Financial Reporting Council

Key Findings Reported in 2020/21 Inspection Cycle

May 2022

Introduction

This document sets out the key findings we reported in the 2020/21 inspection cycle which relate to the private sector audits the FRC's Audit Quality Review team inspected at the seven largest audit firms ("Tier 1 firms"). The findings have been anonymised in view of the statutory confidentiality requirements which apply to the individual inspection reports. The audits inspected were those of entities that had financial year-ends in the period 30 June 2019 to 30 June 2020 (inclusive).

We categorise each completed inspection into one of four grades:

Grade 1 – Good

Grade 2 – Limited improvements required

Grade 3 – Improvements required

Grade 4 – Significant improvements required.

We only include key findings in our reports on those audits we assess as grade 3 or 4. In sharing our key findings in this document we are looking to facilitate informed dialogue with audit committee chairs, and others, regarding our inspection approach, how we assess the significance of our findings and how we report any key findings arising.

Our inspection approach and how we report

Our inspections of individual audits focus on the quality of the audit work performed in the areas we select for review, the sufficiency and appropriateness of the audit evidence obtained and the appropriateness of the key audit judgments made by the audit engagement partner and their team.

For each inspection we issue a confidential report to the audit engagement partner and the audit committee chair (or other person with equivalent governance responsibilities). This sets out the scope of our review, any key or other findings arising, the actions the firm proposes to take to address our findings and any good practices which we identified in specific areas.

Our inspection reports distinguish between any key findings arising and other findings.

A key finding relates to the sufficiency or quality of the audit evidence obtained, the appropriateness of key audit judgments or another substantive matter such as auditor independence. One or more key findings will result in an overall audit quality assessment of either "Improvements required" (Grade 3) or "Significant improvements required" (Grade 4), depending on their severity, to safeguard audit quality and/or comply with relevant requirements.

Any other findings reported will, on their own, only result in an overall audit quality assessment of "Limited improvements required" (Grade 2), regardless of the number of such findings.

Entity	Audit area	Key finding(s)
1	**Independence Considerations**	The audit team did not adequately consider the perceived threats to independence arising from the provision of non-audit services. The audit team did not evidence consideration of self-interest as a threat and whether suitable safeguards were required. Consultation with the Ethics Function regarding the audit fee to non-audit fee ratio for the 2019 audit was prior to signing as opposed to when the ratio was expected to be exceeded or when the non-audit fee increase occurred, as required by Ethical Standards. The tax partner providing the non-audit services also provided support to the audit team in its response to the significant tax risk.
	Compliance with Laws and Regulations	The audit team did not obtain sufficient understanding of the operation of relevant controls across all jurisdictions to address and respond fully to the identified significant risk that non-compliance with law or regulation might have material adverse consequences for the group. Further, where issues were identified, insufficient evidence was obtained to conclude on issues identified and whether they were isolated or representative of broader concerns.
	Taxation	The reporting to those charged with governance did not reflect why taxation had been elevated to a significant risk. The audit team should have challenged and evaluated whether a further tax liability on a 'receivable' basis was only a remote possibility, given the potentially contradictory evidence.

Entity	Audit area	Key finding(s)
2	**Revenue**	The audit team did not test the categorisation of X sales, to ensure that the reconciling items between the gross revenue and the revenue recognised in the financial statements were correctly treated. Further, the audit team did not demonstrate sufficient challenge of management for the adjustment to revenue for these sales or assess the completeness of the revenue recognised in the internal systems.
	Bank reconciliation testing	The audit team did not investigate a net reconciling item in the period end bank reconciliation and therefore did not: • Consider or evidence whether the net reconciling item was made up of significant items offset against each other that would require substantive testing to be performed; or • Communicate this difference appropriately to those charged with governance.
	Inventory	The audit team's focus and approach was insufficient and did not provide adequate assurance over the valuation of inventory at the period end, including: • Specific to the net realisable value/cost test, the audit team's substantive testing was inappropriate as this was based on an incorrect population, resulting in too small a sample and consequently insufficient audit work; and • The evaluation of the rebate provision was based upon unrealistic assumptions and excluded various inventory categories with no justification or explanation for the assumptions and exclusions.
	Pension scheme assets	The audit team performed insufficient procedures over the valuation and existence of pension scheme assets. In particular, the audit team inappropriately relied on asset statements from investment managers.

