



Governance *in brief* FRC issues Practice Aid to help audit committees assess audit quality

Headlines

- Audit committees should ensure that there is adequate focus on audit quality at the planning stage of the audit.
- Auditors make a number of professional judgements during the course of an audit and the audit committee must make sure they understand and can challenge the basis of these judgements.

Background

In 2012, changes to the UK Corporate Governance Code asked audit committees to explain in the Audit Committee Report in the Annual Report how they have assessed the effectiveness of the external audit process. At the time no guidance was issued to assist with this task. Many audit committee members have said to the FRC that it is relatively straightforward to assess service levels in the external audit process, but less easy to assess audit quality.

To help audit committees with their assessment, the FRC organised five roundtables where an approach to assessing the effectiveness of the external audit was field tested, with a focus on audit quality and the financial statement process. The FRC's Practice Aid is intended to provide audit committees with some guidance on audit quality and best practice to provide them with a collective ability to challenge the auditor to demonstrate that they have performed a high quality audit, and evaluate the auditor's responses through three lenses which are explained below.

Considering the foundations of the auditor's judgements

Making reliable and objective judgements, at all stages of the audit, underpins the auditor's opinion and is critical to delivering high audit quality and gaining the trust of shareholders. Critical to these judgements are the auditor's mindset and culture, skills, character and knowledge, and their quality controls.



	Descriptions	Matters to consider
Mindset and culture	Auditors must concern themselves with the interests of the company's investors and other stakeholders eschewing all personal and commercial interests that would conflict with their responsibilities. Accordingly, auditors are expected to adhere to high professional and ethical principles such as integrity and objectivity.	<ul style="list-style-type: none"> • Is there an appropriate degree of challenge & professional scepticism? • Is the manner in which decisions are made reflective of the values underlying the ethical standards? • Is there clear articulation of the rationale for particular conclusions?
Skills, character and knowledge	The competence to perform a high quality audit is founded on: strong auditing skills (investigative, analytical and judgmental) developed through effective training and relevant experience; effective communication skills; and the strength of character to approach the audit with a high degree of professional scepticism. Necessary personal attributes include: rigour, perseverance and robustness; a sound knowledge of business, its industry and the environment in which it operates; and understanding of the legal and regulatory frameworks (including professional standards) that are relevant to the audit and the financial statements.	<ul style="list-style-type: none"> • Is there active engagement on misstatements? • Is there evidence that the auditor is developing its knowledge of the business and the challenges and opportunities it is facing? • Is the auditor providing concise, easy to understand explanations of the issues?
Quality control	Effective quality control of an audit engagement involves identifying the risks to audit quality and establishing adequate controls at the engagement level to address these, taking account of controls at the audit firm level. In a group audit this includes establishing controls over risks to audit quality relating to component auditors' work.	<ul style="list-style-type: none"> • Is there communication of the assessed risks to the quality of the audit? • Is assurance provided over the work with teams in other countries? • Is there adequate discussion of the remedies for any deficiencies identified in internal or external audit quality inspections?

The key professional judgements the auditor makes during the audit

The Practice Aid describes two distinct stages of the core audit. There is the planning stage, to design audit procedures to look for potential material misstatements in the financial statements based on a preliminary risk assessment; and the performance and evaluation stage.

In the planning stage, the auditor:

- develops an understanding of the company, its business and the environment in which it operates, including the company's financial reporting process and the applicable financial reporting framework;
- makes judgements about materiality (i.e. what would influence the economic decisions of users based on the financial statements);
- identifies risks of material misstatement in the financial statements whether inherent or control related, and assesses their likelihood and impact; and
- designs procedures that are both appropriate by their nature for the assertions to be tested, and sufficient in extent, to enable the auditor to conclude, with a high level of assurance, whether the financial statements contain material misstatements. These procedures are focused most intensely on addressing the risks judged most significant.

In the performance and evaluation stage, the auditor makes judgements when:

- performing the audit procedures;
- scrutinising any issues that arise to determine whether there are in fact any material misstatements; and
- determining the implications for the financial statements and the auditor's report.

