

FRC Brief - 2021

FRC Audit Quality Inspection and Supervision of Deloitte LLP (audit quality)

The Financial Reporting Council (FRC) conducted an audit quality inspection and found key matters relevant to audit quality with Deloitte LLP. Findings from the audit were not fully representative of the quality across all firm audits due to the FRC's focus on higher risk audits. The report gives an overview of the inspection work done on the largest seven firms and Deloitte's performance was assessed, with 56% requiring limited improvements. The report highlights the firm's commitment to improve audit quality and suggests further improvements. The FRC plans to increase its inspection on KPMG banking audits and audits conducted by BDO and Mazars. Deloitte's audit quality plan incorporates UK specific procedures but should be extended to assess the overall effectiveness of audit quality initiatives. To drive continuous improvements, Deloitte continues to invest in audit processes, policies, quality controls and new technologies. The firm is also monitored by the Independent Chartered Accountants of England and Wales (ICAEW), which provides further independent assurance on the quality of audits.

Audit Quality Inspection and Supervision: High-Risk Audits and Responding to Covid-19 (going concern)

The report discusses high-risk audits and their inherent complexity, focusing on future cash flows, impairment assessments, and going concern evaluations. Good practices observed include enhanced auditing procedures in response to increased risks from Covid-19, and strong procedures related to going concern concerns. The creation of 'centres of excellence' for specific audit areas has also been a positive step. Covid-19 has heavily impacted going concern assessments and firms have reacted by strengthening their procedures and establishing expert panels on high-risk audits. The evaluation of management's impairment and going concern assessments remains a challenge that requires a robust response. Sectors focused on include financial services, retail, construction and materials, and manufacturing. The main recurrent findings relate to the evaluation of management's impairment and going concern assessments, with improvement needed in these areas. The report stresses the importance of senior team oversight, the use of internal experts, and robust procedures for audit success.

Enhanced Audit Quality and Governance Processes (governance)

The text discusses improvements in audit and governance processes that focus on high-risk sectors, entities experiencing financial difficulties, those with high estimation uncertainty, and where there are governance or internal control weaknesses. The newly formed independent Audit Governance Board (AGB) oversees the progress and achievements of these audits, ensuring quality and timely reporting. Increased communication is highlighted with management and governing bodies to set clear expectations of audit information. The Audit Quality Plan (AQP) introduces changes in governance, leadership, acceptance, engagement performance, ethical matters, culture of challenge, and information communication. The establishment of independent audit governance boards is identified as a significant step for oversight and accountability. A focus is observed on the quality initiative, root cause analysis,

structure, risk identification and control. It is recommended that audit quality plans adopt forward-looking measures which contribute directly or indirectly to audit quality. Good practices note a strong oversight and governance structure with regular reports and updates to governing bodies.

Regulatory Guidelines for Investment Advisers and Brokers Against Fraudulent and Manipulative Practices (fraud)

The document outlines guidance regarding the maintenance of client funds and securities by investment advisers and restrictions on fraudulent practices. All investment advisers are required to maintain client funds with broker-dealers or other qualified custodians. Acts of fraud, deception, or manipulative business practices connected to the selling, buying, or advertising of securities are declared unlawful. Persons primarily involved in advising others about securities or their sale and purchase should not engage in fraudulent acts that would deceive their clients. The regulations also focus on penalties for fraudulent actions and other dishonest conduct involving securities transactions. These include any kind of deceptive activities, fraudulent concealment, embezzlement, misappropriation of funds, counterfeiting, extortion, or any equivalent activities under foreign law. Furthermore, the guidelines caution against the use of deceptive devices for inducing the purchase or sale of any kind of security by brokers or dealers. It indicates that it is unlawful to violate rules and regulations set by the commission to protect investors and maintain fair and orderly markets. The document emphasizes that convicted individuals can face penalties, with a heavier penalty for acts resulting in substantial losses or gains. Factors considered in determining the penalty include harm to others, unjust enrichment, previous violation history, and need for deterrence. Lastly, it discusses ethical controversies related to issues such as human rights, carbon emissions, and tax fraud, especially within the financial services sector. The act of fraudulently certifying educational curriculum completion to the board by real estate brokers and salespersons can lead to license suspension.

Audit Quality and Standards Review (auditing standards)

The key focus areas of the audit inspections were on firm-wide audit methodology, training, and various new or updated auditing standards such as going concern, audit of estimates, and financial instruments. Findings highlight deficiencies due to lack of professional skepticism, prompting the adoption of transparent and visible enforcement procedures to mitigate poor conduct in auditing. The report also underscores the need to enhance auditing standards and the operational separation of the big four firms. Several newly effective auditing standards were introduced, including standards for auditing estimates, going concern, and fraud-related responsibilities in financial statements audits. Additionally, improvements to quality control and engagement quality control review procedures were implemented. An initiative to influence and further improve auditing standards on an international level is also underway, with active participation in key projects and collaboration with the International Auditing and Assurance Standards Board (IAASB).

