



# Major Local Audits

## Audit Quality Inspection



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# Introduction: FRC's objective of enhancing audit quality

The Financial Reporting Council (FRC) is the independent body responsible for monitoring the quality of major local audits.<sup>1</sup> This monitoring is performed by the FRC's Audit Quality Review (AQR) team. Our inspection of major local audits aims to hold firms to account for making the changes needed to safeguard and improve audit quality.

Auditors play a vital role in upholding trust and maintaining public confidence in local public bodies (principally local authorities and health bodies other than Foundation Trusts<sup>2</sup>) by auditing financial statements, satisfying themselves that proper arrangements are in place to secure Value for Money (VfM) and, where necessary, exercising additional powers and duties.<sup>3</sup>

The FRC's objective is to achieve consistently high audit quality so that the public can have confidence in the work of local auditors. To support this objective, we have powers to:

- Inspect the quality of major local audits.
- Set eligibility criteria for local auditors and oversee delegated regulatory tasks carried out by professional bodies, such as qualification, training, registration and monitoring of non-major local audits.
- Consider the implications of poor audit quality and bring enforcement action against auditors, if appropriate, in cases of a breach of the relevant requirements.

The timeliness of local auditor reporting is poor. Timeliness really matters, as it promotes transparency and accountability. As local public bodies face financial pressure and some engage in increasingly commercial activity, it is essential that high-quality financial reporting and the audit process identify and respond to risks on a timely basis. Audited bodies, local auditors and those with regulatory responsibilities must continue to work together to restore timely completion of audits so that public confidence is not further diminished.

In May 2022, the Department for Levelling Up, Housing & Communities (DLUHC) published the Government's response to 'Local Audit Framework: technical consultation'. This set out the next steps to implement the recommendations of the Redmond Review, including improving the oversight of local audit and the transparency of local authority financial reporting.

Legislation is required to ensure that the new regulator – the Audit, Reporting and Governance Authority (ARGA) – has the powers it needs to become the systems leader for local audit and hold to account those responsible for delivering the required improvements. In July 2022, The FRC published its position paper setting out the next steps in our transition to ARGA.<sup>4</sup> This included the recruitment of the Director of Local Audit, who started in September 2022, to make preparations to take on the role of systems leader in shadow form.

This report sets out the principal findings arising from the 2021/22 cycle of inspections at all six audit firms completing major local audits in England (the firms), and how the firms should respond to our findings.

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1 The Local Audit (Professional Qualification and Major Local Audit) Regulations 2014 defines a major local audit as one which meets the following criteria:

- Total income or expenditure of at least £500 million, or
- For a local authority pension scheme, at least 20,000 members or gross assets in excess of £1,000 million.

2 The FRC is not responsible for audit quality monitoring at NHS Foundation Trusts. This is the responsibility of NHS England.

3 Further information on auditor's additional powers and duties is available in Auditor Guidance Note 4 issued by the National Audit Office (NAO) can be found [here](#).

4 The FRC position paper can be found [here](#).

## The FRC



The purpose of the FRC is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.



We have responsibility for the public oversight of statutory auditors.



The FRC engages with key local audit stakeholders, such as DLUHC, NAO, ICAEW, CIPFA and PSAA, in order to contribute to sector-wide initiatives and governance.



## AQR



We monitor the audit quality of major local audits (which include the larger health and local government bodies).



We promote continuous improvement in audit quality.



Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms completing major local audits.

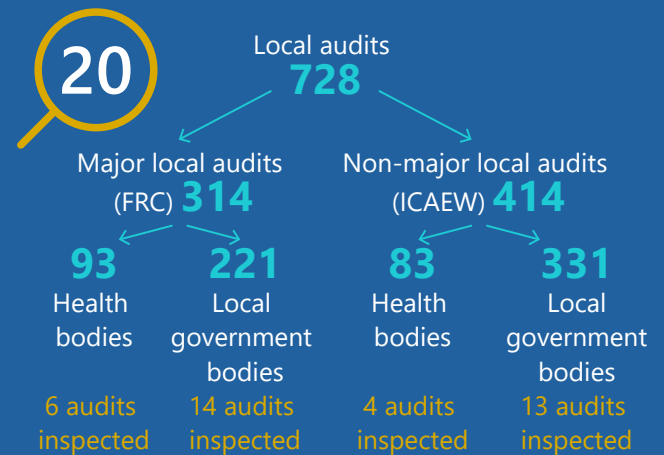


## The firms



Audit firms undertaking local audits	Number of major local audits (within scope of AQR inspection)	Market share %	Reviewed by AQR in 2021/22
Grant Thornton UK LLP	125	39.8%	7
Ernst & Young LLP	72	22.9%	4
Mazars LLP	55	17.5%	3
KPMG LLP	24	7.7%	2
BDO LLP	21	6.7%	2
Deloitte LLP	17	5.4%	2
<b>Total</b>	<b>314</b>		<b>20</b>

## Our inspection process



We inspected the auditors' work on VfM arrangements at 14 bodies.



We work closely with audit committee chairs to improve the overall effectiveness of our reviews.



We assess the overall quality of the audit work inspected.



# Contents

1. Overview	5
2. Review of individual audits and the firms' quality control procedures	12
3. Review of individual firms	24
Appendix 1: Key local audit information	43
Appendix 2: Firms' internal quality monitoring	45

As part of our 2021/22 inspection work, we inspected a sample of individual audits and assessed elements of the firms' quality control systems. This report sets out the FRC's findings on key matters relevant to audit quality at the firms.

Our risk-based selection of audits for inspection provided coverage of each of the audit firms in the market and selected audits with higher-risk attributes. We focused, for example, on audits we had not been able to previously inspect (due to the timeliness of auditor reporting); with qualified audit opinions; where the auditor's additional powers or duties were exercised; of entities experiencing financial difficulties or with material account balances related to commercialisation.

The scope of each individual inspection was also risk based and informed by a range of factors, including previous inspection findings, discussions with audit committee chairs and matters considered significant in the sector. Examples of matters considered significant in the sector included expenditure on services; the disclosure of senior officer remuneration; the appropriateness of capital expenditure; investment property valuation; and, in local government, adjustments between accounting basis and funding basis, such as minimum revenue provision.

Entity management and those charged with governance can make an important contribution to a robust audit. A well-governed entity, with effective internal controls and reporting that is accurate, transparent and timely helps underpin a high-quality audit. While there is some shared responsibility for the quality of audits, we expect firms to achieve high-quality audits, regardless of any identified risk in relation to management, those charged with governance or the entity's financial reporting systems and controls.

Higher-risk audits are inherently more challenging, requiring audit teams to assess and conclude on complex and judgemental matters. Professional scepticism and sector expertise are especially important in such audits. Our focus on higher-risk audits means that our findings may not be representative of audit quality across a firm's entire audit portfolio or on a year-by-year basis.

This report also considers other, wider measures of audit quality. The Quality Assurance Department (QAD) of the Institute of Chartered Accountants in England and Wales (ICAEW) inspects a sample of the firms' local audits that do not meet the definition of a major local audit, the results of which are set out on page 10. The firms also conduct internal quality reviews. A summary of the firms' internal quality review results is included at Appendix 2. These results, together with our inspection findings, provide an overall view of the quality of local audits.

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# 1 Overview

## Inspection results: arising from our review of individual financial statement audits

Our selection of audits to inspect was impacted by the timeliness of local auditor reporting.

Figures compiled by Public Sector Audit Appointments Limited (PSAA) showed that 91% of 31 March 2021 audits of local government bodies were not completed by the target date of 30 September 2021 (42% were completed by 30 June 2022). The backlog of earlier audits is also concerning, with 19% of the 31 March 2020 audits incomplete by 30 September 2021. The incomplete audits include many that we would assess as being higher risk. The firms have informed us of many reasons for this lack of timeliness, including their own resourcing constraints among local audit specialists; the increased complexity of financial statements; delays caused by management; and unresolved accounting issues, such as those related to infrastructure assets.

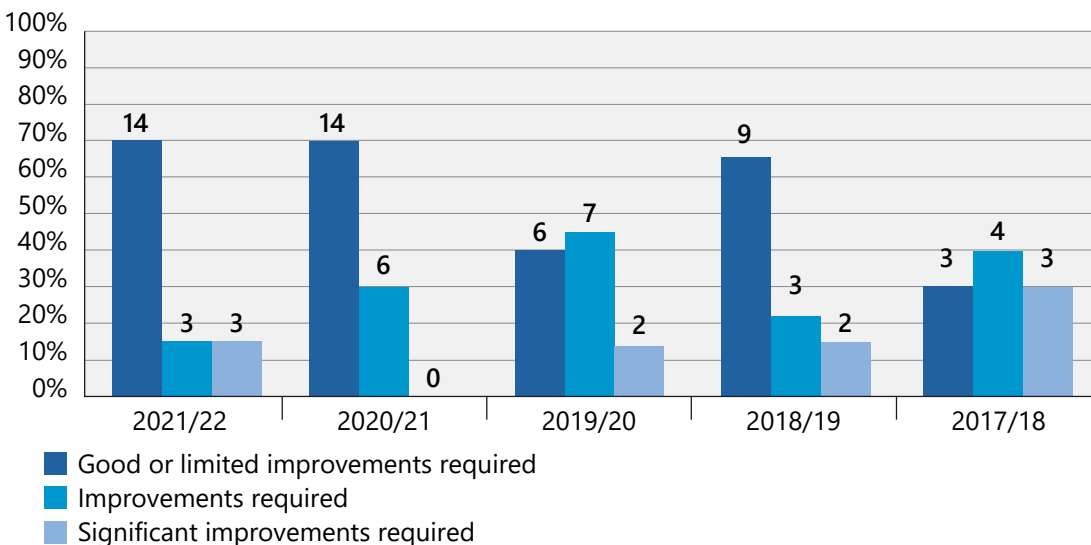
The impact was that seven of the 14 local government audits we initially selected for inspection based on risk had to be replaced because neither the 31 March 2021 nor the 31 March 2020 audits were finalised.

Including replacements, we inspected a total of 20 audits this year across the six firms, six were health bodies and 14 were local government bodies. The local government audits included two pension funds, 11 councils and one other body.

We inspected six 31 March 2020 year-end audits that had not been completed in time for us to previously inspect. All other audits we inspected were for the year ended 31 March 2021.

We replaced half of the local government audits we initially selected for inspection because neither the 31 March 2021 nor the 31 March 2020 audits were finalised.

### All financial statement reviews – for the firms inspected



**The number of audits categorised as good or limited improvements required has remained consistent with the prior year. However, the increased number of audits assessed as requiring significant improvements is unacceptable. Inconsistency is preventing firms from eradicating poor quality audits.**

We assessed 70% of financial statements audits as requiring no more than limited improvements, the same as in the previous year. This is an improvement on the 46% average over the preceding three years.

We continue to identify inconsistency in the quality of audits inspected. The increased number of audit inspections categorised as significant improvements required (15% in 2021/22 and none in 2020/21) and the significance of the underlying findings is unacceptable and concerning. The findings which contributed to this deterioration were inadequate financial statements review procedures, ineffective evaluation of identified misstatements and insufficient justification for issuing a qualified audit opinion. The firms must review their individual quality action plans to ensure this deterioration is addressed and that consistently high-quality audits are delivered.

