Financial Reporting Council

DELOITTE LLP

AUDIT QUALITY INSPECTION

JULY 2020

The FRC

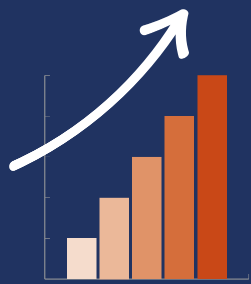
Our purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.

We have responsibility for the public oversight of statutory auditors.

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

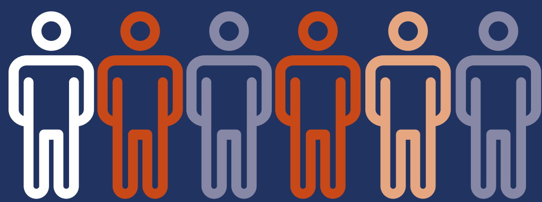
AQR

We monitor the quality of UK Public Interest Entity audits.



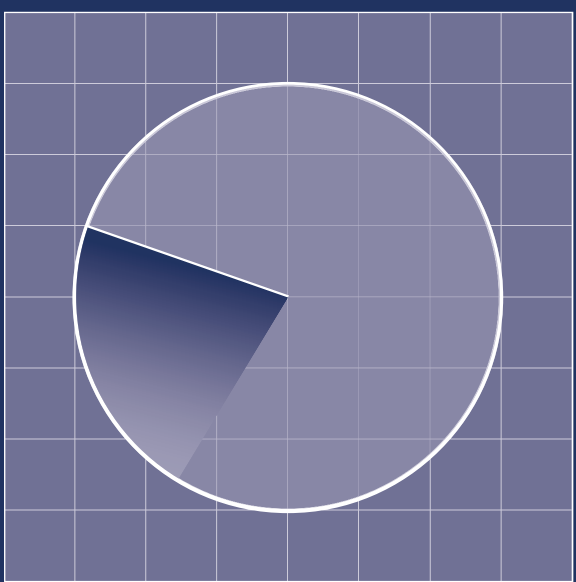
We promote continuous improvement in audit quality.

Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



The Firm

Deloitte has 392 audits within the scope of AQR inspection, including 24 FTSE 100 and 51 FTSE 250 audits.

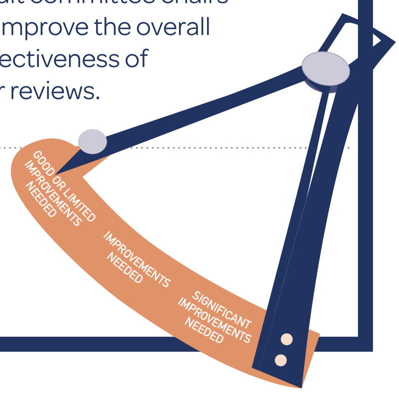


Our inspection process

There are around 3,000 audits within the scope of AQR inspection. Of these, we inspected 130 audits in 2019/20, including the 17 Deloitte audits covered by this report.

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

We assess the overall quality of the audit work inspected.



Financial Reporting Council

Deloitte LLP

Audit Quality Inspection

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

Contents

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

This report sets out the principal findings arising from the 2019/20 inspection of Deloitte LLP ("Deloitte" or "the firm") carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted this inspection in the period from April 2019 to March 2020 ("the time of our inspection"). We inspect Deloitte, and report publicly on our findings, annually.

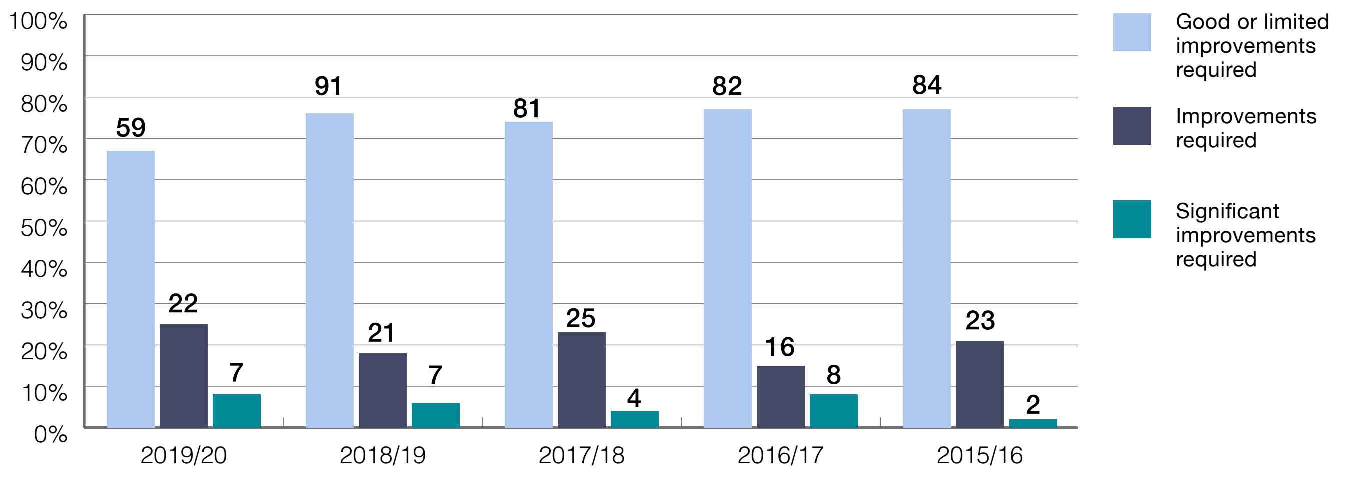
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality.

High quality audit is essential to maintain investor confidence by providing an independent, impartial view of a company's financial statements. Poor auditing may fail to alert management, shareholders and other stakeholders to material misstatements (including those arising from fraud) or financial control weaknesses, in those cases where management have not identified or appropriately amended them. The combination of management not meeting their responsibilities in this respect and poor auditing could potentially put businesses and jobs at risk. High quality audit matters and we will drive audit firms to implement the necessary changes to reach the required standards.

Our priority sectors for inspection in 2019/20 were Financial Services, General Retailers, Business Support Services, Construction and Materials, and Retail Property. Of the 108 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: Financial Services – 18, General Retailers – 16, Business Support Services – 6, Construction and Materials – 3, and Retail Property – 8. We also paid particular attention to the following areas of focus: going concern and the viability statement, the other information in the annual report, long-term contracts, the impairment of assets and fraud risk assessment.

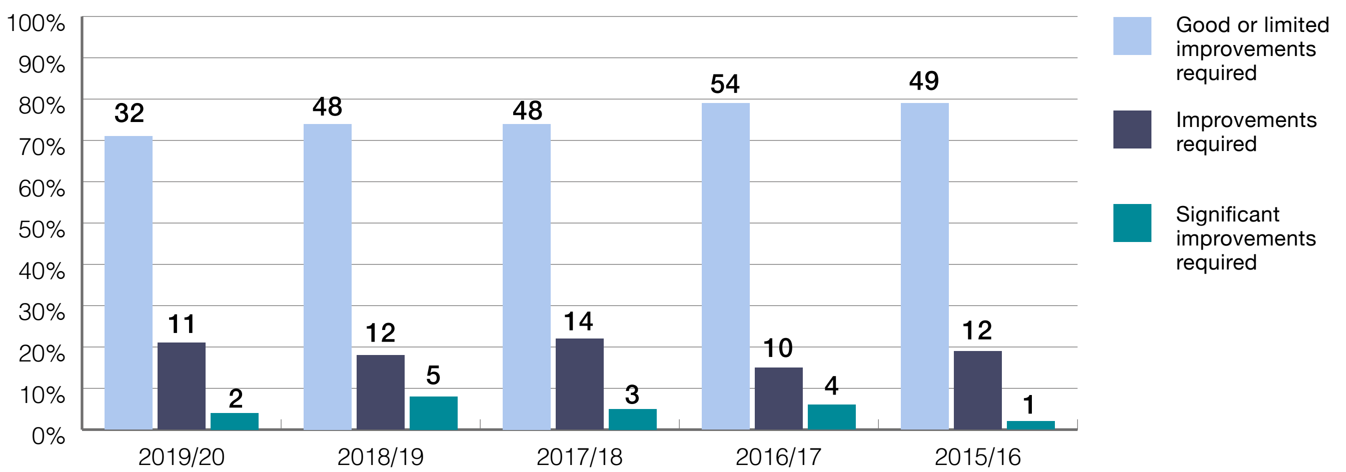
Our assessment of the quality of audits reviewed

All reviews – for the seven firms inspected annually



An audit is assessed as good or limited improvements required where we identified either no or only limited concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more issues. Significant improvements required indicate we had significant concerns, typically in relation to the sufficiency or quality of audit evidence or the appropriateness of key audit judgements.

FTSE 350 reviews – for the seven firms inspected annually



Due to resourcing constraints, we reviewed fewer audits overall than in recent years. Across all firms, we completed 130 audit inspections compared to 160 in 2018/19. We did broaden the scope of our reviews to include more aspects of the audit, including the auditor's response to fraud risk. Changes to the proportion of audits falling within each grading category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our inspections are also informed by the priority sectors and areas of focus referred to above. We are also cognisant, when making our selections, of the Competition and Market Authority's recommendation that FTSE 350 entity audits should be subject to inspection approximately every five years. 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; nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at the firm. Nonetheless, any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

1 Overview

Commentary on our inspection work at the largest audit firms

Overall, 59 (67%) of the 88 audits reviewed in our 2019/20 inspection cycle, across the seven firms inspected annually, required no more than limited improvements. The number of audits requiring more than limited improvements, 29 (33%), remains unacceptable.

