

ᠵᠠᠨᠠᠨᠠᠨ 2011

Audit Quality Thematic Review

Firms' audit quality monitoring

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2015
The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368.
Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

Financial Reporting Council

Audit Quality Thematic Review

Firms' audit quality monitoring

1	Background, scope and key messages	5
1.1	Background and scope	5
1.2	Overview and key messages	6
2	Principal findings	8
2.1	Monitoring the firms' quality control systems	8
2.1.1	Extent of monitoring performed	8
2.1.2	Training for reviewers	9
2.1.3	Communication of findings	10
2.2	Monitoring completed audits	10
2.2.1	Selection of audits to review	10
2.2.2	Approach to audit monitoring	11
2.2.3	Scoping of group audit reviews	13
2.2.4	Concluding on monitoring reviews	13
2.2.5	Assessing the application of the firms' quality controls	14
2.2.6	Remedial action where the firm is no longer the auditor	15
2.3	Root cause analysis	15
2.4	Thematic reviews	16
2.5	Group audits – non-UK component audits	16
3.	EU Audit Regulation and Directive	17

Introduced in 2013, thematic reviews supplement our annual programme of inspections of individual audit firms. In a thematic review we look at firms' policies and procedures in respect of a specific aspect of audit, and their application in practice, to make comparisons between firms with a view to identifying both good practice and areas of common weakness. The reviews are deliberately narrow in scope, and are chosen to focus on an aspect of audit in greater depth than is generally possible in our inspections, or because our inspection findings have suggested that there is scope for improvement in the area concerned.

This document is not designed to be a comprehensive discussion or complete summary of the requirements for audit quality control monitoring. Consequently, as not all aspects of Audit Regulations or the International Standard on Quality Control (UK and Ireland) 1 are discussed, readers should refer to these for all the requirements and to establish their own processes for audit quality control monitoring.

The FRC believes this document will be a valuable tool for audit firms of all sizes in developing, enhancing, and evolving their policies on audit quality control monitoring and contributing to their own processes of continuous improvement – thereby further demonstrating their ongoing commitment to enhancing audit quality. It should also be of interest to audit committees and audit standard-setters.

1 Background, scope and key messages

1.1 Background and scope

This report sets out the principal findings of the first thematic review undertaken by the Financial Reporting Council's ("FRC") Audit Quality Review ("AQR") team during 2015.

It is essential that audit firms have a culture committed to delivering consistent and rigorous audit quality across the firm. Over the last few years audit firms' quality control systems have been under increased focus and, to respond to this, firms have provided additional information on their quality control systems within their Audit Committee presentations, audit tender documents and annual Transparency Reports¹.

This review considers the monitoring performed by nine audit firms² over their quality control systems for audits of financial statements as required by International Standard on Quality Control (UK and Ireland) 1 and the UK Audit Regulations, including the monitoring performed for 50 audits.

This report is intended to promote a better understanding of the firms' quality control monitoring programmes and how these can improve justifiable confidence in audit.

The International Auditing and Assurance Standards Board ('IAASB') is currently considering how its standards on quality control at both a firm and engagement level might be enhanced to better promote audit quality. This report may also provide useful input to the IAASB's work.

1.2 Overview and key messages

All audit firms have quality control systems to promote audit quality and ensure compliance with auditing, ethical and quality control standards and the firms' own policies and procedures. The firms' monitoring programmes evaluate the effectiveness of firms' quality control systems and the quality of completed audits, identifying where improvements can be made.

Overall firms allocate substantial resources to their monitoring of the quality of audits and this is commended. Firms are keen to develop this further to increase the challenge of audit teams and provide assurance on the audit reports issued. However, given the importance of the firms' quality controls in supporting the consistency of the quality of audit work performed across the firm, firms do not devote a similar level of resources to their monitoring of the firms' quality controls.

Historically most firms only identify a relatively small proportion of audits requiring significant improvement, which is a smaller proportion than we find through our own reviews. Where we are able to make direct comparisons, we do find instances where our monitoring has identified required improvements that have not been identified by the firm's reviews or have been treated as less significant. Our 2016/19 strategy is to ensure that our AQR activities support firms achieving further improvements in audit quality and that by the end of the strategy period, at least ninety percent of FTSE 350 audits will require no more than limited improvements as assessed by our monitoring. We would expect the firms' own monitoring programmes to be as robust and challenging as our own. Strengthening the firms' own monitoring will result in more challenging and robust outcomes supporting the firms' culture of promoting audit quality and better equip audit teams to achieve the standards required.