We were encouraged to identify a range of good practice in risk assessment, execution of the audit, and completion and reporting.

Further details of key findings and good practice are set out in Section 2.

## **Inspection results: arising from our review of auditors' work on Value for Money arrangements**

The auditors' work considers whether or not a body has put in place proper arrangements to secure value for money in its use of resources.

Audit firms had to comply with the new requirements of the National Audit Office (NAO) Code of Practice, applicable for the year ended 31 March 2021. The work of auditors in this area was refocused to:

- Promote more timely reporting of significant issues to local bodies.
- Provide more meaningful and more accessible annual reporting on VfM arrangements issues in key areas.
- Provide a sharper focus on reporting in the key areas of financial sustainability, governance, and improving economy, efficiency and effectiveness.
- Provide clearer recommendations to help local bodies improve their arrangements.

# 70%

The number of audits categorised as good or limited improvements required has remained consistent with the prior year.

# 15%

of audits were assessed as requiring significant improvements. This is unacceptable.

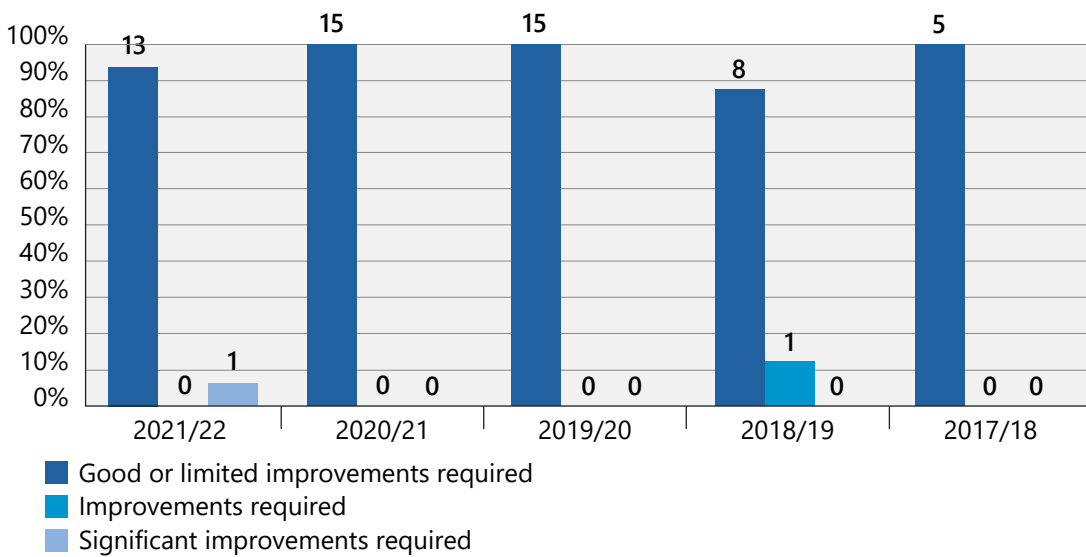
We inspected the auditors' work on VfM arrangements at 14 bodies across the six firms, six were health bodies and eight were local government bodies. The local government bodies included one pension authority, six councils and one other body. Because of the new requirements, all work that we inspected in this area related to the year ended 31 March 2021.

Special provisions were put in place for the reporting of the auditors' work on VfM arrangements due to the Covid-19 pandemic. The target date for completion was up to three months after the date of the completion of the financial statements audit.

Less of the auditors' work in this area was available for us to inspect than financial statement audits. This was primarily due to these special provisions extending the reporting period for the auditors' work combined with the broader issues surrounding the timeliness of local auditor reporting.

The auditors' work on VfM arrangements for 31 March 2021 year ends was reviewed in the 2021/22 inspection cycle.

**Our assessment of the quality of auditors' work on VfM arrangements: for the firms inspected**



**93%** of VfM arrangements inspections required no more than limited improvements.

**Based on our inspections, the quality of auditors' work on VfM arrangements remains high at all but one firm.**

Of the work inspected, 93% was categorised as good or limited improvements required (100% in the previous two years).

One inspection was assessed as requiring significant improvements. The area which gave rise to this categorisation was audit documentation, archiving and engagement with the FRC. The audit procedures and working papers on the VfM audit file were never finalised or reviewed. Changes were then made to the working papers after the firm was notified of our inspection. This is unacceptable and highlighted issues with quality control procedures related to archiving at the firm.

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The firm has established the reasons for this individual instance of unacceptable behaviour and must now determine what changes are required to its quality control procedures to prevent or detect reoccurrence.

Encouragingly, we identified a range of good practice points related to risk assessment, additional procedures and reporting.

Further details are set out in Section 2.

Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for inspection and the scope of individual inspections.

We accept that our planned focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm. The change in our approach to audit selection over time also means that historical comparisons of results need to be treated with care, although we have taken the same approach for the last three years.

For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firms.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

We take robust action for all inspections assessed as requiring improvements or significant improvements. We consider all inspections assessed as requiring improvements or significant improvements against the Regulated Framework for Auditing and under the Auditor Regulatory Sanctions Procedure.

<https://www.frc.org.uk/auditors/audit-quality-review/auditor-regulatory-sanctions-procedure>

Where findings indicate that the Registered Auditor has failed to comply with the Framework, the FRC Enforcement Committee can sanction an audit firm for such breaches under the procedures or may refer the conduct in question for consideration under the FRC Accountancy Scheme or the disciplinary procedures of the relevant Recognised Supervisory Body.



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## **Inspection results: arising from our review of the firms' quality control procedures**

This year, our firm-wide work focused primarily on the following areas:

- Root cause analysis (RCA) process and audit quality initiatives.
- Engagement Quality Control Review (EQCR), consultations and audit documentation.
- Audit methodology (property valuations and going concern).

### **Root cause analysis process and audit quality initiatives**

We focus on RCA and audit quality initiatives given the importance of taking effective action to address our previous inspection findings. AQR reviewed the firms' responses to these findings and considered the efficacy of actions taken through current year inspections.

We continued to observe improvements at individual firms that were linked to the implementation of quality action plans.

### **Engagement quality control review, consultations and audit documentation**

Our key finding related to the need for all firms to:

- Ensure that the appointment of EQCR reviewers is appropriately focused on quality risks, including at non-major local audits.

We identified the following key finding at an individual firm:

- The firm must ensure that appropriate controls operate to prevent and detect the failure to archive audit files.

### **Audit methodology and training (property valuations and going concern)**

One other finding at an individual firm related to:

- Ensuring that the going concern work programmes used by local auditors are suitably tailored to the sector, including the continued provision of service approach.

Further details are set out in Section 2.

## Monitoring review by the Quality Assurance Department of ICAEW

The FRC granted ICAEW a recognition order as a Recognised Supervisory Body (RSB) in November 2015. Under this framework, ICAEW is responsible for the licensing, registering and monitoring of auditors who carry out audits of relevant authorities, as defined in schedule 2 of the LAAA 2014. ICAEW reviews audits outside the FRC's scope. ICAEW does not undertake work on the firm-wide controls or procedures. However, to maintain ICAEW's knowledge of relevant aspects of the firm and its procedures the ICAEW reviewed the results of the firm's audit compliance review (as it applied to local audit), reviewed a sample of CPD records for staff involved in the delivery of local public audit, and liaised with the FRC to obtain information relating to whole-firm procedures relevant to audit work within our scope.

ICAEW's reviews are risk-based, with the aim of reviewing a representative sample of a firm's local audit portfolio over a six-year cycle. ICAEW adopts a cyclical approach to the monitoring of registered local auditors. As a result, not all firms are reviewed every year. In 2021/22 ICAEW undertook reviews of Grant Thornton UK LLP (eight files), Ernst & Young LLP (eight files) and PricewaterhouseCoopers LLP (one file). PricewaterhouseCoopers LLP has no major local audits and so isn't included elsewhere in this report, but the audit reviewed by ICAEW was graded 'good'.

ICAEW reviews are designed to form an overall view of the quality of the audit. Where applicable, both the financial statement opinion audit and work to support the VfM conclusion are reviewed. ICAEW assesses the audits it reviews as either 'good/generally acceptable', 'improvement required' or 'significant improvement required'. Visit [icaew.com/auditguidance](https://www.icaew.com/auditguidance) for further information about ICAEW's audit monitoring process including its approach to assessing audits.

ICAEW has completed its 2021/22 monitoring review and the reports summarising the audit file review findings and any follow up action proposed by the firms were considered by ICAEW's Audit Registration Committee in October 2022.

### Summary

Overall, the audit work continues to be of a generally good standard. Of the 17 reviews, 15 were either good or generally acceptable. One audit required improvement and one audit required significant improvement. These results are consistent with the 2020/21 reviews, with the same grading profile year on year.



# 88%

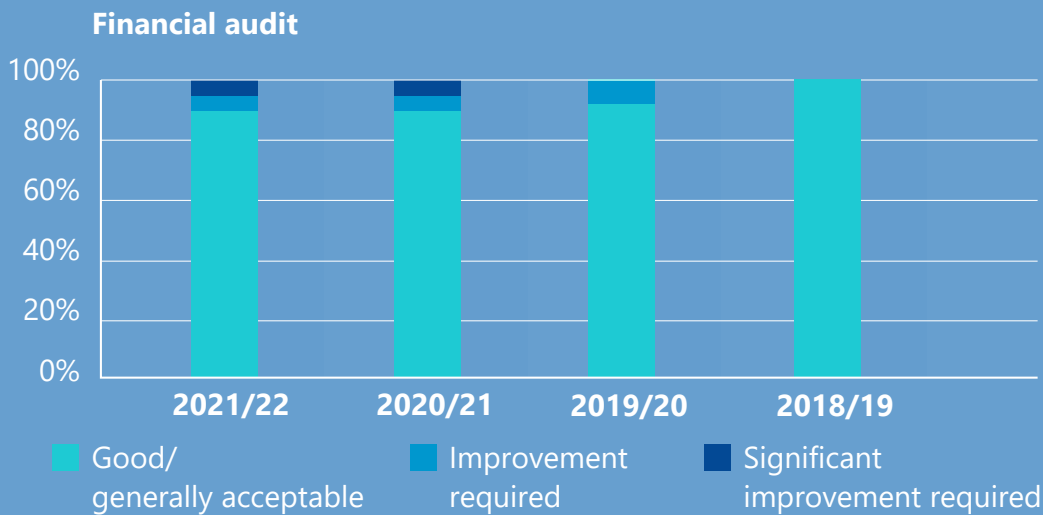
**Of the seventeen ICAEW financial audit reviews, fifteen were either good or generally acceptable.**



Work to support the VfM arrangements conclusions continues to be of a good standard with all reviews being either good or generally acceptable.