Firms have made some improvements and we have observed good practices (for example, better group audit oversight and effective integration of specialists into the audit team at some firms). We acknowledge the steps taken by firms seeking to address the key findings in our 2019 public reports.

However, firms are still not consistently achieving the necessary level of audit quality. They need to make further progress. For example, we continue to find improvements needed in the same three audit areas: impairment of goodwill and intangibles; revenue and contracts; and provisions, including loan loss provisions. Over the past three years, 76 of the 166 (46%) of the findings driving reviews requiring more than limited improvements have been in these areas. These findings often relate to insufficient challenge of, and standing up to, management in areas of complexity and forward-looking judgement. Other audit areas in which we had findings for more than one firm this year include: audit of inventory, group oversight, going concern and investment property valuations.

We take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past three inspection cycles, we have referred 28 audits, across all firms inspected, for consideration of possible enforcement action.

We focused this year on key firm-wide procedures to improve audit quality, including firms' audit improvement plans and their processes to analyse the root causes of audit failings. We have raised findings in these areas to help firms build more effective quality improvement processes going forward. We will continue to focus on ensuring that the firms develop their vital root cause analysis processes to identify areas for improvement and implement change on a timely basis.

We have seen some instances of good practice where audit teams have concerns with the most significant audit judgements. Firms' senior management need to be clear that taking difficult decisions is an appropriate response to improving audit quality, even if it might sometimes mean delaying or modifying opinions, and ultimately losing some audit engagements. The tone from the top needs to support a culture of challenge and back auditors making tough decisions.

We are initiating a number of significant changes to improve audit quality, including:

- Increasing our focus on proactive supervision of the large audit firms. We will identify priority areas to improve audit quality, request the firms to implement suitable actions to achieve them and hold the firms accountable for delivery.

- Moving ahead with plans to increase the transparency of our audit quality assessments through publishing the scope and key findings of each of our individual audit inspections. We plan to publish our first set of these reports, where we have obtained the consent of the audit firm and the audited entity, next year alongside these annual reports on each of the largest audit firms.

- Asking the Big 4 firms, beginning from 2021, to implement operational separation of audit practices from the rest of the firm, so that the audit practices are focused above all else on achieving high audit quality.

- Strengthening the AQR team to increase the number of inspections in our 2020/21 cycle. We inspected a limited number of private companies and significant overseas components of groups during 2019/20, in line with the recommendations of the Kingman Review, and we will build on this as part of our overall target of 145-165 inspections for 2020/21.

We wrote to the major audit firms in December 2019[1] setting out elements that we observe consistently on high quality audits, especially on high risk engagements. The hallmarks of such audits include:

- Significant involvement of partner and other senior team members.

- Good use of specialists.

- Consultation on complex areas.

- Challenge of management leading to changes where assumptions are too optimistic.

- Robust quality control procedures.

- Clear and timely communication to Audit Committees.

We recognise the challenges posed currently by the Covid-19 pandemic, both in relation to the level of uncertainty surrounding forward estimates and projections, and inability to carry out physical procedures (for example, stocktakes). We will consider such matters carefully during our 2020/21 inspection cycle.

Audit selections

In recent years we have selected for inspection an increasing number of 'higher-risk' audits. Reliable reporting and high-quality audit matter most for these companies. This year 42 of the 108 inspections (39%), excluding public sector reviews, were higher risk compared to 32% in the previous year. 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.

1 https://www.frc.org.uk/news/december-2019-(1)/letter-to-audit-firms-on-high-quality-audits

- Headroom on impairment assessments may be lower and the entity's balance sheet may be more sensitive to changes in key assumptions.

- Going concern assessments are less clear cut.

Rigorous challenge of management and the application of professional scepticism are therefore especially important.

Perhaps because higher-risk audits are more challenging, we find that their audit quality tends to be lower. Of the audits that required more than limited improvement this year, we had identified almost half as higher risk. This year 40% (47% last year) of the audits that we identified as higher risk were assessed as requiring improvement, compared with 27% (13% last year) of audits not identified as higher risk.

Other factors that may lead both audit quality and our inspection results to vary over time include:

- The economic cycle: audit can be more difficult in an economic downturn when corporate profitability is lower.

- Changes in accounting, auditing and ethical standards: new standards can require more complex and forward-looking estimates which are more difficult to prepare and audit. Examples in recent years include forward-looking provisioning under IFRS 9 and assessing progressive revenue recognition under IFRS 15.

We have increasingly focused on higher-risk audits because they are where reliable reporting and high-quality audit matter most. Firms must perform audits to the same high standards regardless of the risks associated with the audited entity and the difficulty of the audit work.

We accept that our increased focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm. The change in our approach to audit selection over time also means that historical comparisons of results need to be treated with care.

Deloitte overall assessment

We reviewed 17 individual audits this year and assessed 13 (76%) as requiring no more than limited improvements. Of the ten FTSE 350 audits we reviewed this year, we assessed nine (90%) as achieving this standard.

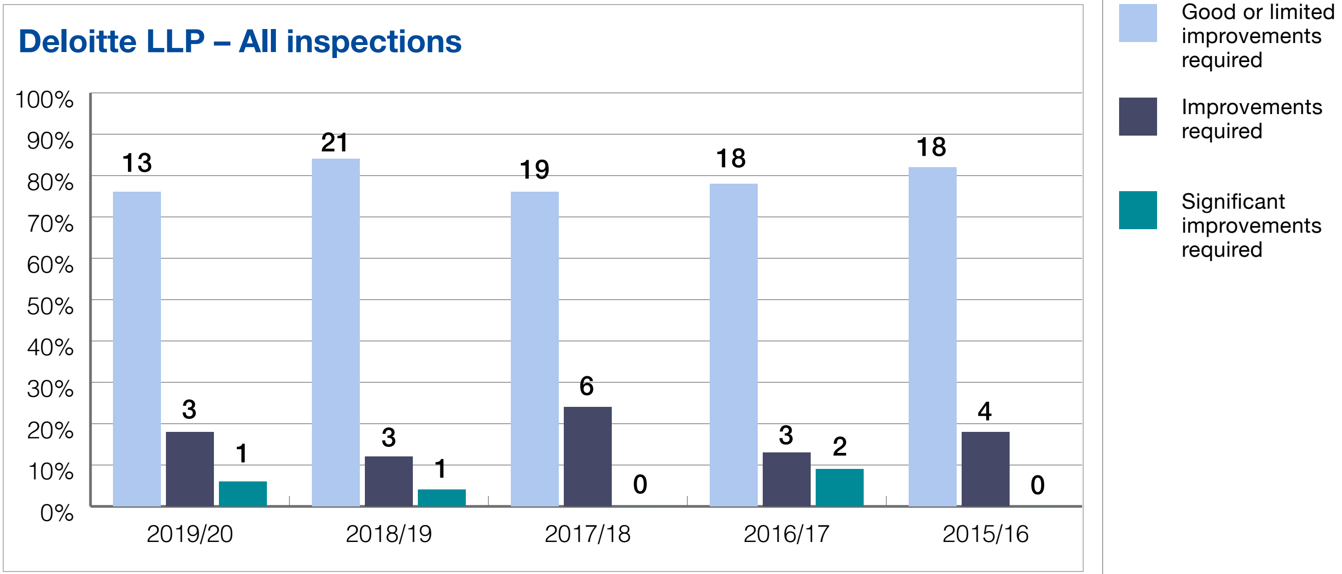
The firm has taken steps to address the key findings in our 2019 public report, with actions that included focused training and standardising the firm's audit work programs. We have identified improvements, for example in the audit of potential prior year adjustments and related disclosures, a key finding last year. We also identified good practice in a number of areas of the audits we reviewed (including effective group oversight and robust risk assessment) and in the firm-wide procedures (including the firm's milestone program, with expected dates for the phasing of the audit monitored by the firm).

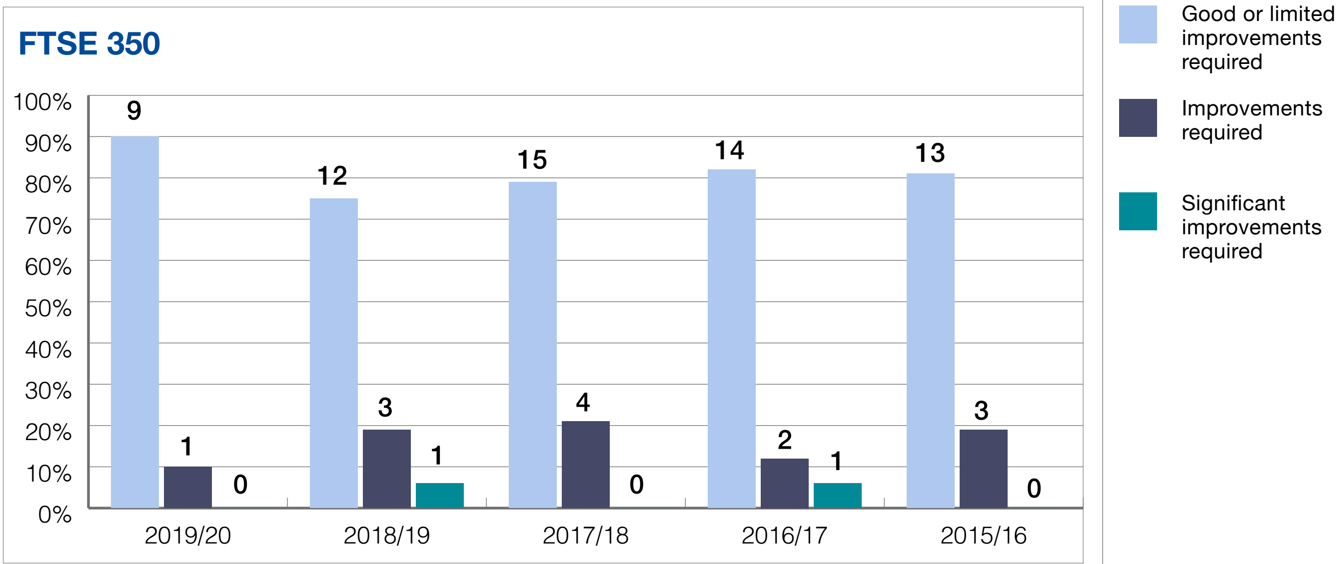
The recurring finding that most contributed to this year's inspection results on individual audits related to the extent of challenge over cash flow forecasts for the impairment of goodwill and other assets. In one instance, this contributed to our assessment of the audit requiring significant improvement.

