Financial Reporting Council

May 2014

# Inspections of Third Country Auditors

## Annual Report 2013/14

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.


The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368. Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.

## Contents

*page*

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship codes as well as UK standards for accounting, auditing and actuarial work. We also represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies

# 1. Background information

## 1.1. Introduction

This report provides an overview of the audit quality inspections of Third Country Auditors by the UK Financial Reporting Council's ("FRC") Audit Quality Review ("AQR") team during the year ended 31 March 2014.

Our principal role continues to be the independent inspection of major audits in the UK. This year, as required by UK law, the scope of our inspection work was expanded to include for the first time Third Country Auditors.

Third Country Auditors ("TCAs") are auditors of companies incorporated outside the European Economic Area[1] ("EEA") that have issued securities on UK regulated markets, principally on the main market of the London Stock Exchange ("UK market-traded companies"). The regulation of TCAs under the EU Statutory Audit Directive is one of the responsibilities delegated by the Government to the FRC. The regulation includes approving them for registration as TCAs in the UK, and independent inspection of their relevant audit work.

The overall objective of our work is to monitor and promote improvements in the quality of auditing by Third Country Auditors of UK market-traded companies. As part of our work, we monitor firms' compliance with the regulatory framework for auditing, including International Standards on Auditing and relevant ethical requirements. The Standards are those effective at the time the relevant audit was undertaken.

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 identified weaknesses requiring action by the firms than on areas of strength and are not intended to be a balanced scorecard or rating tool. Were the FRC to conclude that the TCA was not competent to undertake audits of UK market-traded companies, it would initiate the process of removing the firm's registration.

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.

## 1.2. Background

In accordance with the requirements of European law[2], the UK has implemented into UK Law the requirement that the auditors of companies incorporated outside the EEA which are UK market-traded companies should be subject to a level of regulatory oversight similar to that required for the audits of listed companies incorporated within the EEA.

[1] The European Economic Area comprises the members of the European Union plus Iceland, Liechtenstein and Norway.
[2] Articles 45 and 46 of the Statutory Audit Directive (2006/43/EC)

As 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 one of the four largest global networks of audit firms. There are significantly more third country issuers on UK markets than for any other EU Member State and they and their auditors come from a wide spread of countries.

The EU regime recognises the costs and complexities which would be involved in extensive cross border regulation of audit firms. It therefore excludes from the requirement for external quality assurance review audit firms that are already subject to an equivalent system of review in their home country. To this end the EU has determined that the arrangements in a number of third countries are equivalent. In addition the EU has excluded from the scope of quality assurance reviews for a limited period audit firms in a number of countries that are in the process of introducing equivalent arrangements. Other Third Country Auditors, known as "Article 45" TCAs, are subject to the FRC's requirements for external audit quality review. There is more information in Appendix A on these three groups of countries - "equivalent", "transitional" and "Article 45" TCAs.

## 1.3. Monitoring the Work of "Article 45" Third Country Auditors

The Third Country Auditor inspection regime commenced in 2013/14. As at 31 March 2014 there are 45[3] "Article 45" Third Country Audit firms, from 25 countries, who audit 55 UK market-traded companies that are in scope for review. All but four of these are audited by firms who are members of the largest four global networks of firms. The FRC is focussed on those UK market-traded companies that it considers to be of significance for UK investors.

The FRC completed three inspections by 31 March 2014:

- Ernst & Young LLP, Kazakhstan
- Deloitte, Kazakhstan
- Ernst & Young, Bahrain

## 1.4. Costs

The process for monitoring Third Country Auditors is expensive and the costs of dealing with the legal and practical challenges to carrying out inspections in some jurisdictions can be significant. The direct costs of the Third Country Auditor inspection activities falling within our scope are funded by the auditors inspected. If audit firms were to make their audit working papers available to the FRC in London, this would reduce the cost of an inspection significantly. Firms have chosen not to do so for a mixture of legal and risk management reasons.

[3] A further four audit firms are registered in accordance with Article 45 but at present have no relevant audit clients.

## 1.5. Other Reporting on Our Findings

We do not prepare reports on an individual Third Country Auditor. However, as is the case under our principal UK inspection programme, we issue a confidential report on each audit engagement reviewed to the audit engagement partner. We also provide a copy to the chair of the audit committee, or those charged with governance.

## 1.6. Purpose of this report

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.

# 2. Principal findings

## 2.1. Our approach to the assessment of individual audits

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)

An audit is assessed as requiring significant improvements if:

- We have significant concerns in relation to the sufficiency or quality of audit evidence; or
- We have significant concerns in relation to the appropriateness of audit judgments in one or more key audit areas; or
- The implications of other matters were considered to be individually or collectively significant.

An audit makes a vital contribution to the confidence that may be placed on financial statements. It is important to emphasise, however, that our reviews focus on how a particular audit was performed and are not designed to assess whether the information being audited was correctly reported. A poor overall assessment of the audit, therefore, does not necessarily imply that the financial statements were materially inaccurate or complete, or that an inappropriate opinion was issued.

As for our UK inspections, our Third Country Auditor reviews 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 explanations provided to us by audit teams to supplement the evidence on the audit files.

