



Financial Reporting Council

GRANT THORNTON UK LLP

AUDIT QUALITY INSPECTION

JUNE 2017

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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About the FRC and its Audit Quality Review team

Our objective

The FRC's mission is to promote high quality corporate governance and reporting to foster investment. The Audit Quality Review (AQR) team contributes to this objective by monitoring and promoting improvements in the quality of auditing.

What we do

The FRC is the designated competent authority for statutory audit in the UK. It is responsible for the public oversight of statutory auditors and for ensuring that the various regulatory tasks set out in legislation are carried out by the FRC or the Recognised Supervisory Bodies to whom the FRC may delegate many of those tasks. These tasks include the monitoring of audit work. The FRC is responsible for monitoring the audit work of UK firms that audit Public Interest Entities (PIEs), and certain other UK entities, and the policies and procedures supporting audit quality at those firms. The monitoring work is undertaken by the AQR team.

The AQR team also reviews audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area.

The AQR team

The AQR team consists of approximately 35 professional and support staff. Collectively, our professional staff have extensive audit expertise (including appropriate professional education, relevant experience in statutory audit and financial reporting, specific training on quality assurance reviews and specialist expertise). Our audit quality review work is subject to rigorous internal quality control reviews. Independent non-executives advise on and oversee our work. Independence requirements for staff and non-executives are set out in Appendix B.

Working with Audit Committees (or equivalent bodies)

Audit Committees play an essential role in reviewing and monitoring the effectiveness of the audit process. We are committed to engaging with Audit Committees to improve the overall effectiveness of our reviews and to support our common objective of promoting audit quality. From 2017/18 we are increasing the level of our pre-review discussions with Audit Committee Chairs. We send our reports on each individual audit reviewed to the Chair of the relevant Audit Committee (or equivalent body) and offer them an opportunity to meet with us at that time. We also request feedback from Audit Committee Chairs on our report and discussions held with them.

Priority sectors and areas of focus

We adopt a risk-based approach to our work, as set out in Appendix B.

Our priority sectors for inspection in 2016/17 were natural resources/extractive industries; companies servicing the extractive industries; business/support services including the public sector; and media. We reviewed a number of audits from these sectors at the firms, together with a number of first year audits (this was identified as an area of focus given the extent of changes in auditors following increased audit tendering). We also paid particular attention to the audit of revenue recognition, IT controls and tax provisioning.

Thematic reviews

In addition to our annual programme of audit reviews, we undertake thematic reviews each year. We review firms' policies and procedures in respect of a specific area, and their application in practice, enabling us to make comparisons between firms with a view to identifying both good practice and areas for improvement.

This year we have published reports on Root Cause Analysis (September 2016). The Use of Data Analytics (January 2017) and Quality Control Review Processes (March 2017).

Developments in Audit 2016/17

In addition to reports on our audit quality reviews of the major firms, the FRC intends to publish later in 2017 an overall report on the quality of audit in the UK, covering work across the FRC in relation to audit quality and other relevant developments. The first such report was published in July 2016 and an update was issued in February 2017.

We expect all the firms we inspect to make continuous improvements such that, by 2019, at least 90% of FTSE 350 audits reviewed will be assessed as requiring no more than limited improvements.¹ The next Developments in Audit report will include aggregate information on firms' performance against this target.

¹ FRC Plan and Budget 2016/17

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Audit Quality Inspection

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The AQR assesses the quality of audit work and policies and procedures supporting audit quality at firms which audit Public Interest Entities

1 Overview

This report sets out the principal findings arising from the 2016/17 inspection of Grant Thornton UK LLP (“Grant Thornton” or “the firm”) carried out by the Audit Quality Review team of the Financial Reporting Council (“the FRC”). We conducted this inspection in the period from January 2016 to January 2017 (“the time of our inspection”). We inspect Grant Thornton UK LLP, and report publicly on our findings, annually.

Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm’s audit work. Our findings cover matters arising from our reviews of both individual audits and the firm’s policies and procedures which support and promote audit quality.

We are grateful for the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2016/17 inspection.

Structure of report

Section 2 sets out our key findings requiring action and the firm’s responses to these findings.

Appendix A provides details of the types of audits reviewed in 2016/17.

Appendix B sets out our objectives, scope and basis of reporting.

Appendix C explains how we assess audit quality.