Our observations are based on our reviews and we have discussed our findings with each of the firms concerned. The key messages in this report are relevant to all audit firms to consider in improving their audit quality monitoring procedures and we will expect to see improvements in future inspections. This report also makes recommendations where we have observed good practices. All audit firms are recommended to consider our good practice observations and implement such procedures, where appropriate.

¹ The Statutory Audit Directive requires annual transparency reporting by auditors of UK companies with securities admitted to trading on a UK regulated market. In 2014, the six largest firms voluntarily included 'audit quality indicators' within their Transparency Reports including the scope and results of the monitoring they had performed. Some other firms, including the three other firms covered by this thematic review, have also included this information within their most recent transparency reporting.

² BDO LLP, Crowe Clark Whitehill LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit plc, Mazars LLP, PricewaterhouseCoopers LLP and RSM UK Audit LLP (previously Baker Tilly UK Audit LLP).

1.3 Monitoring the firms' quality control systems

All firms undertake annual monitoring of their quality control systems. However, the frequency and scope of the review, the resources dedicated to it and the follow up of issues raised varied significantly.

Good practices observed

- Communicating failures in the application of the firm's quality control procedures to the individuals concerned and reflecting these in their performance appraisal and remuneration decisions.
- Undertaking root cause analysis on issues identified from monitoring the firm's quality controls as well as reviews of individual audits.

Key messages

- Firms should consider whether:
 - The extent and frequency of their monitoring is appropriate to meet regulatory requirements.
 - The sample sizes for testing the firm's quality controls are sufficient to obtain reasonable assurance that they are operating effectively.
- Audit firms should allocate sufficient and appropriate staff to undertake their monitoring and provide them with adequate training and guidance to ensure consistency between reviewers.

1.4 Monitoring completed audits

All firms' monitoring includes an annual review of a sample of completed audits to cover all individuals signing audit reports at least once every three years.

Good practices observed

- Moving away from completing procedural type checklists towards a risk focused review; leading to a more challenging review of the audit.

- Undertaking a review of a group audit including reviewing the audit of a significant UK component.
- Ensuring that relevant findings are discussed with both the training and the ethics and independence teams.
- Undertaking in depth thematic reviews of specific aspects of audits where there are recurring issues as part of the firms' quality monitoring is a positive step for improving audit quality.

Key messages for audit firms

- Firms should require reviewers to provide a clear summary and justification that supports the outcome of a review.
- Firms should assess whether individuals involved in the firm's quality control processes, in addition to the audit partner³, ought to have identified the issues arising and required them to be addressed prior to completion of the audit.
- Firms should review the last completed audit for each entity covered by their monitoring.

Key messages for Audit Committees

Audit Committees play an essential role in reviewing and monitoring the effectiveness of the audit process. In particular, their work in this area can make an important contribution in building investor confidence in the quality of the external audit and ultimately in the credibility of the financial statements. In May 2015, the FRC issued 'Audit Quality – Practice Aid for Audit Committees' which gave guidance on assessing audit quality throughout the audit process.

All of the firms in our review include information on their annual monitoring programmes within their annual Transparency Reports. However, Audit Committees may require a higher level of detail than is provided publicly in these reports and they may consider requesting their audit firms to provide an overall annual report on their monitoring activities⁴.

3 "Audit partner" throughout this report means the person responsible for signing the audit opinion. At some firms this may be a partner, director or senior manager of the firm.

4 FRC Guidance on Audit Committees (September 2012): Paragraph 4.22

The firm's report would provide a high level summary of the areas for improvement identified and the actions that they are planning to take. Audit Committees may wish to discuss the matters reported with the firm.

Furthermore, with a steady increase in tendering activity in the audit market, Audit Committees, in deciding the most suitable firm to appoint, will be more frequently involved in assessing the strength of individual audit firms. During this process, the Audit Committee may wish to request a report on the findings of each firm's audit quality monitoring and discuss matters arising with them.

To enhance their oversight of the effectiveness of an audit and their evaluation of audit quality, Audit Committees may wish to consider:

- enquiring annually for the latest results of the firm's monitoring and whether their audit was reviewed, discussing the findings and the remedial action taken or planned to address them; and
- asking whether the scope of the review included any UK components and whether the audit team have received any feedback from the monitoring performed by network firms responsible for audit work on overseas components.