Each review is subject to rigorous quality control procedures. These procedures 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 both a high quality of reporting and that a consistent approach is adopted across all inspections.

An outline of our inspection process, basis of reporting and scope of inspections can be found in Appendix B.

## 2.2. Overall assessment of audits reviewed in 2013/14

We reviewed and assessed the quality of selected aspects of three audits, one at each of the three audit firms inspected.

Our reviews focussed on audit evidence and related judgments for material areas of the financial statements and areas of significant risk.

One of the audits was graded as “Limited improvements required” and two as “Improvements required”.

## 2.3. Key messages to audit firms and audit committees

Audit firms should pay particular attention to the key messages which we set out below. These messages are also of relevance to audit committees. Audit committees play an essential role in ensuring the quality of financial reporting. In particular their work in discussing with auditors the audit plan as well as the audit findings, contributes greatly to the quality of that audit.

The key messages arising from our inspections of Third Country Auditors relate to:

- Annual report and audited financial statements
- Communication with the audit committee

It may be that these points arise because of differences between practices in the UK and elsewhere. Auditors should be aware of the particular requirements relating to UK market-traded companies.

We also draw to the attention of Third Country Auditors the key messages set out in the FRC’s Annual Report (May 2014) on all the audit quality inspections it conducted in 2013/14.

### Annual report and audited financial statements

**ISAs require that audit firms should read the Annual Report for consistency with the financial statements. They should make appropriate arrangements with management or those charged with governance to obtain the other information to be included in the Annual Report prior to the date of the audit report. If it is not possible to obtain all the other information prior to the date of the audit report, they should read such other information as soon as practicable.**

**Audit committees should ensure that management arranges for the other information to be prepared and shown to the auditors as early as is practicable.**

We found instances where the Annual Report was prepared, and subsequently issued, after the date of issue of the audited financial statements, and the audit firm did not read the other information in the Annual Report for consistency.

The Annual Report contains important financial and other information. The audit opinion covers the financial statements and does not cover other information in the Annual Report. However, the auditor is required to read the other information in the Annual Report to identify material inconsistencies, if any, with the audited financial statements because their credibility may be undermined by such inconsistencies. If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other financial information needs to be revised.

A lack of review of the other information in the Annual Report increases the risk of unidentified material inconsistencies with the audited financial statements.

### Communicating with the audit committee

**Audit firms should communicate effectively with the audit committee. In particular audit firms should communicate significant findings arising from the audit. Audit firms should also evaluate whether the two-way communication with the audit committee has been adequate for the purpose of the audit.**

**Audit committees have a role to play in ensuring there is appropriate two-way communication with the audit firm.**

We found instances where there was insufficient communication between the audit team and the audit committee.

In one instance no audit issues report was issued to the audit committee following the year end audit, and no meeting was held between the audit team and the audit committee to discuss the audit findings. The communication between the audit team and the audit committee was, therefore, not sufficient to be effective.

The auditor’s communication with the audit committee is an integral element of an audit. Inadequate two-way communication may be indicative of an unsatisfactory control environment. It also increases the risk that the auditor and/or the audit committee may not have been made aware of issues or other matters relevant to the audit opinion on the financial statements.

## 2.4. Restrictions on our access to audit working papers

In 2013/14 we completed fewer reviews of audits undertaken by Third Country Audit firms than anticipated. This was due to difficulties encountered in navigating the legal and practical challenges to carrying out inspections in some jurisdictions, and the FRC is continuing to discuss legal difficulties with certain audit firms with respect to planned inspections.

FRC inspections may result in the identification of deficiencies in an audit. In addition, through the quality control remediation part of the inspection process, inspected firms identify and implement practices and procedures to improve future audit quality. As a result of the obstacles referred to above, investors or potential investors in UK regulated markets who rely on the audit reports of FRC registered Third Country Audit firms in these jurisdictions are deprived of the benefits of FRC inspections of auditors.

Where, as in the case below, there are clear legal or regulatory impediments to our ability to inspect Third Country Audit firms, we will publish this on our website and in our reporting.

Where on the other hand we conclude that an audit firm is simply not cooperating fully to enable their audit of UK market-traded companies to be inspected by the FRC, we will initiate the process of removing that firm from the register of approved Third Country Auditors

During 2013 the FRC selected Ernst & Young Qatar for inspection. Ernst & Young Qatar were the auditors to Commercial Bank of Qatar QSC for the year ended 31 December 2012. The Qatar Central Bank has written to the firm and denied the FRC access to the audit working papers. Accordingly the FRC is currently unable to carry out an inspection of this audit.

Andrew Jones

Director - Audit Quality Review

FRC Conduct Division

May 2014

# Appendix A – Background and scope of our work

## Legal requirement and scope of our work

The legal requirement for an inspection of a Third Country Audit firm by the FRC arises from the Statutory Audit Directive (2006/43/EC) ("SAD") which was adopted by the European Union in May 2006, and transposed into UK company law in June 2008. The SAD included specific provisions on the regulation of the auditors of those non EEA companies who have issued securities admitted to trading on EU regulated markets ("third country auditors"). In particular the Directive and the UK implementing legislation requires the FRC, as the UK competent authority, to subject registered third-country auditors to its systems of oversight and quality assurance reviews. The underlying principle is that all auditors of companies traded on EU regulated markets should be subject to regulation, regardless of where the relevant issuer is incorporated.