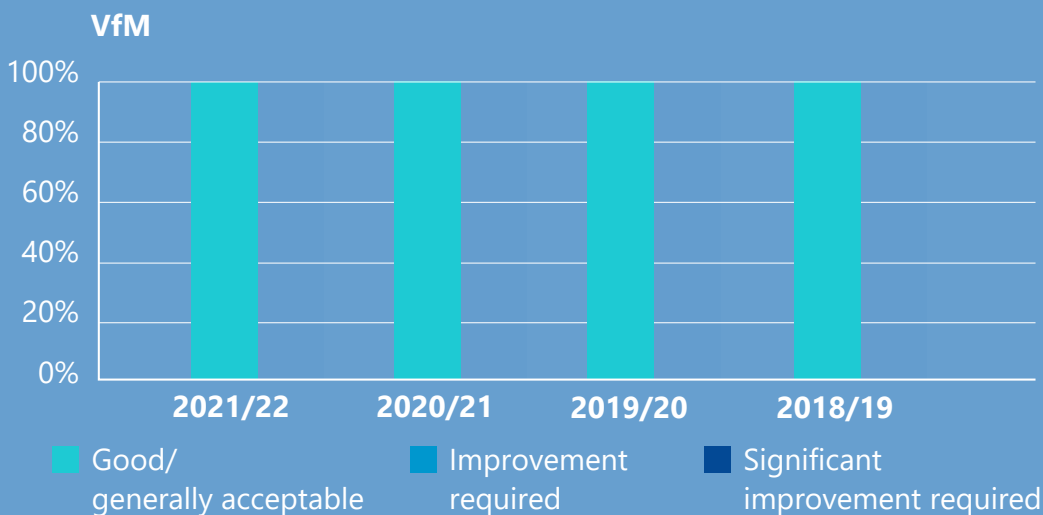
ICAEW continues to identify and share examples of good practice across all the firms subject to review.

## Results



# 100%

All of the eleven VfM arrangements reviews were either good or generally acceptable.



## 2 Reviews of individual audits and the firms' quality control procedures

### Review of individual audits

We set out below the key areas where we consider improvements in audit quality are required. As well as findings on audits assessed as requiring improvements or significant improvements, the key findings can include those on individual audits assessed as requiring limited improvements but considered key due to the frequency of occurrence across the audits we inspected.

It is imperative that all firms consider what improvements they need to make in response to our findings, regardless of whether the findings were identified on their own audits.

### Financial statements audit

#### Urgently improve financial statements review procedures and the evaluation of identified misstatements

Auditors are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement. Auditors must:

- Ensure that the financial statements are consistent with underlying records.
- Evaluate the impact of unadjusted audit differences on the financial statements before concluding that they are free from material misstatement.

#### Key findings



We identified significant improvements required on three audits. On all three audits, the procedures performed were inadequate or ineffective as they failed to ensure that primary statements were free from material errors. Key findings included failure to:

- Detect two material errors in the audited financial statements. This included cash deposits in the primary statements being overstated by £1.7 billion. This was caused by an error in accounts preparation that was not present in underlying records or the notes to the accounts.
- Detect material errors and disclosure omissions in the audited financial statements, including the loss on disposal of non-current assets being overstated by £45 million. This was caused by incorrect adjustment of an audit difference.
- Evaluate the impact of unadjusted audit differences on each line item in the financial statements. Based on the unadjusted audit differences that the auditor reported to the Audit Committee, operating expenses were materially misstated. Operating expenses were the benchmark used by the auditor to set its materiality level.

**AQR identified material errors in two sets of audited financial statements.**

**On one audit, the unadjusted audit differences reported to the Audit Committee were material.**

## Ensure there is sufficient justification to support modification of an audit opinion

An auditor forms an opinion on the financial statements by evaluating the audit evidence obtained, modifying their report if sufficient audit evidence cannot be obtained to conclude that the financial statements are free from material misstatement. Audit teams must ensure that modified audit opinions are supported by clear reasoning that is consistent with the underlying audit evidence.

### Key findings



We identified weaknesses in the justification supporting modified audit opinions on two audits, one of which was assessed as requiring limited improvements. We reported a similar finding at a different firm last year.

One audit was assessed as requiring significant improvements because there was insufficient justification for modifying an audit opinion. The audit opinion was modified due to an inability to obtain sufficient appropriate evidence over inventory. The auditor was unable to attend management's inventory stock counts. Alternative procedures, including the auditor's own independent inventory count at balance sheet date, were performed over part of the inventory held with no issues arising. The residual inventory balance was not material. No consideration was given to how undetected misstatements could possibly be material.

## Improve the quality of audit procedures over pension asset valuation

Investment asset valuations and return on investments are key drivers of the net assets available to fund pension benefits. Both are key performance indicators on which management and other users of the financial statements focus. The valuation of investments can be highly complex, particularly when there is an absence of quoted prices in active markets. Audit teams must perform sufficient procedures to assess the reasonableness of asset valuations, including adequately evaluating the use of, and conclusions from, service auditor reports.

### Key findings



We raised findings on two audits, one requiring more than limited improvements. Findings that required improvements included:

- Insufficient evidence was obtained that the valuation of investment assets classified at Level 2 was materially accurate. The primary substantive procedure over the valuation of these assets was to compare valuations obtained from the custodian to those provided directly by fund managers. Considerable assurance was taken when they agreed, on the basis that both parties performed completely independent valuations. There was insufficient evidence that these valuations were independent.

**On one audit, there was insufficient justification for modifying an audit opinion.**

- Insufficient evidence was obtained to rely on the valuation controls at fund managers. The service auditor reports received for two fund managers were not evaluated. The service auditor reports received for eight of the other nine fund managers were inaccurately evaluated, with the auditor reaching the incorrect conclusion that there were no relevant valuation processes or controls in place.
- There was no evidence that audit procedures were performed to test the accuracy of the return on investments, comprising profit on disposal of investments and changes in market value of investments. The return on investments was highly material.

We reported good practice in this area at a different firm.

### **Continue to improve the evaluation and challenge of assumptions used in investment property valuations**

Accurate valuation of investment property provides users of the financial statements with assurance over a body's stewardship of public money. Valuations can assist users in holding bodies accountable for the decisions made when investing public money in property.

The valuation of investment property is complex and involves the use of assumptions and the application of judgement. Auditors should evaluate and challenge those assumptions which could have a material effect on valuations.

#### **Key findings**



We raised findings on two audits, one requiring more than limited improvements. On one audit, improvements were required due to insufficient evaluation and challenge of key assumptions used in the valuation of investment property. We reported good practice in this area on other audits at the same firm.

## Improve the quality of audit procedures over the valuation and classification of financial assets

Some councils have become increasingly commercial. The nature and value of material one-off items should be presented in a way that is helpful to users of the financial statements. Auditors are expected to obtain appropriate audit evidence that material items are valued appropriately.

Classification of financial assets is important in understanding liquidity and ensuring accurate presentation of the cash flow statement. Auditors are expected to appropriately test classification.

### Key findings

We identified weaknesses on five audits, two of which required more than limited improvements:

- On one audit, improvements were required due to insufficient consideration and challenge of the financial model supporting the valuation and classification of a long-term debtor.
- On another audit, there were insufficient procedures to conclude on classification of financial assets as short-term investments or cash and cash equivalents.

## Continue to enhance audit procedures over expenditure

Auditors should undertake appropriate procedures to test the accuracy and occurrence of expenditure. The validity of recorded expenditure is important to users of the accounts as financial planning, including savings plans, is based upon it. Previously, we reported that the firms needed to address deficiencies in the audit work on expenditure.

### Key findings

We inspected the testing of expenditure on most of the audits inspected. The quality of audit work inspected has improved. However, we identified ten audits that required limited improvements across all six firms, including:

- On two audits, there was no testing of the completeness and accuracy of source data when performing substantive analytical procedures.
- On another audit, there were arithmetical errors when performing substantive analytical procedures.
- On a further audit, there were weaknesses in the supporting evidence obtained when testing employee benefits. In particular, where differences between amounts paid and supporting records provided by management were identified.
- On an additional audit, no roll-forward procedures were undertaken when testing the operating effectiveness of controls at an interim date.
- On the same audit, there were weaknesses when testing the operating effectiveness of automated controls.

## Continue to enhance the testing of journal entries

Management override of controls is presumed to be a significant risk and a fraud risk on all audits. The level of risk varies, but this risk is present in all entities and appropriate testing should be performed. Auditors are required to design an appropriate response to this risk, which must include testing of journal entries. When selecting journals for testing, auditors consider identifying characteristics that fraudulent journals often have.

### Key findings



The quality of audit work inspected has improved. However, we identified five audits that required limited improvements across three firms, including:

- On one audit, testing was not performed as planned for two of ten identifying characteristics because the auditor entered incorrect date ranges into the firm's journals software when running reports.
- On the same audit, journals recorded in the 20-day period after year end were tested because the auditor expected that to be the closedown period. The period covered by this testing should have been extended to three months after year end to align with the actual closedown period.
- On two further audits, journal entries with the characteristics identified by the auditor were not tested for appropriate business rationale or authorisation.

## Implement measures to improve audit quality in response to other issues driving lower audit quality assessments

### Key findings



On one audit assessed as requiring improvements, we identified deficiencies in the testing performed over business rates. Findings included that:

- Material debtors and creditors were not appropriately tested.
- A sufficiently precise expectation was not set when performing substantive analytical procedures over business rates income.
- There was insufficient evaluation of key assumptions used by management's expert when valuing the provision for business rate appeals.



## Good practice



We identified examples of good practice in the audits inspected, including the following:

### Risk assessment and planning

Timely risk assessment and planning is important to ensure the audit team tailor an effective audit approach which responds to those risks.

- **Fraud risk assessment:** The audit team's fraud risk assessment demonstrated a good understanding of the sector and financial pressures at the council. Because of the incentive for management to manipulate its reserves position, the audit team identified fraud risks for revenue expenditure funded from capital under statute, minimum revenue provision and the flexible use of capital receipts. The audit team appropriately designed tests of details to address these risks.

### Execution

The execution of an audit plan needs to be individually tailored to the facts and circumstances of the audit.

- **Use of an expert to assist audit property valuations:** The audit team appropriately evaluated the competence, capabilities and experience required to audit a highly specialised property. It engaged an auditor's expert to provide support in testing the valuation, which enhanced the team's audit evidence in this higher-risk area.
- **Evaluation of assumptions used in investment property valuations:** The audit team's testing of yields was particularly robust and included evaluation of the comparators used by management's valuer against third-party market data. Where appropriate, the audit team demonstrated challenge of management's valuer.
- **Challenge of management:** The audit team demonstrated rigour when challenging the assumptions made in setting the business rates appeals provision, in particular by benchmarking to other councils. The audit opinion was ultimately qualified as the auditor was unable to obtain sufficient appropriate audit evidence over the amount of the provision.

### Completion and reporting

The completion and reporting phase of an audit is an opportunity to stand back and assess the level of work performed against the audit plan and ensure that the reporting of the outcome of the audit is appropriate and timely.

- **Evaluation of errors identified in testing:** The audit team robustly followed up on errors identified in its additions testing by extending its sample and challenging management to recognise a prior-year adjustment.
- **Consultation:** The audit team consulted with an internal panel of senior public sector specialists on the sufficiency and appropriateness of the audit procedures performed over a subsidiary whose financial performance had deteriorated in the year. There was clear evidence of challenge by the audit team in areas such as the disclosure of events after the balance sheet date and parent company guarantees.

Good practice examples included effective use of experts and internal consultation with senior public sector specialists on higher-risk matters.

