findings in this sector included:

- key assumptions for impairment assessments include macroeconomic and sector forecasts and small changes in these key assumptions can, in some instances, result in a material impairment. In some instances, auditors did not adequately challenge which assets were at risk of impairment or the assumptions used to support the valuation of assets; and

- where groups operate across a number of jurisdictions, tax and regulatory requirements can be complex, particularly for groups operating in highly regulated sectors such as gambling. We found instances where auditors had not adequately understood the relevant regulation across all jurisdictions, the management process for ensuring compliance, and the completeness of liabilities recognised.

Manufacturing inspections (7 inspections)

We have seen poor quality in the audits of manufacturing entities with three audits graded as 'requiring improvements' or 'significant improvements'. This is a complex and diverse sector with entities experiencing a range of impacts from Covid-19 and increased economic uncertainty, and significant variety in the complexity of transaction flows.

Key findings

Key findings in this sector included:

- impairment assessments for goodwill and intangible assets are inherently complex and subjective. We saw one key example where auditors had not adequately assessed and challenged management's impairment methodology, including the identification of the groups of assets to be assessed for impairment;

- revenue recognition may be complicated by the granting of customer rebates and by different patterns of transactions in the different regions and sectors of a business. We found instances where auditors had not sufficiently tested key elements of revenue, including provisions for rebates payable and the cut-off of revenue between periods; and

- instances where the audit team had not exercised sufficient oversight to ensure that the component audit teams had performed sufficient procedures over the cost and valuation of inventory and mineral reserves balances.

Areas of audit focus

Our areas of focus for 2020/21 were going concern and the viability statement, long-term contracts, impairment of non-financial assets, Other Information in the Annual Report, fraud risk and the application of IFRS 15 and IFRS 16. Findings and good practices in these areas are largely described above, but we also separately identified the below:

- The Other Information in the Annual Report – the key finding in this area was insufficient evidence of auditors adequately considering the Other Information in the Annual Report to support the disclosures made.
- Fraud risk - key findings in this area related to insufficient testing over journals, with examples being auditors:
  - not testing the completeness of journal listings;
  - not ensuring performance of journal testing by component auditors;
  - failing to justify the sufficiency of the criteria used to search for journal postings that could indicate management override of controls; and
  - failing to sufficiently test those journals identified as meeting higher-risk criteria.

  Individually less significant findings were also identified in respect of the rigour of the auditor's fraud risk assessment and the completeness of testing performed over cash balances and intercompany transfers.
- For the application of IFRS 16, no key findings were identified, but individually less significant findings were identified where auditors had not sufficiently evidenced procedures to ensure that all relevant leases were identified and that reasonable assumptions were used to estimate the value of lease liabilities.

Information Technology

IT Inspectors within the AQR team supported approximately a third of all inspections performed during the 2020/21 cycle. This is consistent with the previous year, though the mix of inspections was more weighted towards financial services entities (including banks and insurers), which represented approximately 40% of inspections subject to IT scope in the 2020/21 cycle, up from around 30% in the previous year.

We were encouraged to see an increasing trend of data tools and data analytics successfully deployed by audit teams. This is particularly the case on bank audits where common 'off the shelf' data tools, along with more bespoke approaches, were regularly being used to perform testing procedures over full loan portfolios, for example in the assessment and re-performance of SICR staging. Similarly, revenue recognition continues to be an area where data analytic techniques were applied to analyse full populations of revenue transactions. This was particularly the case for entities with high volumes of low value transactions and clearly defined sales channels.

Key findings

Common IT-related inspection findings can be broadly categorised as follows:

- Recurring instances where auditors have not sufficiently responded to issues related to excessive privileged access on key IT systems. This included cases where the auditor had not sufficiently expanded their IT testing to mitigate the associated risks, for example through identification and testing of appropriate compensating controls or through IT substantive procedures. We also identified cases where the overall audit response was not sufficient where it had been concluded that the privileged access issues could not be mitigated through further IT testing procedures.

- In relation to complex group audits and the oversight procedures performed by group IT teams, we identified a number of examples where key IT-related reporting from component teams was missing from the group audit file, or there was a lack of evidence of the group team's assessment and challenge of component team testing and results.

