FRC Audit Quality Inspection and Supervision of Tier 2 and Tier 3 Audit Firms | December 2022

KINGSLEY NAPLEY
WHEN IT MATTERS MOST

The following table captures in tabular form the key findings and observations of good practice from the Financial Reporting Council's (FRC) audit quality inspection and supervision of Tier 2 and Tier 3 audit firms covering the period between 2016/17 and 2021/22. We encourage firms to read the full report, which is available at https://www.frc.org.uk/document-library/audit-firm-supervision/tier-2-and-3-audit-firms

Key findings	Example areas for improvement		Good practice observations
Individual audit inspections			
Estimates and judgements	Insufficient challenge of the assumptions used by management to support, for example: the carrying value of intangible and tangible assets, including forecast growth rates, and discount rates; defined pension scheme liabilities, including mortality rates, discount rates and inflation; and, the capitalisation of development costs. Inadequate sensitivity analysis, for example on management's impairment or ECL models. Insufficient challenge of management's experts, for example in terms of the assumptions, including yields, used within property valuation models.		Overarching observations of good practice in firms (applying to audit procedures generally) include: **Risk assessment and planning** Consulting a wider range of sources relevant to understanding audit risks at entities, particularly in complex sectors. Adopting more detailed procedures in first year audits to better understand audit risks. Adapting planning approaches to take account of risk factors such as the Covid-19 pandemic. Planning for a greater senior level involvement in key audit areas. Considering whether they had the appropriate expertise to challenge underlying assumptions and, if not, engaged additional support.
Revenue	Audit procedures resulted in insufficient independent evidence being gathered, for example by not corroborating information from an entity's finance system to supporting independent evidence such as customer orders, signed delivery notes, or cash receipts. Insufficient procedures to evaluate the appropriateness of revenue recognised on long term contracts.		

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<table>
<tr>
<td></td>
<td>Limitation of sample sizes used in substantive testing without adequate explanation.

Reliance on substantive analytical procedures without having confirmed the accuracy or completeness of the underlying data or having formed independent expectations.</td>
<td rowspan="3">Execution

Validating source data upon which estimations were based.

Testing management’s models using IT applications.

Engaging with and challenged management’s expert.

Considering plausible alternatives to management’s assumptions.

Preparing audit working papers which documented in sufficient detail how they had challenged management.

Completion and reporting

Preparing a detailed memorandum drawing together the key facts and considerations in support of the auditor’s conclusions.

Presenting graduated findings to Audit Committees, for example whether estimates were considered to be optimistic, balanced or pessimistic.</td>
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<tr>
<td>Going concern</td>
<td>Reliance placed on future events, such as a refinancing or disposal of illiquid investments, or on support from group companies or shareholders, without adequate assessment of the feasibility of the events or means of support available.

Reliance on liquidity ratios without adequate review of detailed liquidity movements across a period.

Insufficient procedures over the viability statement, including the assessment of the appropriateness of the period used by management.</td>
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<tr>
<td>Inventory</td>
<td>Insufficient procedures performed over provisions for obsolescence, including the appropriateness of the characteristics (such as the type or age of an item) used by management to determine the obsolescence provision.

Insufficient rationale for decisions to limit the sample of inventory counts attended.

Insufficient procedures performed to support the appropriateness of overheads capitalised into inventory at the year end.</td>
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Financial statement disclosures	Procedures to check the accuracy and appropriateness of the financial statement disclosure notes were not evidenced. Material errors in disclosure notes were not identified. Accounting errors in the consolidation were not identified or the consolidation workings did not reconcile to the final financial statements.		
Journal entries	Audit procedures did not sufficiently assess and validate the completeness of journal entry system reports obtained from management. Inadequate understanding of the risk characteristics of journal entries in determining the basis for sample selection and reviewing anomalies or exceptions. Failure to evidence an appropriate fraud risk assessment that supported how higher risk journal entries were selected for review. Insufficient evidence retained or documented to support the results of journal testing performed.		

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Key Findings	Example areas for improvement		Good practice observations
Quality control procedures			
Audit methodology	Checklist-type working papers being used which do not adequately allow auditors to evidence the work they have performed in order to support the conclusion reached, particularly where greater levels of scepticism and challenge are required. Methodology not being updated on a timely basis for revisions to the ISAs. Inappropriate use of fixed, capped or limited sample sizes without demonstrating how the sample adequately addresses audit risks across the population of items, particularly in significant risk areas. A lack of guidance on how to assess the design and implementation or operating effectiveness of an entity's general IT controls, and how to respond to exceptions or deficiencies identified in any testing performed. Instances of audits not being archived within the permitted time frame and audit working papers in significant risk areas being amended after the date of the audit report.		Adapting audit software to be able to tailor audit procedures relevant to the entity. Introducing additional audit working papers covering the additional PIE audit requirements in the ISAs, or sector specific areas, which were not incorporated into their off-the-shelf audit methodology, including guidance on sampling.
Compliance with ethical requirements	Inadequate policies and procedures in relation to non-audit services, including not seeking approval from the Responsible Individual (RI) for the audit, resulting in breaches of requirements in relation to, for example, the provision of prohibited services and failure to hold appropriate consultations.		Developing bespoke ethics and independence guidance documents (rather than merely referring to the Ethical Standard).

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	Where internal consultations were held, a lack of evidence as to consideration of whether an objective, reasonable and informed third party would consider there to be an independence threat. Inadequate policies, monitoring and safeguards in relation to long association, particularly on non-PIE audits. Inadequate monitoring of overdue audit fees, which may pose an independence threat.		Introducing mandatory technical consultations in relation to non-audit services or where a non-PIE RI's tenure exceeded 10 years.
Acceptance and continuance	Inadequate process for considering of the risks associated with an entity and whether the firm or its staff had appropriate experience to undertake audits. Inadequate processes to identify where an entity was a PIE, therefore giving risk to risks of breaches of ethical requirements and deficiencies in the entity's financial statements not being identified.		Convening special internal panels to consider appointments to higher-risk or higher-profile entities.
Human resources (recruitment, performance management and reward processes)	Inadequate appraisal processes which do not link audit quality to reward, promotion or recognition, particularly in relation to RIs and decisions to promote people to RI roles. A small pool of RIs able to act as Engagement Quality Control Reviewers (EQCR), and EQCRs failing to apply adequate challenge to the audit team. Insufficient mandatory technical training, as well as the absence of attendance monitoring and the assessment of the effectiveness of the training, and a lack of softer skills training.		Developing sector specialisms and build an appropriate team of suitably experienced RIs and staff. Developing an accreditation system for individuals working on PIE or other specialist audits.

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Internal quality monitoring	An unsatisfactory grading system, for example, one which does not adequately distinguish between findings of different severity or which potentially impact on the integrity of an audit as a whole. We found that some firms had no grading system at all. Use of a checklist type approach which does not facilitate understanding of the issues arising or their remediation. The EQCR's role not being considered in the review. Insufficient communication or follow-up of IQM findings. In three audits we assessed as requiring more than limited improvements, the firm's IQM process (conducted by an external service provider) had assessed the audits as requiring only limited improvements, raising concerns about the depth and rigour of the IQM process.		Ensuring that RIs are subject to IQM at least every two years (with some firms adopting an annual approach). Using audit quality indicators to select files for review. Conducting Root Cause Analysis (RCA) on key IQM findings.

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