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# Audit Quality Thematic Review

## Engagement Quality Control Reviews

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# Financial Reporting Council

## Audit Quality Thematic Review

### Engagement Quality Control Reviews

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Introduced in 2013, thematic reviews supplement our annual programme of audit inspections of individual firms. In a thematic review we look at firms' policies and procedures in respect of a specific aspect of audit, and its 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 the engagement quality control review process. Consequently, as not all aspects of the International Standards (UK and Ireland) are discussed, readers should refer to these for all the requirements and to establish their own process for engagement quality control reviews.

The FRC believes this document will be a valuable tool for audit firms of all sizes in developing, enhancing, and evolving their policies for engagement quality control reviews 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 standard-setters.

# 1 Background, key messages and scope

## 1.1 Background

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

It is essential that within audit firms there is a culture of commitment to delivering consistent and rigorous audit quality. Over the last few years audit firms' quality control processes have been under increased focus and an effective engagement quality control review contributes to maintaining and enhancing firms' audit quality.

This thematic review considers the work performed by the engagement quality control reviewer ("EQCR") in the audit of financial statements. The EQCR is a suitably qualified person, with sufficient and appropriate experience and authority to independently and objectively evaluate the significant judgments the audit team made and the conclusions reached in formulating the auditor's report. When our inspections or the firm's own monitoring identifies a failure by the audit team to address certain matters satisfactorily this often raises the question of the effectiveness of the EQCR's role in preventing audit quality deficiencies. This report is intended to promote a better understanding of the role of the EQCR and how this can support and enhance confidence in audit.

For the purposes of this review we visited the nine audit firms currently within the scope of AQR inspection<sup>1</sup> to review their audit methodology, guidance and training provided to partners and staff in respect of the engagement quality control review ("EQC review") process. We also met with a selection of EQCRs to understand how they perform this role and the challenges they face.

Our annual monitoring of audits completed in 2015<sup>2</sup> included a focus on the work performed by the EQCR in evaluating the significant judgments made by the audit team and the audit team's response to matters raised by them.

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 firms have established EQC review procedures for financial statement audits. The firms have different practices, however, in a number of areas. Whilst we were pleased to see on a small number of audits that the EQC review had directly contributed to improving the quality of the audit we were disappointed that in a tenth of audits our reviews identified weaknesses in the audit work performed which the EQC review process had not identified.

We consider it good practice for firms' audit quality monitoring to evaluate the effectiveness of the EQC review and for firms to require EQCRs to obtain formal feedback on their performance. These practices enable firms to evaluate EQCRs' contribution to audit quality, so that any lessons are learnt and they can contribute more to improving the quality of the firm's audit work. All firms are recommended to consider how they evaluate the effectiveness of the EQC review and implement additional procedures, where appropriate, to reduce the occurrence of audit weaknesses that are not identified by the EQC review process.

We identified areas where firms should consider making improvements to their procedures and the application of these procedures in practice. We have discussed our findings with each of the audit firms concerned and the following observations are applicable to all firms. We will expect to see improvements in the areas identified by this report in future inspections of individual firms.

<sup>1</sup> 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)

<sup>2</sup> 67 audits of financial statements for year ends between March 2014 and April 2015 for entities in the retail, construction, support services, industrial products, banking and insurance industries: FTSE 100 (9 audits); FTSE 250 (25 audits); other full listed (8 audits); AIM (9 audits); and other non-listed public interest entities (16 audits)

- Audit firms should consider whether:
  - their EQCR eligibility criteria include adequate levels of technical expertise, experience and authority for audits of listed entities and/or in specialist sectors, consistent with that required by the individual signing the audit report;
  - their processes can be improved for the EQCR to evaluate whether they have maintained their objectivity throughout the audit so that any potential threats are identified, considered and safeguarded. It should be clear to the Audit Committee that the EQCR is not a member of the audit team but part of the firm's quality control processes;
  - actions are needed to ensure that on all audits the EQCR's involvement is timely and effective in maintaining audit quality and that matters identified by the EQCR are appropriately addressed; and
  - the evidence of the EQCR's review and challenge requires improvement to meet the increased requirements of the EU Audit Regulation and Directive.

The principal findings arising from the review are set out in section 2.

## 2 Principal findings

The EQC review is an important part of audit firms' quality controls and contributes to maintaining the quality of the audit work performed. There are two primary standards published by the FRC (ISQC1<sup>3</sup> and ISA220<sup>4</sup>) that require an EQCR to be appointed for all audits of financial statements of listed entities and that firms establish criteria for which other audits should also be covered by the EQCR process. All firms have identified audits of other public interest entities, in addition to listed entities<sup>5</sup>, that are required to have an EQCR. For these audits the audit partner<sup>6</sup> is required to ensure that an EQCR has been appointed; discuss significant matters arising during the audit, including those identified by the EQCR, with the EQCR; and not date the auditor's report until the completion of the EQC review. We are pleased that, where required, EQCRs were appointed for all audits we reviewed.

In meeting their responsibilities auditors should pay particular attention to our principal findings in the following areas:

- EQCR eligibility
- EQCR objectivity
- Evidence of the EQC review
- Effective EQC reviews
- Assessing the effectiveness of the EQCR

### 2.1 EQCR eligibility

- Audit firms should consider whether their EQCR eligibility criteria include requirements for adequate levels of technical expertise, experience and authority for audits of listed entities and/or in specialist sectors, consistent with that required to be able to sign the audit report.

The firm is required to establish policies and procedures to address the appointment of engagement quality control reviewers and establish their eligibility through the technical qualifications required to perform the role, including the necessary experience and authority (ISQC1.39).

All firms appoint and allocate EQCRs to audits centrally, matching the EQCR's experience to the audited entity and considering the EQCR's availability to perform the role.

Most firms appoint individuals as EQCR to an audit when they have a level of experience and authority commensurate with that of the audit partner. If an individual is not considered to have the experience and authority to sign the entity's audit report then they should not be considered to have the experience and authority to act as the EQCR. Most firms, therefore, only allow audit partners to act as EQCR for audits of listed entities. However:

- One firm permits directors to act as EQCR on listed entity audits but not as the audit partner. Another firm appoints some senior staff members as EQCR who have never acted in an audit partner role. As the EQCR is required to evaluate the significant judgments made by the audit team, they should have sufficient experience of making such judgments themselves and the authority to challenge the audit partner's judgments.
- At one firm, for audits in specialist sectors such as banks, some EQCRs did not have sufficient specialist experience, limiting their ability to evaluate key judgments specific to that industry.

3 International Standard on Quality Control 1 (UK and Ireland) ("ISQC1"), *Quality control for firms that perform audits and reviews of financial statement, and other assurance and related services engagements*

4 International Standard on Auditing 220 (UK and Ireland) ("ISA220"), *Quality control for an audit of financial statements*

5 An entity whose shares, stock or debt are quoted or listed on a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body.

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

## 2.2 EQCR objectivity

- Audit firms' policies and procedures should include clear guidance detailing circumstances that might threaten the objectivity of the EQCR, how this might be safeguarded and requiring EQCRs to evaluate whether their objectivity has been maintained throughout each audit.

The firm shall establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer and provide for the replacement of the engagement quality control reviewer where the reviewer's ability to perform an objective review may be impaired (ISQC1.40 and 41).

It is important that EQCRs perform their reviews with an objective mindset. Firms provide limited guidance or training as to the matters the EQCR should consider in evaluating their objectivity. One firm requires the EQCR to re-confirm their objectivity at the completion stage of the audit. We believe this helps to ensure that any situations that have arisen as the audit has progressed have been appropriately dealt with. During our reviews we identified some circumstances that have potential to threaten the EQCR's objectivity. For example:

- **EQCR taking on the audit partner role** - On one audit the EQCR was to become the audit partner following completion of the audit and, as part of the handover process, attended Audit Committee meetings as an observer. Attendance at these meetings creates a risk that the EQCR's objectivity was impaired and a new EQCR should have been appointed immediately.
- **EQCR's identity** - In seven audits we noted that the name of the EQCR was provided in audit tender and audit committee planning documents. In some cases they were listed together with members of the audit team and, in one case, the EQCR's telephone number was provided. We

appreciate that Audit Committees are likely to be interested in the qualifications and experience of the individual assigned to perform the EQCR role. However, if the Audit Committee were to contact the EQCR directly this could threaten the EQCR's objectivity. Audit firms' policies generally did not provide any specific guidance as to how information about the individual taking on the EQCR role on behalf of the firm should be provided to the Audit Committee. It is important to recognise that the EQCR is part of the firm's quality control procedures and is not a member of the audit team.

Further, EQCRs should ensure that they do not become involved in forming the audit team's judgments or take on other responsibilities that may affect their objectivity.

## 2.3 Evidence of the EQC review

- Audit firms should consider whether their methodology provides for adequate evidence that the procedures required by the firm's policies for the EQC review have been performed.

The firm shall establish policies and procedures on documentation of the engagement quality control review which require documentation that:

- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
- (b) The engagement quality control review has been completed on or before the date of the report; and
- (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate (ISQC1.42 and ISA220.25).

The firm shall establish policies and procedures to require the engagement quality control review to include:

- (a) Discussion of significant matters with the engagement partner;
- (b) Review of the financial statements or other subject matter information and the proposed report;
- (c) Review of selected engagement documentation relating to significant judgements the engagement team made and the conclusions it reached; and
- (d) Evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate (ISQC1.37).

The EQC review is an important part of the firm's quality control process, contributing to ensuring the consistent application of the firm's procedures. It is important that there is adequate evidence of the key matters considered by the EQCR and how they have concluded on the significant judgments reached during the audit. If there is a lack of evidence of the EQCR's challenge of key judgments made by the audit team, it is difficult for the EQCR to demonstrate that their review was sufficiently robust to be effective in maintaining audit quality.

At most firms, the evidence to assess the scope, extent and effectiveness of the EQC review may be seen in a variety of sources:

- Checklists confirming completion of procedures required by standards.
- Copies of draft financial statements and reports to the Audit Committee that have been annotated by the EQCR during their review.
- Sign-offs on key audit working papers that indicate that the EQCR has read them.

- EQCR review notes showing the areas in which the EQCR challenged the audit team.
- Audit file notes of the significant matters the EQCR discussed with the audit team and how they were resolved.
- Time recorded by the EQCR on the audit.

There were 12 audits where there was insufficient evidence that the EQCR had performed an adequate and timely review. In the other audits reviewed there was evidence that the EQCR had reviewed work papers relating to significant judgments. In three audits, there was clear evidence of the EQCR's challenge leading to further audit work being performed, directly improving audit quality.

One firm does not retain either the questions raised by the EQCR during their review or the EQCR's comments on the financial statements or communications with the Audit Committee. As a result, other than sign-offs on checklists and on individual working papers, there was no evidence of the extent of the EQCR's review and challenge of the audit work performed. We understand that the firm is implementing new procedures to improve this.

From 17 June 2016 the EU Audit Regulation and Directive ("ARD") will come into force in the UK. EU Regulation 537/2014 sets out specific requirements for the EQCR.

The reviewer shall record at least the following: The oral and written information provided by the key audit partner(s) to support the significant judgements as well as the main findings of the audit procedures carried out and the conclusions drawn from those findings, whether or not at the request of the engagement quality control reviewer (Article 8.4(a))

The statutory auditor or the audit firm and the reviewer shall keep a record of the results of the review, together with the consideration underlying those results (Article 8.7).

The FRC has issued a consultation paper<sup>7</sup> on the changes that are required to UK standards, including ISQC1 and ISA220, to reflect the requirements of the EU ARD. In considering the findings of this report and what action they should take, audit firms should consider how the evidence of the EQCR's review and challenge can be improved to comply with the proposed changes.

