

# **BDO LLP**

## **AUDIT QUALITY INSPECTION**

**JUNE 2017**

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

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## About the FRC and its Audit Quality Review team

### Our objective

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

### What we do

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

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

### The AQR team

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

### Working with Audit Committees (or equivalent bodies)

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

### Priority sectors and areas of focus

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

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

### **Thematic reviews**

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

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

### **Developments in Audit 2016/17**

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

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

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<sup>1</sup> FRC Plan and Budget 2016/17

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# Financial Reporting Council

## BDO LLP

Audit Quality Inspection

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

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# 1 Overview

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

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

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

## Structure of report

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

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

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

**Appendix C** explains how we assess audit quality.

## Scope of our 2016/17 inspection

We estimate that the firm audited 77 UK entities within the scope of independent inspection as at 31 December 2015. Of these entities, our records show that 60 had securities listed on the main market of the London Stock Exchange, including one FTSE 350 company. Appendix B sets out information on audits of non-UK entities within scope at the time of our inspection (which included two FTSE 350 companies).

We reviewed selected aspects of eight individual audits in 2016/17. In selecting which aspects of an audit to review, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The communications with the Audit Committee (or equivalent) were reviewed on all of these audits, and the audit of revenue was reviewed on nearly all of these audits. Other areas we reviewed across a number of these audits include the audit of provisions, IT controls and journals. The audit of valuations and impairments was not reviewed on most audits as it was not identified as a significant risk.

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

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

The FRC issued a single revised Ethical Standard in 2016, effective at a firm-wide level from 17 June 2016 and applicable to individual audits for financial periods starting on or after this date. We discussed the firm's approach to implementing the revised Ethical Standard during our 2016/17 inspection. We will review this area in detail as part of our 2017/18 inspection, along with the firm's implementation of the revised UK Auditing Standards effective for financial periods starting on or after 17 June 2016.<sup>3</sup>

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

### **Progress made in the year**

We have seen an improvement in relation to certain key findings highlighted in last year's report, in particular controls testing. However, we continue to identify some findings in relation to the audit of revenue and journals and the communications with Audit Committees. Aspects of these findings were different in nature to those identified last year and the firm has continued to focus on actions to address them.

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

- Guidance and training: there have been updates to the firm's guidance and training in a number of areas, including embedding data analytics for use in the audit and improving senior staff and partner review procedures.
- Methodology: there have been changes to the way in which internal controls are required to be assessed on audits.
- Ethics and independence: there have been improvements to compliance monitoring procedures, including introduction of a rolling programme for audit partners' financial interests, and updates to the independence systems.
- Internal quality monitoring: there is now more consistency in the process through increased central input.

### **Good practice identified**

Examples of good practice we identified in the course of our work include the extent of involvement of senior team members in key aspects of the audit, including in the planning and review processes.

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

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

## Key findings in the current year requiring action

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

### Individual audit reviews

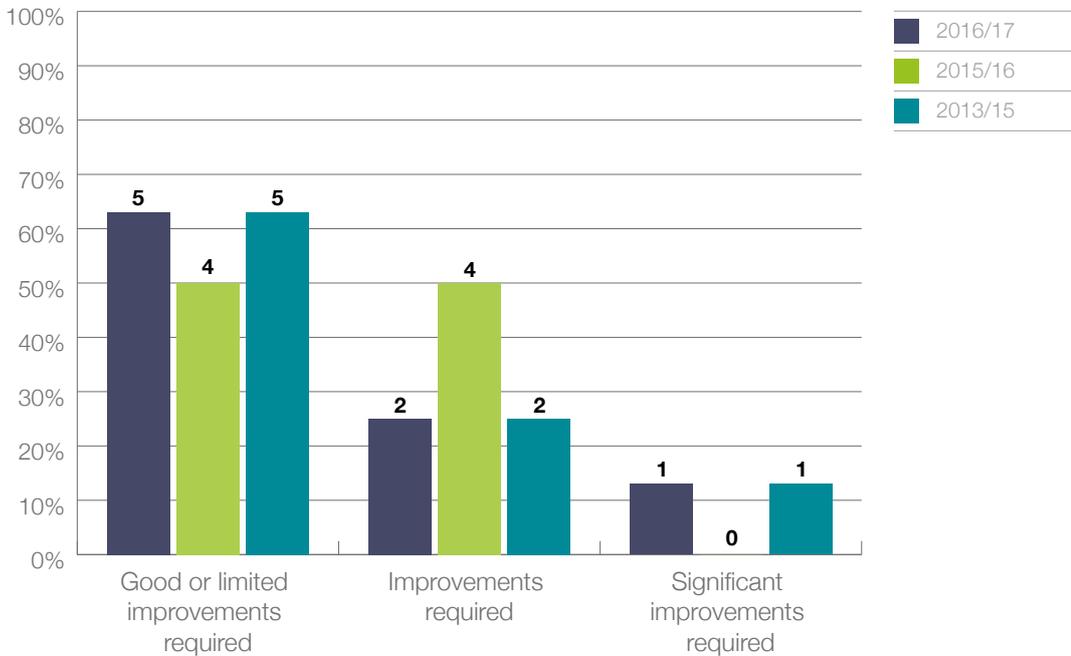
- Improve the quality of information provided and the communication with Audit Committees in areas of judgment.
- Improve the quality of audit evidence and challenge to management in relation to the audit of provisions.
- Ensure that improvements to substantive analytical review procedures are embedded in the audit of revenue.
- Improve the extent of corroborative evidence in the testing of journals.

### Review of firm-wide procedures

- Ensure the Ethics Partner is always consulted on independence matters when required.

## Assessment of the quality of audits reviewed

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



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

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## Issues driving lower audit quality assessments

The principal issues resulting in three audits being assessed as requiring more than limited improvements in 2016/17 were as follows (where relevant, further details for our key findings are set out in section 2):

- Inadequate evaluation of whether an auditor’s expert’s report provided sufficient and appropriate audit evidence in relation to certain provisions, and reporting this to the Audit Committee.
- Insufficient challenge relating to the lack of disclosures for significant uncertainties, and reporting this to the Audit Committee.
- Insufficient evidence of involvement of the group audit team in the audit of a significant overseas component and the sufficiency of challenge on the appropriateness of the inventory provisions.

## Root cause analysis

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

The firm has continued to develop its process for identifying the causes for inspection findings and is in the process of implementing the recommendations from our thematic report on the subject. The firm has also involved external consultants to assist in revising the RCA methodology.

## Firm's overall response and actions:

In the last year, in order to enhance the depth and structure of our root cause analysis process we enlisted the help of a specialist external firm who have worked with other industries. We have implemented our new approach within the audit stream and will continue to develop and assess potential uses within the firm as a whole. We have had an enthusiastic response from individuals involved in the process and the approach has provided deeper insight through understanding the relationships between seemingly unrelated causes that can combine together to generate some of the issues arising.

Whilst investigating the specific issues arising in this report a number of common causes have been identified:

- The experiences, knowledge and quality of the senior members of the engagement team were a key influence on the quality of the work performed and standard of documentation. We have implemented a number of actions including, establishing a forum for all senior managers and directors who work on public interest engagements and ensuring that quality issues are directly reflected in staff appraisals.
- Effective project management remains an important function to be undertaken on an audit engagement to ensure the right work is done by the right person at the right time. We have included enhancements to the latest version of the audit tool to ensure audit teams focus on the important areas of project management including setting a detailed timetable. We will continue to monitor the application of specialist skills to support audits such as valuations and data analytics.
- Our root cause analysis to date has indicated that improvements could be made to the review process. We will therefore investigate the inter-relationships between reviews carried out by the different members of the team during the audit process.
- Our investigations highlight that consistency of approach and documentation contributes towards audit quality. We have identified areas where existing templates require enhancement and where new templates are required to help audit teams fully document complex matters. These include the enhancement of an ISA 540 'Auditing Accounting Estimates, including Fair Value Estimates and Related Disclosures' audit workpaper template which was released in April 2017 and a current ongoing project to develop further our ISA 260 communications which will be delivered in October 2017.
- The knowledge and understanding of the client and the audit committee is of particular importance to audit quality as requirements become more complex. Smaller listed companies do not always have the same resources as larger listed companies. We will assist and help them fulfil their critical role in governance. We are currently designing new communications for new and existing clients detailing the legal and ethical regimes in place for public interest entities.

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## 2 Key findings requiring action and the firm's response

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

### **Improve the quality of information provided and the communication with Audit Committees in areas of judgment**

Effective communication with Audit Committees is important to assist them in discharging their responsibilities. Providing Audit Committees with sufficient information in areas of uncertainty assists them in understanding matters relevant to the audit and in considering risks and judgments that may affect the financial statements.

We reviewed the communication with Audit Committees on all audits. We found some examples of good communication, including in relation to risk identification and concluding on how the audit procedures addressed the specific risks. However, on some of the audits reviewed, we identified areas where the communications could have been improved. For example, we identified the following:

- Insufficient information and evidence of challenge on estimates: the audit team did not provide the Audit Committee with the necessary detail to enable them to understand the uncertainties surrounding the related estimates used as a basis for the provisions.
- Insufficient discussion of the adequacy of disclosures in the financial statements: not providing the Audit Committee with sufficient information on contract-related risks to help assess whether the relevant disclosures were adequate.
- Insufficient reporting of identified control weaknesses: not providing details of control weaknesses identified in the audit.

### Firm's actions:

Our audit teams are fully aware of the importance of these communications and want to get them right. Our root cause analysis showed that audit teams had an understanding, but had not confirmed that the Audit Committee was aware of the facts and circumstances relating to significant areas of uncertainty and therefore did not appreciate the need to repeat that information. We have clarified with audit teams that they should ensure it is the case that Audit Committees are aware of information related to areas of uncertainty and that the audit team's view on these uncertainties is communicated clearly.

A number of actions will be undertaken:

- We have established a project team to examine improving our communications with those charged with governance. This includes revising our report templates, making them easier to prepare and properly focussed on key issues. We will be including visualisations for subjective judgments and estimates to enable audit committees to appreciate alternative potential outcomes.
- We will review our audit planning processes and format of reporting to ensure the documentation used to communicate with those charged with governance is prioritised appropriately.

### Improve the quality of audit evidence and challenge to management in relation to the audit of provisions

The amount of provisions recognised in the financial statements relies on judgments made by management, in some cases with the assistance of external experts. Audit teams should obtain sufficient and appropriate evidence to assess the reasonableness of those assumptions and provide an appropriate level of challenge to management.

We identified cases where the audit team did not:

- Adequately evaluate whether an auditor's expert's report provided sufficient and appropriate audit evidence in relation to certain provisions.
- Provide sufficient challenge to management in respect of the level of inventory provisions.

### Firm's actions:

In relation to both issues noted our root cause analysis identified that the teams were not following the provisions of ISA 540 'Auditing Accounting Estimates, including Fair Value Estimates and Related Disclosures' precisely, although they were embracing the overall requirements. We have created a new ISA 540 workbook which was released in March 2017 to be used when dealing with significant audit estimates. This should ensure that we make appropriate assessments of the work of the expert and provide sufficient challenge to management about key judgments made in relation to provisions and the sensitivities around these judgments.

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## **Ensure that improvements to substantive analytical review procedures are embedded in the audit of revenue**

Revenue is an important driver of an entity's operating results and auditors need to evaluate and address fraud and other risks in relation to revenue recognition. A failure to perform sufficient audit work in this area increases the risk that a material misstatement of revenue in the financial statements will not be identified.

BDO audit teams often use substantive analytical procedures in the audit of revenue. The firm provided additional guidance and detailed training for its audit staff on their application of substantive analytical procedures in September 2016.

We continued to find weaknesses in this area on certain audits, which were carried out before the training had taken place. The findings primarily related to the lack of precision in developing expectations and insufficient corroboration of management's explanations regarding variations from expectations.

### **Firm's actions:**

As noted in our 2015/16 report we undertook root cause analysis as a result of the issues identified and put in place actions as described above. As acknowledged this guidance was not in place when the files which were reviewed as part of the 2016/17 review were signed off. The guidance specifically focuses on determining whether substantive analytical procedures ("SAPs") are a suitable response to risk, and if they are, assisting teams ensure that any SAPs created are robust and precise. We have not discouraged teams to consider SAPs as a source of audit evidence but we have encouraged teams to think carefully about the strategy of their responses to risk in all areas of the financial statements, in particular revenue, and appreciate that SAPs have limitations in some circumstances. We will monitor the situations where SAPs are used over the next year.

## **Improve the extent of corroborative evidence in the testing of journals**

Auditors need to evaluate and address fraud risks in relation to the financial statements. The testing of journals is one of the procedures required by auditing standards to respond to the risk of fraud. A failure to perform sufficient audit work in this area increases the risk that a material misstatement in the financial statements relating to fraud would not be identified.

BDO rolled out its new data analytic tool for journals testing in 2015 and we have seen some consequent improvement in the audits we have reviewed, including the focus on fraud risk characteristics when determining which journals should be tested. However, on some audits, the audit team did not obtain sufficient audit evidence in the examination of the journal entries selected for testing.

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### **Firm's actions:**

Our data analytics tool has now been in place for two years. Comments arising from our internal reviews and external reviews as noted above show a continual improvement in the work being performed in this area. Where issues are still being highlighted on specific files we have found that the work was not performed sufficiently early in the audit cycle and the initial understanding of fraud risk factors was not done as well as it should have been. This caused the team to identify a number of journals as being indicative of a risk when in fact they were not, and hence they then concluded that there was no need to obtain corroborating evidence.

We will continue to discuss the importance of proper identification of fraud risk factors which are then related to the circumstances of the client at the planning stage and the corroboration of journals back to source documentation. This has been covered in a number of communications to partners and managers working on public interest entity audits as well as our series of 'top ten areas of focus' videos for the stream released in July 2016 and November 2016.

We will continue to monitor our work to ensure that we continue to see improvements.

### **Ensure the Ethics Partner is always consulted on independence matters when required**

Consultations with the Ethics Partner are important to ensure audit teams are applying appropriate judgments in independence related decisions.

Ethical Standards required that, for listed companies, where the fees for non-audit services for a financial year are expected to be greater than the annual audit fees, the audit engagement partner should discuss the circumstances with the Ethics Partner. We noted instances where the required consultation had not taken place, had taken place retrospectively or should have taken place earlier.

Firms are required to ensure that the audit engagement partner and Ethics Partner are notified when others within the firm propose to adopt contingent fee arrangements. However, we noted an instance where engagement terms were agreed before the audit engagement partner and Ethics Partner had been consulted on the contingent fee arrangement.

In cases where non-audit services involve providing advice to management, the audit team should consider whether management are adequately informed and have the appropriate skills and competencies to make their own decisions. We identified a case where the firm noted that management were competent enough to make an informed decision, but it was unclear how they had arrived at this conclusion.

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### Firm's actions:

Whilst not extensive in number we acknowledge that there are still circumstances arising where the ethics partner is not consulted appropriately and on a timely basis. We undertook a root cause analysis to investigate how to reduce even further the number of incidents where teams and individuals fail to follow correct procedures.

A number of causes were identified:

- Partners are required to complete a number of different forms for different reasons, which means the process is not always efficient and information can be missed – we are reviewing this process and the potential for simplification.
- The audited entity may engage directly with other parts of our business for non-audit services without fully appreciating the complexity of the independence requirements. As noted earlier in this report we are designing new communications for new and existing clients covering the legal and ethical regime in place for public interest clients.
- Where audited entities become public interest for example, due to an increase in market capitalisation, they do not always inform us on a timely basis and this leads to implications for our independence. In order to address this issue we need to ensure that there is a process in place at the planning and completion stages of the audit to confirm with the audited entity any changes in status.
- We are reviewing our engagement take on process to assist in the timely notification and evaluation of any non-audit services.

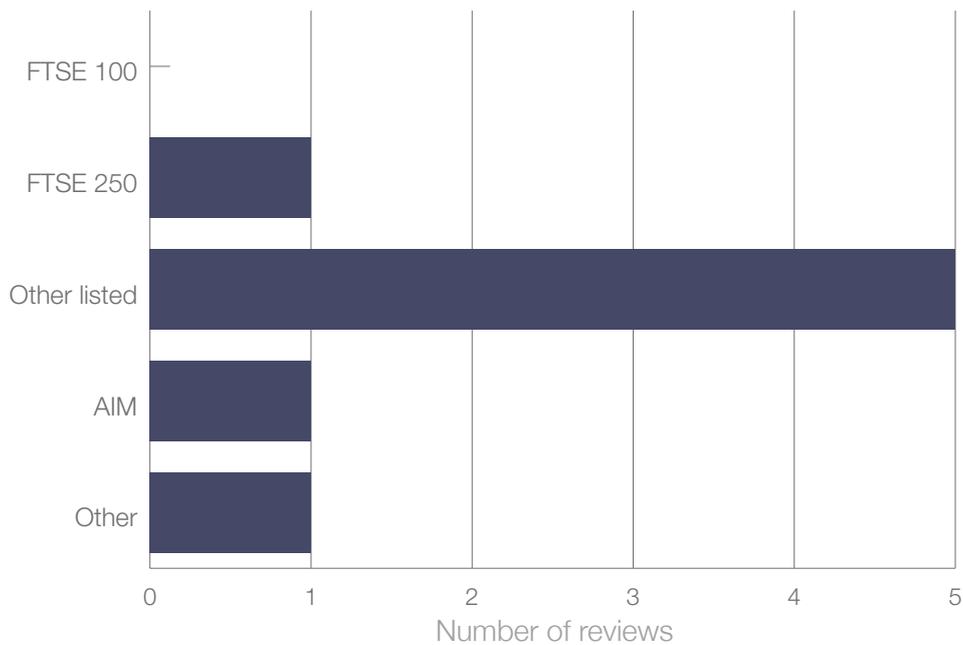
### Audit Quality Review

FRC Audit and Actuarial Regulation Division

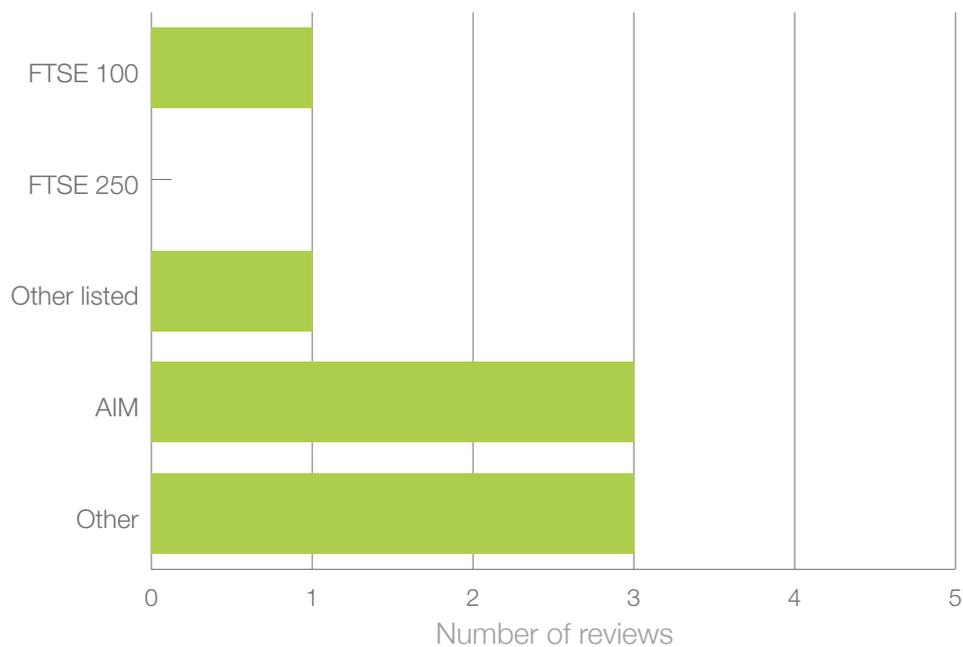
June 2017

## Appendix A – Audits inspected in 2016/17

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



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



## Appendix B – Objectives, scope and basis of reporting

Matter	Explanation
Objectives of our inspection	<p>The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with Relevant Requirements as defined in the Statutory Audit and Third Country Auditor Regulations 2016 (SATCAR). A full list of the Relevant Requirements is set out at Regulation 5(11) SATCAR, and includes amongst other requirements, applicable legislation, the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies.</p> <p>The standards referred to in this report are those effective at the time of our inspection, or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.</p>
Audits in the scope of our inspection	<p>Our Audit Quality Review (AQR) team monitors the quality of the audit work of statutory auditors in the UK that audit Public Interest Entities (PIEs) and certain other entities within the scope retained by the FRC (these are currently large AIM entities and Lloyd's Syndicates). Monitoring of all other statutory audits is delegated by the FRC to Recognised Supervisory Bodies under a series of Delegation Agreements. The overall objective of our work is to monitor and promote continuous improvement in audit quality in the UK.</p>
	<p>In addition to the UK audits in scope, the UK firm audits a number of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area. These audits are inspected by us under separate arrangements agreed with the relevant regulatory bodies in those jurisdictions. The results of these reviews are included in this report. Our records show that, at the time of our inspection, the firm had six such audits, including one FTSE 100 and one FTSE 250 company.</p>
	<p>BDO also supplies audit services to local authorities and the NHS (Local Public Audits - LPAs). Whilst we review LPAs undertaken by firms, this is done under separate arrangements agreed with the Public Sector Audit Appointments Limited (PSAA), previously the Audit Commission. The results of these reviews are not included in this report because the LPA inspections fulfil a different purpose to those considered in this report. These reviews of LPAs form part of the PSAA's assessment of the quality of contracted-out audits. The PSAA publishes its assessment both in overall terms and individually by firm. The most recent reports can be found on its website.</p>

Matter	Explanation
Impact of our risk-based inspection approach	Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected for review and cannot be relied upon for this purpose.
Key audit areas inspected	In selecting which aspects of an audit to inspect, we take account of those areas considered to be higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The rationale for including each area of audit work (or excluding any area of focus listed in the auditors' report) is documented as part of the planning process for each audit inspected.
Our reports on individual audits	We issue a report on each individual audit reviewed during an inspection to the relevant audit engagement partner or director and the chair of the relevant entity's Audit Committee (or equivalent body).
Our focus on achieving continuous improvement in audit quality	We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with Relevant Requirements and to agree an action plan with the firm designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified which require action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool. However, we also seek to identify examples of good practice at each firm.
Basis of our public reporting	While our public reports may provide useful information for interested parties, they do not provide a comprehensive basis for assessing comparative audit quality at individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review (which, in turn, reflects the firm's client base). An issue reported in relation to a particular firm may therefore apply equally to other firms without having arisen in the course of our inspection fieldwork at those other firms in the relevant year. Also, only a relatively small sample of audits within our scope is selected for review at each firm. The findings may therefore not be representative of the overall quality of each firm's audit work.

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

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## Appendix C – How we assess audit quality

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

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

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

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

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

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

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

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

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



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