We have highlighted in this report aspects of firm-wide procedures which should be improved, including strengthening the monitoring of the firm's audit quality initiatives.

The firm needs to take specific action to address the root causes of our findings, particularly in relation to non-FTSE 350 audits.

Our assessment of the quality of audits reviewed





Reviews of individual audits

Our key findings related principally to the need to:

- Improve the extent of challenge over cash flow forecasts in relation to the impairment of goodwill and other assets.
- Enhance the effectiveness of substantive analytical review and other testing for revenue.
- Improve the assessment and extent of challenge regarding management's estimates, particularly for model testing.

Good practice observations

We identified examples of good practice in the audits we reviewed, including the following:

- Effective group oversight.
- Robust risk assessment.
- Effective substantive testing on a bank.
- Comprehensive IFRS 9 expected credit loss (ECL) audit programme.
- Thorough testing of IT control deficiencies.
- Good quality reports to the Audit Committee.

Further details of our findings on our review of individual audits are set out in section 2, together with the firm's actions to address them, as well as details of the good practices identified in those audits.

Review of firm-wide procedures

This year, our firm-wide work focused primarily on the following areas:

- Partner and staff matters relating to the FY18 performance year.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root Cause Analysis (RCA) process.

The reason for the focus on RCA and audit quality initiatives is the importance of taking effective actions to address recurring inspection findings.

Our key firm-wide findings in these areas related principally to the need to:

Partner and staff matters

- We had no significant findings to report.

A&C procedures

- We had no significant findings to report.

Audit quality initiatives

- Strengthen the monitoring procedures of the audit quality initiatives.
- Strengthen the culture of challenge in the audit process.
- Increase the number of in-flight reviews (internal reviews undertaken during the audit).

RCA process

- Further improve the RCA process, in particular the methods of identifying RCA themes and reporting of good practices.

Good practice observations

We identified examples of good practice in our review of firm-wide areas, including the following:

- Partner and staff matters: the effective use of a wide range of audit quality measures to assess the performance of partners and staff, incorporation of upward feedback into partner appraisal and promotion processes and robust central processes around the review and monitoring of partner portfolios.
- A&C procedures: the effective interaction of the firm's finance and resourcing systems with the client acceptance and continuance process to monitor resourcing needs.
- Audit quality initiatives: a formal milestone program, with expected dates of phasing of the audit required.
- RCA process: timing of reviews, use of dedicated RCA staff and interviewing the whole team together (as well as individual members).

Further details of our findings in these firm-wide areas are given in section 3, together with the firm's actions to address them, as well as details of the good practices identified.

Firm's internal and ICAEW quality monitoring results

This year we have included, in each of our public reports, summary results of the firm's internal inspection results, together with, where performed, those of the ICAEW's latest quality monitoring. We consider that these results provide additional relevant information in relation to the assessment of the firm's audit quality.

The results of the firm's internal inspection results, together with those of the ICAEW's latest quality monitoring, are set out in Appendix 1.

Results of RCA and firm's related actions

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

In section 3 we have commented on the firm's RCA processes, based on our review of them earlier in the inspection cycle. The firm has since performed RCA in respect of our current findings and considered the outcome in developing the actions included in this report. We have reviewed the results (and related processes) of this and set out our key observations below, including whether there have been improvements in the related RCA processes since our review earlier in the year:

- There has been an improvement in the RCA-related processes commented on in section 3, including the reporting of themes and good practice points.

- The firm has a good level of coverage of RCA reviews across internal and external inspection findings, which includes both engagement and firm-wide inspection findings.

- The RCA themes are set out in a reasonable level of detail in the firm's report, although not as detailed as some other firms. One of the RCA themes focuses more on the evidencing of challenge of management, rather than the extent of the challenge.

- The actions set out in the firm's responses include some areas which will be developed further by the firm, which we will review when these plans are completed.

We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques and responsiveness of actions further.

Firm's overall response and actions:

Audit quality remains our number one priority and we have a relentless commitment to it. We are pleased with our results for the inspections of FTSE 350 entities achieving 90% assessed as good or needing limited improvement, which included some of our highest risk audits. We are disappointed that our overall inspection results did not meet this quality bar. Our objective is for 100% of our audits to be assessed as good or needing limited improvement and we know we still have work to do in order to meet this standard. We thank the FRC for their insights and comments and continue to strive for the highest audit quality across every engagement, in particular in the areas where we have had findings.

We welcome the FRC's increased focus on higher risk audits and their associated complexities. Our quality programmes focus on these audits and we consider our public interest role to be even greater here. We recognise and accept the FRC's findings on the individual inspections. We have performed independent root cause analysis on every finding and have taken action for all findings at the individual audit level as well as action across all our audits where we could experience similar findings.

There were four overall themes from our root cause analysis in the areas of FRC findings on the audits inspected. These were:

1. The need to improve and appropriately evidence the challenge of management in complex judgemental areas.

2. The need to improve project management of the timing of certain audit procedures, including better communication with entity management on how they have prepared for the audit.

3. The audit team's prioritisation of higher risk work meaning lower risk work received less focus.

4. The need to improve our on-the-job coaching so that senior members of the audit team use their skills and knowledge to develop the rest of the audit team.

Embedding a culture of challenge in our audit practice underpins the key pillars of our audit strategy. The FRC selects our highest risk audits for review, which inherently contain the riskiest judgements, and we are committed to delivery of the highest possible quality on these audits, as we are for all of our audits.

In order to address these root causes we have taken significant action over the last year, building on the actions and programmes from prior years. We continue to invest in all these programmes and we set this out in detail throughout this report. A summary of our actions is included in this section.

In order to address the issue of enhancing the challenge of management in complex judgemental areas, our actions (with further details in section 2) include:

- We are focussing more central oversight on higher risk audits, including expanding our inflight programmes to enhance the quality of the audit before the audit report is signed. Additional central oversight during the audit enables us to bring even more challenge to management, boards and audit committees at these companies.

- We continue to develop and invest in our risk sensing capabilities to gather a range of data sources to identify companies and industries that display certain risk characteristics. This provides data to engagement teams to consider in bringing challenge and provides central insight to companies or industries where we may need to focus additional oversight.

- We have introduced an audit quality award scheme which recognises and rewards the behaviours we value, including bringing challenge to management. We continue to develop ways in which we can embed the recognition of positive behaviours within our annual performance evaluation processes, in particular in relation to challenge.

- As part of our audit transformation strategy we are piloting new ways of reporting on fraud, going concern and internal controls to give readers of audit reports more transparency. These are subject to the limitations of the current audit regulation framework. We will also be rolling out further enhanced audit tools in the form of additional Deloitte Way Workflows on key areas over the coming year again supporting consistency and focused challenge on the right areas.

- We have increased the involvement of specialists in our audits, for example, including forensic specialists when certain fraud triggers are met. We have also expanded our use of specialists in impairment, pension balances and our credit centre of excellence. These all enhance the challenge in these complex areas.

- We have implemented enhanced learning, coaching and support programmes covering for example, tackling cognitive bias, identifying fraud, and even more focus on internal controls. We have employed change management professionals to help us supplement our learning programmes with the emphasis on deeply embedding our programmes, in particular transformation changes, within audit delivery. This aids challenge of management through consistency in applying the learning and new tools, adoption of workflow and enhanced consistency in approach and challenge, and ensuring work happens at the right time so challenge is built into the audit process throughout.

- A simple but important step we are taking is to stop referring to the companies we audit as ‘clients’ to underscore our role as auditors acting in the public interest.

In order to address the issue of improving project management, our actions include:

- As part of our audit transformation strategy, we have recently launched the Audit Blueprint, an interactive project management tool that will enable audit teams to more consistently raise timing issues with company management and the audit committee.

- We continue to enhance our programme of audit milestones which require audit teams to have performed certain tasks by certain dates in an audit cycle.

- We have recruited change management and project management experts to ensure we can embed our audit transformation tools deeply within audit delivery teams.

In order to address the issue of the prioritisation of higher risk work over lower risk work (meaning the lower risk work does not receive adequate focus), we maintain that we want our audit teams to focus on the highest risk areas of an audit but we recognise that lower risk areas of work also need sufficient attention. In order to address these issues we are taking the following action:

- We continue to roll out our enhanced audit tools, the Deloitte Way Workflows, to additional areas of the audit. These support a consistent testing approach, based on a guided risk assessment tool. When these workflows are fully implemented they will ensure that all audit teams perform the same level of work on balances classified at the same risk level and that the work is evidenced and reviewed in a consistent way.