Scope of our 2016/17 inspection

We estimate that the firm audited 78 UK entities within the scope of independent inspection as at 31 December 2015. Of these entities, our records show that 65 had securities listed on the main market of the London Stock Exchange, including one FTSE 100 and four FTSE 250 companies.

We reviewed selected aspects of eight individual audits in 2016/17. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The audit of revenue and the communications with the Audit Committee (or equivalent) were reviewed on all of these audits.

We now publish periodically on our website the names of entities whose audits we reviewed.² The names are published after the entity's next Annual Report has been issued. The final list for our 2016/17 reviews will be published around the end of June 2017.

We also reviewed selected aspects of the firm's policies and procedures supporting audit quality.

The FRC issued a single revised Ethical Standard in 2016, effective at a firm-wide level from 17 June 2016 and applicable to individual audits for financial periods starting on or after this date. We discussed the firm's approach to implementing the revised Ethical Standard during our 2016/17 inspection. We will review this area in detail as part of our 2017/18 inspection, along with the firm's implementation of the revised UK Auditing Standards effective for financial periods starting on or after 17 June 2016.³

In response to the findings from our last inspection, the firm undertook to implement certain actions. We reviewed the actions taken by the firm and the extent to which they have contributed to improvements in audit quality.

Progress made in the year

Given the timing of their implementation, the effectiveness of changes made in response to our prior year findings will continue to be assessed through our subsequent inspections. We have continued to identify findings in certain areas which we highlighted in last year's report, although these findings were, in some cases, different in nature to those identified last year.

In last year's report we noted that the firm's monitoring procedures were insufficient to ensure that ethical breaches were identified and reported on a timely basis. The firm has committed to increase the frequency of their compliance reviews. We have, however, identified further significant findings in our current inspection in respect of firm-wide independence matters. These findings indicated weaknesses in the internal controls at the firm relating to auditor independence.

We have also reported weaknesses in the firm's audit software for changing and re-setting electronic passwords in our previous two public reports. Due partly to delays in system development, no action had been taken at the time of our review in November 2016. The firm has re-introduced password reset testing in the first quarter of 2017.

The firm has enhanced its policies and procedures in the following areas:

- Direction, supervision and review of group audits: The firm revised its guidance to clarify required procedures for group audit teams and to emphasise greater involvement in the work of a component auditor. The 'Quality Support Team', established during 2015, will work alongside the EQCR on higher risk group audits as part of their review procedures.

² <https://www.frc.org.uk/Our-Work/Audit-and-Actuarial-Regulation/Audit-Quality-Review/AQR-Audit-Reviews.aspx>

³ The FRC has established a Technical Advisory Group (TAG) to provide guidance on implementation issues relating to the revised Standards. The output from TAG meetings is published on the FRC's website.

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- Raising the audit quality benchmark for partners: The 2016/17 audit quality goals have been updated to seek to ensure that audit partners comply fully with the firm's mandatory reporting and consultation requirements, regularly attend relevant professional development training and target 2A or above in any external quality review or in the firm's National Audit Review (NAR) programme. Audit quality metrics now reflect the results of internal and external quality reviews of engagements where an individual served as EQCR.
 - Strengthening the firm's audit quality monitoring arrangements: For the firm's 2016 quality review programme, a specialist central review team reviewed the effectiveness of the firm's quality control systems.

Good practice identified

Examples of good practice we identified include:

- the audit work relating to financial investments on one audit. We considered this to be of a high standard, in particular the auditors' level of challenge; and
- the audit work relating to pension balances on another audit. The audit approach included effective communications and consultations with the firm's internal specialists.

Key findings in the current year requiring action

Our key findings in the current year requiring action by the firm, which are elaborated further in section 2 together with the firm's actions to address them, are that the firm should:

Review of firm-wide procedures

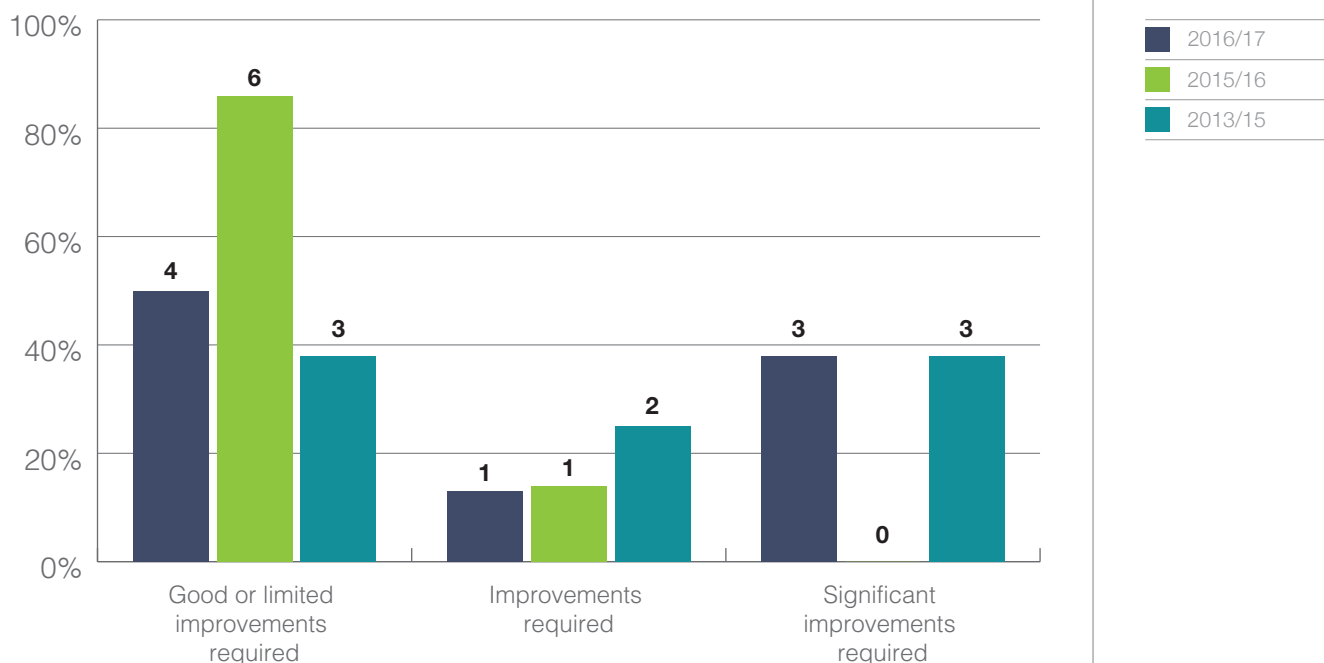
- Further improve its systems to ensure compliance with the Ethical Standards.
- Give more weight to audit quality and ethical requirements when promoting and appraising staff.

Individual audit reviews

- Improve the extent of challenge of management in relation to areas of judgment, in particular with regard to impairment reviews and judgmental valuations.
- Strengthen the effectiveness of audit procedures relating to revenue.
- Ensure more effective communication with Audit Committees.
- Provide a more accurate description in auditors' reports of the audit procedures performed.

Assessment of the quality of audits reviewed

The bar chart below shows the results of our assessment of the quality of the audits we reviewed in 2016/17, with comparatives for our two previous inspections.⁴ The number of audits within each category in each year is shown at the top of each bar.



Issues driving lower audit quality assessments

The principal issues resulting in three audits being assessed as requiring significant improvements in 2016/17 included the following (where relevant, further details for our key findings are set out in section 2):

- Failure to evaluate sufficiently the entity’s methodology, assumptions and judgments used in determining provisions.
- Inaccurate disclosures of materiality in the audit report and insufficient testing of income.
- Insufficient audit procedures in relation to investments, in particular the evaluation and challenge of management’s valuation expert.

⁴ Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm. Annual inspections of Grant Thornton commenced in 2015/16.

Root cause analysis

Thorough and robust root cause analysis (RCA) is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved. The firm has performed RCA in respect of our key findings in this report.

The firm has continued to develop its process for identifying the causes for inspection findings and is in the process of implementing the recommendations from our thematic report on the subject. The firm has appointed a Director to lead the update to the design and implementation of the RCA process.

Firm's overall response and actions:

We welcome the FRC's recognition that the firm has now enhanced its policies and procedures in all areas that had been identified in previous FRC inspections. In the area of changing and re-setting electronic passwords, we have linked a previous control to the new quarterly quality checks of files.

In addition, we have already put in place a number of changes to policies and procedures to address the issues arising from the 2016/17 review and have plans in place to address the remaining issues in the near future.

We have in response to the challenges from the FRC and the change in the Ethical Standard made significant investment in the Ethics Function. We have increased the resources and set in place a programme of updating policies and procedures, to build systems that are fit, not just for today, but for the future shape of the firm and the ever changing external environment.

We are committed to continual improvement of audit quality. As part of this commitment to audit quality, we have put in place resource to identify root causes and drive enhancements to policies, procedures and training. We have changed the policies and procedures to ensure that audit quality is a primary consideration for promoting, appraising and remunerating our people.

We are disappointed with the results of audits reviewed this year. This is not in line with the results of our most recent internal reviews or the previous year's FRC review, but these are important findings and we take them seriously. We have undertaken root cause analysis of the individual file reviews and taken appropriate action. The AQR and we have directly fed back to the audit practice the results from the FRC review.

Our audit quality processes are constantly evolving and we are determined in our efforts to ensure our work is of the highest quality. We will continue to work with the FRC to ensure the firm delivers best-in-class services to our clients.

2 Key findings requiring action and the firm's response

We set out below the key areas where we believe improvements are required to enhance audit quality and safeguard auditor independence. The firm was asked to provide a response setting out the actions it has taken or will be taking in each of these areas.

Further improve the firm's systems to ensure compliance with the Ethical Standards

The Ethical Standards in place at the time of our review required the firm to establish policies and procedures to ensure that the firm, and all those in a position to influence an audit, acted with integrity, objectivity and independence. Furthermore, Auditing Standards require the firm to establish policies and procedures to provide reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

We have identified a number of significant findings in respect of firm-wide independence matters since 2015. These findings indicated weaknesses in the internal controls at the firm relating to auditor independence including:

- The firm informed us during our prior year inspection that no testing of partner personal independence had taken place at the firm for three years. The firm's response included an internal audit review of its system to monitor prohibited investments. The internal audit report was highly critical of the firm's processes: the partner responsible for the system did not report to the Ethics Partner, was not subject to oversight and his team were unaware that they had to escalate issues to the Ethics Partner regarding holdings in prohibited investments.
- Our review, and subsequent analysis by the firm, highlighted a number of prohibited investment breaches and noted systemic weaknesses over monitoring prohibited investments.
- A senior manager was seconded to an AIM-listed audit client in 2014 to assist with the preparation of financial statements. The audit partner consulted with a member of the ethics team but the assessment of the circumstances did not adequately demonstrate that this was an emergency situation, in accordance with the Ethical Standards. Furthermore, there was no evidence that this service had been discussed with and approved by the Ethics Partner.
- We noted eight instances where consultations on non-audit to audit fee ratios were completed later than required by the Ethical Standards. None of these had been reported as breaches. The firm subsequently reported to us an additional five such instances. This is a recurring issue that the firm had not addressed satisfactorily.

We have noted a significant increase in the firm's commitment to take action to address these weaknesses (for example, moving the Global Independence System ("GIS") team within the ethics function, the appointment of a new Ethics Partner, the recruitment of additional resource into the ethics function and improved disciplinary procedures). However, we are concerned about the number and significance of the above findings, the controls in relation to auditor independence and any wider implications.

Firm's actions:

The firm's leadership has clearly demonstrated its commitment to the quality agenda. As part of this agenda the firm has created a new role, Head of Quality, Ethics and Excellence, which reports directly to the Chief Executive Officer. The Head of Quality, Ethics and Excellence holds the formal Ethics Partner role and has been specifically tasked with improving the firm's compliance in this area. The firm has invested more resource in the Ethics Function some of which is as a direct response to the issues arising from the FRC review.

The responsibility for maintaining and monitoring the Global Independence System (GIS) has now been moved in to the Ethics Function to specifically address the issues arising from our internal audit report. The internal audit of the GIS system was suspended whilst the firm invested in a central support team to maintain the GIS accounts for partners. The internal audit is now completed on an annual basis. The Ethics Function is formalising the monitoring programme of the GIS system to ensure that key checks are completed on a monthly basis, including monitoring prohibited investments.

The central support team, which is used to maintain the GIS accounts for the partners, has now been extended to include directors. This programme commenced in 2016 and is expected to be completed by the end of 2017.

The prohibited investment breaches related almost entirely to investments that were not disposed of immediately but which were disposed of within the timescale allowed by the firm's policy. The firm has changed its policy to reduce the timescale for the disposal of restricted investments.

In 2016 the firm introduced a red-lines policy for partners which trigger sanctions for non-compliance. Compliance with GIS policy is included in the red-lines policy and is one of the factors taken into account in the annual quality grading which directly impacts remuneration.