## The auditors' work on Value for Money arrangements

### Urgently improve audit documentation, archiving and engagement with the FRC

Sufficient and appropriate evidence serves a number of important purposes, including making the engagement team accountable for its work and enabling the conduct of audit quality inspections in accordance with applicable regulatory requirements. Audit firms are expected to finalise and archive their evidence and comply with regulatory requests.

#### Key findings



We identified findings on one inspection where significant improvements were required. Key findings included significant weaknesses in the audit team's evidence of procedures undertaken and its engagement with the FRC. In particular:

- The evidence on the VfM audit file was not finalised.
- The working papers and audit procedures on the VfM audit file were not reviewed.
- The VfM audit file was not archived.
- The firm incorrectly informed us that the VfM audit file had been archived before we selected it for inspection.
- A member of the audit team made changes to the VfM audit file after we had notified the firm of our inspection. This issue appears to be isolated.

**On one inspection, changes were made to the VfM audit file after we notified the firm of our inspection. This is unacceptable.**

#### Other findings



This year we inspected the auditors' work on VfM arrangements at 14 bodies and identified findings on six inspections across five firms, including:

- On one inspection, the audit team should have considered the council's group and commercial activities in its risk assessment and commentary.
- On another inspection, the reporting of a significant weakness in arrangements should have more clearly explained the nature and extent of the weakness identified, and the recommendation for improvement should have addressed all relevant matters.
- On a further inspection, the audit team reported that it had undertaken additional procedures that were not performed. Instead, the auditor relied on a regulator's monitoring visit. The auditor's reporting should have made clear the extent to which its conclusions relied on the findings of a regulator's monitoring visit instead of its own additional procedures.

None of these findings were assessed as significant enough to require more than limited improvements. They are, however, areas that all firms should maintain a focus on in future.

## Good practice



We identified examples of good practice in the inspections we performed, including the following:

- **Good integration with the financial statements audit:** The financial statements audit identified issues with the accounting for private finance initiatives, including payments made to the contractor for assets that had not been received. Integration with the financial statements audit work resulted in the identification of a significant weakness in contracting arrangements and recommendations for improvement being made.
- **Timely reporting:** On one inspection, a timely update was provided to the Audit Committee when a significant weakness in arrangements was identified. The audit team issued an addendum to its audit plan highlighting the issues identified, its updated risk assessment and the proposed changes to the audit strategy.
- **The Auditor's Annual Report:** On four inspections, the auditor's reporting was comprehensive, well-structured, and made good use of benchmarking data. Communication was clear, including the nature of significant weaknesses identified and their impact on the entity.
- **Consultation:** On one inspection, the audit team consulted with an internal panel of senior public sector specialists to determine if the identified significant weaknesses in arrangements required the auditor to exercise its additional powers and duties. There was clear explanation of their reasoning and conclusion for why this was not required.

## Review of the firms' quality control and review procedures

We review firm-wide procedures based on those areas set out in International Standard on Quality Control (ISQC) 1, in some areas on an annual basis and others on a three-year rotational basis. Our firm-wide work covered all six firms completing major local audits. The table below sets out the areas that we have covered this year and in the previous two years.

Annual	Current year 2021/22	Prior year 2020/21	Two years ago 2019/20
<ul style="list-style-type: none"> <li>• Audit quality focus and tone of the firm's senior management</li> <li>• Root cause analysis (RCA) process</li> <li>• Audit quality initiatives, including plans to improve audit quality</li> <li>• Complaints and allegations processes</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation of the FRC's Revised Ethical Standard (2019)</li> <li>• EQCR, consultations and audit documentation</li> <li>• Audit methodology</li> <li>• Internal quality monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• Audit methodology (recent changes to auditing and accounting standards)</li> <li>• Training for auditors</li> </ul>	<ul style="list-style-type: none"> <li>• Partner and staff matters, including performance appraisals and reward decisions</li> <li>• Acceptance and continuance (A&amp;C) procedures for audits</li> </ul>

The key findings and good practice identified are reported in each firm's 2022 Audit Firm Specific Report on public interest entity audits.<sup>5</sup>

We extend our work on the firms' quality control and review procedures, where necessary, to cover matters specific to local audit and report the findings here. This work primarily focused on:

- RCA process and audit quality initiatives.
- EQCR, consultations and audit documentation.
- Audit methodology (property valuations and going concern).

The reason for the focus on audit quality initiatives and RCA is the importance of taking effective action to address recurring inspection findings.

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## Root cause analysis process and audit quality initiatives

Firms are expected to develop audit quality plans (AQPs) that drive measurable improvements in audit quality and include initiatives which respond to identified quality deficiencies, as well as forward-looking measures which contribute directly or indirectly to audit quality.

The RCA process is an important part of a continuous improvement cycle designed to identify the causes of specific audit quality issues (whether identified from internal or external quality reviews or other sources) so that appropriate actions may be designed to address the risk of repetition. All firms have been performing RCA for several years. We reviewed the firms' RCA processes last year and assessed changes, including responses to our previous findings, in the current year.

The key findings and good practice identified are reported in each firm's 2022 Audit Firm Specific Report on public interest entity audits.

We will continue to assess each firm's RCA process. We encourage all firms to develop their RCA techniques further as well as focus on measuring the effectiveness of the actions taken as a result.

We reviewed the RCA on all local audits where we had identified more than limited improvements in our last inspection cycle. All four of the firms impacted use the same RCA process as on public interest entity audits. The four firms developed actions to address our findings. We performed the following:

- Ensured actions were coherent and clear on how they would deliver continuous improvement and enhanced audit quality, linking to our findings.
- Assessed whether they included evaluation of required training.
- Conducted follow-up meetings with firms to discuss and challenge aspects of the RCA process and subsequent actions taken to improve audit quality.
- Considered, in hindsight, the efficacy of the RCA process and the actions taken with reference to current year inspection findings.

We observed improvements at firms that were linked to the implementation of AQPs. Where we found recurrent key findings at the same firm, further commentary is provided in Section 3.

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5 Audit firm specific reports on public interest entity audits can be found [here](#)

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## Engagement Quality Control Review, consultations and audit documentation

An EQCR is required to be an objective evaluation, by a suitably qualified audit practitioner, of the significant judgements made by the audit team. The reviews are completed on public interest entities and other heightened risk audits before the audit report is signed.

Our review evaluated the six firms' policies and procedures for the appointment of EQCR reviewers to local audits. All firms appoint an EQCR reviewer dependent on quality risk. Additionally, three of the firms appoint an EQCR reviewer to all major local audits. In aggregate, 59% of major local audits had EQCR involvement compared to less than 1% of other local audits.

### Key findings

Our key finding related to the need for each firm to:

- Ensure that the appointment of EQCR reviewers is appropriately focused on quality risks, including at non-major local audits.

We recognise that a firm's response to identified quality risks may include other forms of engagement reviews that are not an engagement quality review. For example, a firm's response may include reviews of the engagement team's procedures relating to certain risks, or significant judgements, by personnel who have specialised technical expertise.

Consultation with a firm's central functions, on difficult or contentious matters, enables auditors to be guided by the collective experience and technical expertise of the firm. We reviewed the firms' policy for areas where mandatory local audit specific consultations are required. We had no key findings in this area.

Audit documentation comprises the evidence obtained and conclusions drawn during an audit. Archiving ensures that the documentation is maintained, should it be needed in the future. We reviewed the firms' arrangements relating to the assembly and timely archiving of final audit files, and the monitoring and approval of changes made to audit files after the signing of the audit report.

### Key findings

We identified the following key finding at an individual firm:

- On one inspection, we identified that the audit file supporting the auditor's work on VfM arrangements had not been archived. The firm's controls failed to identify that this audit file was not archived. The firm must ensure that appropriate controls operate to prevent and detect the failure to archive audit files.

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## Audit methodology (property valuations and going concern)

The firms' audit methodology, and the guidance provided to auditors on how to apply it, are important elements of the firms' overall system of quality control, to help audit teams perform audits consistently and comply with auditing standards. In the current year, we evaluated the quality and extent of the firms' methodology and training relating to the audit of property valuations and going concern assessments. We had no key findings in this area although we did identify some less significant issues.

### Other findings



During our inspection visit, we identified one audit where the auditor's report contained a material uncertainty in relation to going concern. The auditor's assessment focused on financial sustainability rather than the principle of service continuity.

Our finding related to the need for an individual firm to:

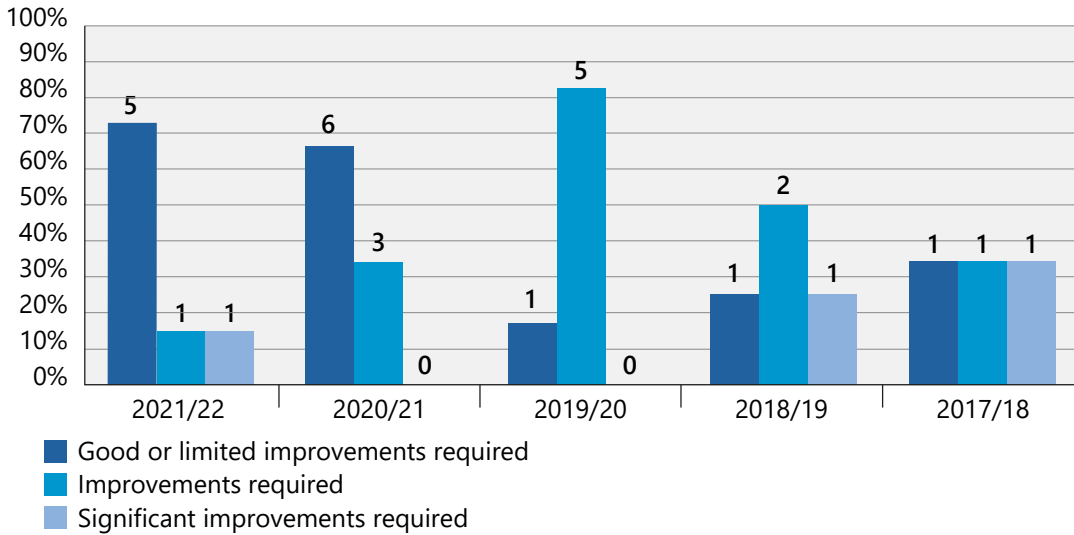
- Ensure that the standardised work programmes used by local auditors are suitably tailored to the sector, including the continued provision of service approach.

### 3 Review of individual firms

In this section, we set out our assessment of the six firms that perform major local audits. We completed at least two audit inspections at each firm.

#### Grant Thornton UK LLP

##### Our assessment of the quality of financial statement audits reviewed



Given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm. Further details are set out on page 8.

We assessed 71% of financial statement audits as requiring no more than limited improvements compared with 67% in the previous year and 23% on average in the preceding three years.

While there has been an overall improvement, it is unacceptable that one financial statement audit we inspected was found to require significant improvements and another required improvements. Urgent and robust action is required to address these findings and to ensure that they do not recur.

We inspected the auditor's work on VfM arrangements at four bodies; all inspections were assessed as requiring no more than limited improvements (the same as the previous year).

The firm performed RCA on the three financial statement audits assessed as requiring more than limited improvements in the previous inspection cycle. AQR reviewed the RCAs and the firm's Public Sector Quality Investment Plan (PSQIP), which incorporated the firm's responses.