The performance and evaluation stage also involves evaluating management's judgements and determining whether sufficient, appropriate evidence has been obtained or whether more work needs to be done.

During the course of their audit, the auditor will need to demonstrate to the audit committee that they have:

- **made appropriate judgements about materiality** – failure to make an appropriate judgement, or to update materiality during the audit, reduces audit quality by driving an inappropriate work effort, even if the auditor's risk assessment is valid;

- **identified and focused on the areas of greatest risk** – inadequate skills or knowledge could reduce audit quality because of a failure to identify and evaluate relevant risks, and direct audit testing appropriately;
- **designed and carried out effective audit procedures** – the auditor has to make judgements about the nature and extent of audit work that needs to be performed, so that it is responsive to the risks identified, and takes account of the materiality levels set;
- **understood and interpreted the evidence they obtain** – the auditor makes judgements about whether the evidence they have found is sufficient and appropriate for them to conclude that the financial statements as a whole are not materially misstated; and
- **reported with clarity and candour** – the auditor has communicated key accounting and audit judgements, and conclusions, to the audit committee in a way that is understandable and demonstrates that they have exercised an appropriate degree of challenge to management.

Sources of evidence

“Roundtable participants suggested that the audit committee bases its assessment on inputs obtained in the course of undertaking its normal activities for oversight of the financial reporting process. The primary source of such evidence is likely to be its observations of, and interactions with, the auditors.”

FRC’s Audit Quality: Practice aid for audit committees (May 2015)

The FRC Practice Aid sets out key matters for audit committees to consider when assessing the auditor in the areas noted above – we recommend that audit committee members refer to the guidance (see below for further details) for the full list of those matters. Four key sources of evidence or inputs are suggested to help inform the audit committee’s assessment:

External	External parties, such as regulators, prudential supervisors and shareholders may offer (or be asked for) views on audit quality.
Management	Interactions with management and other employees of the company, such as internal audit may give insights into their views of the auditor and audit quality.
Auditor	The primary source of evidence is likely to be the audit committee’s own observations of, and interaction with, the auditor. Under the new extended auditor reporting regime, audit committees have a further opportunity to assess audit quality by reviewing the auditor’s external report. The audit committee can assess the auditor’s ability to explain in clear terms what work they performed in key areas, and also assess whether the description used is consistent with what the detailed audit plan shared with the committee.
Audit committee	The committee’s own interactions with management and each other in overseeing the financial reporting process may provide useful insights into the quality of financial reporting, and questions as to how the auditor has addressed any issues arising.

Carrying out the evaluation

“Roundtable participants generally suggested that the assessment should not be a separate compliance exercise, or an annual one-off exercise, but rather should form an integral part of the audit committee’s activities.”

FRC’s Audit Quality: Practice Aid for audit committees (May 2015)

A key message identified at the roundtables was that audit committees often focused more on the outputs of the external audit – the final audit committee paper and the final audit opinion. Participants thought audit committees could focus more on obtaining evidence of quality throughout the audit, and particularly at the planning stage. It is suggested that audit committees could:

- hold an initial audit committee discussion without the auditors to brainstorm factors that could affect audit quality for the current year based on past experience and anticipated changes in the business and business environment;
- ask the auditor to explain the risks to audit quality that they have identified and how they intend to address those risks in their audit strategy and plan;

- probe and challenge the auditor’s strategy and plan in light of the above;
- follow-up at the findings stage of the audit to ask the auditor to explain if they have met the agreed audit plan (obtaining reasons for any changes) and how they addressed the risks to audit quality; and
- hold an audit committee discussion to reflect on their views on audit quality.

For further information

Financial Reporting Council

Audit quality: Practice aid for audit committees (May 2015) – [https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-\(1\).pdf](https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf)

Deloitte View

- We endorse the encouragement to audit committees to become more engaged with planning, which is when the scope and activities of the external audit are agreed. This encouragement echoes the CMA Order and the EC audit reforms.
- There is much practical advice in the Practice Aid and we hope that it will stimulate enhanced discussions on audit quality during the external audit process both amongst audit committee members themselves and with the external auditors.

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