The firm has prohibited the secondment of staff for accounting services to all listed audit clients.

The consultations on non-audit fees to audit fee ratios on all but one case had been completed before the audit report had been signed, but not at the time the non-audit service was contemplated. The firm has updated the procedures to ensure appropriate timely consultation on the cumulative effect of non-audit fees compared to audit fees. The Ethics Function has commenced a programme of firm-wide training on appropriate timely consultation on the cumulative effect of non-audit fees compared to audit fees which will be completed by the end of 2017.

Give more weight to audit quality and ethical requirements when promoting and appraising staff

Audit quality needs to be given sufficient weight when promoting and appraising the firm's audit staff to emphasise its importance and to drive improvements in audit performance.

We noted two areas where the firm appeared to place insufficient importance on safeguarding and enhancing audit quality. These findings were:

- The promotion of a senior member of staff to audit director failed to consider adequately their involvement in an audit recently assessed by AQR as category 3.
- An audit director's annual performance review rating was the highest level, even though they had been part of an audit team that received both a 'marginal fail' on an internal file review and a category 2B from an AQR review.

We also noted three instances involving senior staff where the performance review appeared to take into consideration, contrary to Ethical Standards, the selling of non-audit services to audit clients.

Firm's actions:

Every individual put forward for promotion to audit director now has a quality report from the quality monitoring team. This records all quality monitoring on the individual's portfolio.

The quality monitoring team is preparing a quality report on all engagement leads, to be used in performance reviews, which will identify the audit quality indicators.

The firm has reaffirmed that the quality grade is the primary consideration on both partners' and directors' overall performance grade and remuneration. The Head of Quality Ethics and Excellence sent a communication to all partners and the Head of Assurance issued further guidance to all engagement leads with the same clarification.

The firm does not incentivise people for the selling of non-audit services to audit clients nor is this considered in performance reviews or remuneration discussions. However, the language used in the individual performance reviews was misleading. The firm will issue further guidance in this area and the quality monitoring team will review a sample of completed performance reviews.

Improve the extent of challenge of management in relation to areas of judgment, in particular with regard to impairment reviews and judgmental valuations

Auditors need to adopt a robust approach to the audit of highly judgmental areas, such as impairment reviews and the valuation of assets held at fair value, and appropriately challenge management's assumptions and processes.

We identified a number of issues relating to the extent of challenge of management by audit teams in key areas, including:

- Insufficient assessment, corroboration and challenge of impairment models and assumptions and inputs used by external valuers. For example, on one audit, the sample used to test a key input was too small and it was unclear how the selection basis was appropriate. Valuation variances were not discussed with management and the valuers were not challenged on the differences between their valuations and external sources.
- On two audits, the audit team did not adequately evidence its assessment of the fair value of loan notes and debentures or corroborate management inputs, while insufficient audit evidence was obtained over the recoverability of a bank deposit and two commercial customer exposures.

On the above audits, we noted weaknesses in the audit teams' quality control procedures which are of particular concern when reviewing areas of judgment. We noted a number of significant issues:

- No evidence of review by either the manager, senior manager or engagement partner for an aspect of the audit work in response to a significant risk.
- An audit team did not comply with the firm's internal quality review procedures as the technical review approval occurred after the signing of the auditor's report.
- There was insufficient evidence of timely and appropriate EQCR involvement.
- There was insufficient evidence that financial instruments disclosures and sensitivities had been audited.

Firm's actions:

The firm surveys its clients on a continual basis and one of the areas that we ask for feedback is in relation to our challenge of management. From this we have identified that audit teams do challenge management but it is clear that on occasion the level of detail recorded in the audit files was insufficient to demonstrate that challenge and that the corroboration of the management explanations can be improved. The 2017 audit conference will focus on these areas and in particular, how this is applied on impairment reviews and valuations.

At the audit conference additional training will be given on performing the role of EQCR and how we can learn from good practice to evidence timely and appropriate EQCR involvement.

The firm's technical review process has been changed to make it clear on the consultation documents that approval is required before the signing of the auditor's report.

Strengthen the effectiveness of audit procedures relating to revenue

Revenue is an important driver of a company's operating results and auditors typically need to evaluate and address fraud risks in relation to revenue recognition.