- We are further developing our response to the use of substantive analytical review to audit lower risk areas of an audit (more details are set out on page 19).

- The Audit Blueprint will support teams to focus on actions required at each stage in the cycle of an audit, ensuring that all areas of the audit receive sufficient attention.

In order to address the need to improve our on-the-job coaching by senior members of the audit team, we are taking the following actions:

- Within our business units we are creating small communities who can explore auditing issues in smaller groups in a developmental way. These are led by our business unit quality partners.

- We developed Tech-Ex On Tour last year as a supplement to our mandatory TechEx programme. Tech Ex On Tour focusses on small group learning ensuring that the audit and accounting technical learning from the summer programme is embedded across our audit practice. This programme will be further enhanced this year to ensure that on-the-job coaching is a key feature.

- As described above, our audit quality reward programmes recognise exceptional performance when our auditors 'drive to learn and share knowledge'. We will use this rewards programme to further underscore the value we place on senior auditors spending time coaching other members of the audit team.

We have taken swift action to address issues during the inspection cycle, rather than waiting until the end of the inspection cycle. We have continued to develop our processes that allow us to quickly identify issues as they are emerging, brief individual audit teams or groups who might be affected by the issue and develop guidance to the practice. This allows us to impact the quality of ongoing audits as well as the next reporting cycle. We also welcome the FRC annually to talk through their findings with our audit practice in our compulsory online learning sessions. We will continue to develop further actions to address the RCA findings.

Looking forward, the Covid-19 pandemic presents challenges that have a significant impact on the entities we audit and consequently our audits. We are delivering a comprehensive global response which has a significant focus on enhancing audit quality. We have introduced further independent review and challenge into areas of the audit process, across our full audit portfolio. We have made enhanced tools and guidance available to all our auditors and the guidance issued by the FRC in particular around going concern, APMs and the moratorium has been helpful and we have taken account of these in our guidance. For public interest entities this includes an additional independent partner review of the response to Covid-19 and the audit opinion and increased senior audit partner involvement on all public interest entity audits. We are subjecting our response to challenge by our own System of Quality Control experts in order to continuously improve and respond to the external environment in which we find ourselves. At each stage of our Covid-19 response we have updated the FRC so that they are aware of the actions being taken by the firm, and to ensure we are considering as many areas as possible and adapting our response where needed.

All our audit quality initiatives are captured in our audit quality plan. This encompasses our key objectives and action plans for all aspects of audit quality from monitoring, learning, people, transformation, methodology to business unit quality teams and internal controls. Each of these streams has actions within them which are underpinned by the theme of a culture of challenge. We capture key actions to address root causes, but also emerging issues such as our Covid-19 response. These include actions being taken in response to inspection findings from the FRC. We are further enhancing our plan to have a higher level summary with clear tracking status of key initiatives which will be used for regular reporting to our UK Oversight Board together with our established Audit Quality Indicators. We also highlight that the FRC meet to discuss this report with the INEs after publication, and, the INEs reviewed the response to this report in detail and will continue to monitor progress on the actions arising.

Our firm's annual Transparency Report is the document in which we set out our detailed approach to audit quality and the ways in which we act to protect the public interest. This year's Transparency Report will be issued in September 2020.

We will monitor closely the promptness and effectiveness of the firm's actions. Should these not address our concerns adequately, we will consider what further steps we need to take to both safeguard and improve audit quality.

2 Review of individual audits

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

Improve the extent of challenge over cash flow forecasts in relation to the impairment of goodwill and other assets.

The assessment of potential impairment in goodwill and other assets includes the estimation of future cash flows, which can involve significant judgement and potential management bias. Auditors should corroborate and challenge these assumptions to support their conclusions over the extent of impairment.

Key findings

Given the potential impact on the financial statements, we reviewed impairment of goodwill and other assets on most of the audits we inspected. We identified the following issues and, on one audit, this contributed to our assessment that it required significant improvement:

- On four audits there was insufficient assessment or challenge of management's cash flow forecasts. On one of these audits, there was insufficient evidence for the appropriateness of the cash flow assumptions, including the impact of historical forecasting inaccuracies and errors in the cash flow models. The issues on the other audits included the impairment assessment not being undertaken at a sufficiently granular level, insufficient support for forecast contract renewals and inadequate justification for the level of cash flows used as the basis for the remaining forecast period.

- On two further audits we raised issues about the extent of audit evidence supporting the audit team's conclusions on the level of impairment or available headroom. In one of these audits, the audit team modelled a number of potential scenarios, including factoring in more pessimistic industry forecasts, but there was insufficient support for the weighting placed on the different scenarios. In another case, the audit team did not sufficiently demonstrate to what extent the downside risks in the forecasts could be mitigated by other revenue streams.

- In addition, on one of these audits, there were differences between the forecasts underpinning the impairment review and those used in the going concern assessment; the audit team did not reconcile the impairment and going concern cash flows.

The extent of challenge of management in relation to impairment of goodwill and other assets has featured in our recent inspection cycles. The firm has previously strengthened its consultation procedures. However, in view of the current inspection results, the firm should take further action in this area, including revisiting the sufficiency of the impairment consultation and related procedures.

Firm's actions:

Impairment is a critical area for us and we have been focused on continuous improvement as a result of the inspection findings in recent cycles and have continued to see findings become more granular and entity specific. In our summer 2019 residential TechEx training, aware of the findings from the 2018/19 review, we challenged all auditors to increase their scepticism by training them on the different areas and forms of cognitive bias (further detail is included on page 13). We also focused on how to enhance how we evidence the scepticism we bring to our audits. These actions will have had an impact on September 2019 year ends onwards.

In all audits assessed in this area as needing more than limited improvements, we identified through our root cause analysis that while the senior members of the audit team spent significant time challenging management to ensure that a sufficiently robust assessment had been completed, they did not sufficiently evidence this challenge within the audit working papers. In some audits we also identified that there was insufficient challenge in some areas as a result of project management weaknesses or prioritisation of areas of perceived higher risk or importance over perceived lower risk areas. The evidence of the audit challenge was clearer in circumstances where the company's original underlying assessment was of a high quality.

In response to the root causes identified we have made, or are making, further enhancements as follows:

- We expanded the scope of our impairment centre of excellence consultation requirement to include material intangible assets and property, plant and equipment balances where the valuation is supported by a value-in-use calculation, for FTSE 350 entities or other PIEs where there is a significant risk.

- We have also expanded the requirements when certain criteria are met, such as the engagement being considered higher risk, to include a further consultation and review by the specialist of the conclusions and how planned actions have been addressed. This also ensures that appropriate prioritisation has taken place.

- The Audit Blueprint will also support audit teams to be able to more consistently flag issues with management, Boards and Audit Committees when it is clear that the company's information is not ready for audit in accordance with the agreed audit timetable.

In addition, we have taken, or are taking, the following supporting actions:

- We have updated our consultation template to reflect the most recent inspection findings.

- We held training sessions in late 2019 for all the impairment specialists who perform the consultations, one of which was attended by the FRC, to share updates on recent inspection findings and areas to consider ahead of the December year-end consultations.

- We communicated the FRC findings to the wider audit practice via our monthly compulsory professional update in October 2019, which we record and distribute online and attendance is monitored. This included a presentation from the FRC inspection team.

- We discussed these enhanced requirements in a training session in January 2020 with all partners and practitioners who perform a quality review role, including those formally acting as Engagement Quality Control Reviewers.

- To address the causal factor of assumed knowledge, where teams assume certain facts and conclusions are self-evident and therefore do not evidence them sufficiently, we are developing a series of small group workshops within our quality communities with a focus on 'telling the story' in the audit file.

We are disappointed that issues found in this area led to one of our audits requiring significant improvement. As with all audits falling short of our required quality standards, we have completed extensive root cause analysis and have put in place a range of actions both within the individual audit and at a firm-wide level as detailed above.

In the current Covid-19 environment impairment challenges will be more pronounced and faced by more companies with greater uncertainty. We are enhancing and expanding the support for our engagement teams through our centre of excellence, focusing in particular on the way we audit cash flow forecasts which often underpins the audit work on a number of areas of management estimates. We are also expanding the scope of our training in this area to include reviewing of case studies of areas where we have received findings together with good practice examples.

Enhance the effectiveness of substantive analytical review and other testing for revenue

Revenue is an important driver of an entity's operating results. Audit teams should obtain sufficient and appropriate evidence for revenue. When performing substantive analytical review as part of the audit of revenue, the auditor needs to set an independent expectation of revenue, compare it to recorded revenue and investigate material differences.

Key findings

We reviewed the audit of revenue on most of the audits we inspected, and we identified the following issues in relation to the use of substantive analytical review procedures, where audit teams had mainly assessed the revenue streams as normal risk:

- On four audits, we raised issues regarding the sufficiency of evidence to support the appropriateness of the audit team's independent pricing expectations. On two of these audits there was also insufficient evidence over the reliability of sales volumes data used to set the expectation. For these audits, substantive analytical review constituted the main substantive procedure and there was generally no reliance on internal controls.

- On another audit, the group audit team did not sufficiently justify the adequacy of the component audit team's follow-up of variances identified between the independent expectations set and the actual results of certain revenue streams.

We also identified the following issues with aspects of controls and other substantive testing of revenue:

- On one audit, insufficient testing was performed to ensure recorded revenue reconciled to cash and other sales transactions. On another audit, we raised issues with the sufficiency of testing of a key cash reconciliation control.