- Data testing continued to be a major theme arising from our inspections. It is important that auditors can demonstrate a good understanding of the end-to-end data flows supporting key business processes, including the source IT systems and related interfaces. As in previous years, we identified instances where the completeness and accuracy of these data flows had not been sufficiently tested where relied on in audit procedures.

- Variation in quality of work in the testing of system reports. Regardless of whether these reports are supporting an auditor's testing of controls or being used in substantive procedures, it is important that sufficient testing procedures are performed to assess their reliability. We still commonly saw examples where auditors have not clearly identified the source of the report or performed sufficient testing to assess both completeness and accuracy of reports. It is also important that audit teams recognise that the presence of effective general IT controls does not negate the need to perform specific testing to assess the integrity of reports.

- Audit teams regularly adopt a 'test of one' approach to assess IT automated controls (ITACs). Such an approach is dependent on effective general IT controls supporting the related IT applications. Auditors should consider variations in ITACs and therefore design appropriate testing procedures to ensure all applicable processing variations are tested appropriately. Two common examples of automated controls seen on bank audits are the automated mapping of valuation models to particular products (in the valuation of financial instruments) and the automated matching rules used in the settlement and clearing processes. In both cases, we identified examples where the mapping/matching rules were individually and separately coded within the IT systems, and therefore a test of only one of these did not provide sufficient assurance that others were coded appropriately.

Although the above points represent the most common IT-related inspection findings over the 2020/21 inspection cycle, we have also identified instances of good practice across these and other areas. Specific examples include comprehensive oversight and challenge evidenced by group IT teams, thorough analysis to ensure completeness of general IT controls scoping, and expanded ITAC testing to address multiple processing variations.

It is over a year since the publication of the 'Use of Technology in the Audit of Financial Statements' thematic review, and almost a year since the publication of responses to our earlier consultation on 'Technological Resources: Using Technology to Enhance Audit Quality'.[26] Limited examples of the emerging technologies noted in that report, which included machine learning, natural language processing, and predictive analysis, have been observed during our inspections in the 2020/21 cycle, with these tools largely still in research and pilot phases.

Smaller Firms

Whilst a large portion of the PIE, large AIM companies and Lloyd's Syndicates population is audited by the Tier 1 firms, approximately 178 of these entities are audited by 27 other smaller audit firms. Many of these entities have listed equity or debt and these fall within the scope of the FRC's audit quality review programme. Audits of such entities are inspected on either a three or six-year cycle.

26 Thematic review on 'Use of Technology in the Audit of Financial Statements' https://www.frc.org.uk/getattachment/1c1478e7-3b2e-45dc-9369-c3df8d3c3a16/AQT-Review_Technology_20.pdf, and responses to consultation on 'Technological Resources: Using Technology to Enhance Audit Quality' https://www.frc.org.uk/news/december-2020/technological-resources-%E2%80%93-using-technology-to-enha

FRC inspection cycle for firms inspected on a non-annual basis

Since 2016, firms that are not inspected annually are visited on a six-year cycle, or, for firms that audit a large PIE, a three-year cycle. The majority (121) of the 178 PIE, large AIM companies and Lloyd's Syndicates are audited by nine firms that we visit on a three-year cycle. The 18 firms that audit the remaining PIEs are visited on a six-year cycle, including eight firms that audit two or more PIEs. These firms are either categorised in the Tier 2 or Tier 3 within our supervisory framework.

Inspection findings of firms inspected on a non-annual basis

In 2020/21 we inspected ten firms, being RSM UK Audit LLP, UHY Hacker Young LLP, PKF Littlejohn LLP, Gerald Edelman, Haysmacintyre LLP, MHA MacIntyre Hudson LLP, Jeffreys Henry LLP, Johnston Carmichael LLP, BHP LLP, and Crowe U.K. LLP. The scope of our work included 16 audit file inspections and reviews of firm-wide procedures at eight of those firms. The inspection findings were generally poor, with only six audits of the 16 reviewed being assessed as requiring no more than limited improvements.

Key findings

As we review different firms each year, year-on-year comparisons of an individual firm's results cannot be made. The main themes from our inspections were:

- We consistently observed the audit work around going concern to be weak, and audit teams did not always obtain sufficient and appropriate audit evidence to support their conclusions.

- The audit of judgements and estimates continues to be weak, including concerns around the reliance placed on management's experts, in particular insufficient challenge over the assumptions they used. Auditors did not engage their own experts to assist in challenging assumptions used and did not justify why an auditor's expert was not necessary.