We reviewed the audit of revenue on each audit inspected and identified the following issues on one or more of these audits:

- Insufficient audit evidence was obtained from the revenue testing and in addition insufficient audit work was performed over the integrity and accuracy of management's income report and the disclosure of income by geographical region.
- Insufficient evidence was obtained over the accuracy and completeness of revenue account balances.
- The sampling approach used resulted in too few items being tested and it was unclear that sufficient audit evidence over the revenue balance had been obtained.

Firm's actions:

The findings from the file reviews related to how the firm's methodology is applied within specific situations. The root cause analysis identified that the technical department guidance had not covered these situations so will be expanded.

At the audit conference, additional training will be given on auditing revenue to reaffirm with our people the importance of this area.

Ensure effective communication with Audit Committees

Audit Committees have a key role to play in overseeing the effectiveness of the audit. High quality communications with Audit Committees are therefore essential to safeguard audit quality.

We reviewed the communications with Audit Committees on the eight audits reviewed. On four audits we identified the following areas where the communications could have been improved:

- Insufficient evidence that the audit team had communicated the resolution of outstanding matters to those charged with governance before signing the auditor's report.
- Insufficient reporting to the Audit Committee of the audit procedures performed over new unsecured loan notes and debenture stocks.
- Insufficient evidence that the justification for the increase in the pension scheme risk assessment level to significant, as stated in the audit report, was reported to the Audit Committee (when the actual audit approach was based on a lower risk level).
- Insufficient reporting to the Audit Committee of the audit work undertaken to corroborate a key input to a valuation model on a significant risk area and the potential implications for the audit.

Firm's actions:

The issues identified relate to specific aspects of the communication with audit committees that could have been improved. The audit work programmes for communication with audit committees have been updated to make it clearer the requirement for the final resolution of outstanding matters needs to be documented. The firm is updating the documentation used for Communication with Audit Committees, which is currently in final testing and will be issued in June 2017.

Provide a more accurate description in auditors' reports of audit procedures performed

Extended auditors' reports have improved the transparency of the audit procedures performed in response to those risks identified by the auditors. It is important that the audit procedures performed are described accurately, so that users of the financial statements are properly informed of the audit approach taken to respond to the risks.

In response to concerns over audit report descriptions in our 2016 report, the firm reinforced the use of standard documents by engagement teams. We have seen more detailed description of audit procedures in the firm's auditor reports, which we believe is a positive development. However, the precision with which certain procedures were described still needed improvement in three audits:

- One audit report stated a lower audit materiality than was actually applied, including the level at which matters should be reported to the Audit Committee.
- Another audit report did not accurately describe the level of audit evidence obtained or the procedures performed in relation to pension scheme assets; and
- In a third case, the audit report implied that more procedures were carried out, and greater assurance obtained, than was the case.

The firm should introduce further procedures and controls to address our concerns in this area.

Firm's actions:

The actions we have already undertaken have gone some way to improve things and we are pleased this is acknowledged in the review as a positive development.

There is however more to do and the issues identified relate to the precision of the description of the risk and the audit procedures performed in relation to that risk. The firm has provided additional training on extended auditor reports to the audit practice and clarified the guidance. The audit work programmes for the preparation of extended audit reports have been updated.