2 Principal findings

Audit firms' responsibilities for establishing and maintaining systems of quality control for audit work are set out in International Standard on Quality Control (UK and Ireland) 1 ("ISQC1"). UK audit firms must also comply with Audit Regulations⁵ which require firms to perform annual monitoring of the firms' compliance with the regulations and with the requirements of ISQC1.

Audit firms are required to establish a system of quality control that promotes an internal culture that recognises that quality is essential in performing audits. The firms' monitoring programmes assist in identifying where improvements can be made, by the firm or by individuals, and enable high quality audit work to be recognised. The firm's monitoring of its quality control systems includes two elements:

- An ongoing consideration and evaluation of the firms' quality control systems, and
- Reviews of completed audits.

In meeting their responsibilities, audit firms should pay particular attention to our principal findings in the following areas.

Monitoring the firms' quality control systems

- Extent of monitoring performed
- Training for reviewers
- Communication of findings.

Monitoring completed audits

- Selection of audits to review
- Approach to audit monitoring
- Scoping of group audit reviews
- Concluding on monitoring reviews
- Assessing the application of the firms' quality controls
- Remedial action where the firm is no longer the auditor.

We also comment below on the developing areas of root cause analysis and thematic reviews.

2.1 Monitoring the firms' quality control systems

ISQC1 requires audit firms to establish and maintain a quality control system that provides it with reasonable assurance that the firm, and its personnel, comply with professional standards and applicable legal and regulatory requirements and that reports issued by the firm are appropriate in the circumstances. This system includes a monitoring process to identify any deficiencies in the system of quality control and ensure that appropriate remedial action is taken.

All nine firms carry out annual monitoring to assess whether their quality control systems are operating effectively. As firms' quality control systems are important in supporting audit quality, this monitoring should be performed effectively and robustly. Ineffective monitoring may give false assurance that the firms' quality control systems are operating effectively.

Overall firms allocate substantial resources to their monitoring of the quality of audits and this is commended. However, given the importance of firms' quality controls in supporting their audit quality culture and the consistency of the quality of audit work performed across the firm, some firms do not devote a similar level of resources to their monitoring of the firms' quality controls.

2.1.1 Extent of monitoring performed

- Audit firms should consider whether:
 - the extent and frequency of the firm's annual monitoring programme is appropriate to meet regulatory requirements; and
 - sample sizes for testing are sufficient to provide reasonable assurance that the firms' quality controls are operating effectively.

⁵ All firms working in the regulated area of audit are required to comply with Audit Regulations, or equivalent, issued by their professional body (Association of Chartered Certified Accountants, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants in Ireland operating as Chartered Accountants Ireland and Institute of Chartered Accountants of Scotland).

A Registered Auditor must monitor, at least once a year, how effectively it is complying with the Audit Regulations and take action to deal with any issues found and communicate any changes in procedures to principals and employees on a prompt basis (*Audit Regulation 3.20*).

Audit firms shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are operating effectively (*ISQC1 paragraph 48*).

The Audit Regulations provide guidance that firms' monitoring under the Audit Regulations and ISQC1 should cover the quality controls in a number of specific areas. The extent and frequency of monitoring of these quality controls varied significantly across the firms.

We selected six specific areas to assess to what extent monitoring of the firms' quality controls had been undertaken. Of the nine firms we visited only three had tested all of these. Three firms adopt a rotational approach requiring no testing of some of these controls in the year. The remaining three had not tested one or more of the six quality control areas selected. We understand that the differences arise due to the firms' interpretations of whether there is a requirement under the Audit Regulations to test all of the firms' quality controls annually or whether a cyclical approach can be adopted. Firms should review whether their annual monitoring of quality controls is appropriate to meet regulatory requirements.

Sample sizes used in testing the firm's quality controls varied significantly across the firms. For example, sample sizes for one firm were based on the firm's control testing sampling methodology (which meant that 40 items were tested in most areas); five firms gave no guidance, with this being left to the discretion of the reviewer (with samples ranging from zero to

twelve); and three firms follow sample sizes set out in their global monitoring methodology, with one requiring testing of a single item.