- Other issues raised included insufficient procedures to test management's estimate of unbilled revenue, inadequate testing over the completeness and accuracy of certain online revenue streams and insufficient evidence to provide assurance over the accuracy of revenue cut-off.

The firm's use of substantive analytical procedures is higher than we typically see at other firms. While it can potentially be effective, Deloitte should consider whether audit teams are placing too much reliance on this type of audit procedure, in particular when no controls reliance is being obtained or when it is difficult to set an independent expectation.

Firm's actions:

Revenue is a key audit area and through risk assessment we focus our procedures on the areas where they may be a significant risk of material misstatement.

As a firm, we consider the use of substantive analytical reviews, particularly when in conjunction with data analytics, to be powerful tools in the audit of revenue. Data analytics allow us to gain a deeper understanding of where the risks lie, where to better focus our procedures and consequently lead to the performance of robust substantive analytical review. This allows us to test an entire population, and we will continue to encourage teams to use substantive analytical review procedures, particularly as we develop more statistical tools to be able to interrogate data and identify outliers. We acknowledge that in the inspections referenced the design of some of our substantive analytical review work could have been improved.

The primary root causes identified were firstly senior level team members not providing sufficient in depth coaching of other members of the team designing tests of substantive analytical review, and secondly a tendency of teams not to properly evidence their rationale for taking a particular approach to the testing. There was also a root cause of the prioritisation of higher risk areas of work, such as the significant risk aspect of the revenue testing, meaning that less focus was placed on lower risk areas where substantive analytical review was used.

To address this, we have done, or plan, the following:

- Included the approach to the audit of revenue as one of our Engagement Team Based Learning 'on the job' coaching sessions for the 2020 programme. These programmes tackle live audit matters and also gather teams after an audit to perform a learning debrief. Our intention is that focusing on the overall approach together as a team will ensure our teams understand transaction flows and together challenge the overall approach to ensure that tests are designed appropriately.

- We communicated in our monthly compulsory professional update in November 2019 the areas of challenge, and the FRC inspection team also presented their observations.

- In early 2020 we issued an updated practice aid for performing substantive analytical reviews, providing more guidance to those completing this work. This practice aid highlights the pitfalls identified in 2019/20 external inspections; and

- We plan to do a deep dive session as part of our monthly professional update on substantive analytical reviews in the summer, ahead of December year-end planning work. This will ensure that teams focus at the planning stage on whether substantive analytical review is appropriate, the independence of data sources and the overall body of evidence on revenue considering all elements of testing.

Importantly, given the widespread impact that Covid-19 will have, particularly on year-on-year trends, we are also developing guidance for audit teams to ensure that they challenge their approach and consider what information would be required from management to assess whether it is possible to develop a sufficiently precise independent expectation to use in a substantive analytical review.

Improve the assessment and extent of challenge of management's estimates, particularly for model testing

Estimates and provisions in financial statements are inherently subjective and can be sensitive to changes in management's key assumptions. Audit teams should provide an appropriate level of challenge and adequately test management's key assumptions and related processes.

Key findings

Given the potential impact on the financial statements, we reviewed the audit of management's estimates on all of the audits inspected. We identified the following issues relating to the extent of appropriate consideration or challenge of estimates and provisions, including those in the testing of models:

- In relation to estimating expected credit losses under IFRS 9, on two audits there were insufficient audit procedures or evidence retained to assess the reliability of some of the models used to calculate the provision and the appropriateness of certain assumptions.

- For the audit of a life insurance entity in which there was no controls reliance, the audit team performed insufficient procedures to confirm that the actuarial models functioned as intended.

- In relation to assessing the recoverability of deferred tax assets, on one audit there was insufficient evidence obtained to support the appropriateness of the recovery period with reference to probable future taxable profits.

- On two audits the audit team did not sufficiently justify ranges used in assessing estimates for a conduct provision or pricing differences on commodity testing.

Firm's actions:

The audit of management estimates is one of the most challenging and complex parts of any audit, as often the estimates that have been formed by management cover a very large variety of areas, are many multiples of materiality and use complex models, data from multiple sources and highly judgmental assumptions. Given this, we invest significant time and effort in providing training for audit teams, guidance materials, tools and templates and we will continue to do so. This will remain an area that is challenging for auditors, particularly given the increasing complexity of many of the estimates. Over the last four years we have significantly increased the number of specialists in the audit of management estimates to further assist the audit teams in providing high quality challenge; we expect to add additional specialists in the future.

Our root cause analysis identified challenges in project management (both auditor and audited entity related) and assumed knowledge as being the most prevalent in the findings of the FRC. With the implementation of revised ISA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", we have already taken a number of different actions over the last year and have a programme of further activities planned to assist our audit teams in this area. This includes further guided risk assessment and Deloitte Way Workflow tools which we believe will contribute significantly to helping address both project management assumed knowledge challenges.

We are developing a guide which can be shared with audited entities to set out clear expectations of what is required from management in preparation for the audit of management estimates, and this is linked to our overall Audit Blueprint.

We are introducing a pilot of an additional document to capture in one place the partnerled challenge on management estimates at the end of the audit process, in advance of the implementation of ISA 540 revised which has a "step back" challenge.

In relation to the specific points noted by the FRC, we also highlight the following actions we have taken:

1. Given this was the first year of implementation of IFRS 9 and given the complexity of the expected credit loss estimates required under that standard, we were very pleased that the FRC considered the model audit programme that we developed to be of a high standard. We have continued to develop our audit approach to reflect the lessons we learned from our first year auditing expected credit losses including ensuring the findings raised by the FRC were addressed.

2. We have enhanced the audit training given to all specialists used in audits such as valuations, property, forensic accounting, insolvency, IT, pensions, tax and valuations in order to continually enhance those specialists knowledge of audit quality issues so that their specialist input is targeted accordingly and brings further challenge to the audit process.

3. We have increased the focus given to assessing the risks of material misstatement in the actuarial models used by life insurance companies and ensuring that the response to those risks is appropriate, whether performed by actuarial specialists or the core audit team.

4. We have provided additional guidance to teams on how to use independently developed ranges to assess the reasonableness of the estimates made by management.

The actions we have taken, in particular to enhance scepticism and challenge, will be ever more relevant as the impacts of Covid-19 further heighten the levels of estimation uncertainty which we have to address in audits.

Good practice

We identified examples of good practice in the audits we reviewed, including the following:

- **Effective group oversight:** the group audit team's direction and supervision of components included the issuance of detailed instructions for key areas of focus and involved a robust review of component audit working papers.

- **Effective group oversight:** the evidence of group oversight was comprehensive, with extensive information obtained from the component auditors and good evidence of review and challenge by the group audit team.

- **Robust risk assessment:** for the fair value of financial instruments, the risk assessment included a detailed evaluation of the financial instruments and a thorough analysis of the underlying products and respective inherent risks.

- **Robust risk assessment:** for fraud risk, the engagement risk assessment procedures were well thought through and included the involvement of the firm's fraud specialist team in assessing and responding to the risk of fraud.

- **Effective substantive testing on a bank:** we considered the independent revaluation procedures performed by the firm's financial instruments experts to be comprehensive. Effective testing was also performed over settlement, nostro and clearing account balances which involved the audit team independently rebuilding the bank's tool to enable the matching of the balances to external data feeds.

- **Comprehensive IFRS 9 expected credit loss (ECL) audit programme:** whilst we have seen varying degrees of application, the firm has designed a clear and comprehensive IFRS 9 ECL model audit programme which provides a robust framework for use on audits.

- **Thorough testing of IT control deficiencies:** effective additional procedures were performed to address control deficiencies over privileged access rights and in testing compensating business controls.

- **Good quality reports to the Audit Committee:** these included, in two cases, extensive detail of both the audit work performed and the nature and extent of the audit team's challenge of management in areas of significant risk.

3 Review of firm-wide procedures

We reviewed firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 ("ISQC1"), as well as certain other key audit initiatives. We review some areas on an annual basis, and others on a three-year rotational basis.

This year, our firm-wide work primarily focused on the following areas:

- Partner and staff matters.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root Cause Analysis (RCA) process.

Partner and staff matters

Background

Processes relating to the appraisal and remuneration of partners and staff are a key element of a firm's overall system of quality control and are integral to supporting and appropriately incentivising audit quality. Our inspection included an evaluation of the firm's policies and procedures and their application to a sample of partners and staff for the 2018 appraisal year, across the following areas: appraisals and remuneration; promotions; recruitment; and portfolio and resource management.

Key findings

We had no significant findings to report.

Good practice

We identified the following areas of good practice:

- **Partner and senior staff performance:** the effective use of a wide range of audit quality metrics to assess partners and staff.
- **Partner appraisal and promotion processes:** the incorporation of upward feedback into the process.
- **Partner portfolios:** the robustness of the firm's processes for the centralised review and monitoring of partner portfolios.

Firm's response and actions:

We are pleased with the FRC's comments – we have transformed our people and partner procedures over the last few years. We have enhanced the evaluation process for partners and staff with an increased focus on quality in reward decisions. The INEs have also been involved with this process to provide additional independent challenge. We have continued to instil a cultural change with audit quality front and centre. We will continue to significantly focus on partner and staff matters.

We have plans to further enhance our processes on audit quality objectives and how audit quality dashboards are used to embed audit quality into how we evaluate our people.

Acceptance and Continuance (A&C) procedures

Background

Audit quality control processes incorporate risk management procedures and are undertaken at various stages of the engagement. In accordance with the requirements of ISQC1, the firm has detailed policies and procedures relating to acceptance and continuance decisions for audited entities. We have reviewed these processes and their application within our firm-wide inspection activity this year.

