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[20] 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

20 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 intend 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 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[21] 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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