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3	**Revenue recognition**	Given the identified risk and size of the balance, the design of the detailed audit procedures did not ensure that sufficient, appropriate evidence was obtained to corroborate and conclude on the recognition of the X revenue. Furthermore, the audit team did not sufficiently challenge whether there were alternative methods to recognise revenue.
4	**Pension scheme assets**	The audit team obtained insufficient assurance over the valuation and existence of pension scheme assets. In particular, the audit team did not: • Obtain service organisation control reports for investment managers, to assess whether there were appropriate valuation and existence controls, before placing reliance upon their confirmations; • In the absence of control reports, test the valuation of harder-to-value pension scheme assets, including unquoted equities and bonds, property and other assets held in Pooled Investment Vehicles; and • Consider additional pricing information to assess and challenge the valuation of directly held publicly traded assets.
	Group oversight - Revenue	The group audit team's oversight did not adequately evaluate the revenue testing performed by component audit teams. We had concerns over the evidence supporting revenue testing across multiple components, including: • The consideration of terms, conditions and performance obligations of significant contracts, including the roll-forward of assessments from previous audits for continuing contracts; • The transactional cash receipts testing; • Cut-off testing and evidence of the period to which the services related;

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		• The sampling approach within one material component; and • The IT controls testing over access to a restricted system and substantive testing within one material component.
5	**Understanding and responding to inherent risks**	The group audit team did not demonstrate a sufficient understanding of the entity and the underlying controls in place to minimise the inherent business risks it faced. This resulted in an audit approach which failed to address the risks arising, such as completeness of costs, identification of contingencies and reliance on tender estimated costs and profit.
	Audit of long-term contracts	The group audit team did not adequately challenge and corroborate the significant judgments and accounting treatments for long-term contracts. Specifically: • Contract costs (both incurred and forecast) • Margin movements • Future loss provisions • Validity and appropriateness of variations and claims recognised • Review of subsequent events as at the date of signing the audit opinion The group audit team obtained insufficient evidence to conclude that revenue and contract provisions were not materially misstated.
	Management override of controls	The group audit team did not perform procedures to address the identified presumed fraud risk as it concluded that all journals selected in line with the risk criteria were not 'unusual'.
	Going concern and the impact of Covid-19	The group audit team did not sufficiently challenge management's going concern assumptions in the light of Covid-19.

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	Quality control procedures	In view of the issues identified regarding the work performed over significant risk areas, the quality control and review procedures were ineffective.
6	**Group audit team's oversight of the X component audit**	There was insufficient evidence regarding the group audit team's consideration of the adequacy of the X component audit procedures for several areas, in particular: • The approach to auditing revenue, including the substantive analytical procedures and the extent of additional testing performed; • The sufficiency of the audit team's inventory counts and attendance at management's own physical inventory counts; and • The approach and extent of reliance placed on substantive analytical procedures in the audit of rebates, receivables and trade payables.
7	**Revenue recognition – X component billed revenue**	The audit team did not obtain sufficient evidence that the controls relating to the accuracy of specific information for the X component were appropriately designed and operated effectively to assess whether billed revenue had been invoiced correctly.
8	**Impairment of non-current assets**	The audit team did not obtain sufficient evidence to assess whether an impairment of assets in the X and Y CGUs, or additional sensitivity disclosures, were required. In particular, there was insufficient evidence and challenge in relation to the impact of certain optimistic assumptions in the forecast cash flows of those CGUs.
	Recognition and recoverability of deferred tax assets	The audit team did not obtain sufficient evidence to assess the basis of the recovery of certain Y component deferred tax assets; in particular, whether the relevant historical tax losses would be available to be carried forward.
9	**Group oversight of the component auditor's work - X acquisition**	There was inadequate evidence that the group audit team reviewed or considered key aspects of the component auditor's work on the X acquisition (in particular, certain key judgments and estimates used in the valuation of the redemption agreement, supply agreement and loyalty programme).

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		In addition, there was insufficient evidence of the EQCR's review and challenge of the group audit team's work in relation to the X acquisition.
	Impairment - property, plant and equipment (PPE) and right of use (ROU) assets	The group audit team did not adequately evaluate or challenge certain key aspects of management's impairment assessment, supporting their conclusion that no further impairment of PPE and ROU assets was required. In particular, the group audit team did not: • Perform sufficient procedures to ensure the accuracy of the site level reports used by management; • Sufficiently evidence its evaluation and challenge of management's turnaround plans; and • Address the impact of historical purchase price uplifts in the work they performed. In addition, there was insufficient evidence of the EQCR's review and challenge of the underlying audit work relating to PPE impairment.
10	**Distributable reserves – legality of company's historic distributions**	The audit team did not identify that management had paid illegal dividends because certain current and prior year share scheme transactions had been regarded incorrectly as giving rise to distributable reserves.
	Defined benefit pension scheme arrangements – testing of scheme assets	There was insufficient evidence of audit procedures performed over the valuation of the level 3 financial instruments and insufficient consideration of the higher than market rate of return on the defined benefit asset portfolio.
11	**Assessment of the carrying value of goodwill and other intangible assets – X CGU**	There was insufficient challenge of management and scepticism, or evidence thereof, around the performance improvement assumptions in the X CGU impairment models.

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12	**Going concern – evaluation of management's assessment**	In concluding on whether a material uncertainty relating to going concern existed, there was insufficient evidence that the audit team had adequately considered the significance of the requirement to refinance the revolving credit facility in relation to management's going concern assessment. The audit team should have requested that management clarified the going concern assessment period disclosed in the financial statements, which referred to 'the foreseeable future'.
13	**IFRS 9 Implementation – Expected Credit Losses**	Weaknesses were identified in relation to the evidencing of the nature and extent of certain key audit procedures performed around the ECL calculation. This was specifically highlighted in the testing of data and also the procedures relating to Significant Increases in Credit Risk.
	Settlement / clearing accounts – core banking payments process	Deficiencies were identified in the audit testing of the bank's payments process. There was insufficient evidence to demonstrate the audit team's and IT specialist's understanding of this area, as well as insufficient procedures being performed.
	Quality control and review procedures	In the above two audit areas especially, the audit documentation did not adequately demonstrate that the audit team had obtained sufficient and appropriate audit evidence at the date of the auditor's report. The audit team's review procedures should have resolved the deficiencies identified in our inspection.
14	**Acquisition of trading entities**	There was insufficient audit evidence regarding some significant assumptions and inputs used to determine the fair value of assets and liabilities as of the acquisition date. In particular: • The forecast cash flows for X and Y assets and forecast sales volumes for contract liabilities were not reconciled to those audited by the component auditors and any resulting differences were not identified and tested;

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		• The appropriateness of comparable companies used to determine the margin for contract liabilities was not explained; and • The data on the ongoing legal cases provided by internal counsel was not verified to supporting documentation.
	Going concern	There was insufficient evidence that the audit team assessed the ability of the lender to provide funding as and when required. In particular, the audit team did not: • Challenge management on their assumption that the lender could provide the financing when required; or • Obtain and review the most recent audited or management accounts of the lender or perform other appropriate audit procedures.
15	**Impairment of tangible assets**	Weaknesses were identified in the nature and extent of the procedures performed to test management's impairment assessments at an ABC level. In particular, the audit team did not sufficiently consider or challenge certain key sales and costs assumptions used in the individual cashflow forecasts.
	Revenue recognition	Insufficient procedures were performed to evaluate and test certain material reconciling items in the cash to sales reconciliation for X. In addition, the substantive analytical procedures performed were insufficiently precise to ensure that a material misstatement of the respective balances would be detected.
16	**Expected Credit Losses on loans and advances to customers**	Issues were identified regarding the nature and extent of certain key audit procedures, including those related to: • The Significant Increase in Credit Risk transfer criteria; • Review of the ECL models; and

Entity	Audit area	Key finding(s)
		• Relevant data elements used in the ECL models. As a result, the audit team obtained insufficient evidence to conclude that the ECL allowance was not materially misstated.
17	**Parent company investment in subsidiaries**	The audit team did not obtain sufficient evidence to determine whether the carrying value of the individual investments held on the parent company balance sheet were impaired. The audit team did not adequately consider the impact on the auditor's report, or the associated disclosures within the financial statements, of the lack of an allocation of investment values by subsidiary.
18	**Direction and oversight of the testing of central processes**	There was insufficient evidence of the firm's direction and oversight of the testing of central processes performed by a network firm, to ensure it was sufficient and appropriate for the X financial statement audit.
	Expected Credit Losses for loans and advances	Weaknesses were identified in the nature and extent of certain key audit procedures performed and the sufficiency of audit evidence retained by the firm. These primarily related to: • Significant Increase in Credit Risk procedures; and • The identification and testing of key data elements used in the ECL models.
	Settlement / clearing accounts – core payments process	The firm performed insufficient testing to conclude on the operating effectiveness of the automated reconciliations and the completeness of the related reconciliation break reports, where these were not tested by its network firm.
19	**Revenue**	The audit team did not perform sufficient, appropriate procedures to address the risks of material misstatement in relation to X revenue. In particular: • The audit team performed insufficient procedures to reconcile cash receipts to X revenue; and