- Many firms' audit methodologies permit capped or limited sample sizes. We raised findings where we saw limited samples employed on significant risk areas and Key Audit Matters. Audit teams tend to default to limited sample sizes which can prevent an objective assessment of the actual test results. Limited sample sizes also prevent audit teams from exploring more effective ways of obtaining appropriate audit evidence, such as controls testing, or the use of data analytics.

- We identified improvement areas for firms' system of quality control, including:

  - Developing a linkage between audit quality and reward, including introducing partner appraisals;
  - Inclusion of audit quality within the firm's strategy and its governance structure;
  - Where accounts are prepared by the firm for non-PIE audits, there should be a provision for an independent review of the financial statements prior to the audit commencing;
  - Adequacy of procedures over the audit and checking of disclosures within financial statements;
  - Establishing a linkage of Internal Quality Management (IQM) findings to EQCR performance; and
  - Establishing a system of monitoring continuing professional development hours (CPD) and ensuring that the balance of hours is directed towards audit training for audit staff.

- There is the potential for greater efficiencies to be realised through auditor judgement when considering the best testing procedures. Only one of the audits we reviewed placed reliance on the company's own internal control environment. In all other cases, the auditors either decided it was more efficient to obtain audit evidence through fully substantive procedures, or that the control environment was unreliable. We encourage firms to revisit their training, methodologies and practical applications around controls testing, given the increasing importance of effective controls within growing companies.

- We continue to observe findings in respect of the audit of journals, which included the use of data analytic tools for two audits. The findings centred upon the approach to identifying the highest risk journals and the resultant procedures performed. We encourage all firms to refresh their journals methodology and guidance.

Areas of good practice

We have observed good practice on file inspections and firm-wide systems of quality control during the 2020/21 cycle for firms that are inspected on a non-annual basis.

The themes we observed from our file inspection work, underpinning good practice included, enhanced risk assessment and understanding the business/sector procedures, going concern procedures, the use of reverse stress testing and focused procedures on managements mitigating actions were executed to good effect, and procedures over valuations which in one instance included a well thought through memorandum explaining the procedures and conclusions on a complex area that involved judgement.

The aspects of firms' systems of quality control that we found to be of a high standard included:

- Some firms have adopted elements of the Audit Firm Governance Code where not mandated;
- There are sensible and transparent leadership structures, where the Audit Compliance Principle and quality features prominently within the governance structure;
- Some firms' have invested in a well-trained pool of individuals to act as EQCRs who are deployed to non-PIE audits that are deemed to be higher risk;
- Methodology and guidance for more complex audits/areas has been developed, to assist audit teams;
- An internal system of partner licensing where only individuals with relevant skills, experience and expertise are allowed to undertake certain audits, within complex industries or sectors, including PIE audits.

How we hold these firms to account for poor results

Our findings from both firm-wide and audit file inspections are reported to each firm in a private report. The findings are also reported to the firm's professional body and its registration committee (or equivalent) with a recommendation on whether the firm should continue to be registered to undertake audits and whether other steps should be considered to improve or safeguard audit quality (for example, accelerating the next inspection visit or restricting the firms' ability to undertake PIE audits). In future, we will take control of this registration process for PIE audit firms (refer to section 4).

FRC engagement with non-annually inspected firms to improve audit quality

Throughout the 2020/21 inspection cycle, we increased our engagement with several firms, outside of the periodic inspection visits with a view to improving audit quality. For example, we attended some conferences and training events and for firms taking on new higher-risk audits, we held meetings to ensure that they have considered risks and necessary resources. In addition, we performed interim audit file inspections for larger firms, and we held a webinar for all of the non-annually inspected firms to share common findings from AQR inspections and explain how to prepare for an AQR visit. We intend to continue to increase this engagement in the future.

Public Sector Audits

Local Government and Health Body Audits

The Local Audit and Accountability Act 2014 (LAAA) makes the FRC responsible for the oversight of Major Local Audits in England. Local audits include:

- Local government bodies;
- NHS Trusts and NHS Clinical Commissioning Groups; and
- Certain other prescribed bodies.

A Major Local Audit is an audited body with either revenue or expenditure in excess of £500 million. The oversight of other local audits is the responsibility of the ICAEW, but with oversight from the FRC's POT.