**71%**

At Grant Thornton UK LLP, five of the seven audits inspected were assessed as either good or limited improvements required.

**100%**

At Grant Thornton LLP, all four VfM arrangements inspections were assessed as good or limited improvements required.



Our selection of audits to inspect included higher-risk 31 March 2020 audits that we had been unable to inspect in our previous inspection cycle due to the timing of auditor's reports. When scoping inspections, we considered previous years' findings at the firm and across the sector as areas of focus.

This year, on one audit we inspected, we identified a recurrent key finding. It related to insufficient evaluation and, if necessary, challenge of significant assumptions in investment property valuations. AQR reviewed the firm's response to our previous finding, which was primarily the provision of training to practitioners. This training was provided after the audit on which we identified the recurrent finding was complete. We also identified good practice in this area on two other audits, indicating an element of inconsistency across the audits we inspected. As evaluation and, if necessary, challenge of key assumptions in investment property valuations is a recurring issue for the firm, it must take action to understand the root cause of continuing deficiencies and develop further actions to address inconsistency between audits.

## Key findings



Significant improvements were required to one audit. Findings included:

- Financial statement review procedures were inadequate and ineffective. They did not identify two material errors in the audited financial statements. This included cash deposits in the primary statement being overstated by £1.7 billion. This was caused by an error in accounts preparation that was not present in underlying records or the notes to the accounts.
- Insufficient substantive evidence was obtained that the valuation of pension assets was materially accurate.
- Insufficient evidence was obtained to rely on the valuation controls at fund managers when testing the valuation of pension assets.
- There was no evidence that audit procedures were performed to test the accuracy of the profit on disposal of investments and changes in their market value.

On a further audit, improvements were required:

- Insufficient testing was performed over business rates. The audit team did not:
  - Appropriately test business rates debtors and creditors.
  - Set a sufficiently precise expectation for the substantive analytical procedure on business rates income.
  - Evaluate the reasonableness of significant assumptions when concluding on the material accuracy of the business rates appeals provision.
- There was insufficient evaluation and, if necessary, challenge of the reasonableness of significant assumptions in investment property valuations.

The firm must take urgent and robust action to address these findings, including:

- Performing a full RCA for both audits assessed as requiring more than limited improvements. This must establish the reasons for poor audit quality and how consistent high audit quality will be achieved. This must include actions to promote greater consistency between audits.
- Considering the results from its internal monitoring and of inspections performed by ICAEW to establish if there are any other areas of concern.
- Updating its ongoing PSQIP for all findings and required actions from this inspection cycle.

For the inspection assessed as requiring significant improvements, the firm has commenced these actions by providing us with their RCA, prior to our final report on the inspection being issued.

AQR will continue to test the efficacy of the firm's actions in its PSQIP in our next inspection cycle, where we may also select higher-risk audits that we were unable to inspect this year due to the timing of auditor's reports.

### Good practice



Good practice points were identified on three financial statement audits, including:

- Robust evaluation of errors in additions testing and challenge of management to recognise a prior year adjustment.
- Consultation on the sufficiency of audit procedures and disclosures for a subsidiary whose financial performance had deteriorated in the year.
- Use of an auditor's expert to help audit certain key assumptions in investment property valuations, in a manner that was proportionate to risk.
- Robust testing of key assumptions used in investment property valuations against third-party market data. Where appropriate, the audit team demonstrated appropriate challenge of management's expert.

Good practice points were identified on all four VfM arrangements inspections, including:

- Consultation with an internal panel of senior public sector specialists to determine if the identified significant weaknesses in arrangements required the auditor to exercise its additional powers and duties. There was clear explanation of the reasoning and conclusion for why this was not required.
- Comprehensive evidence of the team's work, evaluation and conclusions supporting the risk assessment and additional procedures.
- Comprehensive well-structured reporting that made good use of benchmarking data. Clear communication, including the nature of significant weaknesses identified and their impact on the entity.



## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of Grant Thornton UK LLP

Overall, the audit work ICAEW reviewed was of a good standard. Seven of the eight files reviewed were either good or generally acceptable, but one file required improvement.

ICAEW concluded that one file needed improvement due to the insufficient challenge of management's expert on long-term asset valuations. This file was a 2019/20 audit and therefore, does not reflect recent improvements the firm has made in this area, following feedback from external reviews in 2020.

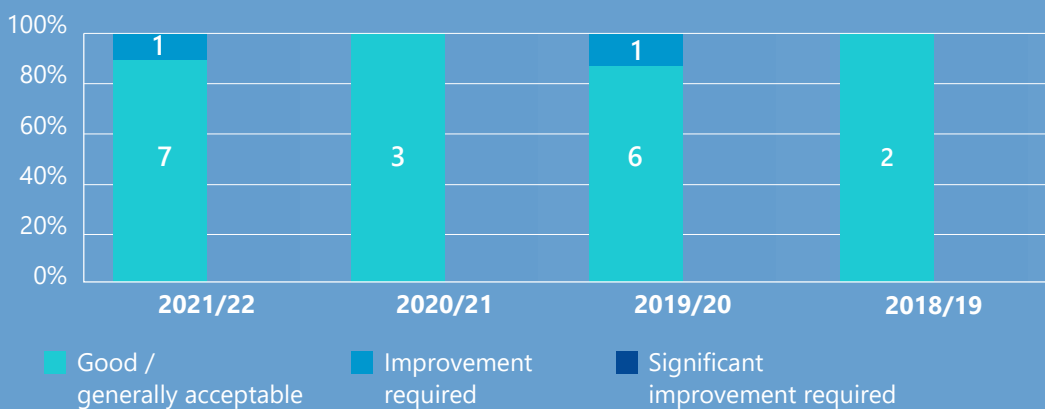
On two of the generally acceptable files, ICAEW identified some improvements needed to audit team's substantive analytical procedure on National Non-Domestic Rates (NNDR) income. ICAEW also identified an omission of a primary financial statement from the audit opinion on the file requiring improvement.

VfM work was good on each of the files reviewed, and ICAEW did not identify any issues with this aspect of the audit team's work.

ICAEW identified and shared examples of good practice across the audits. This good practice included:

- Several examples of applying high levels of professional scepticism.
- Clear and comprehensively documented work in the audit of long-term asset valuations.
- Good levels of challenge and corroboration on assessing valuer assumptions.
- Clear stratification of errors identified in PPE testing to inform the further audit work conducted.
- Comprehensive documentation of the VfM risk assessment.
- Good tailoring of improvement recommendations to reflect an impending local government reorganisation.

The results of ICAEW's financial audit reviews for the last four years are set out below



Note: Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of the firm's performance or overall change in audit quality.

# 88%

Of the eight ICAEW financial audit reviews, seven were either good or generally acceptable.

## Firms response to AQR and QAD inspections



It is pleasing to see that the investment our Firm has made in improving the quality of our audit work has been recognised by the FRC with 71% of financial statements audits requiring no more than limited improvements compared to 67% last year and an average of only 23% in the preceding three years. With the significant change in the work on VfM introduced by the new Code we are delighted that 100% of the VfM reviews were assessed as either Good or only requiring limited improvements, which maintains our track record in this aspect of our work from previous years. We are equally pleased that a large number of the files reviewed have also had areas of good practice identified across different aspects of our work.

Similarly, the QAD reviews concluded that 88% of our financial audit files reviewed in year met the required standard, with only one file (which related to a prior year audit that commenced before much of the enhanced training and documentation had been introduced) being assessed as 'improvement required'. It is pleasing to see that the QAD similarly identified that all of the five VfM files reviewed were good, with no issues identified. Again, QAD identified a number of good practice areas across the majority of our files.

We fully recognise that any file not achieving the required standard is not only disappointing but highlights that there is still work to do to ensure that our high quality standards are replicated across all of our audits. However, as demonstrated by the outcomes of our other external file reviews summarised within this report and our own internal file reviews, the majority of reviews are assessed as either good or only requiring limited improvement. We have responded promptly to the emerging findings of the file assessed by the FRC as requiring significant improvements by undertaking detailed root cause analysis as soon as we were aware that there were issues and well before the file review was finalised. We shared this with the FRC as part of our response to their draft report, reflecting how seriously we have taken this issue and our commitment to implement actions that will enhance future audit quality. A similar process will be followed for the two files assessed as 'Improvement required' by the FRC and QAD.

In addition to the root cause, regular 'lessons learnt' communications have been published and promoted for all team members to access and there has been training delivered to all teams on the key findings of the FRC and QAD reviews. In addition, specific mandatory training has been delivered in each of the key areas of property valuations, including the specific risks around investment property valuations, and the audit of Pension Funds, including the valuation of different categories of investments. New guidance and example working papers have been developed and shared on key areas such as business rates. All emerging issues and themes from both external and internal quality reviews are reported to the monthly Public Sector Audit (PSA) Quality and Financial Reporting Board by our Director & PSA Head of Audit Quality Regulation, to ensure a timely response to any development or changes required to our audit approach.

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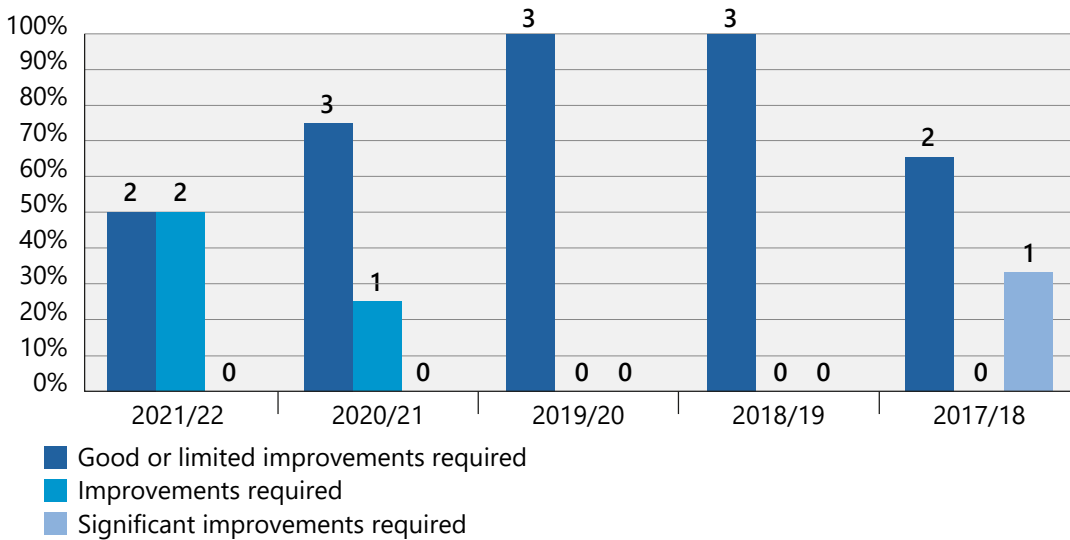
The key issue on the file identified as 'Significant Improvement Required' by the FRC relates to a transposition error in the production of the financial statements. The correct values were reported in the supporting note which was referenced within the primary statements. As soon as the issue was identified we engaged with the audited body to have the error corrected. We accept that our procedures should have identified and corrected this error. We will ensure appropriate checks are undertaken between the version of the accounts used by ourselves to undertake audit testing and the final version on which our audit opinion is given. We have also introduced the requirement for auditors to perform additional checks on the version published by the audited body.