ISQC 1 requires firms to obtain 'reasonable assurance' from the monitoring performed, which is a high, but not absolute, level of assurance. The approach to determining sample sizes for firms' monitoring should, therefore, be sufficient to obtain reasonable assurance that relevant controls are operating effectively.

2.1.2 Training for reviewers

- Audit firms should allocate sufficient and appropriate staff to undertake the monitoring of the firms' quality controls, ensuring that staff are provided with adequate training and guidance so that matters are appropriately identified.

Audit firms shall establish a monitoring process that requires responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility (*ISQC 1 paragraph 48b*).

The monitoring of the firm's quality controls is performed by individuals from either the firm's central monitoring team or from the audit practice. In some cases, this monitoring was undertaken by the individual who had responsibility for operating the control and therefore this was not an independent review.

At five firms we considered the training and guidance provided to individuals to be inadequate, which led to inconsistencies in the work performed. The approach and documentation of findings varied considerably between individuals at both the same firm and across firms. Training should be provided to reviewers to include the purpose of the work, what areas are to be reviewed, the approach to be taken and guidance on appropriate sample sizes.

2.1.3 Communication of findings

- Audit firms should communicate adverse findings from monitoring the firm's quality controls, on a timely basis, to the individuals concerned and consider including these within the individual's performance appraisal and remuneration decisions.

Audit firms are required to communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action (*ISQC 1 paragraph 50*).

Monitoring of the firm's quality control systems may identify individuals that have not complied with the firm's procedures, such as failure to comply with ethics and independence requirements or non-timely or inadequate completion of their continuing professional development ("CPD") records. **Two firms communicate these instances of non-compliance to the relevant individuals and take these into account in assessing their overall performance rating and remuneration.** Instances of non-compliance should be communicated to individuals by all firms.

2.2 Monitoring completed audits

ISQC 1 requires that at least one completed audit for each audit partner is reviewed on a cyclical basis, for example every three years. ISQC1 requires that individuals with sufficient and appropriate experience and authority should be assigned responsibility for the monitoring process. The firms reviewed organise their annual monitoring of completed audits in different ways, largely reflecting the nature of the audits the firm performs.

2.2.1 Selection of audits to review

- Audit firms should consider:
 - introducing a greater element of unpredictability to the selection of audits for review such that individuals subject to monitoring are unable to predict when they will be reviewed or the audit which will be selected; and
 - notifying the audits selected for review no longer than ten days prior to the review starting.

Audit firms' monitoring processes should include, on a cyclical basis, the inspection of at least one engagement for each engagement partner (*ISQC1 paragraph 48(a)*).

If the work of all audit partners is not reviewed each year, then it should be covered over no more than a three-year period, if this is appropriate to the circumstances of the firm (*Guidance to Audit Regulation 3.20*).

Six firms select audits to be reviewed to cover each audit partner every three years with the other three firms covering each audit partner more frequently. Two firms organise their monitoring programmes based on visiting the firms' offices on a cyclical basis and will select all audit partners in those offices which are due for review that year. As a result audit partners are able to more easily anticipate when they will next be reviewed. A number of other firms include a small sample of randomly selected audit partners in order to reduce the level of predictability of when an audit partner is next due a review. Furthermore, some firms include specific individuals within their audit monitoring programme, for example, newly appointed audit partners, individuals who are applying for audit partner status and those individuals who received an unsatisfactory outcome in the prior year.

At most firms audit partners are notified of audits to be reviewed up to ten days prior to the review commencing. At three firms, however, the notification period was between one and three months prior to the review. Due to the long notification period, in three cases the prior year audit was reviewed even though the current year audit was completed at the time the review commenced. This reduces the effectiveness of the monitoring process as these audits may have been completed before the prior year's monitoring findings were communicated to the audit practice. Findings may therefore be raised which have already been remedied in the audit completed subsequently.

2.2.2 Approach to audit monitoring

- Audit firms should consider their approach to the monitoring of audits to ensure that reviews are risk focused and target significant areas of judgement, rather than focusing on procedural matters.
- Audit firms should encourage reviewers to consider whether a matter identified could result in associated issues that require further investigation.
- Audit Committees may wish to enquire whether their audit has been subject to the firm's internal quality monitoring and discuss the main findings with their auditor, together with any remedial action taken or planned.