Our 2020/21 Major Local Audit Inspection Results

We reviewed the audits of 20 bodies with a 31 March 2020 year-end, these were completed by six audit firms. Within the public sector, in addition to the audit of the financial statements, auditors are required to assess whether the entity has proper arrangements in place to secure economy, efficiency and effectiveness in its use of resources (known as 'Value for Money' or VfM).

Our reviews covered both the audit of the financial statements and the audit firm's conclusion on VfM arrangements. The audits we reviewed in 2020/21 included NHS Trusts, Clinical Commissioning Groups, Pension Funds, Unitary, Metropolitan and County Councils.

Our inspection of financial statement audits showed an improvement, with 70% of audits requiring no more than limited improvement (40% in 2019/20). This was especially encouraging against the backdrop of a particularly challenging year for auditors, which saw 55% of local government auditor reports not being issued to the timetable of 30 November 2020.

Significant challenges were posed to the delivery of these audits by the pandemic. In addition, all audit firms engaged in local audits have continued to experience resourcing pressures and the increasing complexity of local audit financial statements.

While too soon to identify this improved audit quality as a trend, it is encouraging. We have seen a number of tangible actions taken by the firms to respond to the previous poor quality issues that the FRC had identified and reported.

Good practice

We were pleased to note several instances of good practices, for example:

- Only issuing the auditor's report (even where this causes a delay) when all required information has been received. In one case a material audit adjustment was made as a result;
- Challenging management's property valuer to disclose a material valuation uncertainty; and
- Use of an auditor's expert to help audit highly specialised property in a consolidated company.

It is important that the firms work to build on this progress, including addressing the key findings we identified in 2020/21 and ensuring past areas of concern do not recur.

Key findings

The most significant audit quality findings this year related to improvements required to:

- Strengthen testing of the occurrence and accuracy of expenditure;
- Evaluate and challenge assumptions used in investment property valuations;
- Evaluate assumptions used in property, plant and equipment valuations; and
- Clarify the rationale and evidence to support any modified audit opinions issued.

Our review of the work performed by auditors on the VfM arrangements conclusions identified no key findings. This is a satisfying result. Over time, we have raised few findings over the firms' work in this area, as the firms' work has been of a consistently high standard.

A detailed analysis of our Local Audit quality inspection activity is provided in our Local Audit public report, which was published in October 2021.[27]

Developments in the Local Audit Sector

The Redmond Review was published in September 2020.[28] It concluded that the local audit market was very fragile and that without prompt action to implement its recommendations, there was a significant risk that audit firms would withdraw from the market. A key recommendation was the creation of a new regulatory body responsible for procurement, contract management, regulation, and oversight of local audit.

In the Government's response to the review,[29] it was concluded that ARGA would be best placed to take on the role of local audit system leader, rather than establishing a new regulatory body, with Public Sector Audit Appointments Ltd (PSAA) retaining responsibility for procurement and contract management.

The Government subsequently issued a public consultation on the proposed new regulatory arrangements in July 2021[30] and the FRC is working closely with them to implement these proposals.

National Audit Office Audits

The FRC is the Independent Supervisor of Companies Act audits undertaken by the National Audit Office (NAO). In addition, we have contractual arrangements in place, agreed on a voluntary basis, to inspect certain non-Companies Act audits performed by the NAO. We also review the NAO's policies and procedures to ensure audit quality ('firm-wide' work) on a cyclical basis. We currently report privately to the NAO on our overall inspection. In respect of our statutory work on Companies Act audit inspections, we provide a report to the FRC Board to support its reporting to the Secretary of State as Independent Supervisor.

Our 2020/21 Inspection Results

We reviewed seven audits performed by the NAO, including four Companies Act audits. Our key findings were in similar areas to those raised in the previous year, in particular relating to improving the extent of challenge in areas of judgement. In addition, we specifically highlighted the need for strengthening the assessment of, and evaluation of work performed by others such as management's experts. We have asked the NAO to identify what actions they will take to mitigate these recurring findings.

We also identified an unacceptable trend of poorer audit quality in those higher-risk and more complex audits inspected relating to financial services and audits of financial services-related balances on other entities. We have raised concerns, based on our inspection findings, in this area for the past six years. We have asked the NAO to consider urgently these issues and identify what steps can be taken to improve the quality of this work.

Increasing transparency

We currently report privately to the NAO on each audit reviewed and on our overall inspection results. In respect of our statutory work on Companies Act audit inspections, we also report to the FRC Board (in its capacity as the Independent Supervisor).

27 Major Local Audit public report published in October 2021: https://www.frc.org.uk/getattachment/97b5a417-d9bf-4649-b3c3-3ae49a350fe7/FRC-AQR-Major-Local-Audits_October-2021.pdf
28 Report on Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting (the 'Redmond Review') published in September 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/916217/Redmond_Review.pdf
29 The Government's response to the Redmond Review published in December 2020: https://www.gov.uk/government/publications/local-authority-financial-reporting-and-external-audit-government-response-to-the-redmond-review
30 The Government's open consultation on Local Audit Framework published in July 2021: https://www.gov.uk/government/consultations/local-audit-framework-technical-consultation/local-audit-framework-technical-consultation

While the NAO has already taken steps to enhance further the transparency of its work by publishing the results of our inspection within its annual Transparency Report on its external website, together with our private annual report to the C&AG, we continue to encourage the NAO to increase the transparency around our reports, by improving both the communication of our inspection results and related engagement with Audit Committees. For Companies Act audits, we would recommend that our reporting is consistent with our inspections of major audit firms.

Third Country Audits

Third Country Auditors (TCAs) are auditors of companies incorporated outside the UK that have issued securities on a regulated market in the UK, most commonly the main market of the London Stock Exchange. Our regulation work includes registering audit firms as TCAs in the UK, and independent inspection of their audit work. We are required to undertake inspections of auditors from countries where the system of auditor oversight is not 'equivalent' or 'transitional' to that required within the UK. We commenced inspections of TCAs in 2013/14.

As at 30 June 2021, there were 96 registered TCAs across 35 countries, including those from equivalent or transitional countries, with 136 issuers with UK traded entities.

In the year to 31 March 2021, partly due to the travel restrictions resulting from Covid-19, only one inspection of a TCA firm was possible, which we carried out using remote methods. No significant issues were identified, and the audit was assessed as requiring only limited improvements. We are also undertaking reviews of TCAs which audit lower risk issuers, using alternative methods, rather than direct inspection of audit files.

Appendix 2: Developments in auditing, assurance, and ethical standards

Appendix 2: Developments in auditing, assurance, and ethical standards

New auditing and ethical standards for the current year

A number of the auditing standards we have issued in previous periods became effective for financial reporting periods beginning on or after 15 December 2019 – including ISA (UK) 540 Auditing Estimates and Related Disclosures and ISA (UK) 570 Going Concern. Revisions to these standards are intended to drive greater professional scepticism and challenge of management – a key theme in the broader work the FRC has been doing on audit firm culture. These new standards require auditors to consider evidence that contradicts management's judgements and estimates, as well as that which corroborates them. They also include new 'stand back' requirements where before forming their opinion, an auditor explicitly considers all of the evidence gathered in the course of an audit in a more holistic way, and in the context of their understanding of the audited entity.

The 2019 revisions to the FRC's Ethical Standard for auditors also became fully effective in this period. The focus of those revisions was on enhancing the reality and perception of auditor independence. Certain prohibitions were enhanced or extended (for example in respect of non-audit services charged on a contingent fee basis, or providing internal audit services to an audited entity). We also strengthened the role and authority of Ethics Partners in the firms, and expanded our definition of the crucial 'third party test' against which auditors must make judgements about matters of ethics and independence.

> *'Consideration of whether the ethical outcomes required by the overarching principles and supporting ethical provisions have been met should be evaluated by reference to the perspective of an objective, reasonable and informed third party (see the definition of independence). Such a person is informed about the respective roles and responsibilities of an auditor (or reporting accountant as applicable), those charged with governance and management of an entity, and is not another practitioner. The perspective offered by an informed investor, shareholder or other public interest stakeholder best supports an effective evaluation required by the third-party test, with diversity of thought being an important consideration'.*[31]

This focus on the views of informed non-practitioners is a significant enhancement to the test, and should help ensure that principled judgements are made on risks to independence.

In our 2019 revision we extended certain restrictions on the provision of non-audit services to a new category of 'Other Entities of Public Interest' (OEPIs). A significant proportion of the audit and assurance policy team's time has been taken up with implementation issues, and providing additional clarification where necessary.[32] We have also restarted a Technical Advisory Group (TAG) consisting of representatives of the audit firms and other interested stakeholders to discuss and resolve issues related to both auditing and ethical standards. This is to help ensure consistent understanding and practice by auditors.

The Government's Consultation on Audit Reform

The FRC as a whole has had extensive engagement in the Government's Audit Reform Consultation process, and is working to help develop specific policy proposals. As the reform agenda continues, we will implement necessary changes to standards and guidance, with the key objective of helping deliver consistently high-quality audit. Changes to standards and guidance will be subject to further public consultation to ensure that they are fit for purpose.

In some areas we have already been able to deliver reforms – in particular through our revision to the UK fraud auditing standard, details of which we set out below, alongside an overview of the other major standards that we have issued.

31 Revised Ethical Standard 2019, I14

32 See for example the implementation guidance at https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/current-ethical-standards

New Standards: Fraud

In May 2021, following a public consultation, we issued a revised ISA (UK) 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements which is effective for audits of financial statements for periods commencing on or after 15 December 2021, with early adoption permitted.

Auditors' responsibilities with respect to detecting fraud in the financial statements have received significant attention in the wake of a series of accounting scandals. Furthermore, in his 2019 review into the quality and effectiveness of audit, Sir Donald Brydon commented that this is a frequently misunderstood area and recommended that the requirements in the auditing standard be clarified. While we noted that the Government's Consultation is considering expanding directors' reporting responsibilities in respect of fraud, we felt that the time was right to make changes to the existing auditing standard in order to clarify and codify the expectations on auditors.

As such, a major aim of our revision of the standard was to clarify that the auditors have an obligation to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud.

In addition to this clarification, the revised standard includes enhancements to the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks. These revisions include, among other things:

- a new requirement for the auditor to undertake risk assessment procedures and design and perform further 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. This is consistent with recent changes to other ISAs (UK) we have described above, and should lead to a significant improvement in audit quality in this area;

- the addition of a paragraph to clarify that the auditor shall remain alert for conditions that indicate a record or document may not be authentic, together with application material which provides examples of conditions that may indicate a physical or electronic document is not authentic or has been tampered with. Recent examples of well-publicised fraud cases have included instances of inauthentic documents playing an important role in the fraud, so we believe this added requirement is an important step forward in the work required of auditors; and

- the inclusion of a requirement for auditors to make inquiries of those who are responsible for dealing with allegations of fraud raised by employees or other parties. Whistleblowing is one key method by which fraud can be uncovered, but recent cases have shown that whistleblowing allegations do not always reach the auditors; we believe this requirement will improve things in this regard.

New Standards on Quality Management (ISQM (UK) 1, ISQM (UK) 2 and ISA (UK) 220)

In July 2021 we issued two new standards on audit firm quality management, replacing the previous quality control standard (ISQC (UK) 1), as well as a revised ISA (UK) 220, which deals with audit quality at the level of individual engagements. The revised suite of standards was designed to introduce a new quality management system approach that is focused on proactively identifying and responding to risks to audit quality.

ISQM (UK) 1 sets out a firm's responsibilities to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements. The new approach requires a firm to tailor its system of quality management to the nature and specific circumstances of the firm, using a responsive and integrated approach.

ISQM (UK) 2 is a new stand-alone standard enhancing and consolidating requirements for engagement quality reviews (EQRs). EQRs are internal firm quality reviews of audits, focusing on the key risks and judgements made by the audit team. They are required for certain categories of audit, and are carried out by audit partners who are independent from the engagement team. The revisions include enhanced criteria for the appointment of an individual as an engagement quality reviewer and bolstered requirements regarding the engagement quality reviewer's responsibilities.

ISA (UK) 220 has a renewed focus on the statutory auditor's responsibility for the quality of individual audit engagements. Further revisions embed the principles of quality management into the engagement level requirements, with an increased focus on considering the nature and circumstances of each audit engagement, which we believe will drive improvements to audit quality at the engagement level.

The revised standard focuses on the important role of the engagement partner in managing and achieving quality on the audit engagement, and reinforces the importance of quality to all members of the engagement team. It also includes new material on the importance of professional scepticism and professional judgment in performing audit engagements, describing impediments to professional scepticism, auditor biases, and actions the engagement team can take.