The firm's internal quality reviews of PSA files concluded in late September 2022 and identified similar themes to both the FRC and QAD. We have now launched a root and branch review of guidance and template working papers to ensure that they are providing the necessary support to audit teams to enable high quality audits to be delivered and clearly evidenced. The extent of our use of External Quality Control Reviewers (EQCRs) and Quality Support Teams (QST) inputs is being reviewed and enhanced as both of these roles act to enhance the quality of our work on complex audits. Our central quality support teams are also proactively engaging with Key Audit Partners and audit teams on a more regular basis to ensure that emerging themes are detected and discussed at the earliest possible stage.

We recognise the importance of continuous improvement and have taken prompt action to ensure that the learning from file reviews is shared with audit teams in a timely way. We are disappointed that our work did not meet the required standards in all instances and will continue to strengthen our procedures and training to limit the risk of this reoccurring.

## Ernst & Young LLP

### Our assessment of the quality of financial statement audits reviewed



Given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm. Further details are set out on page 8.

We assessed 50% of financial statement audits as requiring more than limited improvements compared with 25% in the previous year and 24% on average over the past five years.

It is concerning that two financial statement audits we inspected were found to require improvements. Robust action is required to address these findings.

All three VfM arrangements inspections were assessed as good or limited improvements required (all good or limited improvements required in 2020/21).

The firm performed RCA on the one financial statement audit assessed as requiring more than limited improvements in the previous inspection cycle. AQR reviewed the RCA and the actions taken in response to our finding. We identified no recurrent key findings at the firm that would cast doubt on the efficacy of actions taken to address previous findings.

Our selection of audits to inspect included one higher-risk 31 March 2020 audit that we had been unable to inspect in our previous inspection cycle due to the timing of the auditor's report. When scoping inspections, we considered previous years' findings at the firm and across the sector as areas of focus.

# 50%

At Ernst & Young LLP, two of the four audits inspected were assessed as requiring more than limited improvements.

# 100%

At Ernst & Young LLP, all three VfM arrangements inspections were assessed as good or limited improvements required.

## Key findings



The key findings in this inspection cycle were:

- On one audit, there were insufficient procedures to conclude on classification of financial assets as short-term investments or cash and cash equivalents.
- On another audit, insufficient consideration and challenge of the valuation of a loan, its classification as a long-term debtor, or group boundary implications. This resulted in a lack of evidence that the valuation of the loan was materially accurate or that its classification as long-term was appropriate.

The firm must take robust action to address these findings, including:

- Performing a full RCA for each audit assessed as requiring more than limited improvements. This must establish the reasons for poor audit quality and how consistent high audit quality will be achieved.
- Considering the results from its internal monitoring and of inspections performed by ICAEW to establish if there are any other areas of concern.

AQR will test the efficacy of the firm's actions in our next inspection cycle, where we may also select higher-risk 31 March 2021 audits that we were unable to inspect this year due to the timing of auditor's reports.

## Good practice



A good practice point was identified on one financial statements audit:

- The audit team's fraud risk assessment demonstrated a good understanding of the sector and financial pressures at the council. Because of the incentive for management to manipulate its reserves position, the audit team identified fraud risks for revenue expenditure funded from capital under statute, minimum revenue provision and the flexible use of capital receipts. The audit team appropriately designed tests of details to address these risks.

A good practice point was identified on one VfM arrangements inspection:

- On one inspection, a timely update was provided to the Audit Committee when a significant weakness in arrangements was identified. The audit team issued an addendum to its audit plan highlighting the issues identified, its updated risk assessment and the proposed changes to the audit strategy.



## Monitoring review by the Quality Assurance Department of ICAEW

### Assessment of the quality of audits reviewed of Ernst & Young LLP

Overall, the audit work ICAEW reviewed was of a good standard. Of the eight files reviewed, seven were either good or generally acceptable, but one file required significant improvement.

In the file needing significant improvement, the audit team needed to improve the work done to assess the classification of certain assets as investment properties and whether the negative investment property valuations were appropriate and complied with accounting standards. Improvement is also required on the same file in relation to the audit team's consideration of the cashflow statement, with our review identifying two material errors.

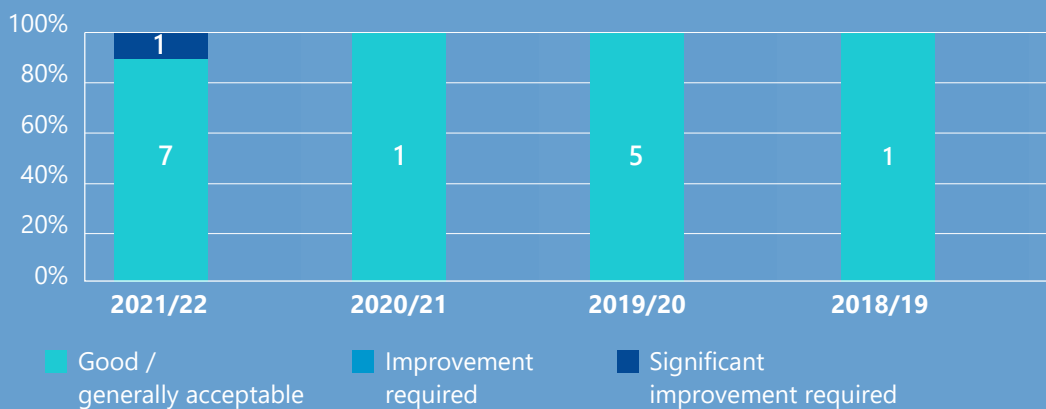
On four of the generally acceptable files, ICAEW identified improvements needed to financial statement disclosure. On two files, accumulated depreciation hadn't been 'zeroed' following a formal revaluation, while on a further two files there were misstatements in the defined benefit pensions scheme disclosure. Other findings (on two files) saw isolated improvements needed in relation to the audit evidence obtained.

VfM work was good on each of the files reviewed, and ICAEW did not identify any issues with this aspect of the audit team's work.

ICAEW identified and shared examples of good practice across the audits. This good practice included:

- The scope and strategy section of the audit file being well-documented, demonstrating a good understanding of the audited entity.
- Good consideration of the risks of fraudulent revenue recognition.
- Clear documentation of the impact of the COVID-19 pandemic.
- Clear and succinct consideration by the audit team of matters identified in the consulting actuaries' report.
- Good use of publicly available information to test the classification of assets.

The results of ICAEW's financial audit reviews for the last four years are set out below



Note: Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of the firm's performance or overall change in audit quality.

# 88%

Of the eight ICAEW financial audit reviews, seven were either good or generally acceptable.



## Firm's response to AQR and QAD inspections



The positive results of nine out of twelve of the financial statement reviews and 100% of the value for money arrangements reviews conducted by the FRC and ICAEW's QAD this year reflect the hard-work and dedication of our team of local audit specialists, and reflect the effort and investment that we continue to make in delivering consistently high-quality audits. We are pleased that examples of good practice were identified across these files and welcome the insights and recommendations on areas for improvement noted in this report.

We are disappointed that three of the engagements reviewed by the FRC and ICAEW's QAD this year fell short of the high audit quality standards that we set ourselves and that our regulators and other stakeholders rightly expect from us.

We have begun the root cause analysis process and will be sharing lessons learnt (both positive and negative) and actions taken in response to the RCA with the audit practice to improve audit quality more broadly.

We are also developing training which communicates the details of the findings, and supports teams in avoiding similar challenges in future engagements.

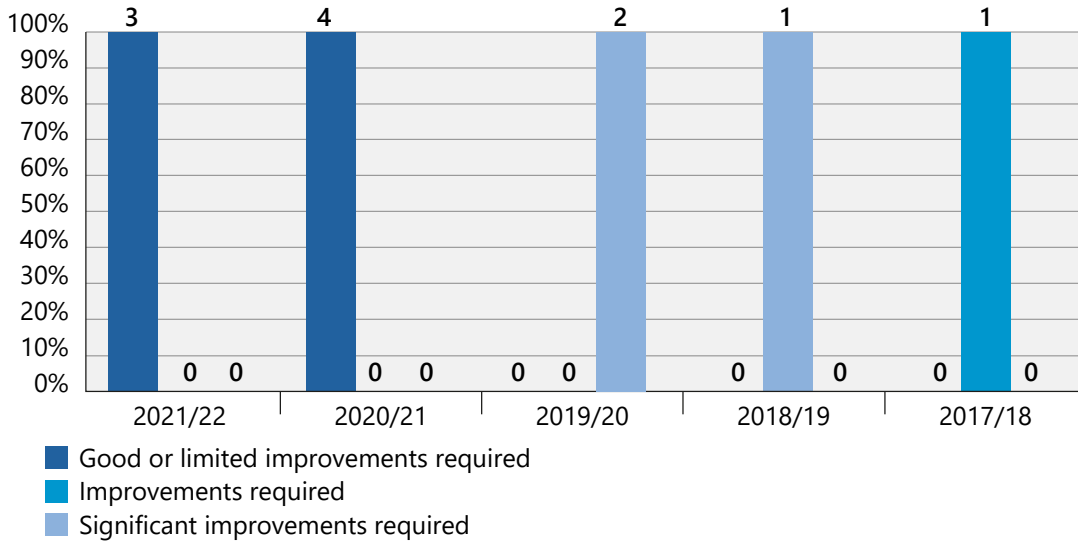
In addition to these specific responses to the findings highlighted, we also continue to evolve our Audit Quality Strategy to enable our people to concentrate their efforts in the right places to drive consistent high quality, whilst maintaining an emphasis on wellbeing. Our refreshed strategy includes renewed focus on:

- Greater standardisation and simplification;
- More effective coaching; and
- Rebalancing and reducing workloads.

We are encouraged that the key findings identified in previous years, particularly in relation to the audit of asset valuations, have not re-occurred this year following our timely intervention and ongoing efforts to support teams in this complex area. The FRC have noted that they have "identified no recurrent key findings at the firm that would cast doubt on the efficacy of actions taken to address previous findings." We have confidence that the actions that we have taken to date have been effective, and are committed to consistently delivering high quality audits that serve the public interest.

## Mazars LLP

### Our assessment of the quality of financial statement audits reviewed



Given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm. Further details are set out on page 8.

The firm has maintained the significant improvement in audit quality results compared to its performance prior to 2020/21. We assessed 100% of financial statement audits as requiring no more than limited improvements compared with 100% in the previous year and nil on average in the preceding three years.

In response to previous improvements in quality results, AQR considered it appropriate to decrease the number of audit inspections to three. When scoping inspections, we considered previous years' findings at the firm and across the sector as areas of focus.

All three VfM arrangements inspections were assessed as requiring no more than limited improvements (all good or limited improvements required in 2020/21).

In our next inspection cycle we may select higher-risk 31 March 2021 audits that we were unable to inspect this year due to the timing of auditor's reports.

# 100%

At Mazars LLP, all three financial statement audits inspected were assessed as good or limited improvements required.

# 100%

At Mazars LLP, all three VfM arrangements inspections were assessed as good or limited improvements required.