Entity	Audit area	Key finding(s)
		• Insufficient evidence was obtained to support the operating effectiveness of management's cash to revenue reconciliation control. Additionally, weaknesses were identified in the testing of year-end credit card receivables to subsequent cash receipts.
20	**Revenue Rebate Accruals**	Weaknesses were identified in the group audit team's assessment supporting its conclusion that the significant fraud risk was limited to six components. Furthermore, for the components for which a significant fraud risk was identified, the group audit team failed to ensure sufficient supervision of the component auditors over the adequacy of the audit procedures performed.
21	**Inventory existence**	The audit team failed to obtain sufficient, appropriate audit evidence over the existence of inventory. Significant weaknesses were identified in the audit procedures performed across all categories of inventory. In particular: • The audit team failed to appropriately evaluate or respond to the counting errors identified in management's store inventory counts, which indicated a potential material misstatement; • Inadequate records were retained of the results, and other audit procedures performed, for the store counts attended; • No roll-back testing was performed for the warehouse counts attended after the period-end date; and • Inappropriate reliance was placed on the third-party confirmation which had been obtained via management.

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	Quality control	The firm's quality control and review procedures were not adequate and effective in ensuring that sufficient and appropriate audit evidence had been obtained for inventory existence.
22	**Fair value of financial instruments**	Deficiencies were identified in the audit team's testing of financial instrument valuation, primarily the work performed over model risk management. The audit team did not perform sufficient procedures in this area or adequately support certain aspects of its assessment and audit approach.
	Existence and accuracy of trading positions yet to be confirmed by a counterparty	There was insufficient evidence to show how the procedures designed and performed by the audit team in this area adequately responded to the potential fraud risk. Furthermore, there was insufficient evidence of the IT specialist's review of the key procedures performed by overseas network firms.
	Settlement / clearing accounts – core payments process	There was insufficient testing of the core payments process and insufficient evidence of the audit team's understanding of this area.
23	**Privileged user access**	Significant deficiencies were identified in the IT specialist team's testing of compensating IT general controls, and the audit team's overall assessment and response to the privileged user access risk identified.
	Expected Credit Loss	Deficiencies were identified in the audit work performed over several key aspects of the ECL impairment allowance. These primarily related to the following: • Completeness and accuracy of data testing; • Significant Increase in Credit Risk testing, including data considerations; • Individually assessed exposures - credit file review procedures; and • Modelled ECL procedures. As a result, the risk of a material misstatement not being detected was unacceptably high.

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	Settlement / clearing accounts – core payments process	There was insufficient testing of the core payments process and insufficient evidence of the audit team's understanding of this area.
	Fair value of financial instruments	Deficiencies were identified in the testing of financial instrument valuation, especially the derivative financial instrument portfolio and the audit team's approach to model risk management.
	Over the counter derivatives	Insufficient evidence was retained to support the audit team's assessment of the risk of unauthorised and unconfirmed trading. Deficiencies were identified in the procedures designed and performed by the audit team and IT specialists to respond to the potential fraud risk in this area.
	Group oversight	The group audit team did not set out in sufficient detail how the audit evidence obtained was appropriate for certain elements of the group audit undertaken by overseas network firms.
	Quality control and review procedures	The audit documentation in the above areas indicated that the audit team had not obtained sufficient and appropriate evidence. The firm's quality control and review procedures should have identified this.
24	**Quality control and review procedures**	The engagement leader and EQCR reviews did not provide sufficient challenge and rigour. The review process failed to identify areas where insufficient audit evidence was obtained and areas where the accounts were potentially materially misstated.
	Impairment	The audit team's procedures to test X for impairment were inadequate and did not provide sufficient evidence to support its conclusion that a material impairment charge should not be recorded.
	Related party transactions	The group audit team failed to consider and appropriately respond to the potential fraud risks arising from the various related party transactions. In particular, the group audit team did not:

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		• Sufficiently consider whether the related party confirmation of the X revenue was appropriate and independent and whether the arrangement was at arm's length; • Perform sufficient procedures to verify the Y commission; • Perform additional procedures to confirm the recoverability of the outstanding debt from Z; and • Assess, challenge or consider the accuracy and completeness of the financial statement disclosures in relation to the above transactions.
	Revenue	For X revenue, the group audit team did not perform sufficient procedures to assess the completeness and accuracy of the inventory invoiced but not dispatched nor evaluate the impact of the estimated unrealised gross margin on these transactions on the group's statement of financial position. For Y and Z revenue, the audit team performed insufficient procedures to place reliance on the results of the "cash proof in total" test. Specifically, there was insufficient evidence to support the group audit team's conclusion that the bank accounts interrogated were used solely for retail and not for other cash receipts.
	Trade receivables recoverability	The group audit team did not sufficiently consider or challenge the sufficiency of the reserve for irrecoverable balances and placed undue reliance on uncorroborated management representations.
25	**Capitalisation and impairment of development costs**	There was insufficient evidence of the group audit team's involvement in and oversight of the work of component auditors to demonstrate challenge on key areas related to capitalisation of development costs (for example, capitalisation after entering mass production, cost overruns, and reclassifications from projects in development to developed projects).

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		There was insufficient evidence to conclude that further impairments were not required as forecasts used to support the carrying value of projects were not sufficiently corroborated.
	Uncertain tax position	The group audit team performed insufficient procedures to challenge management's assessment of the material uncertain tax position.
26	**Credit risk in relation to loan loss provisions**	The audit team performed insufficient procedures on several key audit areas in relation to ECL testing. This included, but was not limited to, the following areas: • Significant Increase in Credit Risk; • The testing of multiple economic scenarios; and • Challenge of key management judgments as part of the individual credit file reviews testing.
27	**Impairment of goodwill and other intangibles (X CGU)**	While the audit team identified that the goodwill impairment model did not initially include an allocation of corporate assets, they failed to detect that the model (used to determine the CGU headroom, discount rate and sensitivity disclosures) was not updated to correct this, after being amended for other challenges made by the audit team on key assumptions. As a result, the CGU headroom and the pre-tax discount rate and sensitivity disclosures in the financial statements were incorrect. The audit team also did not adequately assess the reasonableness and achievability of the cash flow assumptions for the CGU which, combined with the reduced headroom, meant that there was a greater risk of a potential impairment than originally assumed.
	Going concern (covenant compliance)	Management's interpretation of the relevant banking covenant terms was supported by their legal advisers. In assessing this, the audit team should have considered whether it was necessary to seek direct confirmation from the lenders or obtain independent legal

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		advice, before concluding that certain items could be added back for covenant compliance purposes. The audit team should also have assessed whether management's external lawyers were objective in providing their advice around the interpretation of the covenant terms.
28	**Impairment assessments for goodwill and other intangibles in relation to the X and Y CGUs**	The UK group audit team did not adequately assess or challenge the following in concluding whether there was an appropriate level of impairment recognised in certain CGUs: • X: the non-impairment of other intangible assets; and • Y: the achievability of the growth in short-term forecast cash flows and the appropriateness of the discount rate.
	Revenue recognition	The UK group audit team did not adequately assess the completeness and accuracy of the third-party data used to calculate revenue. For the testing of the IT systems, there was insufficient: • Assessment of the design of certain key IT controls; • Justification as to why certain IT control deficiencies reported by the component auditors did not have an impact on the group audit approach; and • Evidence of senior IT specialist involvement and oversight.
	Consideration of liabilities arising from non-compliance with laws and regulations	The UK group audit team's assessment of potential liabilities arising from non-compliance with laws and regulations was insufficient in the following respects: • The justification of the extent of review of communications with regulators; and • The sufficiency of challenge of management's assessment of an ongoing case involving a regulator.

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29	**Impairment assessment of the property estate**	The following deficiencies were identified in the audit team's evaluation and challenge of management's assessment of impairment triggers and subsequent impairment assessment: • The granularity of management's assessment as to which group of properties indicated impairment triggers; • The extent of impairment recognised for the group of properties where impairment triggers were identified; and • The potential impairment implications of post year-end events for certain properties where no impairment triggers had been identified.
30	**Insurance contract**	There was insufficient justification for not requesting management to correct the identified errors relating to the X contract. The audit team should have drawn both the insufficiency of the disclosures and the specific disclosure inaccuracies to their attention.

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