Given the greater number of audit tenders in recent years, we assessed firms' acceptance and continuance processes as at October 2019. We also discussed with senior leadership any proposed changes to these processes together with each firm's strategic decisions. In addition, we considered firms' policies relating to withdrawal/dismissal from audits and, for a sample of audits, the statements provided to the public, successor auditors and the regulatory authority in connection with withdrawal/dismissal.

Key findings

We had no significant findings to report.

Good practice

We identified the following area of good practice:

- **Real time monitoring of resourcing:** The effective interaction of the firm's finance and resourcing systems with the acceptance and continuance process to monitor resourcing needs.

Firm's response and actions:

We welcome the FRC good practice observations. We have continued to invest in our systems in readiness for the new global system of quality control standard for audit firms, ISQM 1. We have a particular focus on audit engagement resourcing and we will continue to assess whether we have the right resources for every engagement and plan our resourcing to support the wellbeing of our people.

Audit quality initiatives

AQR procedures

We reviewed key aspects of the firm's plans to improve audit quality, including the firm's monitoring of the progress of key audit quality initiatives. This included the consideration of recurring themes identified in the RCA of past inspection findings, in the following areas: culture of the firm (including in relation to challenge of management); in-flight reviews (internal reviews undertaken during the audit)/central support; and project management/ milestone programs (monitoring the phases of completion of audits).

Background

Deloitte mandates a number of areas to ensure consistent audit quality and its related initiatives include:

- Standardisation of audit work programs ("Deloitte Way Workflows").
- Project management – required milestones on audits.
- Improved workload management.
- Improved learning initiatives.

Key findings

Our key findings are set out below and have been communicated to the audit leadership during the year so that relevant actions could be taken on a timely basis:

- Strengthen the procedures to monitor audit quality initiatives: Deloitte's detailed action plan sets out the timing and responsibilities for each action and is monitored on an ongoing basis by a number of individuals in the audit practice. Unlike some other firms, Deloitte does not prepare a summary of the actions or formally report on the progress of the key initiatives. While the UK Oversight Board (UKOB) and INEs consider audit quality matters, they do not monitor the audit quality initiatives regularly, with it being on the UKOB agenda only once between July 2018 and July 2019.

- Strengthen the culture of challenge in the audit process, including in relation to the challenge of management: while Deloitte has certain initiatives around culture, including tailored questions in its staff survey, the recurring inspection findings relating to challenge of management indicates that the firm has not sufficiently embedded a culture of challenge into its audit process. There should be more emphasis on challenge of management in the values and expected behaviours of audit teams.

- Increase the number of in-flight reviews: while the firm has other central review and support functions, the level of resources to perform full in-flight reviews, during the audit, and the number of those reviews, is behind some other similar sized firms. These should be increased, given the importance of in-flight procedures and the fact that the other support mechanisms do not adequately compensate for them.

Good practice

We identified the following areas of good practice:

- **Project management procedures:** the firm has a formal milestone program, whereby the firm sets clear targets to enable monitoring of when the key phases of the audit should have been completed.

Firm's response and actions:

Strengthening monitoring procedures

Audit quality is our number one strategic priority. It is of fundamental importance to the UKOB (UK Oversight Board) and our independent non-executives (INEs). Over the last 18 months, we have been evolving our processes and have developed a suite of Audit Quality Indicators (AQIs) which are reported to the UKOB and the INEs on a quarterly basis since March 2019. These AQIs are linked to our detailed audit quality plan (AQP) which captures key objectives across all quality work streams (see page 15). Our development of AQIs is strongly linked to our preparation for ISQM 1 and the audit practice in future, ensuring that we have in place up to date and relevant management information, and a well-defined monitoring approach. We take on board the findings of the FRC's recently published AQI thematic review report to continue improving how we measure our AQIs, specifically moving towards further use of leading AQIs.

We agree with the FRC that enhancing our detailed AQP to have a higher level summary with clear tracking status of key initiatives will be beneficial. We are developing this and expect to provide full details of our enhanced monitoring and reporting in our Transparency Report in September 2020. The UKOB including our INEs are very focused on audit quality, and while reporting of the AQP has not yet been formalised, audit quality matters are already consistently discussed and challenged at that level.

Bringing challenge in our audits

The audit and evidencing of judgements in areas of uncertainty is one of the most difficult parts of any audit, yet one of the most critical. As such a pervasive and critical area, many of our actions in this area are embedded within our responses to other areas and set out above. We are continuing to innovate in how we bring and evidence challenge throughout our audits.

Specific central programme around higher risk audits

- For higher risk audits our central monitoring programmes allow us to take coordinated actions and provide support including additional partner involvement, inflight reviews, specialist involvement and/or coaching in specific areas of concern. Bringing this support during the audit means we can support challenge on those audits and impact before they are signed.

- Our new risk sensing group, within our established Emerging Issues Group, identifies companies and information on certain risk characteristics. This information is used both centrally and by audit teams to bring additional challenge to the companies we audit. We are investing further to expand our risk sensing capability, for example by developing more industry specific data for use by audit teams and a detailed guide for teams to use when assessing risk sensing data.

- The hardest audits we do are those of companies where we identify concerns regarding control environments or governance and where we consider management or the board may not be doing enough to respond to those issues. We have established a robust process for reporting to the Audit Committee and independent non-executives where we identify significant weaknesses in a company's financial reporting environment including around controls or governance. We request those companies to produce a formalised action plan to address our concerns and actively monitor the company's progress against this plan and request regular and verifiable updates. We see this programme as an important part of our public interest role and in bringing challenge to management through our audits. We will continue to develop and invest in this programme over the coming reporting cycle.

- We also believe it critical to consider the companies we accept and reaccept for audit.

- For the most risky and complex matters we have introduced a specialist panel of senior partners and specialists to help challenge a particularly complex or judgemental area. Piloted for some December 2019 year ends, this is now available to audits with greater than normal risk levels with year ends from March 2020 onwards. We would anticipate this being utilised on audits with the most complex or finely balanced judgements to assess.

Recognition and reward

- Our audit quality awards are assessed on four measures: 'courageous actions taken to protect the public interest', 'running into the fire' by using skills/experience to help other audit colleagues in difficulty, 'drive to learn and share knowledge', and 'demonstrating a capacity to change and transform'.

- Partners are identified for award against the same criteria, and these awards are announced by our Audit Business leader. This forms part of the annual partner appraisal and remuneration process.

- The awards are given on a quarterly basis for individuals and teams, sponsored by our audit executive, with nominations by any level of staff. We have recognised 144 individuals and teams as part of these awards over the last year. These awards are highly regarded and publicised and celebrated within the audit practice both by audit leadership and individual business units.

- We continue to develop ways in which we can embed the recognition of positive behaviours within our annual performance evaluation processes, in particular in relation to challenge.

Transformation

- As part of the audit report debate over the last two years we have invested significantly in what we call the audit product of the future. We have piloted a new approach to how we report our audit work on fraud risks, going concern and internal controls. This focuses on providing stakeholders with greater transparency. These are subject to the limitations of current audit regulation, and we welcome the consultation process on the Brydon report issued in 2019.

- The continued roll out of our enhanced audit tools, Deloitte Way Workflows, supports how we embed challenge into the audit process so that the evidence on the audit file is clear and consistent with the work performed.

Use of specialists

- We have increased the use of specialists, including forensic specialists to challenge around fraud and fraud risk factors, and insolvency specialists to challenge on going concern and viability.

- We have expanded the scope of our impairment centre of excellence (as explained on page 17).

- We have increased the number of controls coaches working directly with individual engagement teams. A focus on internal controls has become increasingly important over the last few years within the UK corporate reporting environment and we will maintain our focus on this area.

- Additional use of specialists has also been a feature of our response to Covid-19 in developing additional guidance and in responding as part of individual audits.

Learning and coaching programmes

- We have well established learning and coaching channels and we have worked to enhance these further and we continue to seek to embed mindset change through our training programmes.

- Our core training TechEx in summer 2019, which is attended by all qualified grades of staff, included a focused session on auditing of accounting estimates. We invested significantly in building a programme that included theoretical models covering cognitive bias, practical exercises and interactive activities which involved:

    - Exploring the types of source information available to us which are independent of management and which can either support or contradict management's estimates.

    - Identifying ways of using independent evidence when challenging management's assumptions.

    - Exploring types of cognitive bias which can influence the way we assess information when auditing management estimates: confirmation bias, authority bias and anchoring bias. This session involved a number of practical and theoretical exercises designed to equip our audit staff with the skills necessary to identify and overcoming bias in audit procedures.

- An interactive case study involving role play highlighting potential fraud risks and types of bias in the audit of complex management estimates.
- Group discussions involving a wide range of practitioners from partners to assistant managers, covering the benefits and risks of using past experience versus fresh thinking and challenge.

- We developed our TechEx On Tour programme last year as a supplement to our mandatory TechEx programme. TechEx On Tour focuses on small group learning ensuring that the programme of auditing and accounting technical learning from the summer programme is embedded across our audit practice. This programme will be further enhanced this year to ensure that on-the-job coaching is a key feature.
- We continue to develop our learning programmes to include psychology and other behavioural based theory that can enhance the culture of professional scepticism and challenge in our audits.

As an audit practice one small but important measure we have taken is to stop the use of the term 'clients' to refer to the companies we audit. This type of change takes time to embed, but this is an important mindset shift for us as auditors. Our audit leadership all refer to the companies we audit, and we are driving this change through the audit practice both in the verbal and written language we use.

Our response to Covid-19 has further developed our culture of challenge in the audit process. We have introduced enhanced tools and guidance for our auditors. For listed audits and public interest entities we have introduced an additional independent partner review of the response to Covid-19 and the audit opinion, and we have increased senior audit partner involvement on all public interest entity audits.

Inflight reviews

Our inflight reviews are performed with the same rigour and depth as a full internal practice reviews of an archived file, and are performed in stages along with the audit as it progresses through the various milestones. Our inflight reviews are one of a suite of inflight monitoring, support and review activities in place in our audit practice.

We have responded to the FRC findings that we should do more in this area and we have created a risk monitoring database and dashboard to assist in assessing risk across our PIE audits and monitoring the central support in place around those audits. This was implemented ahead of December 2019 year ends and we undertook a number of incremental inflight actions as a result. We also considered if there were other central actions which would be appropriate to implement. We are now formalising the process of using this dashboard and developing a more automated update process and review cycle throughout the year of the overview this dashboard provides.

The other areas of inflight activities, in addition to the EQCR and full or focused inflight reviews, include: diagnostics during audits to monitor compliance with Audit Quality Milestones; audit health checks which check compliance in specific topic areas; thematic inflight reviews where the audit response to broader themes (such as implementation of new accounting standards) are reviewed at the planning and year end stages and feedback given in real time; and Quality Corporate Reporting reviews which focus on the quality of the reporting in the financial statements. We have coaching programmes, which include internal controls coaches, coaching on specific high risk areas, and focused coaching which combines coaching on high risk areas with inflight review of relevant areas of audit evidence. Additionally, we have impairment specialists who are not part of the team but offer external challenge at the appropriate times.

We also have centres of excellence for various topics, and an established consultation process with technical experts that provide further external challenge to our teams on the most judgemental areas such as impairment or IFRS 9. The Emerging Issues Group provides engagement-specific in-sights through market and industry research. Our highest risk audits are subject to our monitoring programme for higher risk audits that further involves additional monitoring and processes to address this elevated level of risk.

We will develop additional enhancements to our inflight programmes, including a further increase in coverage across our PIE audit portfolio, to address the findings of the FRC. We will agree these further enhancements with the FRC.

The Firm's RCA process

Background

The RCA process should be designed to identify the causes of inspection findings, in order to aim to prevent them from recurring. It is part of a continuous improvement cycle of inspecting audits, investigating the root causes for inspection results and improving the firms' ability to act on them through implementing effective actions.

The firm has been performing RCA for a number of years and follows methodology and guidance issued to it by the global firm, supplemented by additional UK specific procedures.

This year, we have reviewed the firm's 2018/19 process for undertaking its RCA, including resources and timing.

Key findings

The firm should further improve the RCA process, particularly in relation to:

- Methods of identifying RCA themes: the identification of RCA themes is a manual process and could be improved through a degree of automation.

- Reporting of good practices: the reporting of RCA themes does not sufficiently highlight good practices.

Good practice

The firm has continued to develop its RCA process. We identified the following examples of good practice:

- **Timing of reviews:** the firm sets deadlines for completion of RCA on individual audits. This ensures that the RCA is performed on an ongoing basis.

- **Use of dedicated RCA review staff:** some of the staff used to perform RCA are dedicated to this and do not have other responsibilities. This improves the experience and consistency of the process.

- **Team wide interviews:** as well as interviews of individual staff, there are also interviews of all team members at the same time.

Firm's response and actions:

We welcome the FRC's positive comments on the areas of good practice in our root cause analysis (RCA) process and the ways in which it can be enhanced. We continually invest in enhancing our RCA process because we know how important it is for us to identify both positive and negative root causes and to take swift and pervasive action.

As the nature and amount of our RCA activities have increased we are developing how we analyse and identify themes across all RCA activities using technology and visual reporting tools.

To date, we have made improvements through the following actions:

- We have improved our recording of causal themes to facilitate thematic analysis and linkage back to audits and findings. We are continuing to explore the use of our analytics technology to give us further insight.

- We have redesigned our database for recorded causes and themes to facilitate more timely and improved reporting to key stakeholders.

- We have increased the number of positive RCA on engagement reviews that have been identified with good practice, and we have reviewed in detail the areas with no or low level findings to help us identify good practice and behaviours that drive high audit quality; and

- Identified pitfalls and communicated themes from internal inspections to leadership, quality leads and to the wider audit practice on a quarterly basis.

Full details of our RCA activities are set out in our Transparency Report each year and will again be included in detail in the upcoming report in September 2020.

Appendix 1: Firm's internal quality monitoring and ICAEW results

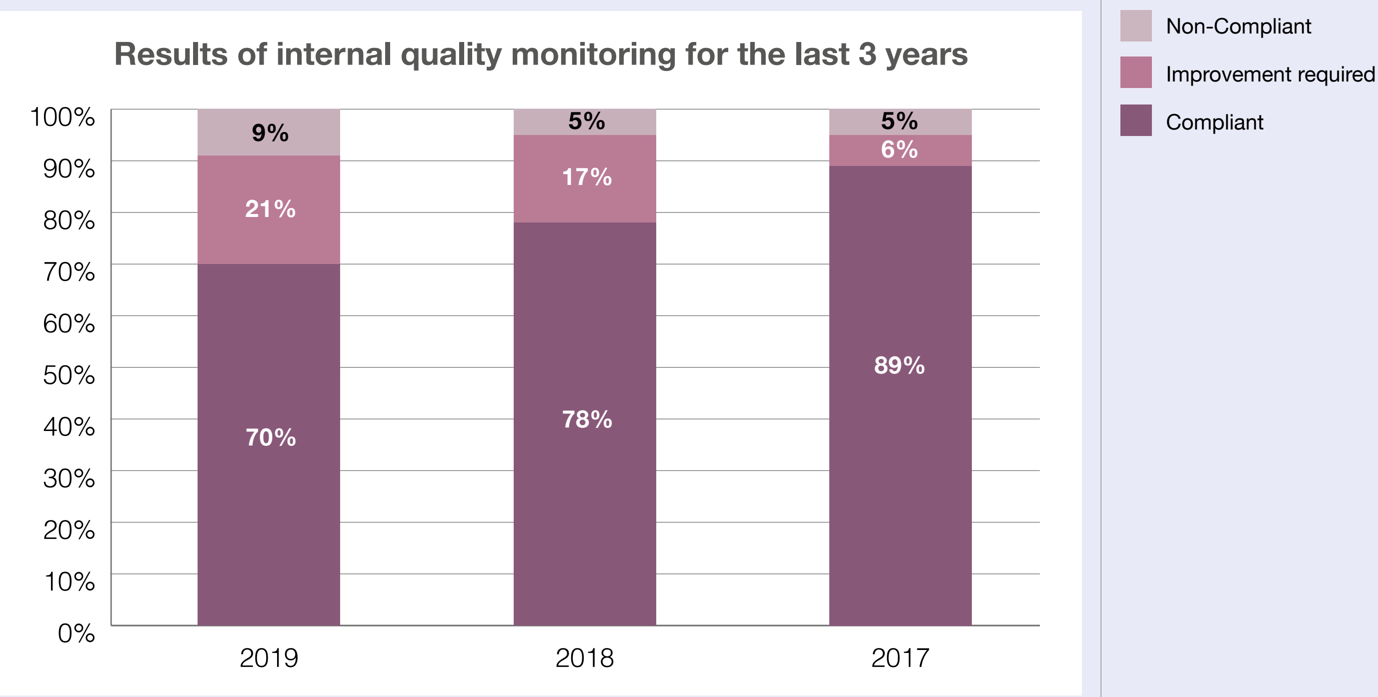
This appendix sets out information relating to the firm's internal quality monitoring for individual audit engagements. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

To understand how the firm's internal quality monitoring results sit as part of the firm's overall assessment of quality this should be read in conjunction with the firm's Transparency Report for 2019 and the report to be published in 2020, which provide further detail of the firm's wider system of quality control, other layers of quality monitoring and, importantly, our focus around public interest.

The scope of inspections and differences in how inspections are performed and rated means that the results of the firm's internal quality monitoring may differ from those of external regulatory inspections and other firms.

Results of internal quality monitoring

The results of the firm's most recent practice review, which comprised internal inspections of 79 individual audits with opinions signed between 1 June 2018 and 31 May 2019, are set out below along with the previous two years.



Engagement reviews are assigned an overall evaluation rating based on the practice review findings noted. The ratings received are classified as either Compliant, Improvement Required or Non-Compliant. A compliant rating indicates there are no exceptions or the exceptions identified are of a very minor nature relating to isolated instances of non-compliance with certain policies, requirements or standards; an Improvement Required rating indicates that there are a small number of findings relating to these areas, whereas a non-compliant rating indicates that non-compliance with several policies, requirements or professional standards or an individually significant matter was identified and it cannot be determined that policies, requirements or professional standards reviewed are fully implemented.

Firm's approach to internal quality monitoring

The firm's internal inspection programme considers the full population of audits performed. Engagements are selected using a risk based approach, focusing on high risk and/or high profile engagements, and to ensure that, as a minimum, each Responsible Individual is subject to review every three years. The firm aims to review FTSE 350 engagements every five years. Selected files are then subject to independent inspection by professionals from the central inspection team, along with reviewers comprising partners and senior auditors from other UK offices, groups and overseas member firms. All members of the inspection team are given thorough training by the leaders in the central inspection team. All reviews of FTSE 350 engagements involve a member of the central inspection team or a director who has undergone regulatory review themselves in order to apply a 'regulatory lens' to the review.

For all internal inspections, the firm uses moderation panels to rate individual findings and the overall engagement and takes into account the ratings applied by regulators when doing so. The moderation panel will normally include three or four members and will be comprised of partners and directors in the central inspection team and experienced partners from the UK or overseas member firms. These panellists are independent from the audit team and the team that undertook the inspection.

The firm undertakes Root Cause Analysis ("RCA") for all improvement required and non-compliant engagement inspections, as well as on positive results to identify factors to support audit quality. The firm performs retrospective remediation of all high and medium findings, and prospective remediation on all other findings in the subsequent year's audit.

Firm's response and actions:

Readers should note the decline in results profile of our internal archived file inspection programme over the past 3 years. Having evaluated the results we consider this decline to be mostly attributable to the continual improvements we have made to our internal inspection process to achieve our objective of assessing the quality of our audits against the highest bar possible. To do this we take account of the expectations of our global regulators including the FRC and the PCAOB as well as our own Deloitte global quality standards, and in 2019 changed our approach to rating individual engagements by making it harder to achieve a Compliant rating, which accounts for 7% of the overall 8% change. We also made our inspections more robust by pushing our reviewers to be more granular in their approach to reviewing, and to employ an even greater level of professional scepticism.

Internal quality monitoring is only one of the firm's measures of audit quality. Audit quality monitoring is reported to and considered by our UK Oversight Board (including our Independent Non Executives) using a range of measures.

Whilst the firm tries to at least mirror the processes of the external regulator due to differences in how inspections are performed and rated, the results of the firm's internal quality monitoring may differ from those of external regulatory inspections and other firms.

Our overall aim is that our internal inspections serve as one of our tools to drive continuous improvement in audit quality. We place our focus on rigorous compliance with applicable standards, also taking account the approaches adopted by our external regulators. We perform a wide and detailed in-depth review seeking to identify areas to be improved on individual audits. We continually assess and seek feedback on our internal monitoring process to make further enhancements to support the delivery of audit quality.

The firm's root cause analysis for the most recent internal inspections programme identified a number of thematic root causes of findings. These were in the areas of:

- **Mind-set related root causes** due to Assumed Knowledge, where information or evidence that is considered obvious to the engagement team as a result of their familiarity or industry expertise) is not included on the audit file to 'tell the story', and examples in individual portfolios of prioritisation of higher risk areas of audit work.

- **Resourcing and deployment root causes** with examples of capacity challenges and issues with work allocation to junior staff on individual engagement teams.

- **Skillset root causes** with examples of certain gaps in knowledge or experience, or particular industry/accounting matters at either preparer or reviewer level.

There were also some additional individual root causes identified on the engagements assessed as non-compliant but these were not considered to be thematic. These related to a workload and capacity cause and to unplanned long term sickness absence. Actions were taken at a business unit level relevant to the specific engagement to address these.

Positive root causes were also identified including examples of:

- The benefits of upfront planning.

- Early partner involvement.

- Good project management.

Thematic causes from engagement reviews were communicated to the business unit leaders and to the practice to increase awareness of the common pitfalls together with positive causal factors identified.

Key actions being taken include:

- Increased challenge by reviewers to identify where the audit file may not tell the story.
- The commencement of a review of the timing of the learning curriculum and the linkage of that to audit transformation including defining the expectations of each grade of staff, including where appropriate a focus on coaching of junior grades.
- Increased focus on capacity as part of our portfolio risk review.
- Additional learning materials or guidance to address identified skillset gaps.

Results of ICAEW monitoring

Background

The firm is subject to annual independent monitoring by ICAEW. ICAEW undertakes its reviews under delegation from the FRC as the Competent Authority. ICAEW reviews audits outside the FRC's population of retained audits, and accordingly its work covers private companies, smaller AIM listed companies, charities and pension schemes. ICAEW does not undertake work on the firm's firm-wide controls as it places reliance on the work performed by the FRC.

Scope

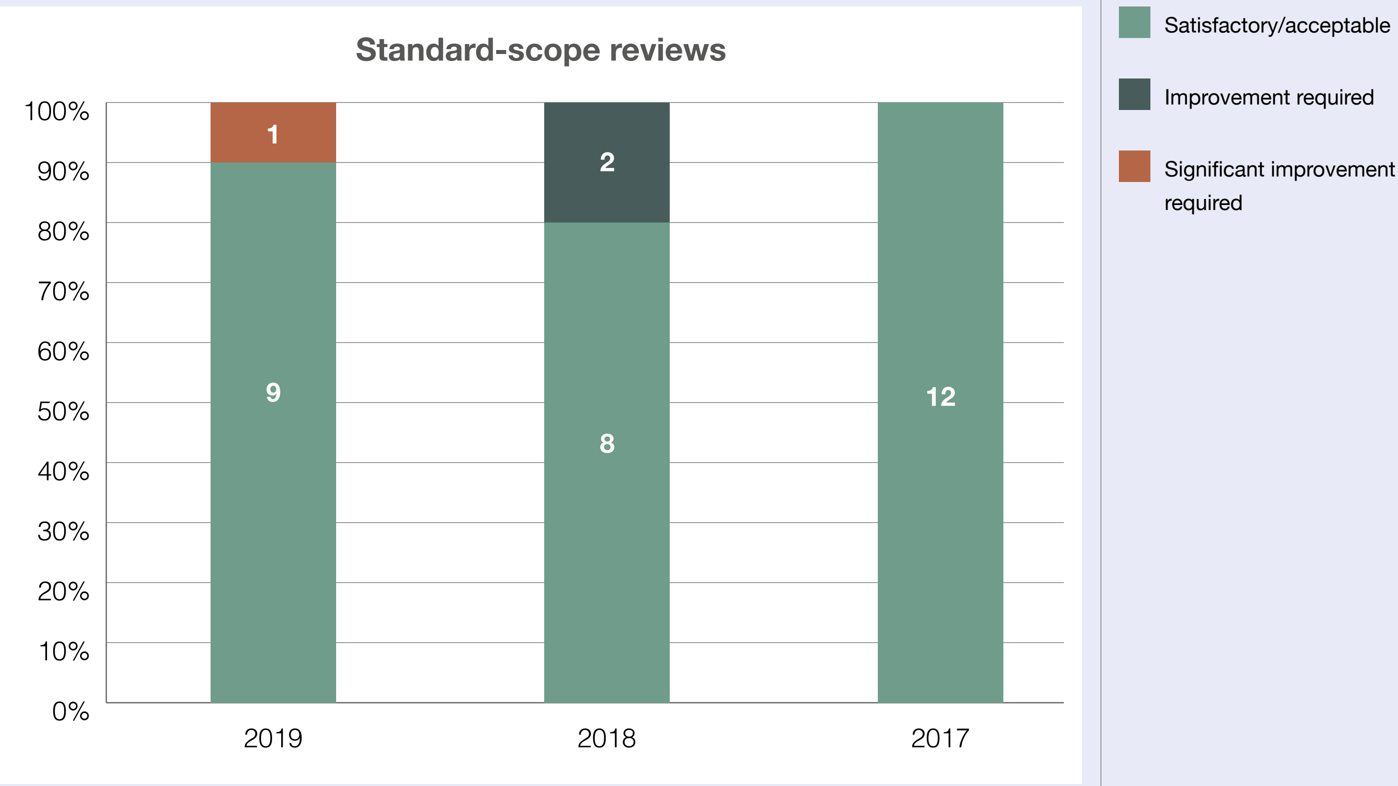
Reviews of audits are either standard-scope or focused. Standard-scope reviews are designed to form an overall view of the quality of the audit. ICAEW assesses the audits it reviews as either 'satisfactory/acceptable', 'improvement required' or 'significant improvement required'. Where appropriate, ICAEW also carries out focused reviews to follow up on significant issues highlighted in the previous year's file reviews or other specific risks. These reviews are limited in scope. Visit icaew.com/auditguidance for further information about ICAEW's audit monitoring process including its approach to assessing audits.

ICAEW has completed its 2019 monitoring review and the report summarising its audit file review findings and any follow-up action proposed by the firm will be considered by ICAEW's audit registration committee in September 2020.

Results

In 2019, the audit work reviewed was generally of a good standard. Nine standard-scope reviews were satisfactory/acceptable, however one required significant improvement. ICAEW did not carry out any focused reviews. ICAEW assessed one audit as needing significant improvement because the consolidated accounts contained errors stemming from mistakes in the consolidation process. The errors should have been identified by the firm's quality control procedures. ICAEW had no significant concerns about the rest of the audit work on this file. Other findings included a theme relating to substantive analytical review of revenue, and isolated aspects of audit evidence and documentation. ICAEW identified and shared a number of examples of good practice.

Results of ICAEW's standard-scope reviews for the last three years are set out below.



Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of a firm's performance or overall change in audit quality.

Response from the firm

Each year we publish the results of the QAD inspections within our Transparency Report and we set out our response to those inspections in detail. We accept all the findings and outcomes of the QAD inspection and as with all inspections, we take the findings seriously. For this year, we are pleased with the results of the QAD inspections, and, we have taken swift actions at the individual audit level and across our total audit portfolio where relevant. For the audit rated as significant improvement required we have completed causal factor analysis and have implemented a range of actions for the individual audit to ensure the matters do not recur. For the thematic finding on substantive analytical review please refer to the actions set out in our response to the AQR findings on the same subject. In addition we highlight that the INEs will be involved in monitoring our response to the findings and the implementation of the actions identified.

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