Audit Quality and Control Environment Adaption Amid Changing Economic Conditions (environment)

The focus of this discussion is based on the audit team's response to subpar quality information and a lack of effective control environment at the audited company. The quality of evidence on

audit files can be impacted by the company's control environment quality and robustness, the proficiency of financial reporting function, and responsiveness to audit recommendations for improvement. The audit approach and materials supporting its implementation need ongoing development due to the changing credit environment and portfolio of audits. Certain good practices were identified relating to audit work on goodwill impairment and challenges faced due to COVID-19, mandatory training, procedures for auditing the allowance for expected credit losses, and disclosure guidance. The increased complexity and uncertainty in the current auditing environment due to recent failures requires reevaluating the plan periodically and focusing on training, tools, and guidance. The findings indicate a need for a clear understanding of the entity and its internal control environment, leading to an increased requirement for IT audit partners to enhance the testing of data environments. The goal is to maintain and improve the quality of UK audit services in this challenging environment. High-quality audits are described as those providing assurance that financial statements are true and fair, comply with auditing regulations and standards, are driven by a robust risk assessment, and report unambiguously the auditor's conclusion. Findings in this sector highlight weaknesses in the audit of the valuation of financial investments and revenue recognition. In most cases, the auditors either found it more efficient to obtain audit evidence through fully substantive procedures or that the control environment was unreliable. Benefits of the revised approach include improved quality management system, proactiveness to evolving circumstances, adaptability to a changing environment, and an enhanced audit quality mindset.

Key Focus Areas for Market Activities and Technological Innovations in Financial Systems (technology)

The text primarily contains insights on financial system processes and identifying the significant interest areas. These are predominantly client onboarding, funds handling, securities management, account management, trade confirmation, securities lending, pricing models for valuations, compliance controls, sales and trading systems, information security, preparation of financial regulatory reports, and record-keeping. Furthermore, technology plays a vital role in ensuring efficiency and innovation in these processes, examples being blockchain technology, artificial intelligence, machine learning, and internet of things in financial product development and sustainability goal achievement. There's also a shifting interest towards digital solutions like distributed ledger technology (DLT), green financial technology, and regulatory technology. However, large technology companies benefit massively from this shift. Lastly, the uneven recovery across sectors and countries was noticed with robust growth in the technology sector, while telecom and financials lag behind.

Revision and Implementation of New Auditing Standards (accounting estimates)

The firm has developed a new template for auditing accounting estimates, in alignment with the requirements of revised ISA (UK). The significant changes to auditing and accounting standards have been incorporated into the firm's methodology and guidance without any major findings. Much progress has been made in areas such as group audits and entity-provided information testing. However, there is a noted increase in findings relating to testing of accounting estimates and use of substantive analytical procedures. Areas needing improvement include management challenge relating to accounting estimates, property valuations, impairments, unidentified errors and omissions in financial statements, and audit documentation. Revised ISA (UK) and updated standards are effective for financial statement audits starting from December onwards, mandating an overall evaluation of obtained audit evidence and a consideration of contradictory evidence to management's assumptions and

estimates. Emphasis is further on audits of banks, building societies, and other credit institutions in line with the revised financial instruments standards.

Enhancing Accountability and Audit Quality (accountability)

To avoid group think and foster innovation, the PMO function involved its partners in delivering specific workstreams, through scheduled meetings and standardized reports for driving accountability and consistency. As part of the culture change program's second year, 'high challenge and high support' will be incorporated across the audit practice to inculcate accountability at a local level. Quality control and oversight are highlighted as crucial elements. Key areas that need reinforcement include effective implementation of the audit quality plan (AQP), strengthened by accountability, and effective oversight. Audit quality plans must comprise of forward-looking metrics that directly or indirectly impact audit quality. The entity types covered include UK public interest entity audits, large private companies, UK incorporated AIM listed entities, etc. For the / inspection cycle, the number of audits reviewed saw an uptick. Additionally, operational improvements have been proposed with a larger emphasis on monitoring, remediation of deficiencies, and proactive responses to evolving circumstances. In essence, enhancing requirements around firm leadership's responsibilities will drive an improved firm-wide mindset with respect to audit quality.