We expect this new approach to result in a step change in audit quality. Some of the benefits the revised approach will bring are:

- the robustness and effectiveness of the activities undertaken by the firm to address engagement quality should be improved by the customisation of the quality management system to the specific nature and circumstances of the firm and the engagements it performs;
- the system should facilitate its own continual improvement over time, since there is an emphasis on firms monitoring and remediating identified deficiencies, considering the effect of decisions across the quality management system and working towards increased integration of the various components of the system;
- the approach facilitates proactive responses by firms to the evolving circumstances they encounter, which will help keep the standard fit for purpose and adaptable to a changing environment; and
- an improved firm-wide mindset with respect to audit quality, driven by an improved tone-from-the-top resulting from enhanced requirements regarding a firm's leadership's responsibilities and accountability.

The standards will be effective for audits of financial statements for periods beginning on or after 15 December 2022, with the first results from monitoring and remediation processes the following year. Early adoption of the revised standards is strongly encouraged, and we would note that even if firms do not early adopt, they should nevertheless begin thinking now about how to design and implement the various elements of their quality management system. On this point, we would note that the IAASB released guidance on first time implementations of the revised standards in June 2021.[33]

New Standards: Reviews of Interim Financial Information (ISRE (UK) 2410)

In May 2021, we issued a revised ISRE (UK) 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity.[34] This is the first update that this standard has received since it was originally issued in 2007.

Our primary objective was to strengthen and clarify some of the requirements in relation to going concern when performing a review of interim financial information, in the context of current expectations and recent changes to auditing standards (most notably ISA (UK) 570 Going Concern).

While acknowledging the different level of assurance offered by an interim review as compared to an audit engagement, we believe that there was significant value in aligning requirements on going concern, where appropriate, across the two types of engagement. Revisions include:

- strengthened review and reporting requirements around going concern;

33 New Quality Management Implementation Guides issued by the IAASB in June 2021: https://www.iaasb.org/news-events/2021-06/new-quality-management-implementation-guides-now-available
34 ISRE (UK) 2410 published in May 2021: https://www.frc.org.uk/getattachment/08bac29d-781a-44bc-bd54-ef2a9bef1edd/Revised-ISRE-(UK)-2410-June-2021.pdf

- clarified requirements on directors' responsibilities with respect to going concern;[35] and
- enhanced requirements linking interim work to the risk assessment conducted when undertaking the prior year audit.

While our revisions were not made directly as a result of Covid-19, they are even more important now given the likely increased focus on going concern, both in the annual financial statements and in interim financial information.

The effective date of the revised standard is for financial reporting periods beginning on or after 15 December 2021.

International Auditing and Assurance Standards Board

As we set out in Section 3, we work closely with the IAASB in its programme of enhancing and developing the international auditing standards. The FRC's Director of International Auditing and Assurance Standards is a board member of the IAASB, and an active participant in key projects.

The 2021 year has seen significant progress at the international level in many areas, including:

- **Going Concern:** An IAASB working group has been gathering information to help in determining what actions may need to be taken in this area. This has including liaising with the IASB regarding their own work on this topic;

- **Audit Evidence:** Work has continued on a project looking to clarify and modernise ISA 500, and emphasize in the standard the auditor's responsibility to exercise professional scepticism;

- **Fraud:** The IAASB is currently at the information gathering stage regarding a project to assess the need for further work on this topic, and the FRC is looking to influence where possible, as this has been an area of significant activity in the UK recently;

- **Group Audits:** Towards the end of 2020, the IAASB consulted on a revised ISA 600, which would significantly improve audit quality for group engagements. The revised standard promotes a risk-based approach at the group level and reinforces the need for robust and efficient communication between various parties, including group and component auditors. The IAASB hopes to issue a final standard in December 2021, which the FRC will then look to adopt in the UK shortly thereafter.

- **CUSP:** In 2021, the IAASB has been working on drafting principles and guidelines that are designed to address complexity, understandability, scalability and proportionality (CUSP) in the ISAs;

- **Technology:** An FRC technology working group continues to collaborate with the IAASB technology working group on a range of issues, including on how AI and Machine Learning might be effectively deployed to improve audit quality, how key AI terms such as explainability[36] could be used in audit and the handling of exceptions;

- **Extended External Reporting (EER):** In April 2021, the IAASB issued non-authoritative guidance on the application of ISAE 3000 (Revised) to EER assurance. This guidance seeks to enhance the credibility and influence of EER reports, and represents a valuable step forward in promoting reliable assurance over a variety of matters, including ESG issues; and

- **Horizon-scanning:** Looking further ahead, the IAASB will be looking at revising and updating ISRE 2410 and ISA 330 in coming years.