## 2.4 Effective EQC reviews

- Audit teams and EQCRs should ensure that the EQCR's review is performed in a timely manner at appropriate stages during the audit and be diligent in addressing matters raised by the EQCR.
- EQCRs should ensure that their review is effective to safeguard auditor independence and the quality of the audit work performed.

The firm shall establish policies and procedures setting out the nature, timing and extent of an engagement quality control review (ISQC1.36).

- Conducting the review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the EQCR's satisfaction on or before the date of the auditor's report (ISQC1.A43).
- The extent of the EQCR may depend, among other things, on the complexity of the engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances (ISQC1.A44).

We were pleased that our discussions with a selection of EQCRs indicated that no budgetary restrictions are placed on the amount of time they can spend performing their role. It is important that EQCRs have sufficient time to perform their review and to ask any questions necessary to evaluate the significant judgments reached by the audit team.

If the EQCR is involved too late in the audit process there may be insufficient time for the audit team to address the matters raised satisfactorily. On most audits there was evidence that EQCRs were involved at appropriate stages during the audits with adequate time for matters to be satisfactorily resolved. However, on some audits the EQCR's involvement in the planning, fieldwork and/or completion stages was too late to provide meaningful input. In some cases, the audit team provided other evidence that the EQCR had been involved earlier than the audit working papers showed. In two of these audits we identified weaknesses in the audit work performed to which the lack of timely involvement of the EQCR may have contributed.

On four audits the EQCR's questions had not been satisfactorily resolved by the audit team. Audit teams should be more diligent in addressing the questions raised by the EQCR and the EQCR should only give their approval when all matters have been satisfactorily addressed.

We identified issues on eleven audits which potentially should have been identified and raised by the EQCR. Examples include:

- **Sufficiency of audit evidence:** On five audits insufficient audit evidence was obtained in certain areas of significant risk. There was a lack of evidence of the nature and extent of the EQCR's review of these areas;
- **Group audit considerations:** On two audits the group audit team were not sufficiently involved in the work of the component auditors. There was no evidence that this was challenged by the EQCR;
- **Independence and ethics:** On four audits we considered that the audit team's safeguards to reduce independence threats were not sufficient. The EQCR had not identified this and required the audit team to reconsider the safeguards applied; and

<sup>7</sup> 'Enhancing Confidence in Audit: Proposed revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees' (September 2015)

- **Communicating with audit committees:** In two audits, significant changes to the planned audit approach for an area of significant risk were not communicated to the Audit Committee. There was no evidence of review by the EQCR of the communications with the Audit Committee.

## 2.5 Assessing the effectiveness of the EQCR

- In six cases we assessed the audit as requiring more than limited improvements. This indicates that the EQC review, for these audits, may not have been effective in safeguarding the quality of the audit or auditor independence.

Audit firms are required to establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence and capabilities to perform engagements and that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements (ISQC1.29 and 32).

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

Acting as an EQCR is an important part of the firm's quality control processes and feedback should be obtained to either identify where improvements are required or recognise where good work is performed.

Five firms have a formal process for EQCRs to obtain feedback from audit teams or from the firm's audit monitoring to evaluate their contribution to the quality of the audit. We did note some examples where poor outcomes from both the firm's own monitoring and external monitoring led to an individual's approval to act as an EQCR being restricted or removed.

However, not all firms' monitoring considers the effectiveness of the EQC review or whether any significant weaknesses subsequently identified in the audit work should or could have been identified by the EQCR.

All audit firms should consider whether they have appropriate arrangements to assess EQCRs' contribution to audit quality, to ensure that lessons are learnt and that EQCRs can contribute more to improving audit quality. Assessment of EQCRs' performance should be incorporated in firms' annual performance reviews.

## 2.6 Next steps

This report identifies a number of areas where the effectiveness of the EQC review, and the evidence of the EQCR's challenge of key judgments made by the audit team, needs to be improved. We expect all firms to consider what action they need to take in response to our findings.

We will expect to see improvements in the areas concerned in our future inspections of individual firms.



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