The Importance and Impact of Interviews in Compliance, Supervision and Evaluation (interviews)

There is an intensive focus on utilizing interviews as a robust tool for internal monitoring, supervisory tasks, and regulatory compliance. This is shown through mandatory annual face-to-face interviews and inspections with agents and their customer files. Interviews also play a critical role in obtaining direct information from issuers and holistically capturing the prospective costs of strategies such as ESG integration. Further, the assessment process for individual members of the management body involves a comprehensive analysis of various credentials and reviews, along with interviews and questionnaires that cover areas like reputation, integrity, and potential conflicts of interest. The methodology used for root cause analysis (RCA) also relies heavily on interviews to determine causal factors and yield a more focused approach. Disclosure of inside information and public expectations are also thoroughly considered to prevent misleading the public, especially around financial objectives and market communications such as interviews and roadshows. The concept of continuous ongoing supervision is also emphasized, which includes the use of interviews in the evaluation of CCP's arrangements, strategies, processes, and mechanisms. The importance of conducting effective interviews in search of evidence is highly spotlighted, along with broader coverage and recognition. Training is also recognized as important, with a call to enhance interview depth and the RCA process, highlighting the need for further professional development in these areas. Additionally, the direct role of media in conducting interviews and distributing information is acknowledged, emphasizing the wider reach and influence interviews can have.

Effective Use and Improvement in Audit Data Analytics: Revenue and Long-Term Contracts Assurance (data analytics)

- Comprehensive audit data analytics were successfully implemented during two audits, demonstrating a detailed comprehension of the entity's systems, procedures, and revenue, which provided effective assurance over revenue. - These analytics were complemented by

other audit procedures, while the consultation and use of audit data analytics have seen significant enhancements courtesy of the audit investment plan. - Audit data analytic techniques were used on revenue and journals, enabling targeted responses to identified risks. - Some areas were identified for improvement including: revenue process evaluations including IT systems, assessment of scope and extent of controls testing, evidence of analysis of customer contracts, challenge of judgements and accounting treatments for long-term contracts, reconciliation of cash receipts to revenue, and obtaining sufficient evidence to support the development of revenue expectation. - Notably, there was effective usage of data analytics to test unbilled revenue, understand its relation to the recognition of cash and debtors, and challenge assumptions used for long-term contracts. - Encouragingly, there was an increasing trend in deploying data tools and analytics successfully by audit teams. However, limited sample sizes hinder teams from exploring more effective ways of obtaining audit evidence, such as controls testing or via data analytics.

Reinforcing Ethical Standards and Practices in Finance and Government Sectors (ethics)

The text discusses the importance of maintaining ethical standards within the government and finance sectors. This includes payments to charity made on behalf of government employees which will not be treated as received by them for tax purposes, and no deduction will be allowed for such payments. In the finance sector, there is an emphasis on training and continuous education on ethical practices. Furthermore, various controversies related to ethics, tax fraud, and anti-competition are highlighted, indicating the need for strengthening ethics controls. Various firms have appointed ethics officers and enhanced training for employees to increase awareness of ethical standards concerning audits and financial transactions. Lastly, the document references the need for independent valuer to identify potential interests that may constitute a material interest as per ethical and professional standards.

Audit Quality Inspection, Resilience, and Risk Management (business model)

The focal point is audit methodology and the establishment of a credit center of excellence for supporting teams in banking audits. Senior team members are knowledgeable about the company, industry, and business model, also having past experience in challenging management decisions. It's essential that all business model aspects line up with the desired culture, regularly tracked progress, with special emphasis on first-year audits and understanding the business models of audited groups. There is recognition of firms' business models' resilience through the pandemic, looking at their capability to deal with accounting and auditing challenges in their service delivery. A regular review indicates satisfactory risk management structures in place, with all firms acknowledging crucial risks in audit quality, talent management, operational resilience of IT/systems, and strategic business model. Adjustments in tier firms' business models due to strategic decisions are being monitored, particularly those influenced by external environmental changes.

Enhancing Audit Quality through International Collaboration and Revised Standards (international audit)

Concerns regarding auditor skepticism and independence are frequently mentioned in international audit inspections and official reports, prompting the need for continual improvements in audit quality. Key developments involve collaborations with the International Auditing and Assurance Standards Board (IAASB) and Sir Donald Brydon's report on audit

quality. The Financial Reporting Council (FRC) is an active participant in the development of international standards and stand-alone guidance; with a member of its staff serving on the IAASB board. Implications from this cooperation could significantly alter how audits are defined and reported. A recent revision to the ISA (UK) aims to clarify auditors' responsibilities related to potential fraud. New quality management standards focus on proactive identification and responses to risks to audit quality. The FRC's active participation in the IAASB aids in the enhancement and development of global auditing standards.

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