The monitoring process adds value to the audit practice, either by identifying potential areas for improvement or by giving assurance that everything is satisfactory. For both reasons the review must be done effectively. The monitoring process should be entrusted to a principal, principals or other persons with sufficient and appropriate experience (*Guidance to Audit Regulation 3.20*).

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances (*ISQC1 paragraph A64*).

Auditing is a complicated process involving a series of professional judgments culminating in the audit opinion. The review provides assurance that the quality control procedures which are built into the audit process have worked satisfactorily (*Guidance to Audit Regulation 3.20*).

Resources

Firms use staff from manager to partner level to undertake reviews of audits. Two firms have a dedicated, central team who undertake all audit monitoring reviews, five firms use a combination of a central team with partners and staff from the audit practice and the remaining two select all of their reviewers from the audit practice.

Most firms perform their monitoring of audits over a fixed time period during the year, usually lasting 2-3 months. One firm, which has a central team, has a rolling programme of reviews throughout the year.

A summary of the average time spent on each review is set out in the table below. The majority of firms allocate up to five days to each review. However, at two firms the time allocated is driven by the number of audit hours spent and one of these firms allocates significantly more resource to the review of its most significant audits.

Table 1: Average time allocated to audit reviews

Firm	Average length of review
A	5 days
B	2-5 days
C	5 days
D	5 days
E	2-3 days
F	5 - 10 days depending on the size of the entity
G	5 days
H	Listed or related entity including subsidiary with greater than 1,000 engagement hours = 5 days Listed or related entity - Head office with < 2,000 hours = 7.5 days Listed or related entity - Head office with > 2,000 hours = 10 days
I	Smaller, non-PIE entity = 2 days 3,000 hour audit = 7 days + 2 days of specialists' time. 10,000 hour audit = 25 days + 3 days of specialists' time.

Review methodology

Completed audit work is reviewed to assess whether auditing standards and the firm's procedures have been followed and the audit report issued by the firm is appropriate. To aid consistency firms have developed work programmes for reviewers to follow.

The work programmes used are generally checklists requiring a "yes", "no" or "not applicable" response. Where a "no" response is provided, reviewers are asked to provide some further explanation and to obtain a response from the audit team. On each audit the reviewer then lists the key findings arising and the audit partner is required to provide a response.

We noted that there is little explanation of the significance of a "no" answer and, in a few cases, that there was a lack of consideration of the further implications. For example:

- The reviewer concluded that the level of materiality was too high, but there was no consideration of the impact of this on the audit work performed.

- The reviewer concluded that a risk relating to the dominance of management had not been responded to in a specific area of the audit, but there was no consideration of whether this risk had been identified in the continuance procedures.

- An ethical matter relating to the permissibility of a non-audit service was identified by the reviewer, but there was no consideration as to whether the related threats and safeguards had been adequately concluded on.

Two firms have recently revised their approach to monitoring for some of the population selected for review, moving away from procedural type checklists towards a risk focused review. Reviewers are encouraged to challenge audit teams' judgments over the significant risks identified and the audit approach taken. **This change in approach, together with the increased time spent reviewing the firms' most significant audits, has substantially increased the involvement of the audit team in the review**

process and provided a more challenging and robust review of their audit work, improving the findings and recommendations arising.

We strongly encourage other firms to consider the potential benefits of moving away from a procedural checklist-based approach. We would expect firms' own monitoring programmes to be equally as robust and challenging as that of a regulator.

2.2.3 Scoping of group audit reviews

- Audit firms should consider including significant UK components within the scope of their monitoring of group audits on a more frequent basis.
- Audit Committees may wish to discuss with the audit partner the scope of the firm's audit monitoring to ascertain whether any UK components were included or if the review was restricted to work at group level.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of whether the firm's quality control policies have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances (*ISQC1 paragraph A64*).

The audit report on the group financial statements is the responsibility of the group audit partner who is responsible for the direction, supervision and performance of the group audit, including audit work performed in relation to components. Components may be audited by the UK firm, overseas network firms or by other audit firms. Firms' monitoring programmes are only required to cover the audit work performed by the UK firm. Therefore, in all firms, a component will not be selected for review if it is audited by an overseas network firm (see section 2.5).

Six firms do consider whether the review of a group audit should include the audit of a significant UK component. However, one firm only reviews audit work for a UK component where the group audit partner is also the audit partner for the UK component. In many cases the audit work in key areas (for example: revenue, inventory, investment property) is undertaken by a UK component team. Historically, for some audits selected by both the firm and the AQR, monitoring outcomes have differed as a result of the firm excluding a significant UK component from the review (consequently weaknesses in the audit of this component, as identified by AQR, were not identified and assessed by the firm). We therefore do not consider it appropriate for reviews of group audits to only consider the work performed at group level. In view of the benefits of a robust monitoring process, firms should ensure that sufficient and appropriate coverage of UK components is achieved, including where the audit of the UK component is the responsibility of another audit partner of the firm.

2.2.4 Concluding on monitoring reviews

- Audit firms should consider requiring reviewers to:
 - provide a clear summary and supporting justification for the outcome of a review, which addresses both the individual and cumulative significance of their findings; and
 - corroborate audit partners' responses to findings, where these are considered to mitigate the significance of a finding.

ISQC1 does not require firms to give an overall grading to the audits reviewed but eight firms do use grading criteria to assess the quality of the audits reviewed. The overall assessment of the grading is judgmental, taking into consideration the nature of the findings and the responses of the audit partner. We attended a sample of moderation meetings which are held to discuss the results of audit reviews performed and to ensure that the outcomes are consistently assessed. A number of firms have opted to voluntarily disclose the outcome of their annual monitoring of audits as an 'Audit Quality Indicator' in their annual Transparency

Reports. However, it should be noted that there is a lack of comparability of gradings as each firm uses different criteria and judgment is required to evaluate findings.

Where audits were graded, we identified a fifth of audits across four firms where the final conclusion on a specific finding or the overall grading was ambiguous. Based on the information presented by the reviewer, and the firms' grading definitions, we consider that the grading in these cases was not supported. In some cases the response from the audit partner was deemed to mitigate a finding, but this conclusion was reached without corroborating their response to the audit work performed.

One firm does not provide an overall outcome or grade for an audit as they believe this encourages audit partners to focus more on how the audit needs to be improved, rather than on negotiating the grade awarded. Matters arising on a review are communicated to and discussed with the audit partner, reported to the firm's senior partners and taken into consideration in the audit partner's appraisal discussions. Significant matters which may affect the appropriateness of the audit opinion are reported to the firm's audit technical department and any significant ethical matters are reported to the firm's Ethics Partner.

2.2.5 Assessing the application of the firms' quality controls

- Firms' audit monitoring processes should include an assessment of whether individuals involved in applying the firm's quality controls should have identified issues arising. If so, this should be considered in their performance review and remuneration decisions.

The firm shall communicate to relevant audit partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action (*ISQC1 paragraph 50*).

All firms consider the audit monitoring outcomes in relation to the competence of the audit partner to deliver audit quality. Whilst the audit partner takes overall responsibility for the quality of each audit, the firm's quality controls are applied to the audit. This may include the involvement of an engagement quality control reviewer ("EQCR"), consultations with the firm's technical specialists on difficult or contentious matters, technical reviews of financial statements and additional reviews of the audit work as it is being performed.

The application of the firms' quality controls to audits is important in maintaining audit quality. Audit monitoring can provide valuable information on the application of these controls but, in most cases, the findings of this are not used to assess the effectiveness of the firms' quality controls. Where there are significant findings on an audit, the review should consider the effectiveness of these quality controls and whether they should have identified and corrected the deficiencies prior to the audit being completed.

Six firms do consider the outcome of audit monitoring when assessing the performance of the EQCR and positive or adverse findings will be considered when assessing their performance. However, this does not extend to those operating the firms' other quality controls. For example, if a significant disclosure error or omission in the financial statements is identified there is no consideration of whether this should have been identified through the technical review process.

Where the application of these quality controls requires improvement, this should be communicated to the individuals involved and considered in their performance reviews. Furthermore, firms should consider how good performance in applying the firms' quality controls should be evaluated and, where appropriate, rewarded.

All firms discuss the findings from their monitoring of audits with their technical and training departments, so that additional guidance or training can be provided for audit staff as appropriate. **In addition, two firms discuss the findings with their ethics and independence teams.**

2.2.6 Remedial action where the firm is no longer the auditor

- Firms should consider what steps need to be taken where the results of a review indicate that an audit report issued may be inappropriate and the firm no longer audits the entity.

The firm shall establish policies and procedures to address cases where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement. Such policies and procedures shall require the firm to determine what further action is appropriate to comply with relevant professional standards and legal and regulatory requirements and to consider whether to obtain legal advice (*ISQC 1, paragraph 52*).

When the firm identifies that an audit requires significant improvement, all firms consider whether the audit opinion given was appropriate and determine what further action will be taken. In some cases we reviewed it was concluded that further work was required to support the opinion given.

However, in one case, a review identified a number of material disclosure omissions, such that the audit opinion should have been qualified. The firm concluded that, as it no longer audited the entity, it had no further responsibility and no action was required. We consider that the firm should have brought this matter to the attention of management and/or the successor auditor.

As a result of increased tendering activity, changes of auditors are now more frequent. There is more likelihood that audits selected for review will be for the firm's final year as auditor. Firms should consider how their policies and procedures address cases where the audit opinion is assessed as being potentially inappropriate and the firm is no longer the auditor.

2.3 Root cause analysis

Firms have implemented various remedial actions to address audit and quality control deficiencies. These include enhancing their quality controls, changing their audit methodologies and processes, developing new audit tools and supporting guidance and providing further training addressing specific issues.

The identification of effective remedial actions by firms is a challenge. While certain remedial actions may address a particular deficiency, they may not address the underlying cause and the deficiency may therefore reoccur. It is important that firms take steps to gain a clearer understanding of the underlying causes of recurring deficiencies to enable them to implement remedial actions which are likely to be effective. Root cause analysis involves questioning why a problem arose until the cause is identified, such that actions address the underlying cause rather than the symptoms. Root cause analysis may also be used in understanding what has led to an audit being performed well such that these best practices can be shared more widely.

All nine firms are taking action to analyse the root causes of issues identified through their monitoring. However, the firms are at different stages as some have commenced this more recently than others. The approach taken and resources dedicated to this varies significantly across firms and the main focus tends to be on issues arising on individual audits.

Firms should further develop their processes for undertaking root cause analysis and allocate responsibility for this work to an individual with appropriate authority in the firm. Root cause analysis should be performed on a timely basis on findings from both the monitoring of audits and the firm's quality controls and the results shared with relevant individuals within the firm.

2.4 Thematic reviews

Three firms have commenced thematic reviews to look at an aspect of audit work in more depth. These reviews are generally aimed at areas where the firms have identified recurring issues on audits, such as the audit of cash flow statements.

Thematic reviews may help firms to gain a better understanding of the reasons for recurring issues in a particular audit area and to develop effective actions to achieve improvements. The addition of thematic reviews as part of the firms' monitoring is a positive step for improving audit quality.

2.5 Group audits – non-UK component audits

- Audit firms should consider:
 - requesting component auditors from overseas network firms to provide details of the outcome of their most recent internal or external quality reviews and arranging to discuss the findings arising with them; and
 - requesting other network firms to undertake reviews of specific non-UK components as part of their internal monitoring process where a component is significant or the audit partner has specific concerns.
- Audit Committees may wish to ask how the group auditor has assessed the competence of non-UK component auditors, including whether the audit team have received any feedback on the monitoring performed by network firms responsible for audit work on significant components.

Where the group engagement team requests a component auditor to perform audit work on the financial information of a component, the group engagement team shall obtain an understanding of the component auditor's professional competence (*ISA 600 paragraph 19*).

For group audits, the audit work in relation to significant non-UK components may be performed by overseas network firms. Auditing standards⁶ require group auditors to assess the competence of component auditors. The findings of the most recent internal or external review of a component audit performed by an overseas network firm, together with details of the action taken in response, can provide useful information for this assessment.

Firms may wish to consider requesting overseas network firms to review audits of specific non-UK components of UK groups within their monitoring process.

⁶ ISA (UK&I) 600: Special considerations – Audits of Group Financial Statements (including the work of component auditors)

3. EU Audit Regulation and Directive

From 17 June 2016 the EU Audit Regulation and Directive (“ARD”) will come into force in the UK. The FRC has issued a consultation paper⁷ on the changes that are required to UK standards, including ISQC1. In considering the findings of this report and what action they should take, audit firms should also consider any relevant proposed changes as set out in the FRC’s consultation.

⁷ ‘Enhancing Confidence in Audit: Proposed revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees (September 2015)’



Financial Reporting Council

8th Floor

125 London Wall

London EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk