Financial Reporting Council

29 May 2015

Audit Quality Inspections
Annual Report 2014/15

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.

contents

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 2015. It should be read in conjunction with the more detailed inspection findings in our individual major audit firm reports, which are published separately.

The focus of our inspection activities is on promoting a continuous improvement in audit quality. This is achieved primarily through the independent inspection of major audit firms[1] in the UK.

The findings from our inspections reflect the challenges of auditing large and complex entities within tight reporting timeframes, the extent of judgment required, and our exacting expectations of the auditors of public interest entities.

Section 2 provides an overview of our inspection results and discusses a number of key messages that either arise from our inspections or are forward looking in nature, which we believe will contribute to further improvements in audit quality.

Section 3 analyses the results of our inspections, including the four categories we use to describe the quality of the audit work we inspected. To assist the understanding and interpretation of these inspection results, Section 3 includes additional context in respect of our inspection process and the assessment of individual audits.

The broad range of activities we undertook in 2014/15 is summarised in Section 4, and in the case of the two significant thematic inspections, Section 5. The FRC's Third Country Auditor inspections in 2014/15 are also included (Section 6) for the first time.

Section 7 provides an outline of our inspection plans for 2015/16 and includes an update on progress in respect of the implementation of the Competition and Markets Authority's ("CMA") recommendations. This Section also includes a discussion of the significant implications for our inspections of the Revised EU Statutory Audit Directive and the related new Regulation, and the Local Audit and Accountability Act.

The Auditor Regulatory Sanctions Procedure came into effect in November 2013. Section 8 summarises the matters considered under the Procedure in 2014/15.

1 There are currently nine "major audit 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.

2 Overview of Inspection Results and Key Messages

2.1 Introduction

An overview of our inspection results together with a number of key messages we wish to highlight are set out below. The key messages emphasise the efforts that both we and audit firms are making to achieve further improvements, and in particular to address recurring issues. Audit committees also have an essential role in promoting improvements in audit quality given their oversight of the audit process.

2.2 Overview of inspection results

Our assessment of the quality of individual audits continues to show an improvement with 67% of all audits inspected in 2014/15 assessed as either good or only requiring limited improvements. This compares with 60% in 2013/14.

The quality of FTSE 350 audits is higher than other categories of audits inspected with only 6% assessed as requiring significant improvements (10% for all audits inspected).

While our inspection results continue to show an improvement in the quality of the audit work inspected we remain concerned that 33% of all audits inspected in 2014/15 (40% in 2013/14) were assessed as either requiring improvements or significant improvements. We discuss in Section 2.3 a number of initiatives to promote further improvements in audit quality and Section 3.2 provides further detail on our inspection results.

It is important to note that a number of factors can influence our inspection results. These include the firms we inspect which may differ from year to year and the risk model we use to inform the selection of listed and AIM companies' audits we inspect. The sample of audits inspected is also weighted towards the FTSE 350 in response to recommendations from the CMA and also included a number of significant banks and building societies (as part of a thematic inspection). As a consequence the audits inspected may not be representative of the market as a whole. 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.

Notwithstanding these factors, the 2014/15 inspection results are consistent with our overall judgment that audit quality is improving.

2.3 Recurring themes and actions to deal with them

Issues common to previous inspections continue to be identified. A number of initiatives including root cause analysis and remediation are now being undertaken by firms to promote further improvements in audit quality and in particular to reduce the extent of recurring issues.

We are continuing to evolve our inspection approach to promote further improvements in quality including thematic inspections and the implementation of the Auditor Regulatory Sanctions Procedure.

Section 3.5 provides an overview of the more common issues, many of which have been identified in prior inspections including:

Insufficient scepticism in challenging the appropriateness of assumptions in key areas of audit judgment such as impairment testing and property valuations.

Insufficient or inappropriate procedures being performed. This is common to many audit areas including revenue recognition.

The failure to adequately identify the threats and related safeguards to auditor independence and to appropriately communicate these to audit committees.

To promote further improvements we require firms to develop action plans to address the weaknesses identified in individual audit engagements and firm-wide procedures. In conjunction with the development of these action plans we now require firms to undertake a detailed root-cause analysis of the factors contributing to the issues arising from our inspections. Those action plans together with the related analyses are then subject to follow-up inspections.

A further initiative has been to require audit firms to undertake remedial action to address certain deficiencies identified by our inspections where these are deemed to be particularly significant or may call into question the appropriateness of the financial statements or the audit opinion. In a small number of instances in 2014/15 we required firms to perform additional audit work to remediate the deficiencies we identified from our inspections.

We have also initiated a number of thematic inspections in recent years in areas where we believe there are opportunities to accelerate improvements. In particular, the results of our inspection of bank and building society audits which we discuss in more detail in Section 5.2 indicated that there were improvements in the quality of certain aspects of the audit of loan loss provisions and related IT controls, particularly at those firms where we had in recent years identified significant issues. This improvement was less obvious elsewhere, however, with two audits of UK subsidiaries of foreign banks being assessed as requiring significant improvements.

The three thematic inspections we propose to undertake in 2015/16 together with the two we undertook in 2014/15 (Section 5) are further examples of the initiatives we are undertaking to improve audit quality.

We have also made use of the additional powers that the Auditor Regulatory Sanctions Procedure now provides. Five matters arising from our 2014/15 inspections were specifically considered under this Procedure. At the date of this report two of these matters were concluded, with sanctions determined, while a further matter was referred for consideration under a professional accountancy body's disciplinary procedures. Further details are set out in Section 8. We are also able to refer more serious matters to the FRC's Accountancy Scheme, which investigates matters of misconduct affecting the public interest.

The initiatives discussed above reflect our commitment to addressing recurring issues and enhancing the effectiveness of our inspection regime to achieve further improvements in audit quality.

2.4 Evolving inspection programme

Our inspection programme, which is responsive to emerging issues and risks, will give prominence in 2015/16 to the audits of businesses in potentially high audit risk industry sectors including those where complex supplier arrangements are likely to be prevalent and to audits where there has been a recent change in auditor.

Each year we assess what industry sectors and other matters we should give priority to in our inspection programme. Given the focus in recent months in respect of complex supplier arrangements, food, drink and consumer goods manufacturers and retailers have been designated as a priority sector for our 2015/16 inspections and a significant number of audits we plan to inspect will be from those business sectors. These inspections will pay particular attention to the extent to which the audit team has challenged and corroborated the appropriateness of how complex supplier arrangements are accounted for. Corporate Reporting Review (CRR) as part of their programme of reviews of financial statements will also be giving priority to the reporting of these arrangements. We also plan to inspect a number of first year audits to assess the extent to which changes in auditors have an impact on audit quality.

In early 2015 we engaged external consultants to undertake an extensive review of our inspection activities and how these can promote continuous improvements in audit quality. The outcome of this review will be incorporated in the FRC's Strategy for 2016/19.

2.5 Extended reporting by auditors

Firms have responded positively to the new auditor reporting requirements. This is the first year these reports have been subject to inspection and it is understandable that in some cases improvements are required to the clarity and accuracy of the auditor's description of the work performed to address the assessed risks.

The revised Auditing Standard on auditor reporting, which became 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 the direction of 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 regarding whether it considers the Annual Report to be fair, balanced and understandable, 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, which are intended to make the auditor's report more informative for investors, place the UK at the forefront of the wider international developments in auditor reporting.

The application of these new requirements was a particular area of focus in our inspections. As these requirements are relevant to a significant proportion of the audits we inspected, we gained a valuable insight into how firms were interpreting and applying them, and this was reflected in the FRC's recent survey on the take-up of extended auditor reports, a copy of which can be found on the FRC's website. https://frc.org.uk/Extended-auditors-reports.pdf

Firms responded positively to these new requirements, and we were generally satisfied that the extended audit reports appropriately reflected auditors' work and judgments. We did, however, identify a small number of instances where the auditor's description of the nature or extent of audit work performed was inaccurate. This included:

Inaccurate or imprecise descriptions of the procedures performed, such as reference to the use of experts or to the performance of controls testing when in fact this had not occurred.

Two instances where the scoping section of the auditor's report was liable to misinterpretation as to the balances that had been subject to audit procedures.

These findings indicate that firms need to improve their review procedures to ensure that the description of the procedures in the auditor's report is consistent with the underlying audit work performed.

Given the importance of extended auditor reporting, we will continue to monitor how the application of these requirements evolves in practice in subsequent inspections.

A Practice Aid for Audit Committees has also been published by the FRC. This can be found on the FRC's website.

2.6 Extended audit committee reporting

Given the potential developments in audit committee reporting, we will be carefully monitoring how audit committees report our findings and will seek explanations from the auditors where we consider our findings have not been appropriately reported.

In October 2013 the CMA reported on proposals to enhance the transparency of our inspection findings following its investigation of the Statutory Audit Services Market. In particular the CMA recommended that audit committees of FTSE 350 companies, whose audit had been subject to an AQR inspection, should disclose the principal findings and our overall assessment of the quality of the audit in the annual report and accounts, together with how they and the auditors were responding to the issues raised.

The FRC announced in April 2014 that it would consult on the CMA's recommendation in time for updates to the UK Corporate Governance Code to be made in 2016. This is in line with the FRC's commitment not to amend the Code more than once every two years.

Notwithstanding this, the FRC is aware that some audit committees have indicated that they may wish to implement aspects of the CMA's recommendation in advance of any changes to the Code in 2016. It, therefore, issued advice to audit committees in November 2014 to assist them in this regard, a copy of which can be found on the FRC's website.https://frc.org.uk/Transparency-of-AQR-findings

The advice to audit committees is that in accordance with the Code they should report how they have made their own assessment of the effectiveness of the audit process. Therefore where we have reviewed a company's audit, audit committees would be expected to discuss our findings with their auditors and to consider whether any of those findings are significant for these purposes and, if so, to make appropriate disclosures. Such disclosures should be in the audit committee's own words and deal with what action they and the auditors plan to take. It is important that investors understand what the company itself believes to be important and how it has applied its judgment. Such reports should meet the Code's expectation of reports being fair, balanced and understandable.

In making their report audit committees should not, however, disclose our overall assessment of the quality of the audit work inspected. This assessment approach was designed to help audit committees understand the significance of the issues identified and their implications. It is not intended to provide an assessment of the reliability of the financial statements as a whole or the audit opinion and we are concerned that its publication could mislead and distract attention from the key issues identified by the Committee. Section 3.4 discusses our approach to the assessment of the quality of audit work we inspect.

We will be monitoring how audit committees report our findings.

3 2014/15 Inspection Findings

3.1 Introduction

In this Section we provide an analysis of our inspection results for 2014/15 and the findings reported to both auditors and audit committees. Our approach to the inspection and assessment of quality of individual audits is also discussed to assist the understanding and interpretation of these findings.

3.2 Summary of inspection results for individual audits

Audit quality categories: Five year analysis

The following chart summarises our assessment of the audit work we inspected on individual audits (excluding Third Country Auditors, Public Sector and follow-up reviews) by audit quality category over the last five inspection cycles[2].

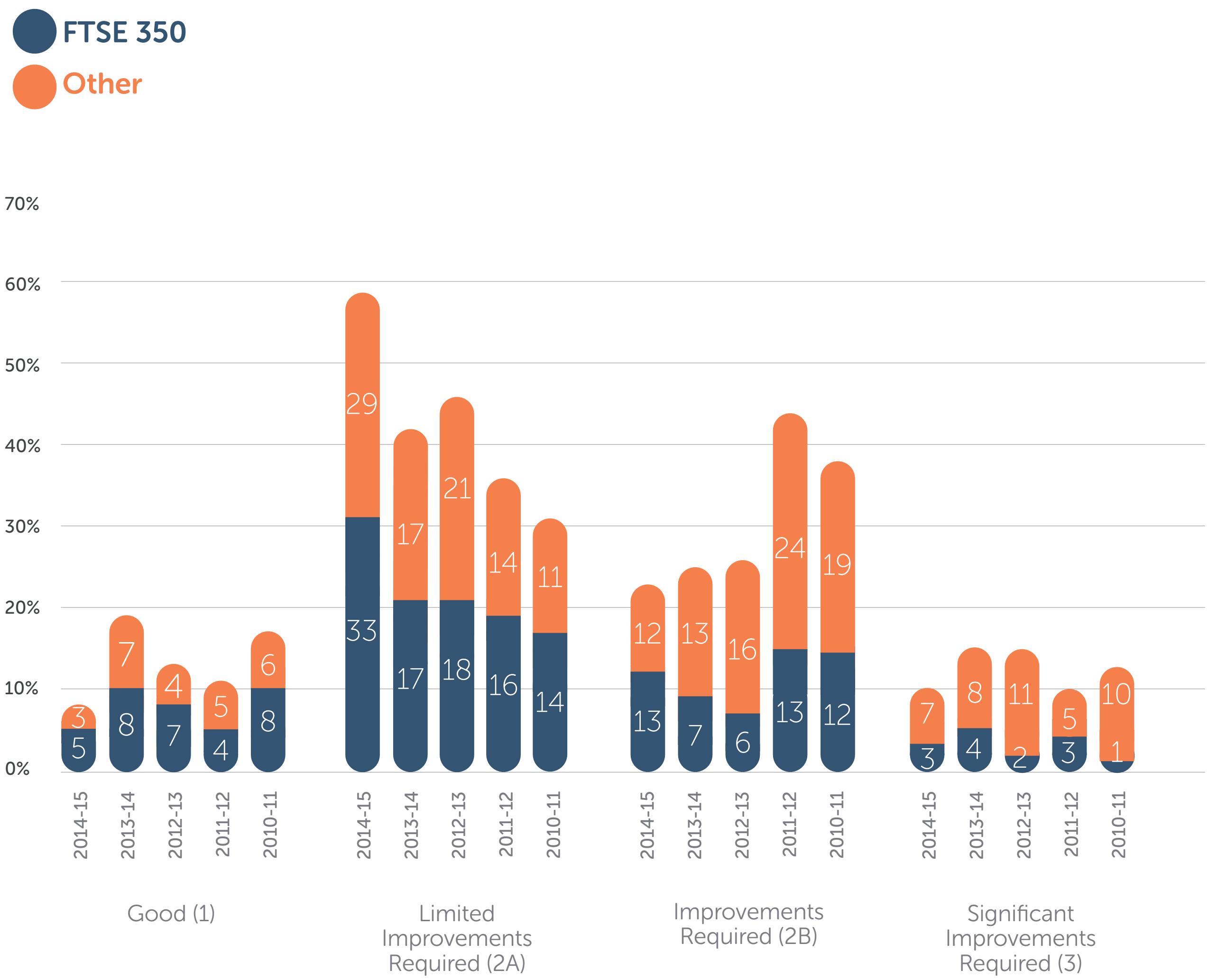
Our assessment of the audit work we inspected in 2014/15 continues the gradual improvement of prior years with 67% of those audits assessed as either good or only requiring limited improvements. This compares with 60%, 59%, 46% and 48% in each of the preceding four years.

Audits assessed as requiring limited improvements is the most common categorisation and has been for the last three inspection periods. In the two preceding periods, the lower categorisation of improvements required, was the more common assessment.

In respect of ten audits, we concluded that the audit work we inspected required significant improvements. This represented 10% of the audits we inspected in 2014/15, an improvement on three of the four preceding inspection periods. The proportion of FTSE 350 audits requiring significant improvements was lower at only 6%. This is consistent with our general view that FTSE 350 audit work we inspect is of a higher standard than that of other audits.

2 Section 4.3 provides a reconciliation of the overall number of audits inspected and those reported in this Section.

Audit Quality Categories - number and percentage

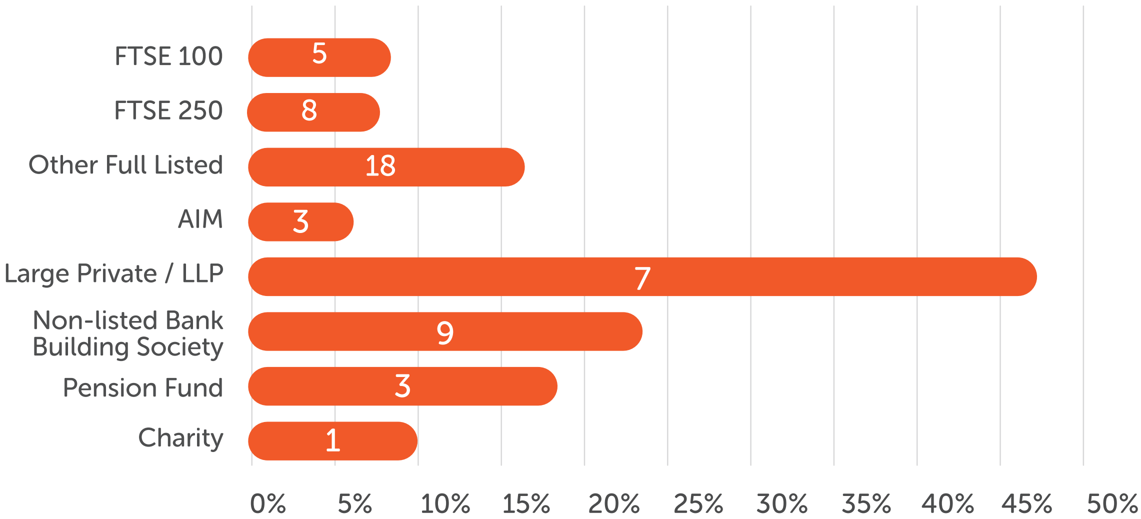


A range of different factors contributed to audits being assessed as requiring significant improvements with no specific themes discernible. These included an inadequate assessment of the self-interest threat arising from the provision of non-audit services on one audit and, in another audit, the use of the wrong Auditing and Ethical Standards, as required by UK Audit Regulations. Two audits assessed as requiring significant improvements were of UK subsidiaries of foreign banks. Issues in relation to these are discussed in more detail in Section 5.2.

The number of audits assessed as requiring significant improvements was not evenly spread across the eight major audit firms inspected in 2014/15. One firm had three while two firms had two each.

Audit quality categories: audits requiring significant improvements

The following chart provides an analysis (by number and percentage) of all audits assessed as requiring significant improvements (category 3) by type of entity in the last five years. A brief commentary on this analysis is set out below.



Listed companies outside the FTSE 350 continue to account for the largest number of audits assessed as requiring significant improvement in the last five years (18 in total). This represents 16% of smaller listed audits inspected in this period. However, large private companies and LLPs have the greatest proportion (47%) of audits assessed as requiring significant improvements in the last five years. By contrast only 7% of all FTSE 350 audits inspected were assessed as requiring significant improvements.

These results indicate that there continues to be a correlation between the size of the entity and our findings, with a higher proportion of smaller entity audits assessed as requiring significant improvements. This is consistent with wider concerns within the FRC in respect of the quality of financial reporting by smaller listed and AIM companies. In response to these concerns the FRC undertook a thematic inspection of the auditors' consideration of the quality of financial reporting in smaller listed and AIM companies which is discussed further in Section 5.3.

3.3 The inspection of individual audits

Appendix A discusses our overall inspection process and basis of reporting. Further context is provided below in respect of the nature and extent of our inspection of individual audits.

An inspection of an individual audit includes assessing compliance with the requirements of relevant standards, particularly the applicable Auditing and Ethical Standards, and other aspects of the regulatory framework for auditing. The focus of our inspection is on the appropriateness of the key audit judgments made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained by the auditors to support those judgments. Our inspections identify areas where improvements are required to safeguard or enhance audit quality. Only selected aspects of the audit are inspected and, therefore, our inspections are not designed to identify all weaknesses that may exist in the performance of the audit work or to express a view on the audit as a whole.

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 and excluding each area of audit work is explicitly documented as part of the planning process for each audit inspected.

The focus of our inspections is on the audit work performed by the audit firm with overall responsibility for the audit report. In the majority of cases this will be a UK audit firm.

In the context of a large UK-based multi-national group we will inspect the group audit work and aspects of other work undertaken at a group level by the UK audit firm and some of the audit work in respect of any significant UK subsidiary or division.

In certain instances the UK subsidiary or division may not be significant, and our inspection, therefore, may be limited to a selection of the audit work undertaken at a group level only. Even where a UK subsidiary or division is significant, the majority of the audit work across the group may be performed by non-UK auditors. As a consequence the proportion of the overall audit work on such groups subject to our inspections will be limited. Notwithstanding this, it should be emphasised that it is the UK audit firm that signs the audit report and, therefore, has overall responsibility for the planning and control of the audit work irrespective of where and by whom this work is performed: the focus of our inspection is, therefore, on how the UK audit firm has fulfilled its responsibilities in this respect.

3.4 Our approach to the assessment of the quality of audit work

Our initial assessment of an audit engagement is based primarily on the evidence on the audit files provided to us. However, our inspection conclusions take account, as appropriate, of the explanations provided to us by audit teams to supplement the evidence on the audit files.

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 the Monitoring Committee, which includes 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 the assessment of quality, across all inspections.

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)

Significant improvements required (category 3)

This four tier structure has been used consistently since 2008, although there have been some minor refinements to the category descriptions over the years.

The category descriptions are intended to distinguish between the number and significance of the areas requiring improvements that we formally report to the auditors and audit committees. This distinction, which is judgmental and often finely balanced, is discussed below.

Typically an audit is assessed as good where we have identified no areas for improvement that warrant inclusion in our formal report on the audit.

A categorisation of 2A is generally considered to be appropriate where we report limited concerns in a small number of areas. In such circumstances it is expected that the auditor would adjust the audit approach in subsequent audits to address the issues raised.

Where we report a number of matters but these are assessed as neither individually or collectively significant then a category 2B would be considered appropriate. In such circumstances it is expected that the auditor would consider whether any remedial action is required in respect of the audit inspected and to amend its procedures for subsequent audits.

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, or the appropriateness of key audit judgments, or the implications of other matters that are considered to be individually or collectively significant. In such circumstances some remedial action may be required to address the issues identified and to confirm that the audit opinion remained appropriate. It is also likely that we would review a subsequent audit to ensure that appropriate action had been taken and that the issues identified were properly addressed in that audit.

Whether a matter is considered to be significant is a matter of judgment. Factors taken into account in assessing significance include the materiality of the area or matter concerned, the extent of concerns regarding the sufficiency or quality of the audit evidence, whether appropriate professional scepticism appears to have been exercised in forming audit judgments, and the extent of any identified non-compliance with Standards or a firm's methodology.

It is important to emphasise that 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 or that the financial statements failed to show a true and fair view or that any elements of the financial statements were not properly prepared.

Equally where we have assessed an audit as requiring significant improvements this does not necessarily imply that there has been misconduct on the part of an individual or audit firm which may warrant investigation in accordance with the FRC's Accountancy Scheme, or that a sanction should be applied under the Auditor Regulatory Sanctions Procedure. Each instance is considered by the Monitoring Committee on a case-by-case basis and referrals for such action are made when considered appropriate.

3.5 Analysis of audit inspection findings

At the conclusion of our inspection of individual audit engagements we formally report those matters arising from the inspection where we expect the auditors and, where appropriate, the audit committee to take action in subsequent audits to address these matters. The number of matters reported will depend on the quality of the audit work and the complexity of the key areas of audit judgment, but typically these average two or three matters per inspection. Set out below is an analysis, by category of findings, of the matters we reported arising from the inspection of 105 individual audits in 2014/15.

Analysis of Inspection Findings	Number of Findings
Fair value and value in use measurements	55
Audit of allowance for loan losses and loan impairments	35
Reporting to audit committees	26
Revenue recognition	24
Group audits	18
Fraud procedures	15
Internal control testing	15
Adequacy of review and supervision	13
Inventory	12
Adequacy of financial statements and disclosures	10
Independence & ethics	10
Audit finalisation	9
Other findings	13
Grand Total	**255**

The above analysis indicates that fair value and value in use measurement is the most common area in which we have found matters to be reported. This category of finding is broadly defined with issues relating to the audit of impairment testing and investment property valuations featuring prominently. As our inspections focus on key areas of audit judgment, it is not surprising that a significant proportion of our findings relate to fair value measurement. This is consistent with prior inspections. Insufficient scepticism in challenging the appropriateness of key assumptions continues to be a key concern, notwithstanding that there has been some improvement noted. Utilising appropriately experienced staff to assess and challenge assumptions and other key judgments is critical in addressing these concerns.

The number of findings in relation to the audit of loan losses and loan impairments, and to a lesser extent internal controls testing is largely driven by the FRC's banking thematic inspection which took place in 2014. Notwithstanding the number of matters reported our inspection results indicated an improvement in the quality of these aspects of audit work. This inspection is discussed in Section 5.2 and in a separately published report.

Audit committee reporting, revenue recognition and the group audit are, where relevant, always inspected. This is a factor in the proportion of findings identified in these areas.

In respect of reporting to audit committees, our findings generally related to inadequate communication of the planned audit approach, or issues arising from the audit to those charged with governance. The communication of threats and safeguards in relation to the provision of non-audit services also continues to be an issue but the majority of these are classified under independence and ethics as the substantive issue was the failure to assess the independence threats and safeguards.

Our findings in respect of revenue recognition covered a wide range of revenue types and differing audit procedures but frequently related to insufficient or inappropriate procedures being performed. Particular examples included testing that did not cover all key controls or adequately assess the effectiveness of the controls, insufficient testing of the accuracy and completeness of certain system generated information that was relied upon for the testing of revenue and insufficient investigation of variances arising from testing or sufficient corroboration of management's explanations of the variances.

Group audit findings included instances where we considered the scope of the group audit work was insufficient. A particular issue was the extent to which the group audit team had considered the nature and complexity of the group when concluding on the appropriateness of the thresholds for determining significant components by size.

In previous years we raised concerns in respect of the audit of letterbox companies. These are companies where virtually all of the work is performed by auditors other than those signing the audit report. Our concerns related to the control, supervision and review of the audit procedures performed by other auditors. Firms appear to have responded to such concerns as they were not a feature of this year's inspection findings.

Further details in respect of the findings from our inspection of audits in 2014/15 can be found in our individual major audit firm inspection reports.

3.6 Firm-wide inspection findings

The number and nature of findings arising from our inspection of individual audits continues to indicate that firms' internal quality control and monitoring procedures require further strengthening or improved application in practice. We test these as part of our firm-wide inspection procedures and a number of findings are included in our major audit firm inspection reports.

One aspect of a firm's control environment is its governance arrangements. Most of the firms subject to our inspections are covered by the Audit Firm Governance Code. The FRC has been reviewing the implementation and effectiveness and has recently published a discussion paper on this.

In respect of internal quality monitoring procedures we noted that these primarily focused on the group audit work and did not necessarily cover UK components. Firm-wide procedures were often excluded from monitoring programmes. Moderation processes for ensuring the consistency of findings and resolving conflicts also required improvement.

In light of these findings our 2015/16 thematic inspections will include a review of firms' internal quality monitoring procedures and the role of the engagement quality control reviewer.

4 Summary of Activities

4.1 Introduction

This Section summarises the inspections and other activities undertaken in 2014/15.

4.2 Scope of inspections

We undertake full scope inspections of major audit firms[3]. These inspections cover a sample of audits of public interest entities and the firms' policies and procedures supporting audit quality[4]. Appendix A outlines the inspection process and basis of reporting and Appendix B sets out the scope of inspections for 2014/15. The frequency of inspection of individual major audit firms varies. The Big Four firms together with BDO LLP and Grant Thornton UK LLP are inspected annually while other major audit firms are inspected on a three yearly cycle.

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[5], at those firms with ten or fewer audits falling within the scope of independent inspection. These inspections are discussed in Section 4.11.

Other inspections undertaken in 2014/15 include Crown Dependency Auditors (Section 4.5), the Public Sector (Section 4.6), thematic inspections (Section 5) and Third Country Auditors (Section 6).

4.3 2014/15 inspection activity

In the year to 31 March 2015 we inspected 126 individual audit engagements, an increase of 25% from the prior year. This reflects the progress we have made in implementing the CMA recommendations that each FTSE 350 audit be inspected on average every five years and that each major audit firm (where practicable) be inspected annually.

The audits related to financial years ending between December 2012 and June 2014, with around 50% being 31 December 2013 year ends. An analysis of the audits inspected by category of inspection, together with comparatives, is set out in the following table:

3 Major audit firms are those that audit more than ten entities falling within the scope of independent inspection, as determined each year. The relevant firms are listed in Section 1.
4 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 ("major audits").
5 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 Reviews 2014/15	Audit Reviews 2013/14	Audit Reviews 2012/13
Major Audit Firms			
Deloitte LLP	20	17	16
Ernst & Young LLP	16	16	14
KPMG LLP/ KPMG Audit Plc	20	17	15
PricewaterhouseCoopers LLP	22	19	16
Big Four Firms	**78**	**69**	**61**
Baker Tilly UK Audit LLP	-	6	-
BDO LLP	8	-	7
Crowe Clark Whitehill LLP	5	-	-
Grant Thornton UK LLP	8	-	10
Mazars LLP	5	-	-
Joint audit adjustment	(1)	-	-
	103	**75**	**78**
Firms Auditing Ten or Fewer Entities within Scope	-	-	11
Crown Dependency Audit Firms[6]	2	7	8
	105	**82**	**97**
Third Country Auditors	4	3	-
Private Sector Audits	**109**	**85**	**97**
Public Sector			
National Audit Office	6	6	6
Audit Commission	-	-	4
Audit Commission Appointed Firms	11	10	4
	17	**16**	**14**
Total Audits Inspected	**126**	**101**	**111**

In Section 3.2 we provide a summary of our assessment of individual audits. This summary excludes certain categories of inspections included in the above table as follows:

	2014/15	2013/14	2012/13
Private Sector (excluding Third Country Auditors) Audits Inspected	105	82	97
Follow-up reviews (assessed on a different basis in prior years)	-	-	(12)
Audits not assessed	-	(1)	-
Assessed Audits per Section 3.2	105	81	85

6 This total relates to Crown Dependency companies audited by stand-alone Crown Dependency firms. A further 7, 11 and 10 Crown Dependency audits were inspected at the major audit firms in 2014/15, 2013/14 and 2012/13 respectively.

A further analysis of audits inspected by type of entity is provided in the table below:

Type of Entity	2014/15	2013/14	2012/13
FTSE 100	14	14	13
FTSE 250	40	22	24
FTSE 350	**54**	**36**	**37**
Other Full Listed	33	27	29
AIM	8	7	8
Non-listed Banks	4	2	6
Building Societies	3	5	6
Large Private Companies	1	2	3
Pension Funds	3	4	4
Charities	2	2	2
Collective Investment Funds	-	-	2
LLPs	1	-	-
Public Sector	17	16	14
Total Audits Inspected	**126**	**101**	**111**
Total UK Banks and Building Societies	**13**	**10**	**14**

Since our inspections commenced in 2004, we have inspected more than 1000 audits, including the audits of 173 FTSE 100 companies and 254 FTSE 250 companies. The composition of these indices changes quarterly and a number of audits have been inspected more than once.

We use a risk model covering UK listed and AIM quoted companies, to inform the selection of audits to be inspected each year. A significant proportion of the audits selected in 2014/15 were drawn from those identified as higher risk within the risk model, and certain priority sectors (support services, information technology and banking).

4.4 Interaction with audit committees

Audit committees are a key audience for our inspection findings and we would welcome comments and observations on how we might engage further with audit committees to improve the overall effectiveness of our inspections.

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. This is sent at the same time as it is provided to the audit firms.

On a number of audits we held a discussion with the audit committee chair at the commencement of our inspection. This included the 13 bank and building society audits inspected in 2014/15. Such discussions helped us plan certain aspects of the inspection.

On two occasions audit committee chairs requested a meeting to discuss our inspection findings following the receipt of our report on the inspection of their respective audits. In both cases we had not held an initial discussion at the commencement of our inspection, and the audit committee chairs found it helpful to gain a better understanding of the relative significance of the findings and our expectation of what action was required by both the audit committee and the auditor. Feedback from one of these chairs indicated that their subsequent audit had been more thorough as a consequence of our inspection. We would welcome requests from audit committee chairs to discuss our inspection findings, particularly where our assessment of audit quality is that improvements or significant improvements are required.

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.

4.5 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[7], 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, 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 2014/15 our Crown Dependency inspections included major UK audit firms, and a limited inspection of KPMG Channel Islands Limited. In total we inspected nine audits of Crown Dependency companies.

One of the benefits of these inspection arrangements is that the audits of companies incorporated in a Crown Dependency, but which are listed in the UK, are subject to our inspection. These include a number of major FTSE 350 companies, of which there were eight FTSE 100 companies. The findings from our inspection of the audits of Crown Dependency companies are incorporated within the findings in Section 3.

The cost of these inspections is met by the individual firms concerned.

7 The European Economic Area ("EEA") comprises the members of the European Union plus Iceland, Liechtenstein and Norway.

4.6 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 audit 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, which forms a small part of the NAO's activities. This inspection, which is undertaken annually, comprises the review of two 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, at the request of the NAO, we review four of its government department and public body audits.

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 audit firms and, therefore, subject to full scope inspections as discussed in Section 4.2.

The inspections we undertake on behalf of the Audit Commission form part of its assessment of the quality of contracted-out audits. Given the different objective of these inspections, the findings are excluded from this report and our major audit firm reports. The Audit Commission publishes its assessment both in overall terms and individually by firm. The most recent report can be found on the Audit Commission's website.

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 2014/15 we inspected 11 local authority and health body audits.

Following the enactment of the Local Audit and Accountability Act, Public Sector Audit Appointments Limited assumed responsibility from the Audit Commission on 1 April 2015 for the determination and oversight of these inspections for the foreseeable future. Further anticipated changes to these inspections are discussed in Section 7.4.

4.7 Liaison with Corporate Reporting Review ("CRR")

We work closely with the FRC's CRR team which supports the FRC's Financial Reporting Review Panel and with whom we share both information and findings. Thus our selection of reports and audits for review is influenced by common priority sectors and areas of focus.

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. This includes an initial CRR technical review of the financial statements of a number of audits we inspect. On occasion we may seek additional assistance in relation to more significant accounting issues.

We continued 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. However, necessary differences between our respective processes and in particular the differing time scales for both our reporting, limit the practicability and effectiveness of joint reviews.

4.8 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 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.

UK Auditing Standards introduced a requirement for extended audit reports for listed and certain other entities (those which apply the UK Corporate Governance Code) with effect from September 2013 year ends. As discussed earlier in this report, our 2014/15 inspections covered the application of the new reporting requirements in practice. We have provided regular feedback to our standard-setting colleagues on this area, including the extent to which statements made in extended audit reports about the audit approach and procedures are consistent with our findings.

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. This is an increasingly important area of our work and we are working closely with our international counterparts to ensure that relevant feedback from audit inspections is provided at an early stage of major projects relating to International Auditing, Ethical and Quality Control Standards which are being planned or undertaken.

4.9 Collaboration with the Prudential Regulation Authority ("PRA")

During 2014/15 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 work 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, in particular those audits inspected as part of the banking thematic inspection, and the specific areas of the audit work to focus our review.

In turn, we provide the PRA with specific feedback on the issues arising from the audits of the banks, building societies, insurers and investment management companies that we inspected. We also provide them with a copy of our inspection report on each of these audits. If any of our inspections suggest that the audit requires significant improvements, the PRA discusses our findings with both the auditors and the company.

4.10 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 a common inspection methodology for firm-wide procedures.

We note that there continues to be considerable commonality between the nature of our inspection findings and those of audit regulators in other major jurisdictions. There are however, differences in the number of individual findings when compared with those in other jurisdictions, and the extent of these differences can vary from year to year.

In accordance with the Statement of Protocol agreed in 2013 with the US Public Company Accounting Oversight Board ("PCAOB"), our inspections at Ernst & Young LLP and PricewaterhouseCoopers LLP in 2014/15 were undertaken jointly with the PCAOB.

Under the aegis of IFIAR we also participated in a multi-jurisdictional inspection with other international audit regulators.

4.11 Delegated inspections

There are approximately fifty firms with ten or fewer audits falling within our scope of inspections. Many of these firms have only one or two relevant audits 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 2014/15, as was the case in the prior year, the inspection of all such firms was delegated in full.

Where inspections are delegated, we 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 2014/15 23 reports were reviewed and approved in respect of delegated inspections (2013/14: 17 reports).

The revised Statutory Audit Directive and Regulation will affect the extent to which we are able to delegate future inspections. This is discussed in Section 7.

4.12 Basis of funding

We form part of the FRC's Conduct Division and have a staff of approximately 28 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 the Public Sector, the Crown Dependencies and Third Country Auditors, are subject to separate funding arrangements designed to recover in full the costs of these inspections.

5 Thematic Inspections

5.1 Introduction

Our activities include thematic inspections, which focus on particular aspects across a sample of audits and firms. These inspections are particularly appropriate where we think that there may be scope for improvement generally and also to learn from best practice across the profession. We regard them as valuable supplements to our annual programme of inspections of individual firms.

In 2014/15 we undertook two such inspections. These related to the audit of loan loss provisioning and related IT controls in banks and building societies ("banking") and the auditor's consideration of the quality of financial reporting in smaller listed and AIM companies ("smaller companies financial reporting"). These inspections are discussed below.

We are currently undertaking three further thematic inspections in 2015/16 covering audit sampling, the role of the engagement quality control reviewer (EQCR) and firms' internal quality monitoring procedures. The findings from these inspections will be reported in 2016.

5.2 Banking

This inspection was prompted by concerns in prior years that firms needed to strengthen their financial services audit testing, particularly in respect of loan loss provisioning and related IT controls. In addition the pace of improvement in audit quality in this area had not met our expectations. Accordingly, we signalled in advance to firms our intention to conduct this inspection.

The audit of loan loss provisioning and related IT controls was reviewed in respect of 13 individual bank and building society audit engagements at seven firms. We also considered the respective firms' methodology and guidance in these areas.

Overall we concluded from this inspection that there were improvements in the quality of certain aspects of the audit of loan loss provisions and related IT controls, particularly at those firms where we had, in recent years, identified significant issues. These firms had in the main demonstrated that, with appropriate focus and resources, good quality audits can be achieved. It was clear from this inspection that firms with sufficient banking sector experience and access to up-to date specialist knowledge in IT and other relevant areas, such as real estate valuation, are able to audit loan loss provisions to a good standard with only limited improvements required. Nevertheless, this inspection also identified two audits of UK subsidiaries of foreign banks where significant improvements were required.

More details in respect of this inspection are included in a separate report published in December 2014, a copy of which can be found on the FRC's website. https://frc.org.uk/AQTR-the-audit-of-loan-loss.pdf

Our assessment of the 13 banks and building society audits we reviewed as part of this inspection have been incorporated in the overall inspections findings for 2014/15 as set out in Section 3.

5.3 Smaller companies financial reporting

In April 2014, following concerns raised over a number of years by CRR in respect of the quality of reporting by smaller listed companies, the FRC started a three year project to drive a step change in the overall quality of financial reporting by such companies. As part of the first phase of this project we undertook an inspection that specifically considered the work performed by auditors at each major audit firm over the presentation of, and the disclosures in, the annual report and financial statements of smaller listed and AIM (Alternative Investment Market) traded companies ("smaller listed companies"). As a proportion of smaller listed companies are audited by firms other than the nine major audit firms currently within the scope of our inspections, the Quality Assurance Department ("QAD") of the ICAEW conducted a similar review at 22 other firms.

The FRC expects to issue an overall report on the first phase of the project shortly which will include an analysis of the root causes identified and suggestions as to how those involved in the reporting by smaller listed companies can be better supported to deliver improvements in quality. The next phase will then consider how such initiatives can be implemented.

As this inspection was undertaken as part of a wider FRC project and our findings together with those of the QAD form part of the broader project, there will be no separate report that specifically covers the work of auditors. We have, however, reported our findings to the individual firms concerned and the key findings from this inspection are discussed below. These are intended to promote a better understanding of the role of auditors in this important area.

Overall we identified a number of different practices across firms, including some good practice and some areas for improvement. Our findings were also generally consistent with those of the QAD.

In many cases, firms' processes and procedures are applied equally to both larger and smaller listed companies so these findings may also be of relevance to the auditors of larger listed companies. We did, however, note some areas where the procedures applied for smaller listed companies differed from those applied for larger listed companies.

These differences included amongst others, no requirement for an annual technical review or for the disclosure checklist to be completed on an annual basis; technical reviews performed by accredited reviewers who were not full time members of the firm's central technical team or with less seniority and experience than those reviewers for larger listed companies, but with their work reviewed by more senior members of the technical team.

In many cases, such approaches are both reasonable and proportionate having regard to the more straightforward accounting and reporting relevant to many smaller listed companies. Whether they are appropriate will also depend on other aspects of a firm's controls and procedures, such as training, review and consultation.

We concluded that tightening audit practice and procedure in a number of areas would increase the effectiveness of the audits. Areas for improvement include:

- Clearly defining responsibilities;
- Increased and more rigorous use of technical review;
- More rigorous training and experience thresholds for audit engagement partners undertaking listed company audits;
- Improvements in procedures around the collation and reporting of unadjusted audit misstatements;
- Improved procedures at the final completion stages of the financial statements;
- Greater focus on cash-flow statements;
- More focus on evaluating the competence of management to produce annual reports and financial statements at an early stage of the audit;
- A focus on the adequacy of the audit procedures performed over financial statement disclosures and the impact on quality; and
- Improved communication with audit committees of unadjusted disclosure misstatements and management's technical competence to produce good quality financial statements.

6 Third Country Auditor Inspections

6.1 Introduction

This Section provides an overview of our inspections of Third Country Auditors ("TCAs") for the year ended 31 March 2015. The results of these inspections are discussed in Sections 6.7 and 6.8. This is the second year in which such inspections have been undertaken.

TCAs are auditors of companies incorporated outside the EEA that have issued securities on EU regulated markets, which for UK purposes means principally 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.

6.2 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 TCAs. In particular, the Directive and the UK implementing legislation require the FRC, as the UK Competent Authority, to subject registered TCAs 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 following exclusions apply to the TCA inspection regime:

- Auditors of companies that have issued only debt securities are outside the scope if the securities are exclusively denominated in units of a minimum of €50,000 (or equivalent in another currency);
- Audit firms established within the EEA other than in the UK and who have UK market-traded companies as clients are not required to register with the FRC and we do not monitor those auditors or specific audit engagements;
- Audits of UK market-traded companies undertaken by UK audit firms are included within our UK scope of independent inspection as set out in Appendix B; and
- Audits of UK market-traded companies incorporated in one of the Crown Dependencies are subject to monitoring by us under arrangements as discussed in Section 4.5.

6.3 Categories of Third Country Auditors

All TCAs are required to register with the FRC. The FRC's register can be found on the FRC's website https://frc.org.uk/Terms-and-conditions-for-register-of-TCAs

Each TCA is classified in one of the following three categories to which different requirements apply:

"Equivalent" TCAs:

Auditors in those countries that the European Commission ("EC") 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, as we are entitled to place reliance on the system of inspection in their home country. The following 19 countries are considered to be equivalent by the EC:

Abu Dhabi	The Dubai International Financial Centre	Japan	South Korea
Australia		Jersey	Switzerland
Brazil	Guernsey	Malaysia	Taiwan
Canada	Indonesia	Singapore	Thailand
China	Isle of Man	South Africa	United States of America

"Transitional" TCAs:

Auditors in those countries which the EC 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. There are seven transitional countries as follows:

Bermuda	Egypt	New Zealand	Turkey
Cayman Islands	Mauritius	Russia	

"Article 45" TCAs:

Auditors from countries that are neither "equivalent" nor "transitional". These are subject to a system of monitoring by the FRC. The following 25 countries were determined to be Article 45 countries by the EC:

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

6.4 Population of Third Country Auditors

As at 31 March 2015 there were 110 TCAs registered with the FRC from 45 countries with 211 relevant issuers. Most of these TCAs are members of one of the four largest global networks of audit firms.

The UK has significantly more third country issuers than any other EU Member State and they and their auditors come from a wide spread of countries.

Of these, 50[8] were "Article 45" Third Country Audit firms, from 25 countries, who audit 57 UK market-traded companies. All but ten of these were audited by firms who are members of the largest four global networks of firms.

6.5 Monitoring the Work of "Article 45" Third Country Auditors

Our monitoring focuses on those UK market-traded companies considered to be of significance for UK investors. In the year to 31 March 2015 we completed inspections at the following five "Article 45" audit firms:

- Deloitte & Touche, Lebanon
- Ernst & Young PCC, Lebanon
- Ernst & Young, Oman
- PricewaterhouseCoopers SRL, Barbados
- PricewaterhouseCoopers, Papua New Guinea

6.6 Reporting on our findings

We issue a confidential report on each third country audit engagement inspected. This is provided to the audit engagement partner and copied to the chair of the audit committee, or those charged with governance. These reports are similar to those issued for our UK audit inspections and include an overall assessment of the quality of the audit work inspected. Our approach to the assessment of audit quality is set out in Section 3.4.

6.7 Overall assessment of audits reviewed in 2014/15

We reviewed and assessed the quality of selected aspects of four audits, at the abovementioned five firms. This included one joint audit.

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

All four of the audits were categorised as "limited improvements required". In the prior year we inspected three audits, of which one was categorised as limited improvements required and two as improvements required.

8 Five audit firms are registered in accordance with Article 45 but at present have no relevant audit clients.

6.8 Principal findings in 2014/15

The key message arising from our 2014/15 inspections of TCAs relates to the need for auditors to be aware of the particular requirements relating to UK market-traded companies.

Audit firms should perform procedures to identify non-compliance by issuers with the laws and regulations required by the London Stock Exchange.

We identified an instance where an audit firm had not identified that the issuer and the auditor were subject to additional requirements as the company had a Premium Listing on the London Stock Exchange. As a result, the audit team did not identify that the company was required by the London Stock Exchange Listing rules to request the auditors to review the company's Corporate Governance Statement.

6.9 Restrictions on our access to audit working papers

In 2014/15, as was the case in the prior year, we completed fewer reviews of audits undertaken by Third Country Audit firms than planned. This was due to difficulties encountered in navigating the legal and practical challenges to carrying out inspections in some jurisdictions.

Our 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 our 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 we will initiate the process of removing that firm from the register of approved Third Country Auditors.

During 2013 we selected Ernst & Young Qatar for inspection. Ernst & Young Qatar are the auditors to Commercial Bank of Qatar QSC. The Qatar Central Bank wrote to the firm denying us access to the audit working papers. Accordingly we are currently unable to carry out an inspection of this audit. We have drawn this matter to the attention of the Financial Conduct Authority.

6.10 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 are funded by the auditors inspected. If audit firms were to make their audit working papers available in London, this would reduce the cost of an inspection significantly. Most firms have generally chosen not to do so for a mixture of legal and risk management reasons.

7 Future Inspections

7.1 Introduction

In this Section we discuss our inspection plans for 2015/16, together with other developments that will impact future inspections, notably the revised EU Statutory Audit Directive and Regulation.

7.2 Planned inspections in 2015/16

The FRC's Plan and Budget for 2015/16 indicates that we are planning to inspect around 140 audits. This represents a further step up in activity from 2014/15, primarily as a consequence of our implementation of the CMA's recommendation that all FTSE 350 audits be inspected on average every five years. Our planned inspections for 2015/16 assume a target of 70 FTSE 350 audits. If this is achieved this means we will have fully implemented the CMA's recommendation a year earlier than we initially envisaged. This will, however, be dependent on our ability to recruit additional inspection staff in 2015.

In selecting particular audit engagements to inspect, we have regard to the FRC's priority sectors. The priority sectors for 2015/16 are insurance; food, drink and consumer goods manufacturers and retailers; companies servicing the extractive industries; and business services. A significant proportion of the audits we plan to inspect are selected from these sectors, together with a number of first year audits given the extent of changes in auditors following increased audit tendering. Our inspections will pay particular attention to the audit of revenue recognition and complex supplier arrangements.

7.3 EU Statutory Audit Directive and Regulation

The Revised EU Statutory Audit Directive and the new Regulation, which take effect in June 2016, will affect our inspection activities in a number of respects.

A key change is in the definition of public interest entities, which in the Directive has been expanded to include credit institutions (a bank or building society but not a credit union) and insurance undertakings.

Our current scope of inspections, as set out in Appendix B, comprises listed entities (the existing public interest entity definition) together with a range of other entities in whose financial condition there is considered to be a major public interest. Entities captured by the latter grouping are reassessed annually. This currently includes all unlisted banks and building societies.

The change in the public interest entity definition, if we are designated the Competent Authority under the Regulation, will, therefore, have no impact on bank and building society audits subject to our inspections, other than their formal classification as public interest entities. However, in respect of insurance undertakings, these currently fall within our scope of inspections only if they are listed, are mutual life offices having "with-profit" funds of at least £1 billion or if they meet the large private company turnover threshold (£500 million). The classification of insurance undertakings as public interest entities means that unlisted insurers including friendly societies will now fall within the scope of our inspections. This change will also bring a number of additional firms within the scope of our inspections for the first time.

Another important change is that all firms that audit public interest entities must be inspected independently of the profession (i.e. the FRC will no longer be able to delegate the inspection of any such firms to the professional bodies). The frequency of these inspections will, however, depend on the size of the public interest entities, with auditors of large public interest entities required to be inspected every three years, while those firms with only small or medium size entities will only require an inspection every six years.

The above-mentioned changes taken together will, therefore, expand both the number of firms with public interest audits we are required to inspect and the population of audits subject to inspection. We are still assessing the impact of these changes and in particular the number of audit firms that will now be classified as public interest auditors.

Notwithstanding this, it is clear that these changes will significantly affect those firms with ten or fewer audits falling within our current scope of inspection. As noted in Section 4.11 we currently delegate the full inspection of these firms to the professional bodies. If these firms audit at least one entity falling within the revised public interest definition this will no longer be possible.

We anticipate that most of the additional firms we will now be required to inspect will only have a small number of public interest audits. In many cases this is likely to be no more than one or two such audits. A proportionate inspection programme, which covers both a sample of audits and the firm's procedures supporting audit quality will, therefore, need to be developed for these firms. How we report the findings from these inspections will also require consideration.

Consequential changes may also need to be considered in other areas such as the range of entities not classified as public interest that are currently captured by the scope of our inspections.

7.4 Local Audit and Accountability Act

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 4.6 we currently undertake inspections of auditors of local authority and health bodies on a contractual basis for the Audit Commission (Public Sector Audit Appointments Limited from 1 April 2015) covering both the financial statement and value-for-money audits.

Under the Act we are required to inspect those auditors that undertake the very largest of these audits and we anticipate that the number of audits inspected annually will increase to approximately 20. 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 under the Local Audit and Accountability Act. This may have implications for the timeliness of our reporting.

A number of transitional arrangements mean that these changes are not envisaged to impact our inspections until 2018/19. In the interim we continue to plan for their implementation.

8 Auditor Regulatory Sanctions Procedure

8.1 Background

The Auditor Regulatory Sanctions Procedure ("ARSP" or the "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 may take the form of one or a combination of the imposition of restrictions or conditions, a regulatory penalty (fine), and the suspension or withdrawal of audit registration. The Procedure applies to apply to matters identified as part of our UK statutory inspection process. The FRC's Monitoring Committee considers whether matters identified meet the criteria for a sanction as set out in the Procedure. In doing so, the Monitoring Committee has in mind the purpose of the Procedure, which is not to punish auditors but to drive improvements in audits in the future.

A similar procedure applicable to our Crown Dependency inspections was implemented at the beginning of 2015 and will, therefore, be applicable to relevant inspections undertaken in 2015/16.

Further details in respect of the procedure can be found on the FRC's website.
https://frc.org.uk//Auditor-regulatory-sanctions-procedure.pdf

8.2 Matters considered by the Monitoring Committee in 2014/15

Five matters were brought before the Monitoring Committee during the year for specific consideration under the Procedure. These related to poor quality audit work, ethical matters and non-compliance with the UK Audit Regulations.

As at the date of this report two matters were still at various stages of consideration under the procedure.

Of the three matters where consideration under the Procedure was concluded, one was considered to be misconduct, which is outside the scope of the Procedure. This matter was, therefore, referred to the FRC's Conduct Committee who concluded that the matter should be considered under the ICAEW's disciplinary procedures, as it did not appear to raise important issues affecting the UK public interest requiring investigation under the FRC's Accountancy Scheme.

The other two matters were concluded by acceptance of a sanction as described below.

8.3 Sanctions determined

Ernst & Young LLP

Pursuant to the Auditor Regulatory Sanctions Procedure, and following an inspection by the Financial Reporting Council (FRC)'s Audit Quality Review (AQR) team, the FRC's Monitoring Committee determined on 10 November 2014 that Ernst & Young LLP had failed to comply with the Regulatory Framework for Auditing in its audit of an entity's 2013 financial statements. The Sanctions proposed by the Monitoring Committee, and accepted by Ernst & Young LLP, were a condition that Ernst & Young LLP complete by 28th February 2015 specified actions designed to improve the performance of future audits, and a Regulatory Penalty of £52,500.

Mazars LLP

Pursuant to the Auditor Regulatory Sanctions Procedure, and following an inspection by the Financial Reporting Council (FRC)'s Audit Quality Review (AQR) team, the FRC's Monitoring Committee determined on 14 January 2015 that Mazars LLP had failed to comply with the Regulatory Framework for Auditing in its audit of an entity's 2013 financial statements and was liable to sanctions. The Sanctions proposed by the Monitoring Committee, and agreed by Mazars LLP, were a condition that Mazars LLP complete by 31 March 2015 agreed actions designed to ensure the effective performance of future audits, and a Regulatory Penalty of £10,400.

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 2014/15 is set out in Appendix B.

The review of firms' policies and procedures supporting audit quality covers 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 by the auditors 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. Our reviews however, are not designed to "second guess" the appropriateness of the audit opinion. 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 with the firm's action plans designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified requiring action by the firms than on 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 reviews as discussed in Section 4.7. Our focus in relation to financial reporting issues is on the appropriateness of the key audit judgments made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained by the auditors to support those judgments and on 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 the basis of 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 under the ARSP. This is discussed in Section 8.

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 4.9.

Basis of reporting on individual audits

We 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).

These reports contain the more significant matters arising from our review of selected aspects of the audit work which we consider should be reported to both the auditor and those charged with governance.

In addition to reporting specific findings, our reports include an overall assessment of the quality of the audit work we inspected. Our assessment of audit quality is discussed in Section 3.4.

Separately we provide the audit firm with a record ("issues tracker") of the issues identified from our review of the audit file. We require a written response from the audit team in respect of these issues, including details of the action the firm proposes to take in future to address each issue. The content and wording of each issues tracker is discussed with the audit firm prior to being finalised.

Basis of reporting on firms

We prepare a public report on each major audit 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 audit firm[9] 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.

Quality control procedures

A team of qualified accountants, led by an experienced senior auditor ("the inspection leader") is assigned to individual firm inspections. These are completed at various times during the year. The scope of each inspection, which is subject to approval by the inspection leader, is developed from pre-determined criteria and guidance to ensure the consistency of inspections across different firms. The inspection leader is also responsible for reviewing all inspection field work and the initial output of that work including written queries and issues trackers that are provided to firms for a written response. The inspection leader together with the relevant inspector participates in discussions with the firm prior to concluding on which issues should be reported formally to the firms.

All formal reports are subject to further review by staff not involved in the inspection process with a final review performed by the Monitoring Committee which approves the issue of all reports. Its review considers the significance of the matters to be included in the reports, how the issue is articulated together with, where applicable, the appropriateness of the overall assessment of audit quality.

9 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 2014/15

Audits of the following entities were within scope for the 2014/15 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 4.5 discusses separate inspection arrangements in respect of certain Crown Dependency companies.

The above criteria were applied as at 31 December 2013 to identify those entities within the scope of inspection for 2014/15. Further details relating to the inspection scope, including the criteria applied for the 2015/16 inspections, is available on the AQR section of the FRC's website.

https://frc.org.uk/Scope-of-independent-inspections

Financial Reporting Council

Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk