

28 May 2014

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# Audit Quality Inspections

Annual Report 2013/14

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28 May 2014

# Audit Quality Inspections

## Annual Report 2013/14

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# 1 Introduction

This Report provides an overview of the audit quality inspection activities of the Financial Reporting Council's ("FRC") Audit Quality Review ("AQR") for the year ended 31 March 2014.

Our principal role continues to be the independent inspection of major audit firms<sup>1</sup> in the UK. **Section 2** includes a number of key messages arising from these inspections. These should be read in conjunction with the more detailed inspection findings in our individual firm reports, which are published separately. Our findings reflect the challenges of auditing large and complex entities within tight reporting timeframes, the extent of judgment required, and our exacting expectations of auditors of public interest entities.

**Section 2** also sets out the number of individual audits receiving each of the four grades we use to describe the quality of the audit work we inspected. The grading profile of those audits shows an improvement on prior years, although this improvement has not been observed at all firms inspected in 2013/14. These results indicate that the overall quality of audit work in the UK continues to be of a generally good standard but this is not always the case. **Section 3** provides further information on our grading of individual audits over the last five years.

The firms we inspect each year differs and we use a risk model in the selection of listed and AIM companies' audits to be reviewed each year. As a consequence the audits inspected may not be representative of the market as a whole. By way of example, in 2013/14 we gave particular emphasis to the audit of letterbox companies<sup>2</sup>. These factors illustrate that the summaries of our inspection results should be interpreted with caution and that the results in any one year should not be considered in isolation.

In 2013/14 we sought to enhance our interaction and engagement with relevant audit committees. We now send our reports on individual audits directly to the relevant audit committee. We also piloted holding discussions with audit committee chairs at the outset of our inspection of the audit of their respective entities' financial statements.

Our activities in 2013/14, as set out in **Section 4**, included, for the first time, two thematic inspections. Thematic inspections focus on specific aspects of auditing and involve a larger sample of audits and firms. They are particularly appropriate where we think that there may be scope for improvement generally (and to learn from best practice) across the profession. Separate reports are issued on these inspections.

A further development was that the Auditor Regulatory Sanctions Procedure came into effect in November 2013. Its potential effect is already being felt, and it should provide an important instrument for encouraging, and if necessary requiring, firms to improve the quality of audit work in the future.

Our inspection activities will be significantly affected by a number of recent developments - the most important of which are the recommendations made by the Competition Commission, the changes arising from the revised EU Statutory Audit Directive, and the abolition of the Audit Commission. The impact of forthcoming changes is discussed in **Section 5**.

Our inspections focus on where we believe improvements might be necessary, and we do not focus on those areas where we believe quality is good or has been adequately addressed previously. As a result this report is not a balanced scorecard which may create an unduly negative impression of overall audit quality and that there may be more problems in the UK than elsewhere. However, our discussions with overseas regulators confirm that this is not the case and that the issues identified in the UK, and in particular those discussed in this report, are also identified internationally.

We recognise the role our inspections play in promoting the overall quality of audit work in the UK and, consequently, confidence in financial reporting. Generally, improvements in audit quality are achieved because action plans are developed with the firms to address the weaknesses identified in individual audit engagements and firm-wide procedures by our inspections. Those action plans are then subject to follow-up inspections. In common with other regulators we are looking to give greater emphasis to remediation where we consider an audit requires significant improvements and we will, where appropriate, use the additional powers that the Auditor Regulatory Sanctions Procedure now provide. We have referred, and will continue to refer, more serious matters to the FRC's Accountancy Scheme, which investigates matters of misconduct affecting the public interest.

The range of activities discussed in this report together with the number of changes we have made or are expecting to make in the near future reflect our commitment to enhancing the effectiveness of our inspection regime to achieve further improvements in audit quality.

<sup>1</sup> Major audit firms are discussed in Section 4.2.

<sup>2</sup> Letterbox companies are those groups or companies that have little more than a registered office in their country of registration, with management and activities being based elsewhere. In such situations, the auditor is usually based in the country of legal registration, rather than where management is based.

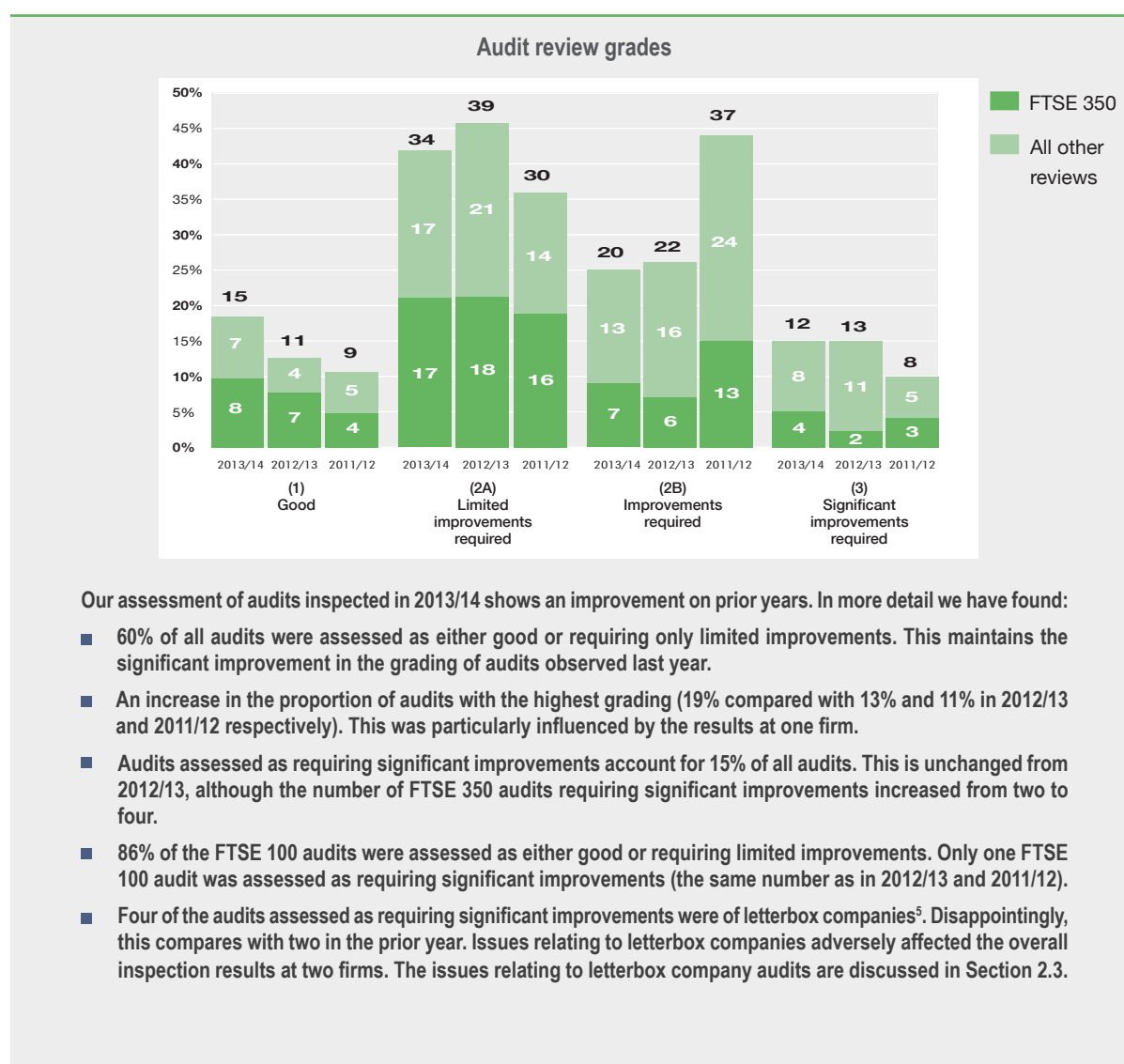
## 2 Key messages

### 2.1 Introduction

In this Section we provide a summary of our assessment of individual audits inspected in 2013/14 and highlight the key issues<sup>3</sup> arising from our 2013/14 inspections and other matters we wish to draw to the attention of audit firms.

### 2.2 Summary of 2013/14 inspection results

The following chart summarises our assessment of individual audits inspected (excluding public sector, third country auditors and follow-up reviews) over the last three inspection cycles (81<sup>4</sup> audits in 2013/14, 85 audits in 2012/13 and 84 audits in 2011/12)<sup>5</sup>. Our approach to assessing an individual audit is set out below.



<sup>3</sup> The absence of a key message that has previously been reported should not be taken to imply that we no longer consider the matter to be of concern, but rather that there are other matters to which we wish to give greater emphasis in 2013/14.

<sup>4</sup> Independently of AQR the FRC has launched an investigation into the preparation, approval and audit of the financial statements of one of the entities whose audit was included in our sample of audits inspected in 2013/14. As a result, a report on our review was not prepared and an assessment of the audit was not completed. This review has, therefore, been excluded from the above chart.

<sup>5</sup> Section 4.3 provides an analysis of the number of audits inspected by category and firm while Section 3 provides additional information, including trends, in respect of our assessment of audits.

### Our approach to the assessment of individual audits

Our reviews of individual audits focus on the sufficiency and appropriateness of the audit evidence obtained to support the key audit judgments made in reaching the audit opinion. Our initial assessment of an individual audit engagement is based primarily on the evidence on the audit files provided to us. However, our inspection conclusions take account, as appropriate, of any explanations provided to us by audit teams to supplement the evidence on the audit files.

We grade the audit work on individual audits as follows:

- good (grade 1);
- limited improvements required (grade 2A);
- improvements required (grade 2B); and
- significant improvements required (grade 3).

Our audit inspection work is subject to quality control procedures which include a peer review process at staff level and a final review of our findings by independent non-executives who approve the issue of all reports. These processes are designed to ensure a high quality of reporting and a consistent approach, including grading, across all inspections.

In previous years we have combined grades 1 & 2A in this report. This year we have reported all four grades separately in order to increase the transparency of our inspection findings.

An audit is given a grade 3 (assessed as requiring significant improvements) if we have significant concerns in relation to the sufficiency or quality of audit evidence, or the appropriateness of significant audit judgments or the implications of other matters are considered to be individually or collectively significant.

It is important to emphasise, that, as our reviews focus on how a particular audit was performed and are not designed to assess whether the information being audited was correctly reported, our assessment does not necessarily mean that an inappropriate audit opinion was issued or that the financial statements failed to show a true and fair view.

However, ISQC 1<sup>6</sup> requires that firms take further action where the results of their internal monitoring processes indicate that an audit opinion may be inappropriate or that procedures were omitted during the performance of the engagement. In the same way we expect firms to consider whether further action should be taken on those audits we have assessed as requiring significant improvements. In future inspections, we plan to give greater emphasis to the adequacy of these considerations. This will supplement our existing practice of undertaking further inspections of audits requiring significant improvement to assess how the issues identified have been addressed in the subsequent audit.

6 ISQC 1: Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.

## 2.3 Key messages

To continue to improve overall audit quality, we expect audit firms to pay particular attention to the key messages set out below.

### Banks and building societies

- The overall grading of bank and building society audits is, and continues to be, generally below those of other types of entity.
- A thematic inspection of bank and building society audits is being undertaken in 2014 to identify why progress in improving quality has been slow and what needs to be done to achieve necessary improvements. It is focused on the audit of loan loss provisions and related IT controls.

We inspected five bank and five building society audits in 2013/14<sup>7</sup>. As in previous years, our inspections included the audits of a number of major financial institutions where issues of significance were identified. One audit was assessed as requiring significant improvements. No audits were assessed as good (grade 1) and 56% were assessed as requiring improvement (grade 2B). Further information on the grading profile for bank and building society audits can be found in Section 3.

The audit of loan loss provisions continues to be of concern and it is disappointing that we have not seen any significant improvement in this area. Weaknesses in the testing of loan impairment models and related assumptions were key issues. Insufficient challenge of management or the failure to obtain further evidence to support provisioning judgments were common themes in the issues identified. The audit procedures to test management's identification of loans subject to forbearance arrangements for both provisioning and disclosure purposes also continued to be a concern.

As in previous years deficiencies were identified in the testing of the operational effectiveness of general IT controls and IT application controls on a number of bank

and building society audits. As discussed below, issues of this nature, however, are not restricted to financial sector audits.

In view of the recurring nature of our findings, and the lower overall grading profile, we have concluded that, despite the focus we already give to bank and building society audits, our routine inspections are not providing sufficient incentive to firms to improve their work in this sector, particularly in relation to loan loss provisions and related IT controls. We are, therefore, undertaking in 2014 a thematic inspection of the quality of bank and building society audits in these areas across the major firms. This inspection will consider the actions being taken by firms to address the issues of a recurring nature identified by our routine inspection monitoring. The findings from this thematic inspection are expected to be published in autumn 2014.

A number of high profile issues in respect of the conduct of banks and building societies have come to light in recent years. While the conduct of banks and building societies is the responsibility of other regulatory authorities, we have sought to support their work through our thematic inspection in 2013 of the audit of fraud risks and compliance with laws and regulations.

### Group audit considerations

- The quality of audit work at a group level has contributed to the number of audits assessed as good in 2013/14.
- Where audit work at a component level is inspected this is more likely to give rise to issues that adversely affect our overall assessment of the audit work.
- Firms should ensure there is greater consistency in quality between the audit work undertaken at group level and that in respect of components.

<sup>7</sup> See Footnote 4.

<sup>8</sup> Crown Dependency means Jersey, Guernsey or the Isle of Man.

In considering our inspection findings it is important to note that our responsibility when reviewing group audits is limited to the planning and control of the audit by the group engagement team, including their evaluation of the adequacy of the work performed by component auditors, and selected aspects of other work performed by the UK or Crown Dependency<sup>8</sup> firm at a group or component level. In the case of many FTSE 350 and other large listed companies, a significant amount of the underlying audit work is frequently performed by auditors in other jurisdictions and, as a result, is outside the scope of our review.

The nature and extent of audit work we inspect can, therefore, significantly affect our overall assessment of an audit. In a number of cases, our inspection was limited to the audit work undertaken at a group level, and we have seen improvements in quality as the requirements of ISA 600<sup>9</sup> become more fully embedded. This was a factor in the number of audits assessed as good in 2013/14. Conversely, where we inspected the audit work undertaken by the UK audit firm on a component this was more likely to give rise to issues which adversely affected our overall assessment of the audit.

With the exception of letterbox companies which we discuss below, many of the audits inspected in 2013/14 that we assessed as requiring significant improvements included a review of detailed component audit work in addition to that undertaken at group level.