35 Note that these responsibilities are not set by the review standard, they exist separately in law and regulation.
36 'Explainability' refers to how simple it is to explain how the results of a learning algorithm (used in predictive analysis) have been deduced.

Appendix 3: Tier allocation of audit firms

Appendix 3: Tier allocation of audit firms

Firms allocated to the tier as at 1 September 2021		
Tier 1 firms	**Tier 2 firms**	**Tier 3 firms**
• BDO LLP • Deloitte LLP • Ernst & Young LLP • Grant Thornton UK LLP • KPMG LLP • Mazars LLP • PricewaterhouseCoopers LLP	• Crowe UK LLP • Haysmacintyre LLP • MHA Macintyre Hudson LLP • PKF Littlejohn LLP • RSM UK Audit LLP	• Beever & Struthers • Begbies • Bennett Brooks & Co Limited • BHP LLP • Bright Grahame Murray • BSG Valentine(UK) LLP • CBW Audit Ltd • Deloitte (NI) Ltd • Edwards Accountants (Midlands) Ltd • Edwards Veeder (UK) Limited • Elderton Audit UK • Gerald Edelman • Hazlewoods LLP • Jeffreys Henry LLP • Johnston Carmichael LLP • Moore Kingston Smith LLP • Nexia Smith & Williamson Audit Ltd • Shipleys LLP • UHY Hacker Young LLP

Glossary

Most definitions in this report have been explained upon first introduction, however some words first appear in table form, or have attached assumptions that differ from the ordinary usage meaning. For clarity, we have further explained these words below.

Audit Non-Executives	The Operational Separation principles on governance stipulate that the Big Four should create an Audit Board to be chaired by, and have a majority of, Audit Non-Executives (ANEs). The ANE chair should not chair any other governance body in the firm and at least one ANE should maintain specified skills and independence requirements.
Audit Services	Audit services are: • Reporting required by law or regulation to be provided by the auditor; • Reviews of interim financial information; • Reporting on regulatory returns; • Reporting to a regulator on audited entity assets; • Reporting on government grants; • Reporting on internal financial controls when required by law or regulation; and • Extended audit work that is authorised by those charged with governance performed on financial information and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.
Big Four	The four largest audit firms in the UK: PricewaterhouseCoopers LLP, Ernst & Young LLP, KPMG LLP and Deloitte LLP.
FTSE 100	A weighted stock market index composed of the 100 largest companies by market capitalisation listed on the London Stock Exchange (LSE).
FTSE 250	A weighted stock market index composed of the 101st to the 350th largest companies by market capitalisation on the LSE.
FTSE 350	A market capitalization weighted stock market index composed of the constituents of the FTSE 100 and FTSE 250 indexes.
Non–audit Services	'Non-audit services' comprise any engagement in which an audit firm provides professional services to: • An audited entity; • An audited entity's affiliates; or • Another entity in respect of the audited entity other than the audit of financial statements of the audited entity.
Non-Big Four	Audit firms outside the Big Four.

PIEs (Public Interest Entities)	Public Interest Entities: On 17 June 2016 the PIE definition included entities governed by the law of a member state whose transferable securities (equity and debt) are admitted to trading on a regulated market in the EEA, credit institutions and insurance undertakings. **As of 1 January 2021**, the regulated market scope has reduced to UK regulated markets only. Public Interest Entities (PIEs) are: *(a) An issuer whose transferable securities are admitted to trading on a UK regulated market;* *(b) A credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, which is a CRR firm within the meaning of Article 4(1)(2A) of that Regulation; or* *(c) A person who would be an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertaking as that Article had effect immediately before exit day, were the United Kingdom a Member State.*
Smaller Firms	In the context of this report, we have defined smaller audit firms as those which are not the seven large audit firms within the Tier 1 category (see Appendix 3: Tier allocation of audit firms). Of these 27 smaller firms, 24 have been defined as Tier 2 or Tier 3 firms for the purposes of our supervisory framework.

Financial Reporting Council

Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300
www.frc.org.uk