## Good practice



Good practice points were identified on two financial statement audits, including:

- Robust testing of key assumptions used in property valuations against third-party market data. Where appropriate, the audit team demonstrated appropriate challenge of management's expert.
- Use of an auditor's expert to review investment property valuations, in a manner that was proportionate to risk.

Good practice points were identified on two VfM arrangements inspections, including:

- Comprehensive evidence of the team's work, evaluation and conclusions supporting the risk assessment and additional procedures.

## Firm's response to AQR inspections



We welcome the results of the FRC's inspection of our 2020/21 local audit work. We are passionate about delivering high-quality audit to public bodies for the benefit of the communities they serve. Our positive results over the last two inspection cycles demonstrate the efficacy of the investments we have made and are testament to the hard work and commitment of our teams.

Our work on VfM arrangements is a key part of the local audit and we are pleased that the FRC identified good practice in the way we document and evidence this work. We are also pleased the FRC continues to recognise good practice in our approach to auditing the valuation of property assets, reflecting the investments we have made to support our teams in this key area.

Notwithstanding these strong results, we remain committed to the continuous improvement of our local audit work and we will continue to drive forward our audit quality agenda. This remains the responsibility of our Key Audit Partners, reflecting our commitment to setting an appropriate "tone from the top" with regard to audit quality. We will consider the actions required to address the limited improvement areas identified in this year's FRC inspections and from our own internal quality reviews. We will also look to learn more from the good practice identified to understand the principal drivers for the high-quality work and share this across our audit service line.

## KPMG LLP, BDO LLP, Deloitte LLP and PricewaterhouseCoopers LLP

We previously inspected a single audit at each firm so aggregated the inspection results into one graphical summary to avoid publicly identifying the results of individual inspections.

PricewaterhouseCoopers LLP no longer perform any major local audits so are not currently in scope of our inspection activity. AQR increased the number of audits inspected at the other firms to two. Performing more than one inspection at each firm allows us to individually report on each firm and responds to previous audit quality results at some of the firms.

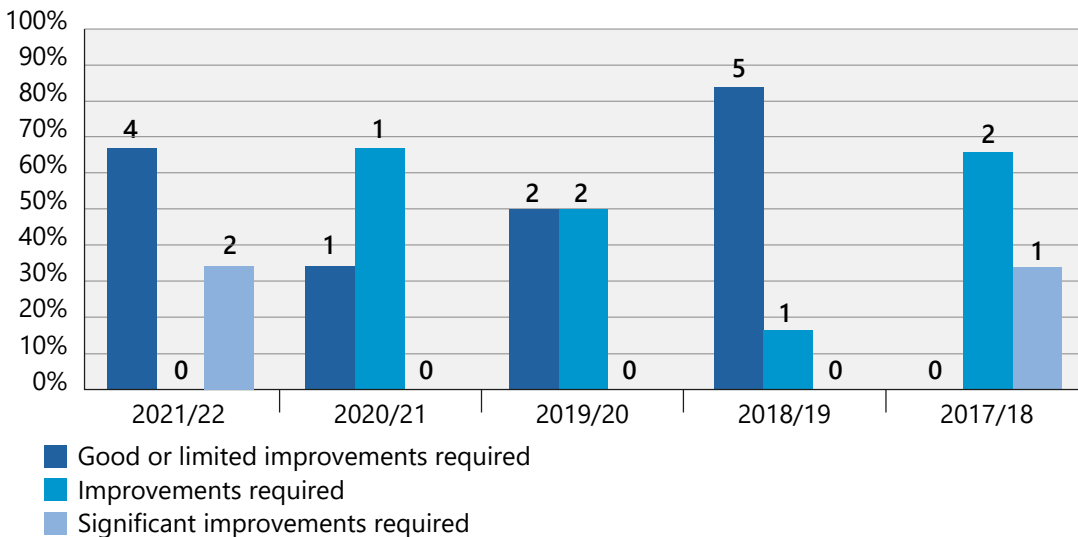
The graph below aggregates the results of the financial statement audits we inspected. This allows us to present comparators without publicly identifying the results of individual inspections.<sup>6</sup>

Care is required in interpreting these results. The grade profile of our inspection findings may not be representative of audit quality at individual firms or across the whole portfolio of audits performed by this group of firms.

**PricewaterhouseCoopers LLP do not currently have any major local audits so are no longer in scope of our inspection activity.**

**AQR increased the number of audits inspected at the other firms to two. This allows us to individually report findings at each firm.**

### Our assessment of the quality of financial statement audits reviewed



The results of each firm's 2021/22 audit inspections are presented individually below.

<sup>6</sup> In 2020/21 and 2021/22, three firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2019/20, all four firms were inspected.

In 2018/19, three firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP.

In 2017/18, two firms were inspected. No inspections were performed at PricewaterhouseCoopers LLP or Deloitte LLP.

## KPMG LLP

The two financial statement audits inspected were assessed as good or limited improvements required.

The two VfM arrangements inspections were assessed as good or limited improvements required.

No individual instances of good practice were identified on these two inspections.

The firm should aim to maintain the quality of work observed and consider the results of its internal monitoring to establish if there are any areas of concern.

### Firm's response to AQR reviews



We are pleased that our continued drive and investment in audit quality has sustained our audit quality inspection results. Audit quality is at the heart of our strategy and our focus now is on embedding further, sustainable improvements across our business. Our Audit Quality Plan brings together our key priority areas to drive continuous improvements in audit quality. This year's plan includes a focus on: the continued rollout of KPMG Clara - our modern global audit system; continued investment in our "high challenge, high support" culture; and embedding changes to our Root Cause Analysis (RCA) process which drives audit quality through our aligned behaviours. We have also continued to embed changes to our governance, to help build trust in our firm and the wider profession and in readiness for International Standard on Quality Management (ISQM) 1.

## BDO LLP

Of the two financial statement audits inspected, one was assessed as requiring significant improvements and one was assessed as good or limited improvements required.

The one VfM arrangements inspection was assessed as requiring significant improvements.

It is unacceptable that two inspections were assessed as requiring significant improvements. Urgent and robust action is required to address these findings.

Our selection of audits to inspect included one higher-risk 31 March 2020 audit that we had been unable to inspect in our previous inspection cycle due to the timing of the auditor's report. When scoping inspections, we considered previous years' findings at the firm and across the sector as areas of focus. We identified no recurrent key findings at the firm that would cast doubt on the efficacy of actions taken to address previous findings.

# 100%

At KPMG LLP, the two financial statement audits inspected were assessed as good or limited improvements required.

# 100%

At KPMG LLP, the two VfM arrangements inspections were assessed as good or limited improvements required.

# 50%

At BDO LLP, one of the two financial statement audits inspected was assessed as requiring significant improvements.

## Key findings



The key findings in this inspection cycle were:

- On one financial statements audit, there was insufficient justification to support modification of the audit opinion. The audit opinion was modified due to an inability to obtain sufficient appropriate evidence over inventory. The auditor was unable to attend management's inventory stock counts. Alternative procedures, including the auditor's own independent inventory count at balance sheet date, were performed over part of the inventory held with no issues arising. No consideration was given to how undetected misstatements could possibly be material.
- On the same financial statements audit, the impact of unadjusted audit differences was not considered on each line item in the financial statements. Based on the unadjusted audit differences that the auditor reported to the Audit Committee, operating expenses were materially misstated. Operating expenses were the benchmark used by the auditor to set its materiality level.
- On one VfM arrangements inspection, there were significant weaknesses in the audit team's documentation, archiving and in its engagement with us as a regulator. In particular:
  - The evidence on the VfM audit file was not finalised.
  - The working papers and audit procedures on the VfM audit file were not reviewed.
  - The VfM audit file was not archived.
  - The firm did not realise that the VfM audit file had not been archived.
  - The firm incorrectly informed us that the VfM audit file had been archived before we selected it for inspection.
  - A member of the audit team made changes to the VfM audit file after we had notified the firm of our inspection. This issue appears to be isolated.

The firm must take urgent and robust action to address these findings, including:

- Performing a full RCA for each inspection assessed as requiring significant improvements. This must establish the reasons for poor audit quality and how consistent high audit quality will be achieved.
- Considering the results from its internal monitoring to establish if there are any other areas of concern.
- Updating its ongoing Public Sector Audit Quality Improvement Plan (PSAQIP) for all findings and required actions from this inspection cycle.

AQR will test the efficacy of the firm's actions in its PSAQIP in our next inspection cycle, where we may also select higher-risk 31 March 2021 audits that we were unable to inspect this year due to the timing of auditor's reports.

### Good practice



More encouragingly, good practice points were identified on two financial statement audits, including:

- Engaging an auditor's expert to provide support in testing the valuation of a highly specialised property. This enhanced the audit evidence in this higher-risk area.
- Robust risk assessment discussions among the engagement team, including Key Audit Partner-led fraud discussions, demonstrated a good understanding of the risks facing the organisation.
- Interactions and discussions with the Audit Committee were clearly recorded and evaluated to determine if additional audit procedures were required in response.

A good practice point was also identified on one VfM arrangements inspection:

- Good integration with the financial statements audit. The financial statements audit identified issues with the accounting for private finance initiatives, including payments made to the contractor for assets that had not been received. Integration with the financial statements audit work resulted in the identification of a significant weakness in contracting arrangements and recommendations for improvement being made.

### Firm's response to AQR reviews



The firm's Leadership Team, Audit Executive and Public Sector team have noted the disappointing findings from the AQR reviews of the financial statements and VfM conclusion for one major local audit. On determining the issues underlying these findings we immediately undertook robust actions and we are carrying out further actions, consistent with our overall objective of delivering high quality audits. These actions are set out below.

We were pleased to note the good practice, ie around engaging an auditor's expert, risk assessment discussions and recording and evaluating interactions with audit committees. These were all in areas where there had been a focus over the prior 12 months to improve practice and enhance audit quality. We will further review the root causes of the behaviours to enable audit teams to emulate them elsewhere. More generally we will consider all of our root cause analyses and internal monitoring and update our Public Sector Quality Improvement Plan for all findings as appropriate.

## **Financial statements audit**

With regards to the findings in relation to the Financial Statements audit, whilst we are in the process of completing a root cause analysis into the matter under our new dedicated RCA partner the indications are that the failings arose from the Key Audit Partner (KAP) in the sector concerned having insufficient personal and team resource for his portfolio.

Accordingly, subsequent to the receipt of these results we reviewed and adjusted the relevant KAP's portfolio so that he has available capacity to ensure the delivery of high quality audits. Second, the firm has not pitched or re-pitched for any further major contracts in this area. The portfolio review and the decision not to tender were undertaken as part of a wider audit stream initiative instigated by the firm's Leadership Team over the course of the last twelve months.

## **VfM arrangement assessment**

On learning that changes had been made to working papers by a member of staff we immediately carried out an urgent investigation into the matter, under the overall direction of the firm's Leadership Team. The individual concerned was suspended within three days of the FRC querying the matter with us and dismissed following completion of the investigation.

BDO's forensics team, as part of their investigation, obtained a full list of VfM engagements from the BDO Public Sector team and identified that a number of these files had not been archived and were 'locked' when the issue was identified on this VfM audit in 2022. The forensic team also reviewed these files for evidence of late amendments to working papers. No concerns of inappropriate conduct were identified from this review. The firm are satisfied, in respect of VfM work, this is an isolated incident.

The reason that the individual was able to change the working papers post finalisation was because the file had not been archived. The root cause of the files above not being archived was due to the fact that the policy in place at the time did not explicitly refer to archiving of VfM files. That policy was changed to be in place for all VfM arrangement assessments for periods beginning on or after 31 March 2022. To be clear there has always been a policy in place to archive all financial statement audit engagements.

From Q4 2022, we will also implement central oversight and monitoring of all signed opinions and conclusions to ensure timely completion of the corresponding workpaper files.



## Deloitte LLP

Of the two financial statement audits inspected, one was assessed as requiring significant improvements and one was assessed as good or limited improvements required.

The one VfM arrangements inspection was assessed as good or limited improvements required.

It is unacceptable that one of the two financial statement audit inspections identified that significant improvements were required. Urgent and robust action is required to address these findings.

Our selection of audits to inspect included one higher-risk 31 March 2020 audit that we had been unable to inspect in our previous inspection cycle due to the timing of the auditor's report. When scoping inspections, we considered previous years' findings at the firm and across the sector as areas of focus. We identified no recurrent key findings at the firm that would cast doubt on the efficacy of actions taken to address previous findings.

### Key findings



Significant improvements were required on one audit, where financial statement review procedures were inadequate and did not ensure that the financial statements were free from material errors and disclosure omissions. This included the £45 million overstatement of the loss on disposal of non-current assets caused by incorrect adjustment of an audit difference.

The firm must take urgent and robust action to address this finding, including:

- Performing a full RCA for the financial statement audit assessed as requiring significant improvements. This must establish the reasons for poor audit quality and how consistent high audit quality will be achieved.
- Considering the results from its internal monitoring to establish if there are any other areas of concern.
- Updating its ongoing Audit Quality Plan (AQP) for all findings and required actions from this inspection cycle.

AQR will test the efficacy of the firm's actions in its AQP in our next inspection cycle, where we may also select higher-risk 31 March 2021 audits that we were unable to inspect this year due to the timing of auditor's reports.

# 50%

At Deloitte LLP, one of the two financial statements audits inspected was assessed as requiring significant improvements.

# 100%

At Deloitte LLP, the one VfM arrangements inspection was assessed as good or limited improvements required.

## Good practice



Good practice points were identified on the two financial statement audits:

- On one audit, the strategy for selecting samples for detailed valuation testing was particularly well focused on risk. The audit team performed a planning analytical procedure to inform its sample selection. The audit team set a precise expectation for the movement in value of each individual property using third-party market data to identify outliers for sample testing.
- On another audit, the audit team demonstrated rigour when challenging the assumptions made in setting the non-domestic rates appeals provision, in particular by benchmarking to other councils. The audit opinion was ultimately qualified for this matter.

A good practice point was also identified on one VfM arrangements inspection:

- The commentary was supported by comprehensive evidence of the team's procedures, evaluation and conclusions reached. This included detailed notes of meetings with key officers.

## Firm's response to AQR reviews



Audit quality is and will remain our number one priority. We are proud of our people's commitment to delivering high quality audits and we continue to have an uncompromising focus on audit quality.

We are therefore extremely disappointed that one of our audits fell significantly short of the high standards we set and which should be expected from our audits. We have completed an RCA (as we do for all external inspections) and we are in the process of finalising the actions identified to respond to the RCA findings. These actions will be captured in our AQP which is monitored, reviewed and challenged by the Audit Executive and the Audit Governance board. In addition we are performing remediation of the audit file for the audit in question and the entities accounts will be restated. We are considering our internal monitoring to identify whether any additional matters in relation to local audits, or findings of a similar nature have arisen and where we need to take action.

It is positive that the FRC acknowledged that they did not identify any recurrent key findings which would cast doubt on effectiveness of previous actions taken. We take inspections very seriously and we have sought to address previous findings in particular through enhancing our audit approach in relation to property valuation. We have also reflected on the wider matters identified in the FRC cross firm reports. We regularly share findings and areas of challenge in inspections with our audit practitioners to support continuous improvement. We also value the identification of good practice in both the financial statement audits reviewed and will ensure that we share the lessons from that good practice with our teams.

## Appendix 1: Key local audit information

### Identifying major local audits

An analysis of available local audit data for the year ended 31 March 2022 identified 314 major local audits within AQR scope. The number of bodies changes annually as the definition of a major local audit is dependent upon meeting one of the following criteria:

- Total income or expenditure of at least £500 million; or
- For a local authority pension scheme, at least 20,000 members or gross assets in excess of £1,000 million.

The following table sets out the total number of local audits by sector, along with those assessed as meeting the major local audit definition. The audits for opted in local government bodies were awarded to five audit firms in five tiered tranches, following a full tender process conducted by PSAA in 2017. These audit appointments were made to cover five accounting periods, ending with 31 March 2023. The table also sets out the number of major local audits whose financial statement audit was subject to inspection by AQR.

Category	Total population	Major local audits	Inspected by AQR in 2021/22
Health Bodies (NHS Trusts and clinical commissioning groups)	176	93	6
Local government councils	347	131	11
Other bodies	128	16	1
Local authority pension funds	77	74	2
<b>Total</b>	<b>728</b>	<b>314</b>	<b>20</b>

## Audit firms completing local audits

There were six audit firms that completed at least one audit of a major local body for the financial year ended 31 March 2022.<sup>7</sup> The three firms with the largest market share of major local audits were Grant Thornton UK LLP, Ernst & Young LLP and Mazars LLP, with a collective share of 80%. All the firms involved, including the number of audits they completed and their respective market shares, were as follows:

Audit firm	Number of local audits	Market share	Number of major local audits	Market share	Inspected by AQR in 2021/22
Grant Thornton UK LLP	287	39.4%	125	39.8%	7
Ernst & Young LLP	189	26.0%	72	22.9%	4
Mazars LLP	121	16.6%	55	17.5%	3
KPMG LLP	49	6.7%	24	7.7%	2
BDO LLP	44	6.1%	21	6.7%	2
Deloitte LLP	38	5.2%	17	5.4%	2
<b>Total</b>	<b>728</b>		<b>314</b>		<b>20</b>

<sup>7</sup> PricewaterhouseCoopers LLP audited one non-major local audit for the year ended 31 March 2021. This was inspected by the Quality Assurance Department of ICAEW in its 2021/22 monitoring cycle.

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## Appendix 2: Firms' internal quality monitoring

### Results of firms' own monitoring

#### Background

This appendix sets out aggregated information relating to the six firms' internal quality monitoring (IQM) for individual audit engagements. It should be read in conjunction with each firm's transparency report, which provides further detail of the IQM approaches and results, and the firm's wider system of quality control. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

Due to differences in how inspections are performed and rated, the results of the firms' IQM may differ from those of external regulatory inspections and should not be treated as being directly comparable to the results of other firms.

#### Firms' approach to internal quality monitoring

The firms' internal inspection programmes generally consider the full population of both major and non-major local audits performed. The programmes are varied but are usually risk-based as well as structured to cover Key Audit Partners over a fixed period of time. Audit files are selected for review based on a number of criteria, including risk and public interest. Reviews are supervised by the firms' own internal quality teams.

#### Scope

The firms' IQM programmes, relating to local audit, covered 20 individual audits, of which eight related to major local audits.

The aggregate number of major local audits covered by the firms' own IQM was less than that of the AQR and amounted to:

Coverage of all local audits            2.7%

Coverage of major local audits       2.5%

Two firms had not completed and one firm had not started their planned IQM programmes when this report was compiled. This appendix excludes individual IQM reviews that had not been completed.

Three of the remaining five firms, who had completed at least one IQM review, did not review the work on VfM arrangements on each audit selected for review. Three of the remaining five firms reviewed 31 March 2020 local government audits where 31 March 2021 audits were not complete.

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## Results

### Financial statements audit

In aggregate, the firms reported that across the 20 financial statement audits reviewed, 18 (90.0%) were of a good standard or required only limited improvements. One audit was assessed as requiring improvements and one audit as requiring significant improvements.

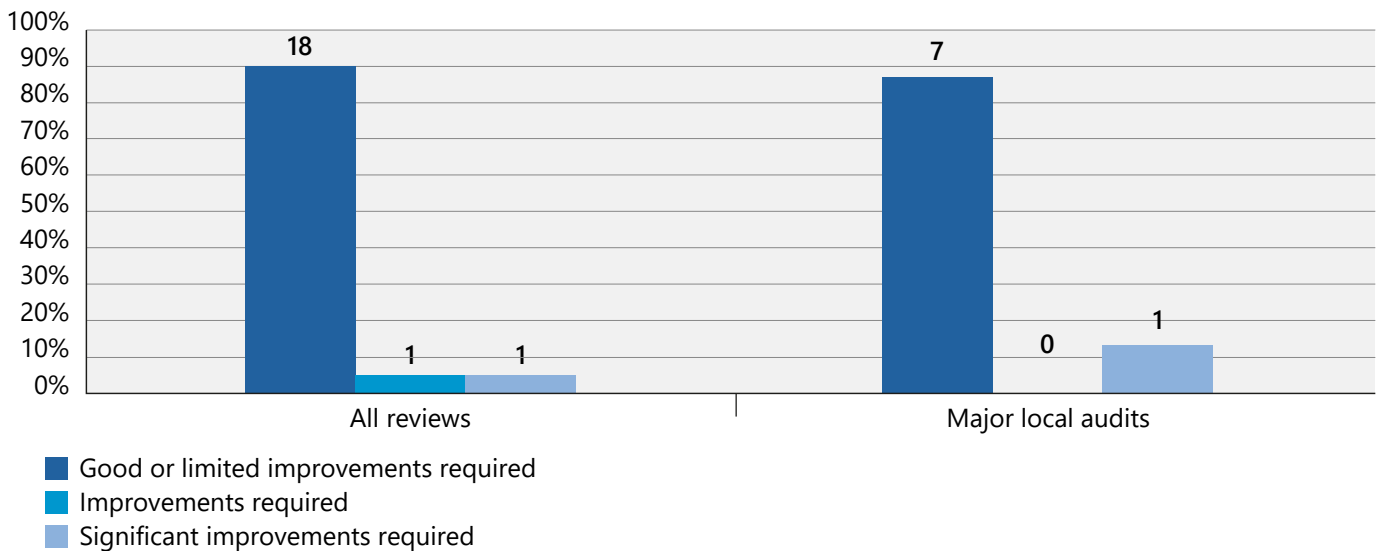
For the firms' major local audits, seven financial statements audits were reviewed and six (87.5%) were assessed as either good or requiring limited improvements. One audit was assessed as requiring significant improvements.

The firms reported that of the 16 VfM arrangements reviews, 15 were of a good standard or required only limited improvements. One review was assessed as requiring improvements.

The results of the firms' financial statement opinion reviews for local audits are set out below.

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### Aggregate of the firms' own internal quality monitoring



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The firms' various IQM programmes generally use the same grading categories as AQR but where this is not the case, we have aligned as closely as possible to those that would result from the AQR process.



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