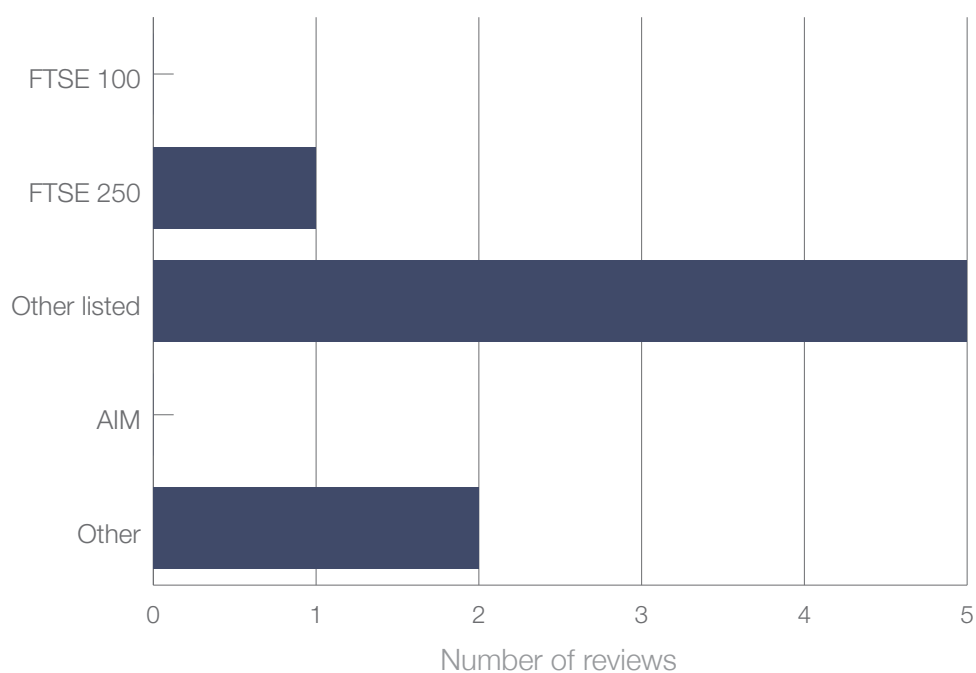
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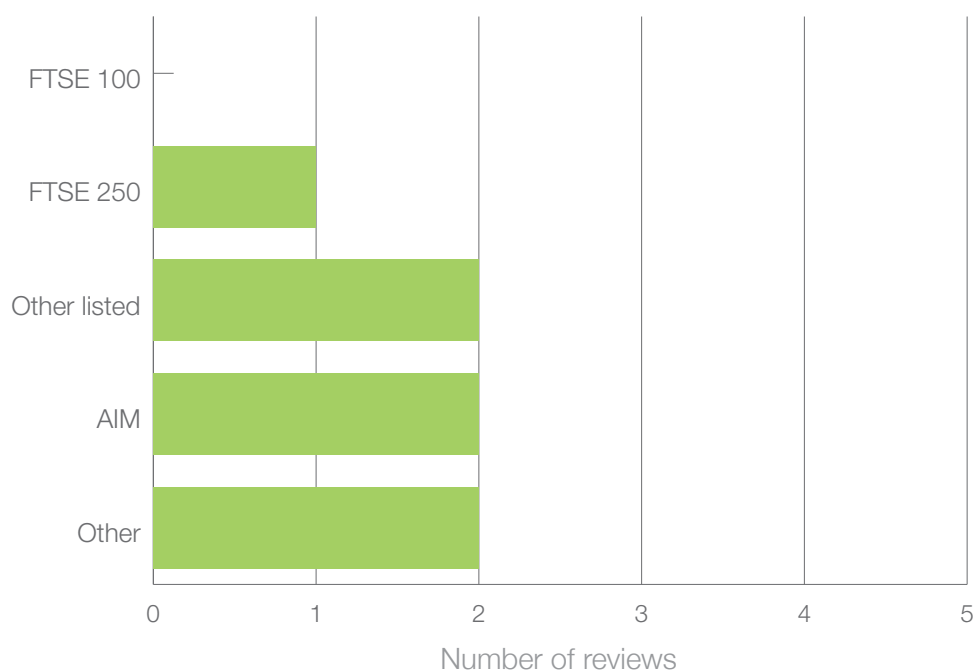
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Appendix A – Audits reviewed in 2016/17

The following chart provides a breakdown of the audits inspected in **2016/17** by type of entity:



The following chart provides comparative information for the audits inspected in **2015/16**:



Appendix B – Objectives, scope and basis of reporting

Matter	Explanation
Objectives of our inspection	<p>The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with Relevant Requirements as defined in the Statutory Audit and Third Country Auditor Regulations 2016 (SATCAR). A full list of the Relevant Requirements is set out at Regulation 5(11) SATCAR, and includes amongst other requirements, applicable legislation, 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 inspection, or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.</p>
Audits in the scope of our inspection	<p>Our Audit Quality Review (AQR) team monitors the quality of the audit work of statutory auditors in the UK that audit Public Interest Entities (PIEs) and certain other entities within the scope retained by the FRC (these are currently large AIM entities and Lloyd's Syndicates). Monitoring of all other statutory audits is delegated by the FRC to Recognised Supervisory Bodies under a series of Delegation Agreements. The overall objective of our work is to monitor and promote continuous improvement in audit quality in the UK.</p>
	<p>In addition to the UK audits in scope, some UK firms audit a number of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area. These audits are inspected by us under separate arrangements agreed with the relevant regulatory bodies in those jurisdictions. The results of these reviews are included in this report. Our records show that, at the time of our inspection, the firm had one such audit, a FTSE 250 company.</p>
	<p>Grant Thornton UK LLP supplies audit services to local authorities and the NHS (Local Public Audits - LPAs). Whilst we review LPAs undertaken by firms, this is done under separate arrangements agreed with the Public Sector Audit Appointments Limited (PSAA), previously the Audit Commission. The results of these reviews are not included in this report because the LPA inspections fulfil a different purpose to those considered in this report. These reviews of LPAs form part of the PSAA's assessment of the quality of contracted-out audits. The PSAA publishes its assessment both in overall terms and individually by firm. The most recent reports can be found on its website.</p>

Matter	Explanation
Impact of our risk-based inspection approach	Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the 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.
Key audit areas inspected	In selecting which aspects of an audit to inspect, we take account of those areas considered to be higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The rationale for including each area of audit work (or excluding any area of focus listed in the auditors' report) is documented as part of the planning process for each audit inspected.
Our reports on individual audits	We issue a report on each individual audit reviewed during an inspection to the relevant audit engagement partner or director and the chair of the relevant entity's Audit Committee (or equivalent body).
Our focus on achieving continuous improvement in audit quality	We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with Relevant Requirements and to agree an action plan with the firm designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified which require action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool. However, we also seek to identify examples of good practice at each firm.
Basis of our public reporting	While our public reports may provide useful information for interested parties, they do not provide a comprehensive basis for assessing comparative audit quality at 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 relatively small sample of audits within our scope is selected for review at each firm. The findings may therefore not be representative of the overall quality of each firm's audit work.

Matter	Explanation
<p>Inspection findings included in our public report</p>	<p>We exercise judgment in determining those findings to include in our public report on each inspection, taking into account their relative significance in relation to audit quality, in the context of both the individual inspection and any areas of particular focus in our overall inspection programme for the year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.</p>
<p>Independence</p>	<p>In line with legal requirements for the Competent Authority's independence from the audit profession, the FRC's funding is secure and free from undue influence by statutory auditors. All Board members, FRC decision-makers and AQR inspectors are subject to appropriate cooling-off periods from individual audit firms or the audit profession as a whole, depending on the nature and seniority of their roles. Our non-executives and staff are subject to requirements to avoid conflicts of interest by way of the FRC Code of Conduct and applicable staff terms and conditions and AQR inspectors are additionally required to declare that there are no conflicts of interest between them and the statutory auditor under inspection.</p>
<p>Purpose of this report and Disclaimer</p>	<p>This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice. To the full extent permitted by law, the FRC and its employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.</p>

Appendix C – How we assess audit quality

We assess the quality of the audit work we inspect using the following four categories:

- Good (category 1);
- Limited improvements required (category 2A);
- Improvements required (category 2B); and
- Significant improvements required (category 3).

The assessments of the quality of the audits we reviewed in our public reports on individual firms combine audits assessed as falling within categories 1 and 2A.

These four categories have been used consistently since 2008, although there have been some minor refinements to the category descriptions over the years. They reflect our assessment of the overall significance of the areas requiring improvement that we have reported to the Audit Committee and the auditor. We expect the auditor to make appropriate changes to its audit approach for subsequent years to address all issues raised.

An audit is assessed as good where we identified no areas for improvement of sufficient significance to include in our report. Category 2A indicates that we had only limited concerns to report. Category 2B indicates that more substantive improvements were needed in relation to one or more issues.

An audit is assessed as requiring significant improvements (category 3) if we have significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key audit judgments or other matters identified. In such circumstances we may request some remedial action by the firm to address our concerns and to confirm that the audit opinion remains appropriate. We will generally review a subsequent year's audit to confirm that appropriate action has been taken.

We exercise judgment in assessing the significance of issues identified and reported. Relevant factors in assessing significance include the materiality of the area or matter concerned, the extent of concerns regarding the sufficiency or quality of audit evidence, whether appropriate professional scepticism appears to have been exercised, and the extent of non-compliance with Standards or a firm's methodology.

Our inspections focus on how selected aspects of a particular audit were performed. They are not designed to assess whether the information being audited was correctly reported. An assessment that an audit required significant improvements, therefore, does not necessarily mean that an inappropriate audit opinion was issued, the financial statements failed to show a true and fair view or that any elements of the financial statements were not properly prepared.

Equally, assessing an audit as requiring significant improvements does not necessarily imply that the conduct of the relevant audit firm, or one or more individuals within the firm, may warrant investigation and/or enforcement action by the FRC.

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