The effect of the law is that an audit firm from outside of the EEA must be registered by the FRC in order to sign a valid audit report of a relevant third country issuer for UK purposes,

The requirements apply to auditors of companies incorporated outside the EEA that have issued either equity, Depositary Receipts or debt on a UK regulated market. These companies are termed UK "market-traded companies". In practice this means companies listed on the LSE's Main Market. However:

- Companies that have issued debt securities exclusively denominated in units of a minimum of €50,000 (or equivalent in another currency) are outside the scope;

- Audit firms established within the EEA other than in the UK and who have UK market-traded companies as clients are not at present required to register with the FRC and the FRC does not monitor those auditors or specific audit engagements;

- Audits of UK market-traded companies by UK audit firms are subject to the FRC's UK Audit Quality Review processes; and

- Audits of UK market-traded companies incorporated in one of the Crown Dependencies of Jersey, Guernsey and the Isle of Man are subject to the FRC's Audit Quality Review and processes, under arrangements with the authorities in the Crown Dependencies.

## Categories of Third Country Auditors

The EU classifies Third Country Auditors in three groups, to which different requirements apply. Whilst all Third Country Auditors must be registered with the FRC, there are exemptions from the system of monitoring for "Equivalent" and "Transitional" Third Country Auditors. However, all other Third Country Auditors, known as "Article 45" Third Country Auditors, are subject to a system of monitoring by the FRC.

- **"Equivalent" Third Country Auditors:** auditors in those countries that the EU has determined have systems for auditor oversight, monitoring of audit firms, and investigations and discipline that are equivalent to those required within the EU. These auditors are not subject to inspection by the FRC, other than in respect of audits of UK market traded companies that are outside the scope of the system of inspection in their home country.

- **"Transitional" Third Country Auditors:** auditors in those countries which the EU has decided are developing systems of auditor oversight and regulation that will be equivalent to those required in the EU and which should be given a period to achieve such equivalence. These auditors are not subject to inspection by the FRC.

- **"Article 45" Third Country Auditors:** auditors from countries that are neither "equivalent" nor "transitional". As at 31 March 2014 there are UK-market traded companies incorporated in 25 countries as listed below. This includes three countries – Hong Kong, India and Israel - that were previously designated as Transitional. During 2013/14 the EU has determined that these countries had not met the relevant requirements.

  - Argentina
  - Azerbaijan
  - Bahrain
  - Barbados
  - Chile
  - Curacao
  - Georgia
  - Hong Kong
  - India
  - Israel
  - Jordan
  - Kazakhstan
  - Kenya
  - Kuwait
  - Lebanon
  - Morocco
  - Nigeria
  - Oman
  - Pakistan
  - Papua New Guinea
  - Qatar*
  - Saudi Arabia
  - Vietnam
  - Zambia
  - Zimbabwe

These auditors are subject to inspection by the FRC.

*The FRC has been denied access to inspect the audits of banks in Qatar.

# Appendix B – Inspection process and basis of reporting

## Inspection process

We commenced our programme of inspections of audits by Article 45 Third Country Audit firms of UK market-traded companies during 2013. . This does not mean that any specific audit of a UK market-traded company undertaken by an Article 45 auditor has been or will be reviewed by the FRC.

The scope of our work also includes audits of UK market-traded companies undertaken by equivalent auditors that fall outside the scope of the oversight body in the home country.

Following consultation, we concluded that our monitoring of relevant audit firms should be tailored to the risks and significance of each UK market-traded company for UK investors. There are wide variations in the size and significance of these companies.

We make a preliminary assessment of the relevant issuers as being of high, medium or low significance, from the perspective of UK investors. This assessment is based upon available information such as the turnover of the issuer, its market capitalisation, and the nature and extent of the securities traded in the UK. We will refine and develop our approach over time.

We then consider each Article 45 Third Country Auditor and its relevant clients. Where at least one client is assessed as of medium or high significance, we will generally plan to perform our own independent inspection on-site at the audit firm's premises within the next three years. This comprises a review of at least one audit engagement and, where the firm audits more than five relevant issuers, a firm-wide review of policies and procedures supporting audit quality. In general we will not carry out our own review of audits assessed as of low significance.

A possible exception is where another independent audit regulator from an equivalent or transitional country has carried out a quality assurance review of the firm within the previous three years. We will consider relying on that work, provided that we have access to the full inspection report and are able to discuss issues with the other regulator as necessary, and have access to supporting evidence and working papers. In cases where the other regulator has not reviewed the relevant audit(s) we will consider asking that regulator if they would be willing to review the audit as part of their next inspection.

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.

Where undertaken, a Firm-wide review of the policies and procedures supporting audit quality of the Third Country Auditor will cover some or all of the following areas in so far as they impact on the quality of the audits of UK market-traded companies:

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

**Financial Reporting Council**
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

+44 (0)20 7492 2300

**www.frc.org.uk**