#### Letterbox company audits

- Our reviews of the audits of letterbox companies, where virtually all of the work is performed by auditors other than those signing the audit report, continue to raise issues in respect of the control, supervision and review of the audit procedures performed by other auditors.
- Firms should ensure that their methodologies and related guidance for the audit of letterbox companies require sufficient involvement at all stages of the work of other auditors to meet the relevant requirements of Auditing Standards.

Given the concerns we identified in 2012/13, the audit of letterbox companies was an area of particular focus of our inspections in 2013/14.

Letterbox companies are those companies or groups that have little more than a registered office or correspondence address in their country of registration, with general, financial and corporate management and all economic activity being based elsewhere. The group auditor is usually based in the country of registration, rather than where management is based, and the majority of the audit work is performed by auditors in other jurisdictions.

This is in contrast to other large multi-national groups which may well have the majority of their operations overseas, but which have a fully functioning and sizable head office in their country of registration which exercises management and financial control over the group.

In May 2013 we wrote to firms setting out the issues arising from our reviews of the audit of letterbox companies and the need for firms to take action to achieve improvements in their approach to such audits. We also held meetings with firms.

Our key concern was that, contrary to Auditing Standards, the auditor signing the company or group audit report often had insufficient involvement in the audit, including not taking responsibility for the direction, supervision, performance and review of the engagement. In some cases the auditor was relying primarily on sign-offs from other auditors. We were particularly concerned that a number of firms had issued internal guidance which promoted such an approach.

We note that firms have made changes to their methodologies and guidance as a result of our concerns. However, at two firms we considered the revised guidance was inadequate and, in particular, did not make it sufficiently clear that the audit team should be appropriately involved in the performance of the audit work. At a further firm we were concerned that their revised guidance would not be available on a timely basis.

9 ISA 600: Special Considerations-Audits of Group Financial Statements (including the work of Component Auditors)



We have emphasised that we expect appropriate action to be taken by these three firms as soon as possible. So far two have since amended their guidance to address our concerns.

In general we welcome the initiatives firms have taken and we expect to see a reduction in the number of issues identified in our future inspections. In the current year, however, as the audits we inspected were conducted prior to the firms' changes to their methodology and guidance, we continued to identify a number of concerns. These issues significantly affected the inspection results at two firms, where two audits at each firm were assessed as requiring significant improvements.

#### Fair value measurements and impairments

- Deficiencies in the audit of fair value measurements and impairments were identified in a significant number of audits inspected in 2013/14, including five audits where the overall quality of the audit was assessed as requiring significant improvements.
- Limited evidence that firms have robustly challenged management, particularly in respect of the appropriateness of key assumptions and other judgments, was a key concern. Firms, with the assistance of audit committees, should ensure they appropriately challenge management.

The audit of fair value measurements and impairments is an area where we identified a number of deficiencies in our 2013/14 inspections. Our reports on more than 20 audits included issues relating to fair value measurement and impairments, with five of these audits assessed as requiring significant improvements. The extent of the issues identified was disappointing. A number of these related to the valuation of tangible and intangible assets, with a key concern being insufficient challenge of the appropriateness of management's key assumptions in assessing potential impairment, and in particular the feasibility of business plans.

The continued improvement of the economy is likely to reduce the instances where impairment is a finely balanced judgment. Notwithstanding this, we are concerned to see insufficient evidence of firms applying professional scepticism, robustly challenging management's assumptions, or requesting that adjustments be made to the financial statements. Audit committees have a valuable role to play in supporting and encouraging their auditors to challenge management in this way.

#### IT controls

- Significant improvement is required in the audit of IT controls.
- Firms should review their approach to the audit of IT controls and in particular:
  - whether audit teams have been provided with sufficient training and guidance to undertake this work effectively; and
  - when IT specialists should be used.

The audit approach for the largest listed entities, large retailers and financial institutions, where sufficient audit evidence cannot be obtained on a timely basis from substantive testing alone, generally requires the testing of the effectiveness of controls. The testing of IT controls, both general IT controls and application controls, is a key aspect of this approach.

In 2013/14 we strengthened our internal expertise in this area which enabled us to place more emphasis on the audit of IT controls. A range of issues was identified covering both weaknesses in firms' policies and procedures and deficiencies in the testing of controls in practice. Issues in relation to the audit of IT controls were a feature of a significant proportion of the audits we inspected. More common issues included limited consideration of the impact of IT general control weaknesses and insufficient IT general control roll-forward procedures being performed.

We observed on a number of occasions that IT application control testing was overly simplified:

- ‘Tests of one’ were relied upon although insufficient consideration was given to the control attributes or how they applied to different types of transactions.
- There appeared to be a failure to recognise the extent to which reliance was being placed on system-generated information. As a consequence the completeness and accuracy of system-generated reports were not always tested as they should have been.
- This was further exacerbated by the guidance provided to audit teams to support reliance on system-generated reports. This guidance was often at a high level and did not provide sufficient detail to enable audit teams to assess the most appropriate testing approach or how approaches will vary depending on the level of risk or the effectiveness of IT general controls.

We noted that while firms use IT specialists on the more complex audits, their work was sometimes limited to testing IT general controls, and that the testing of IT application controls was generally undertaken by the audit teams. The latter did not always have sufficient understanding, training or appropriately detailed guidance on how to test automated IT application controls effectively.

Firms should review their approach to the audit of IT controls and the training and guidance provided to audit teams about how to undertake testing effectively and when to call upon IT specialists to carry out relevant work.

#### **Auditor independence and ethics: financial interests in audited entities**

- Instances of partners holding financial interests in audit clients indicate that the prohibition on such holdings in the Ethical Standards is not as well understood as it should be.
- Firms should review the robustness of their policies and procedures and the communication thereof, both to prevent and respond to instances of this nature.

Of note in the current year are a small number of further instances of partners holding shares in audited entities contrary to the Ethical Standards. As a result, the FRC is currently investigating two matters of this nature.

The requirements of the Ethical Standards in this regard are fundamental to auditor independence; have been in place for a number of years; and, therefore should be observed by partners and staff. It was, therefore, of significant concern that we continue to identify such matters. Equally concerning in certain of these cases was the failure of the firms’ processes and procedures to respond effectively in a timely manner to such matters once they were identified, or to ensure that the issues were appropriately escalated.

Firms must ensure they have appropriate policies and procedures in place both to prevent and respond to instances of this nature.

#### **Auditor independence and ethics: non-audit services**

- Sufficient consideration is not always given to the appropriateness of providing non-audit services when an entity becomes an audit client or is subsequently listed.
- Firms should ensure they have appropriate procedures in place to monitor the ongoing provision of non-audit services to existing clients.

We continued to identify a range of issues in relation to the provision of non-audit services. These included two instances where insufficient consideration was given to the appropriateness of continuing to provide such services when there was a change in status of the entity.

In the first case the firm provided payroll services to a subsidiary of an entity which was subsequently listed on AIM. The firm continued to provide these services although they were not permissible under the Ethical Standards for a listed entity.

In the other case the firm developed a forecasting model for an entity to facilitate a trade sale. The firm was appointed auditor in the following year and, some years later, the entity listed on the London Stock Exchange.

The firm continued to undertake enhancements to the functionality of the model which was used to develop forecasts supporting a number of management judgments affecting the financial statements. In this instance the firm did not adequately assess the significance of the self-review threat to its independence when it undertook the further work on the forecasting model.

These instances highlight the need for firms to ensure they have appropriate procedures in place to monitor the ongoing provision of non-audit services to existing clients.

### Enhanced reporting by auditors

- Auditing Standards now require a number of important additions to the auditor's report for companies that apply the UK Corporate Governance Code. These are intended to improve the transparency of the audit process.
- Initial indications are that firms are interpreting these requirements differently and are not adopting a boiler plate approach.
- We will review the way in which these new requirements have been implemented as part of our 2014/15 inspections.

The revised Auditing Standard on auditor reporting, which is effective for audits of financial statements for periods commencing on or after 1 October 2012, introduced a number of important additions to the audit report for those companies that apply the UK Corporate Governance Code. In particular the auditor's report should:

- Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the audit strategy, allocation of resources in the audit and directing the efforts of the engagement team;
- Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; and

- Provide a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the auditor's application of the concept of materiality, as disclosed in the auditor's report.

In addition the auditor is required to report by exception if the board's statement in the Annual Report is inconsistent with the auditor's knowledge acquired in the course of performing the audit or if the matters disclosed by the audit committee in the section of the Annual Report describing its work do not appropriately convey the matters communicated by the auditor to the audit committee. The auditor is, therefore, required to report such matters if the audit committee fails to do so.

These changes are intended to make the auditor's report more informative for investors. They place the UK at the forefront of the wider international developments in auditor reporting.

Firms are now starting to apply this Standard and our initial review of early reports indicates that firms are interpreting these requirements differently. It is pleasing to note that these new requirements do not seem to be giving rise to excessive boiler-plate or legalistic auditor's reports.

Given the importance of these changes, as part of our inspections in 2014/15 we will review both the guidance developed by firms to assist audit teams in meeting the additional requirements of the Standard and its application in practice.

## 3 Analysis

### 3.1 Introduction

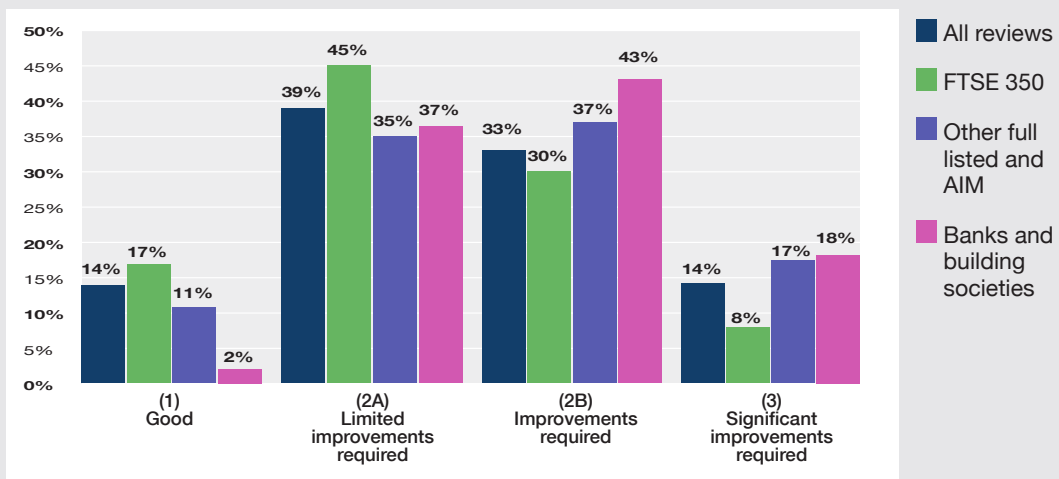
In last year's annual report we provided an analysis of our inspection results over a five year period. In this year's report we have updated the analysis for the current year's inspection results and have provided further analyses by type of entity, in each case using a four level grading system as discussed in Section 2.2.

Over the last five years we have inspected 413 audits including the audits of 72 FTSE 100 companies, 106 FTSE 250 companies and 149 other full listed and AIM companies. Throughout this Section, we have excluded any reviews we have conducted of public sector entities or of third country auditors. We have also excluded follow-up reviews.

### 3.2 Aggregate assessment

The following chart provides the disposition of grades of all audits inspected in aggregate over the last five years with comparatives for the FTSE 350, other full listed and AIM, and banks and building societies<sup>10</sup> respectively. A brief commentary is set out below.

Disposition of audit review grades by type in aggregate over five years



- The disposition of grades of FTSE 350 audits inspected in the last five years continues to be better than that for all audits inspected as indicated by:
  - A higher proportion of audits assessed as grade 1 or 2A (62%).
  - A lower percentage of audits assessed as a grade 3 (8%).
- Conversely the proportion of other full listed and AIM and bank and building societies assessed as grade 1 or 2A is significantly lower (46% and 39% respectively) than that for all audits inspected and also the FTSE 350. The proportion assessed as grade 3 is higher (17% and 18%) than that for all audits inspected and also the FTSE 350.
- The above analysis while confirming a similar pattern to the prior year five year average indicates an increasing differential between FTSE 350 audits and other categories of audits inspected over the last five years.

<sup>10</sup> Banks and building society includes all entities classified as such and therefore includes entities also included in the FTSE 350 and other full listed and AIM analyses above.

### 3.3 Average assessment

The following chart depicts the average grade for all audits inspected in each of the last five years, with comparatives for the FTSE 350, other full listed and AIM and banks and building societies respectively<sup>11</sup>. A brief commentary is set out below.



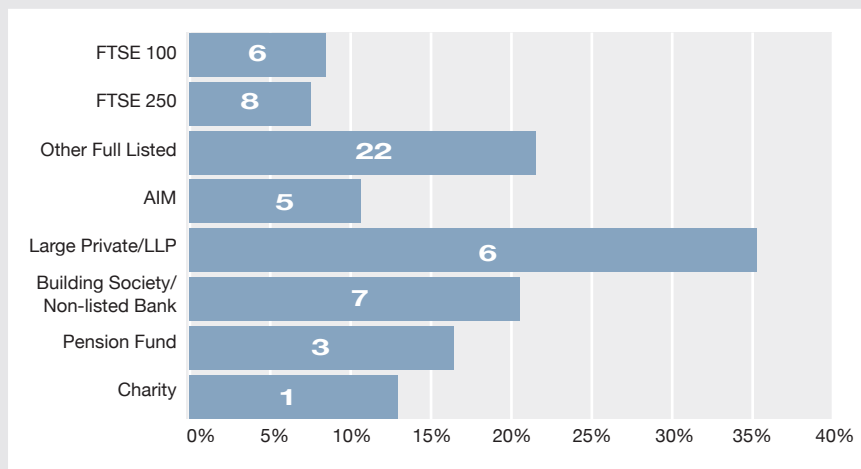
<sup>11</sup> See footnote 4.

<sup>12</sup> Section 4.3 provides details of the number of bank and building societies inspected in each of the last three years.

### 3.4 Audits requiring significant improvements

The following chart provides an analysis of all audits assessed as requiring significant improvements (grade 3) by type of entity in the last five years. The graph shows the number of grade 3 audits for each type of entity inspected in the last five years, together with the percentage of the total audits of this type that this represents. A brief commentary on this analysis is set out below.

**Audits requiring significant improvements by type of entity**



- Listed companies outside the FTSE 350 account for the largest number of grade 3s in the last five years (22 in total). This represents 22% of smaller listed audits inspected in this period.
- By contrast 8% of all FTSE 100 and FTSE 250 companies inspected were assessed as grade 3. The FTSE 350 account for the lowest proportion of audits assessed as grade 3.
- Large private companies and LLPs have the greatest proportion (35%) of audits assessed as grade 3.
- There appears to be some correlation between the size of the entity and the overall quality of the audit, with a higher proportion of smaller entity audits assessed as a grade 3. This is consistent with wider concerns within the FRC in respect of the quality of financial reporting and auditing by smaller listed and AIM companies. In response to these concerns we are undertaking in 2014/15 a thematic inspection of the auditor's consideration of the quality of financial reporting in smaller listed and AIM companies.

## 4 Summary of activities

### 4.1 Introduction

This Section provides a summary of the inspections and other activities undertaken in 2013/14.

### 4.2 Scope of inspections

We undertake full scope inspections of those firms (“the major firms”<sup>13</sup>) that audit more than ten public interest entities falling within the scope of independent inspection, as determined each year. These inspections cover a sample of audits of public interest entities and the firms’ policies and procedures supporting audit quality<sup>14</sup>. Appendix A outlines the inspection process and basis of reporting and Appendix B sets out the scope of inspections for 2013/14. The frequency of inspection varies - with each Big Four firm being inspected annually, while other major firms are inspected on a two or three yearly cycle. In 2013/14 our full scope inspections included Baker Tilly UK Audit LLP (BDO LLP and Grant Thornton UK LLP were inspected in 2012/13). Proposed changes to the frequency of inspection for other major firms are discussed in Section 5.2.

The UK professional accountancy bodies register and authorise firms to conduct audit work. They are responsible for monitoring the quality of audit engagements falling outside the scope of our inspection, but within the scope of audit regulation in the UK. Their work, which is overseen by the FRC, covers audits of UK incorporated companies and certain other entities which have no securities listed on the main market of the London Stock Exchange and whose financial condition is not otherwise considered to be of major public interest. They also undertake inspections, on a delegated basis<sup>15</sup>, at those firms with ten or fewer audits falling within the scope of independent inspection. These inspections are discussed in Section 4.14.

Other inspections in addition to those of the major firms, relate to third country auditors, the Crown Dependencies and the public sector. Further details in respect of these inspections are provided in Sections 4.7, 4.8 and 4.9 respectively.

### 4.3 2013/14 inspection activity

In the year to 31 March 2014 our inspections included the review of 101 individual audit engagements. The audits related to financial years ending between December 2011 and April 2013, with a significant proportion being 31 December 2012 year ends. An analysis of the audits reviewed by category of inspection, together with comparatives, is set out in the following table.

13 There are currently nine “major firms” being Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit Plc, PricewaterhouseCoopers LLP (“Big Four” firms), and Baker Tilly UK Audit LLP, BDO LLP, Crowe Clark Whitehill LLP, Grant Thornton UK LLP and Mazars LLP.

14 The Companies Act 2006, as amended, requires the independent inspection of auditors undertaking statutory audits of listed companies and other entities in whose financial condition there is considered to be major public interest.

15 The Companies Act 2006, as amended, permits the delegation of inspection activities to the monitoring units of the professional accountancy bodies for those firms conducting ten or fewer audits within our scope.

Inspection Category	Audit File Reviews 2013/14	Audit File Reviews 2012/13	Audit File Reviews 2011/12
<b>Big four firms</b>			
Deloitte LLP	17	16	15
Ernst & Young LLP	16	14	13
KPMG LLP/ KPMG Audit Plc	17	15	15
PricewaterhouseCoopers LLP	19	16	16
	<b>69</b>	<b>61</b>	<b>59</b>
<b>Other major firms</b>			
Baker Tilly UK Audit LLP	6	-	4
BDO LLP	-	7	1
Crowe Clark Whitehill LLP	-	-	6
Grant Thornton UK LLP	-	10	1
Mazars LLP	-	-	4
PKF (UK) LLP (Now part of BDO LLP)	-	-	8
<b>Major firms</b>	<b>75</b>	<b>78</b>	<b>83</b>
Firms auditing ten or fewer entities within scope	-	11	11
Crown Dependency audit firms <sup>16</sup>	7	8	-
Third country auditors	3	-	-
<b>Public sector</b>			
National Audit Office	6	6	6
Audit Commission	-	4	4
Audit Commission appointed firms	10	4	4
<b>Total audit files inspected</b> <sup>17</sup>	<b>101</b>	<b>111</b>	<b>108</b>

The above table shows a decrease in total audits reviewed compared with prior years. This reduction results from the decision to delegate to the professional bodies the inspection of audits at firms with ten or fewer entities within scope as discussed in Section 4.14. This delegation has enabled us to increase the number of Big Four firm audits we inspect.

Since we commenced inspection activities in 2004, we have reviewed more than 900 audits, including the audits of 159 FTSE 100 companies and 214 FTSE 250 companies. The composition of these indices changes quarterly and a number of companies have been inspected more than once.

A further analysis of audits inspected by type of entity is set out in the following table:

Type of Entry	2013/14	2012/13	2011/12
FTSE 100	14	13	18
FTSE 250	22	24	18
<b>FTSE 350</b>	<b>36</b>	<b>37</b>	<b>36</b>
Other full listed	27	29	18
AIM	7	8	12
Non-listed banks	2	6	6
Building societies	5	6	4
Large private companies/LLPs	2	3	8
Pension funds	4	4	6
Charities	2	2	3
Collective investment funds	-	2	1
Public sector	16	14	14
<b>Total audit files inspected</b>	<b>101</b>	<b>111</b>	<b>108</b>
<b>Total UK banks and building societies</b>	<b>10</b>	<b>14</b>	<b>11</b>

<sup>16</sup> This total relates to Crown Dependency companies audited by stand-alone Crown Dependency firms. A further 11 and 10 Crown Dependency audits were inspected at the Major Firms in 2013/14 and 2012/13 respectively.

<sup>17</sup> This total includes 12 and 10 follow-up reviews at the Major Firms and those firms auditing ten or fewer entities within Scope in 2012/13 and 2011/12 respectively.



We use a risk model covering listed and AIM quoted companies, to inform the selection of audits to be reviewed each year. The majority of audits selected for review are drawn from those identified as higher risk within the risk model.

#### 4.4 Thematic inspections

In 2013/14 we completed two thematic inspections. These inspections related to audit materiality and aspects of the audit of fraud risks and compliance with laws and regulation. Reports on these inspections were published in December 2013 and January 2014 respectively. Copies of these are available on the AQR section of the FRC's website. These reports contain a number of key messages to both firms and audit committees.

In relation to materiality we noted that firms should review their guidance to ensure it appropriately addresses a wide range of areas where our inspection identified that improvements were required. In respect of the audit of fraud risks and compliance with laws and regulation, the key issue was the relative lack of attention paid to these areas by audit teams. We intend to follow-up with firms the specific actions they have taken to address the key findings in these reports.

Two further thematic inspections are underway in 2014/15 - covering aspects of the quality of bank and building society audits and the auditor's consideration of the quality of financial reporting in smaller listed and AIM companies. The latter inspection forms part of a wider FRC project responding to ongoing concerns in relation to the extent of deficiencies in the quality of financial reporting by smaller listed and AIM companies.

#### 4.5 Interaction with audit committees

Audit committees are a key audience for our inspection findings. The confidential reports on each of the audits we inspect, together with our public inspection reports on audit firms, are important vehicles for communicating our inspection findings. We therefore send a copy of each directly to the relevant audit committee or, where there is no audit committee, to those charged with governance of the audited entity at the same time as it is provided to the audit firms.

In 2013/14 we piloted a change to our procedures under which we held a discussion with the audit committee chair at the commencement of our inspection of twenty audits. Such discussions helped us plan certain aspects of the inspection. No significant concerns about audit quality were raised by the audit committee chairs we spoke to. In most cases they were positive about their relationship with their auditors and were satisfied with the quality of their work and business understanding. This assessment was not always supported by our inspection findings. In a few cases the audit committee chair commented or implied that they would welcome a greater degree of scepticism from their auditors and greater evidence of alternative views to those of management. We intend to extend this pilot in 2014/15 and, in particular, will engage with bank and building society audit committee chairs as part of our banking thematic inspection.

We also hold an annual event at which audit committee chairs are invited to discuss aspects of the FRC's work of particular relevance to audit committees, including issues arising from our inspections. We would welcome comments and observations on how we might further engage with audit committees to improve the overall effectiveness of our inspections.

#### 4.6 Auditor Regulatory Sanctions Procedure

This Procedure, which came into effect in November 2013, provides the FRC with the power to impose regulatory sanctions, in appropriate circumstances, where a Registered Auditor fails to comply with the regulatory framework for auditing (which includes Auditing and Ethical Standards). Regulatory sanctions include the imposition of restrictions or conditions, a regulatory penalty (fine) and the suspension or withdrawal of audit registration. The Procedure is intended to apply to matters identified as part of our UK statutory inspection process. A similar procedure applicable to our Crown Dependency inspections is expected to be implemented in 2014.

By the time the Procedure came into force, the majority of our 2013/14 inspection work had been completed. As a consequence this limited the number of matters where use of the Procedure might have been considered appropriate. While no sanctions have to date been determined under this Procedure, we have on several occasions indicated that we were minded to apply a sanction unless a firm took action to address a particular issue. This approach has been effective in encouraging changes in behaviour.

#### 4.7 Third country auditor inspections

The third country auditor inspection regime commenced in 2013/14. Third country auditors (TCAs) are auditors of non-EEA<sup>18</sup> incorporated companies that have issued securities on UK regulated markets, principally on the LSE main market. The regulation of TCAs under the EU Statutory Audit Directive is one of the responsibilities delegated by the Government to the FRC.

At 31 March 2014 there were 112 TCAs registered with the FRC from 45 countries with 208 relevant issuers. Most of these TCAs are members of the Big Four firm's international networks. There are significantly more third country issuers on UK markets than for any other EEA States and their auditors come from a wide spread of countries around the world.

A number of TCA countries have inspection regimes that have been assessed by the European Commission ("EC") to be equivalent to those in the EEA while others are in the process of establishing such regimes and have been granted transitional status by the EC.

Under the regulatory requirements, our inspection of TCAs excludes those auditors based in countries with either equivalent or transitional status. This reduces the population of TCAs subject to inspection to 49 (registered as "Article 45-Full"), of which four TCAs currently audit no relevant issuers.

In 2013/14 we reviewed three audits undertaken by TCAs. This was fewer than anticipated due to difficulties in navigating the legal and practical challenges arising from inspections in a wide range of jurisdictions around the world.

The audits inspected were undertaken by two firms in Kazakhstan and one in Bahrain. These inspections are discussed in more detail in a separate report. This report, together more information on our TCA inspections can be found on the FRC's website.

#### 4.8 Crown Dependency inspections

Firms undertaking the audits of companies incorporated in the Crown Dependencies (Jersey, Guernsey and the Isle of Man), with securities that are traded on a regulated market in the EEA, are required to be subject to independent inspection. The arrangements that have been put in place ensure that the Crown Dependencies have auditor oversight arrangements that are equivalent to those in place in EEA member countries under the EU's Statutory Audit Directive.

In conjunction with the monitoring unit of the ICAEW<sup>19</sup>, we have entered into arrangements with the Crown Dependency regulatory authorities to undertake these inspections on their behalf. We are responsible for inspecting all major UK audit firms registered to undertake the audits of relevant Crown Dependency companies, together with non-UK audit firms with more than ten relevant audits (currently KPMG Channel Islands Limited and PricewaterhouseCoopers CI LLP). We have also agreed with the ICAEW that where other firms audit FTSE 350 Crown Dependency companies, we will take responsibility for the inspection of those audits.

In 2013/14 our Crown Dependency inspections included major UK audit firms, and PricewaterhouseCoopers CI LLP. In total we inspected 18 audits of Crown Dependency companies. The cost of these inspections is met by the individual firms concerned.

One of the benefits of these inspection arrangements is that the audits of companies incorporated in a Crown Dependency which are listed in the UK are now subject to our inspection. This includes a number of major FTSE 350 companies, including eight FTSE 100 companies. The findings from our inspection of the audits of Crown Dependency companies are incorporated within the findings in Section 2.

<sup>18</sup> EEA (European Economic Area) comprises the EU, Iceland, Lichtenstein and Norway.

<sup>19</sup> The ICAEW is also responsible for registering firms to conduct Crown Dependency audit work.

## 4.9 Public sector inspections

Our public sector inspections cover the National Audit Office and those firms undertaking audits on behalf of the Audit Commission. These inspections are undertaken primarily in the first quarter of each calendar year, the period in which we undertake less inspection fieldwork at the major firms. Public sector inspections, therefore, contribute to the overall efficiency and cost-effectiveness of our inspection activities and add to our overall view of audit quality in the UK. Each of these inspections is discussed below.

### National Audit Office (NAO)

As the Independent Supervisor, the FRC is required under Section 1229 of the Companies Act 2006 to supervise the performance of the NAO's statutory audit work. This inspection, which is undertaken annually, comprises the review of a small sample of statutory audits together with a review of the NAO's policies and procedures relevant to this audit work. The statutory audits reviewed are not "major audits" as defined in the Companies Act and are therefore outside our normal inspection scope. The FRC as Independent Supervisor is required to report on the results of this inspection annually to the Secretary of State.

In addition, by agreement with the NAO, we review a small sample of its government department and public body audits.

Other than the FRC's report to the Secretary of State, we do not report publicly on the findings from these inspections.

### Audit Commission

At the request of the Audit Commission we inspect those firms that undertake local authority and health body audits on behalf of the Audit Commission ("Appointed Firms"). There are currently seven appointed firms, all of which are major firms and, therefore, subject to full scope inspections as discussed in Section 4.2. The inspections we undertake on behalf of the Audit Commission are, however, outside our statutory scope and the findings are not subject to public reporting.

In prior years our inspection also included the Audit Commission's in-house Audit Practice. However this was disbanded in 2012.

Our inspection is limited to the review of a sample of audits covering both the audit of the financial statements and value-for-money audits. The audits and firms inspected each year are determined in consultation with the Audit Commission. In 2013/14 we inspected ten local authority and health body audits. Changes to these inspection arrangements following the enactment of the Local Audit and Accountability Act are discussed in Section 5.4.

## 4.10 Liaison with Corporate Reporting Review

We work closely with the FRC's Corporate Reporting Review ("CRR") team, which supports the FRC's Financial Reporting Review Panel and with whom we share both information and findings. Our selection of reports and audits for review are influenced by a common approach to risk and similar industry focus areas.

We share findings to help direct future selections where there are matters of potential interest or concern to the other work-stream. In particular, if we identify a matter where we consider there is sufficient doubt as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, we draw the matter to the attention of CRR. We also utilise CRR accounting technical expertise to support our review of the conduct of the audit and the appropriateness of the audit opinion.

In 2014/15, we will continue to work collaboratively on a limited number of joint reviews, including the banking thematic inspection and we have made a number of recommendations to inform our respective selections of reports and audits for review.

## 4.11 Input to standard-setting process and policy matters

As an important consequence of our work, we gain an overall understanding of how firms are interpreting and

applying the requirements of Auditing, Ethical and Quality Control Standards. We, therefore, continue to provide regular feedback to the FRC's Codes and Standards Division on issues arising from our inspections in relation to the application of standards in practice and how they might be improved.

Of particular note is the assistance being provided to the review of the Ethical Standards framework which is part of a wider FRC project intended to increase confidence in the value of audit.

We sought input from our colleagues in the Codes and Standards Division in planning our inspection activities for 2013/14. In particular, when scoping the thematic reviews discussed in Section 4.4, we gave particular consideration to the likely value of the output from a standard-setting and policy-making perspective. This is consistent with the FRC's focus on evidence-based decision making.

We also have regular discussions with our international counterparts on standards and policy matters and have participated in various initiatives to engage directly with international standard-setting bodies and others with an interest in this area, such as investor groups.

#### 4.12 Collaboration with the Prudential Regulation Authority ("PRA")

During 2013/14 we met the PRA regularly to discuss areas of mutual interest. These discussions were wide ranging and covered issues relating to banks, building societies, insurance and investment management companies. The PRA shared with us intelligence from its supervisory enquiries which might have a bearing on the external audit, as well as the output from its bi-lateral and tri-lateral meetings with auditors and management. These discussions informed both our selection of audits for review and the specific areas of the audit work to focus on.

In turn, we provided the PRA with specific feedback on the issues arising from the audits of the banks, building societies, insurers and investment management companies that we reviewed in 2013/14. We also

provided them with a copy of our report on each of these reviews. If any of our reviews suggest that the audit requires significant improvements, the PRA discusses our findings with both the auditors and the company.

#### 4.13 International liaison

We meet regularly with other audit regulators and participate in the International Forum of Independent Audit Regulators ("IFIAR") plenary meetings, working groups and inspection workshops. At a European level we are steering group members of the European Audit Inspection Group ("EAIG") which includes audit regulators from all EU member states. The EAIG facilitates the sharing of information between regulators and has developed a database to share inspection findings between members and is in the process of developing a common inspection methodology.

We note that there continues to be considerable commonality between our inspection findings and those of audit regulators in other major jurisdictions.

In accordance with the Statement of Protocol agreed in 2011 with the US Public Company Accounting Oversight Board ("PCAOB"), our inspection at Deloitte LLP in 2013/14 was undertaken jointly with the PCAOB. Further inspections with the PCAOB are planned in 2014/15.

#### 4.14 Delegated inspections

There are approximately fifty firms with ten or fewer audits within our scope. In many cases these firms have only one or two audits within scope and these include a number of very small listed companies. The Companies Act permits the inspection of these firms to be delegated to the monitoring units of the professional accountancy bodies in the UK. In 2013/14 the inspection of all such firms was delegated in full. Previously we undertook inspections of a small sample of audits at these firms, while the professional body monitoring units inspected their policies and procedures supporting audit quality.

Where inspections are delegated, we are required to approve the inspection methodology and the assignment of inspectors to undertake this work. We also review and

approve the completed inspection reports produced by the monitoring units, prior to their submission to the relevant audit registration committee. This oversight provides an opportunity for collaborative working with the respective monitoring units and contributes to the overall quality of their inspection activities.

In 2013/14, 14 reports were reviewed and approved in respect of delegated inspections. Future changes to the delegated inspection arrangements are outlined in Section 5.3.

#### **4.15 Basis of funding**

We form part of the FRC's Conduct Division and have a staff of approximately 23 full-time equivalents. The direct costs of the inspection activities falling within our normal scope are funded by the relevant professional accountancy bodies. Inspection activities outside our normal scope, such as those relating to public sector bodies, the auditors of Crown Dependency entities, and TCAs are subject to separate funding arrangements designed to recover in full the costs of these inspections.

## 5 Future inspection activities

### 5.1 Introduction

Our inspection activities are projected to increase significantly in the near future as a consequence of a number of changes to the regulatory environment. In this Section we discuss the nature of these changes and their impact on our inspections.

### 5.2 Competition Commission recommendations

In October 2013 the Competition Commission issued its report on the provision of statutory audit services to large companies in the UK. This report included a number of recommendations in respect of our inspection activities as follows:

#### *Inspection frequency and reporting*

***AQR should aim to inspect and report on each major firm annually, subject to the firm having sufficient audits within the scope of its inspections to make this practicable.***

As discussed in Section 4.2 our current approach is to inspect and report on the Big Four firms annually, with other major firms inspected on a two to three year cycle. Following the Commission's recommendation we intend to move the inspections of BDO LLP and Grant Thornton UK LLP on to an annual cycle. This will take effect from 2014/15 and will mean that the six largest major firms will now be inspected and reported on annually.

The three other major firms<sup>20</sup> will remain on their current three yearly inspection cycle as the number of audits falling within our scope of inspections is significantly lower than the other firms. In our view annual inspections of these firms would be both impracticable and disproportionate.

Crowe Clark Whitehill LLP and Mazars LLP, which were previously inspected in 2011/12, will, therefore, be inspected in 2014/15 whilst Baker Tilly UK Audit LLP, which was inspected in 2013/14, will not be subject to a further full inspection until 2016/17. In 2015 this will be supplemented by an interim inspection of the adequacy of actions taken or planned.

#### *Inspection of the FTSE 350*

***All FTSE 350 audit engagements should be inspected by AQR on average every five years with each individual audit engagement inspected at least every seven years.***

Our analysis of the current constituents of the FTSE 350 indicates that there are 335 companies that fall within the scope of our inspections. The remaining 15 FTSE 350 companies are excluded as they are outside our remit because they either have EEA or non-Article 45 third country auditors.

Implementing the Commission's recommendation would require us to inspect 67 FTSE 350 companies annually. This compares with 36 or 37 inspected in the last three inspection cycles.

We plan to progressively increase the number of FTSE 350 audits reviewed annually to meet the Commission's recommendation, which we anticipate achieving by 2016/17. In 2014/15 we are aiming to inspect around 50 such audits.

#### *Extended audit committee reporting*

***An audit committee of a FTSE 350 company should report whether AQR had concluded a review of the audit of the company's financial statements in the reporting period, what the principal findings were including grade and how both the audit committee and the auditors responded to these findings.***

We currently report the findings from individual inspections to the auditor and the audit committee in a private capacity as noted in Appendix A. The move from such private reporting to greater public information about specific inspection findings requires careful consideration of the implications and consultation with those affected.

The Commission recommended that the FRC amend the Corporate Governance Code to give effect to this recommendation together with a number of other matters not related to AQR inspections. A number of the other changes to the Code required binding Orders, the finalisation of which was deferred by the Commission, in order that the implications of the amendments to

<sup>20</sup> Baker Tilly UK Audit LLP, Crowe Clark Whitehill LLP and Mazars LLP

the EU Statutory Audit Directive could be assessed. The FRC has therefore decided to defer consideration of whether to make any changes to the section of the Code dealing with the audit committee and appointment of the external auditor until the Code is next reviewed, currently scheduled to be in 2016.

The FRC intends to consult separately in 2014 on guidance to audit committees on how they might report to shareholders on the findings of an AQR review. This was recommended as good practice by the Competition Commission.

### 5.3 EU Statutory Audit Directive

Recent changes to the EU Statutory Audit Directive will limit our ability to delegate the inspection of those firms with ten or fewer audits falling within the scope of our inspection.

As discussed in Section 4.14, we currently delegate the inspection of all such firms to the monitoring units of the professional accountancy bodies in the UK.

From 2016 the revised Statutory Audit Directive will require all firms that audit public interest entities to be inspected independently of the profession. The impact of this change will depend on the definition of a public interest entity for this purpose.

The Statutory Audit Directive definition of a public interest entity includes entities listed on a regulated market in a member state, banks and insurance companies but also allows member states to designate other entities as public interest. The current definition for AQR inspections includes a number of other categories of entities as specified in Appendix B.

A proportionate inspection programme which covers both a sample of audits and the firm's procedures supporting audit quality will need to be developed for this group of firms.

### 5.4 Local Audit and Accountability Act 2014

This Act provides a framework for the regulation of local authority and health body auditors, including audit quality monitoring arrangements. This framework, which mirrors the arrangements set out in the Companies Act, has been put in place following the Government's decision to abolish the Audit Commission.

As discussed in Section 4.9 we currently undertake inspections of auditors of local authority and health bodies on a contractual basis for the Audit Commission covering both the financial statement and value-for-money audits. In future we will be required under the Act to inspect those auditors that undertake the very largest of these audits and we envisage that the number of audits inspected annually will increase from 10 currently to approximately 20. While a number of transitional arrangements mean that these changes are not envisaged to impact our inspections until 2018/19, we are planning their implementation.

As we currently inspect all firms undertaking local authority and health body audits under the Companies Act inspection regime, we envisage that our inspection reports on these firms will, in time, also include the findings relating to those local authority and health body audits inspected.

### 5.5 Cumulative impact on inspection activities

Once fully implemented, we are projecting that the above changes will result in the number of audits inspected annually increasing to around 160, an increase of 60% on 2013/14, while the number of annual inspection reports is likely to exceed 20.

We are currently in the process of recruiting additional resources and are reviewing our processes and structures in order to manage this significant increase in our inspection activity.

# Appendix A – Inspection process and basis of reporting

## Inspection process

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor firms' compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies. The Standards referred to in this report are those effective at the time of our inspections or, in relation to the reviews of individual audits, those effective at the time the relevant audit was undertaken.

Our inspections comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year. The scope of inspections for 2013/14 is set out in Appendix B.

Our review of their policies and procedures supporting audit quality covered the following areas:

- Tone at the top and internal communications
- Transparency reports
- Independence and ethics
- Performance evaluation and other human resource matters
- Audit methodology, training and guidance
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Other firm-wide matters

Our reviews of individual audit engagements and policies and procedures supporting audit quality cover, but are not restricted to, compliance with the requirements of

relevant standards and other aspects of the regulatory framework. Reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained. We also assess the extent to which each firm has addressed the findings arising from our previous inspection.

We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree action plans with the firms designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified requiring action by the firms than areas of strength and are not intended to be a balanced scorecard or rating tool.

Our inspections are not designed to identify all weaknesses which may exist in the design and/or implementation of a firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected for review and cannot be relied upon for this purpose.

When reviewing individual audits, we do not carry out a detailed technical review of the financial statements. Such reviews are the responsibility of CRR. However, we do work collaboratively on a limited number of joint reviews, including in 2014/15 the banking thematic inspection. Our focus in relation to financial reporting issues is on the appropriateness of audit judgments exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Accounting and disclosure issues identified are therefore raised with firms in an audit context rather than a financial reporting context. However, we challenge audit judgments on financial reporting issues, where appropriate, as an integral part of our work.

If we consider there is sufficient doubt as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, we draw the matter to the attention of CRR. CRR will consider such matters in accordance with its operating procedures.



Similarly, if during the course of our inspections we identify a significant concern as to the conduct of an individual or firm, we draw the matter to the attention of the FRC's Conduct Committee. If the Conduct Committee considers that the matter raises important issues affecting the public interest in the UK, and that there may have been misconduct, the matter will be investigated in accordance with the FRC's Accountancy Scheme; otherwise it may recommend that the matter be investigated by the relevant professional body. The FRC's Professional Discipline ("PD") team or the professional body concerned will then determine what, if any, action to take in relation to the matter. In respect of other matters which are not considered to be misconduct the FRC has the power to determine a sanction. This is discussed in Section 4.6.

We share certain information obtained through our inspections with CRR and PD where relevant to their respective responsibilities. Information sharing arrangements with the Prudential Regulation Authority are discussed in Section 4.12.

### Basis of reporting

We prepare a public report on each major firm inspected. These reports together with supplementary information are also provided to the Audit Registration Committees of the relevant professional accountancy bodies in the UK with which each major firm<sup>21</sup> is registered to conduct audit work.

We exercise judgment in determining those findings that are appropriate to include in our public reports, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in our overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

While our public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm may therefore apply equally to other firms without having arisen in the course of our inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and rigorous quality control procedures are applied. These procedures include a peer review process at staff level and a final review by independent non-executives who approve the issue of all reports. These processes are designed to ensure both a high quality of reporting and that a consistent approach is adopted across all inspections.

We also issue confidential reports on individual audits reviewed during an inspection. While these reports are addressed to the relevant audit engagement partner or director they are copied to the chair of the relevant entity's audit committee (or equivalent body).

21 Baker Tilly UK Audit LLP is registered with the Institute of Chartered Accountants of Scotland ("ICAS"). All other major firms are registered with the Institute of Chartered Accountants in England and Wales ("ICAEW").

## Appendix B – Scope of inspections 2013/14

Audits of the following entities were within scope for the 2013/14 inspections.

- All UK incorporated companies with listed equity and/or listed debt.
- All non-EEA incorporated companies with listed equity and/or listed debt audited by a UK Registered Auditor.
- AIM or ISDX-quoted companies incorporated in the UK with a market capitalisation in excess of £100 million.
- Unquoted companies, groups of companies, limited liability partnerships or industrial and provident societies in the UK which have group turnover in excess of £500 million.
- UK incorporated banks not already included in any other category.
- UK building societies.
- Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members.
- Charities with incoming resources exceeding £100 million.
- Friendly societies with total net assets in excess of £1,000 million.
- UK open-ended investment companies and UK unit trusts managed by a fund manager with more than £1,000 million of UK funds under management.
- Mutual life offices whose “with-profits” fund exceeds £1,000 million.

UK incorporated companies do not include those incorporated in the Crown Dependencies of Jersey, Guernsey or the Isle of Man. Section

4.8 discusses separate inspection arrangements in respect of certain Crown Dependency companies.

The above criteria were applied as at 31 December 2012 to identify those entities within the scope of inspection for 2013/14. Further details relating to the inspection scope, including the criteria applied for the 2014/15 inspections, is available on the AQR section of the FRC’s website.













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