Financial Reporting Council

ERNST & YOUNG LLP

AUDIT QUALITY INSPECTION

JUNE 2017

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

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About the FRC and its Audit Quality Review team

Our objective

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

What we do

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

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

The AQR team

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

Working with Audit Committees (or equivalent bodies)

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

Priority sectors and areas of focus

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

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

Thematic reviews

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

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

Developments in Audit 2016/17

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

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

1 FRC Plan and Budget 2016/17

Financial Reporting Council

Ernst & Young LLP

Audit Quality Inspection

Contents

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

1 Overview

This report sets out the principal findings arising from the 2016/17 inspection of Ernst & Young LLP ("EY" 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 EY, 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 inspected 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 272 UK entities within the scope of independent inspection as at 31 December 2015. Of these entities, our records show that 179 had securities listed on the main market of the London Stock Exchange, including 11 FTSE 100 and 33 FTSE 250 companies.

We reviewed selected aspects of 17 individual audits in 2016/17. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The 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. We also reviewed either the audit of investment valuations or impairment assessments, which were usually identified as a significant risk, on all of these audits.

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

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

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

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

Progress made in the year

We have seen an improvement in certain areas this year, in particular IT and other controls testing and the firm's independence procedures. However, we continue to identify findings relating to the challenge of management, communications with Audit Committees and the audit of revenue. For these recurring findings, while certain aspects have improved, the firm is in the process of implementing a number of actions on audits to be considered in our 2017/18 inspection and beyond.

The firm has enhanced its policies and procedures in the following areas and we believe these initiatives have contributed to the overall quality of the audits we have reviewed:

- Continued development and enhancement of the firm's Audit Quality Programme which re-enforce the firm's 'tone from the top' in its commitment to audit quality: in the past year the firm has emphasised the importance of coaching, its Audit Quality Support Team hot reviews, sharing examples of best practice and giving timely recognition for good audit quality. The firm also engaged with a third party to analyse the behaviours and characteristics of high performing audit teams.

- Introduction of a new global audit software tool, Canvas: this was rolled out during 2015 and was used for the first time on most of the audits we reviewed in 2016/17. Improvements have been made to the structure of the audit and the related software supporting project management. It also facilitates more effective communications between the group auditor and component auditors.

- Simplification and rationalisation of the firm's audit methodology: the firm's audit methodology has been restructured to reflect the different phases of the audit, with more easily accessible supporting guidance.

2 https://www.frc.org.uk//Our-Work/Audit-and-Actuarial-Regulation/Audit-Quality-Review/AQR-Audit-Reviews.aspx
3 The FRC has established a Technical Advisory Group (TAG) to provide guidance on implementation issues relating to the revised Standards. The output from TAG meetings is published on the FRC's website.

Good practice identified

Examples of good practice we identified across a number of audits in the course of our work include:

- The interaction of the audit team with both the firm's and management's specialists, including robust reporting by the firm's specialists to audit teams in areas of judgment.
- The extent of the group auditor's involvement in, and evaluation of, the component auditors' work, including improved communications and exchange of audit information (partly due to the introduction of the Canvas software).
- The testing of IT and other controls to conclude on whether they were operating effectively.

We also note the effort taken on the two first year audits we reviewed to understand the business and plan the audit.

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

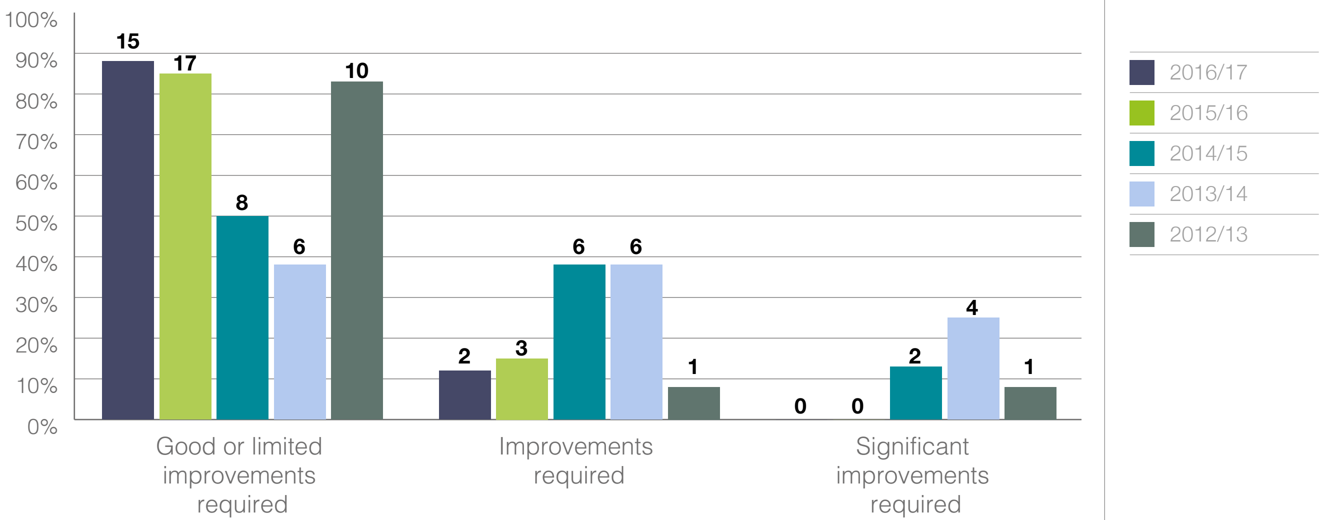
- Apply increased rigour or improve evidence of the challenge of management's estimates and assumptions in impairment testing and valuations of investments.
- Improve the design of audit procedures for revenue in particular in relation to data analytics and completeness.
- Continue to improve the quality of written communications with Audit Committees on significant findings.

Review of firm-wide procedures

- Make enhancements to staff appraisal processes.

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 the previous four years.[4] The number of audits within each category in each year is shown at the top of each bar.



Issues driving lower audit quality assessments

The principal issues resulting in two audits being assessed as requiring improvements in 2016/17 included the following:

- Insufficient attention to the audit completion procedures on one audit. Certain audit working papers had been amended after the date on which the audit file should have been completed or after we had notified the firm that the audit would be reviewed. There was, however, evidence that key audit working papers had been completed and reviewed by the date of the auditor's report. The firm also reported back to us, at our request, on the actions it had taken to improve its monitoring of compliance with completion deadlines.

- On another audit there was insufficient evidence that internal development costs should be capitalised and a lack of rigour when challenging management's assumptions in goodwill impairment testing (further details are set out in section 2).

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 has implemented a number of the recommendations from our thematic report on the subject, including increasing the scope and depth of the RCA and improving its timeliness.

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

Firm's overall response and actions:

We share with the FRC a common objective of promoting confidence in the capital markets by a continuous focus on audit quality. We take our role in helping to sustain stable capital markets seriously and therefore maintaining and continuing to improve audit quality is a priority for us. We welcome the insights and challenges provided by the FRC's inspection.

We continue to invest in developing and supporting our audit teams. In 2014 we initiated a long-term Audit Quality Programme to help us deliver outstanding audit quality on a sustainable basis. We also established our Audit Quality Board which has executive oversight over all matters impacting audit quality. In each of the last three years we have increased our investment in the programme. We are pleased with the results of this investment, which are reflected in the table above, and in particular that more than 90% of our FTSE 350 audits inspected this year were assessed as requiring no more than limited improvements, meeting the target set by the FRC. We were also pleased to receive positive feedback on the audits inspected that were new appointments for us.

Our root causes analysis continues to be a key input into our Audit Quality Programme. We have refined our approach in light of feedback from the FRC's thematic review of root cause analysis. In Section 2, we have explained the causes we have identified for the FRC's key findings and the actions that we took during the period of the FRC's inspection, together with the further actions we plan to take in light of our root cause analysis. Our root cause analysis tells us that key to our good quality results were a consistent message from the firm's leadership and early, detailed partner involvement in audit planning, as well as the focus of our Audit Quality Programme.

We have detailed below some of our key ongoing priorities.

- In 2016, we commissioned a project led by external cognitive psychologists to analyse the behaviours of audit teams which performed at an exceptional level so we can help coach all our teams to replicate these behaviours. The work to roll out the findings has commenced and is a major focus during 2017 helping to drive further improvements.
- Our Audit Quality Support Team (AQST) perform hot reviews of a sample of FTSE 350 and other major audits, providing direct feedback and coaching to audit teams and sharing their observations with the wider audit practice.
- In addition to the focus on coaching we continue to work on improving project management. We began work on this last year with our emphasis on early effective planning and this has been extended into a full cycle milestones programme.

We will continue to focus on these drivers of audit quality and we thank the FRC for its work and the independent perspective it brings.

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. The firm was asked to provide a response setting out the actions it has taken or will be taking in each of these areas.

Apply increased rigour or improve evidence of the challenge of management's estimates and assumptions in impairment testing and valuations of investments

Due to the level of management judgment and potential bias, auditors need to provide an independent and rigorous level of challenge and demonstrate sufficient professional scepticism when assessing the reasonableness of management's estimates and assumptions used in impairment testing and the valuation of investments.

Given the potential impact on the financial statements, we considered either the audit of impairment assessments or the valuation of investments on every audit we reviewed. We identified findings on several of these audits, relating to whether the audit team's challenge of management was sufficiently rigorous or evidenced, including the following on one or more audits:

- In relation to the assessment of goodwill and other assets for impairment, there was insufficient challenge of whether management's cash flow forecasts appropriately reflected the expected timing and duration of important contracts and whether short-term growth rates could be achieved.

- In relation to the valuations of investments, there was insufficient evidence of challenge of whether management had the appropriate information to support the more subjective valuation of certain investments.

Firm's actions:

Our 2017 root cause analysis indicates that teams did not always appreciate what was required in order to convey the level of challenge and rigour they had applied. We also concluded that in some cases, teams did not step back to consider the completeness of their evidence and whether it would enable an experienced auditor, having no prior connection with the audit, to understand the full extent of the work carried out. We will address these findings through our 2017 training and through further support to audit teams from our AQST as set out below.

Our 2016 training programme included training on applying and evidencing professional scepticism in the audit of valuations and impairment assessments. We will incorporate into our 2017 training further emphasis on this area reflecting the results of our root cause analysis. This will include training on the rigour required when challenging estimates and assumptions.

Our AQST reviews have focused on judgmental areas and this will continue. During 2016/17 we have extended the scope of the AQST to include additional Focused Reviews covering selected audit areas as well as the normal cycle of full reviews. Going forward we will include the audit of valuations and impairment assessments in our Focused Review programme.

Improve the design of audit procedures for revenue in particular in relation to data analytics and completeness

Revenue is often identified as a key performance indicator on which investors and other users of financial statements focus. It is an important driver of an entity's results and therefore may be open to manipulation or misstatement, particularly if management are under pressure to meet targets or market expectations. The auditor therefore needs to design appropriate audit procedures when performing the audit of revenue.

We have seen some improvement in the audit of revenue compared with the prior year. We have also seen an increase in the use of data analytics in the audit of revenue, which has the potential to improve audit quality further.

On some audits, however, we still identified findings on aspects of the audit approach, including the following on one or more audits:

– Use of data analytics where the audit of revenue was dependent on a high correlation between revenue and cash. Data analytics were used to establish how much revenue was generated from cash and non-cash items. Insufficient testing was, however, planned and performed over key cash reconciliations upon which the data analytics relied.

– Insufficient testing of the completeness of certain revenue transactions recognised during the year (for example, where the audit approach was designed to focus primarily on revenue deferred at the year-end, rather than revenue recorded in the year).

– Insufficient sample sizes used to audit revenue (for example, where the samples did not reflect all relevant risk factors such as deficiencies in IT and other controls).

Firm's actions:

Our root cause analysis indicated that, whilst the use of data analytics resulted in overall improvements in our audit approach, teams lacked familiarity with aspects of the approach. Our root cause analysis also indicated that some audit teams had prioritised higher risk aspects of revenue but improvement was needed in the audit work addressing completeness (ie under-statement) of revenue recognised during the financial period, assessed as an area of lesser risk. We have provided training in these areas as set out below.

Our programme for auditing revenue using data analytics was issued in November 2015, with pilots run initially followed by wider usage in 2016. We delivered training and practical workshops to focus on the need to complete all aspects of the programme including the related work on cash balances.

Our winter 2016 training included guidance on the audit of revenue, including key messages relating to samples sizes, data analytics and testing for completeness of revenue. In January 2017, further practical guidance was issued to audit teams on testing for completeness. We will continue our focus on the audit of revenue in our 2017 training.

The audit of revenue was a continued focus area for our AQST in 2016 and this will continue in 2017, with particular emphasis on completeness of revenue and data analytics.

Continue to improve the quality of written communications with Audit Committees on significant findings

Auditors need to communicate relevant matters clearly to the Audit Committee, to assist them in overseeing the financial reporting process, assessing management's significant judgments and discharging their governance responsibilities.

We reviewed communications with Audit Committees on all audits we inspected. On some of these audits, insufficient detail was reported to Audit Committees on certain significant findings, including the following on one or more audits:

- The reporting to the Audit Committee did not include the impact of management's assumptions for certain contracts on the goodwill impairment assessment and the recognition of deferred tax assets.

- Reproducing the risks section of the auditor's report in the written communications to the Audit Committee was not an appropriate substitute for reporting the auditor's findings on significant risks.

- Insufficient detail was provided to the Audit Committee on the rationale for, and effect of, valuing investments using assumptions that were more conservative than those used by similar third parties.

Firm's actions:

On those occasions where the extent of reporting to audit committees was less extensive, our root cause analysis indicated that teams considered that they had covered the matters in discussions or that the Audit Committee had expressed a preference for more concise reporting. Evidence of these discussions with the Audit Committee were not always sufficient.

In 2016, we issued a revised Audit Committee reporting template, designed to improve written communication of significant findings. We also provided training during which we shared examples of FRC findings in this area and we will provide further training in 2017. Our AQST continues to focus on the communication of significant findings to Audit Committees.

Make enhancements to staff appraisal processes

Staff performance appraisals, including assessment against relevant objectives, are important to ensure that individuals understand how they contribute to achieving high audit quality and other strategic priorities set out by the firm.

We reviewed a sample of staff appraisals completed in 2015 which were the most recent available at the time our work was undertaken (in early 2016). Based on this review the firm should improve the effectiveness of its staff appraisal processes by:

- Strengthening the link between the assessment of audit quality and overall performance for staff. In the sample of staff appraisals we reviewed, audit quality did not appear to have a direct impact on the staff appraisal process. This could be improved by taking account of the results of internal and external quality reviews on staff performance and having a clearer linkage between the overall appraisal rating, the achievement of quality objectives and remuneration.

- Enhancing controls over the completion of staff objectives. A significant number of staff had not completed their objectives three months after the firm's deadline and, in the sample we reviewed, a number of audit quality objectives set by staff were either too brief or not specific.

- Improving the quality of information on staff appraisal forms. We identified that key information was not always included on staff appraisal forms, such as comments from appraisers, a detailed self-assessment and relevant references to adverse internal and external inspection quality ratings.

Firm's actions:

In 2016, we increased our investment into all key aspects of our annual staff appraisal process to reflect and embed the importance we place on audit quality. In particular:

– We issued detailed guidance to staff and those involved in the staff appraisal process on the importance of audit quality in the performance management and year end rating process. This included targeted guidance on how internal and external inspection grades should be considered in the process plus further guidance on tailoring 2016/17 performance objectives to individual audit quality development needs.

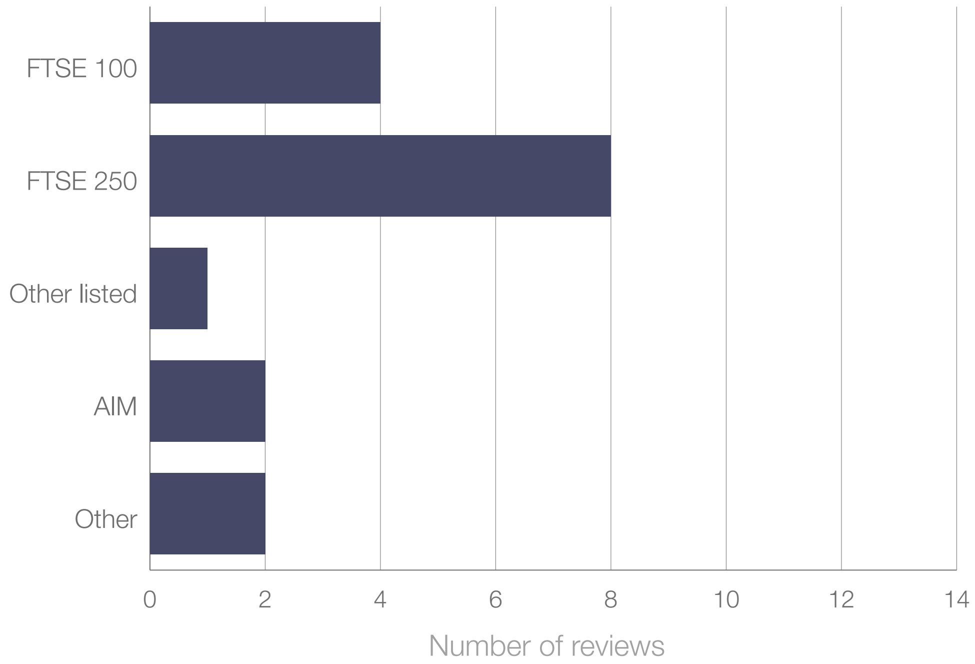
– We issued guidance for partners and team members involved in audits with adverse internal or external inspection ratings to make sure findings and specific assessment comments were accurately reflected in the following year's objectives.

– We undertook a comprehensive compliance programme in relation to the completion of staff objectives including detailed guidance, monitoring, escalating and following up with individuals to ensure that the 2016/2017 objectives were completed by the deadline set.

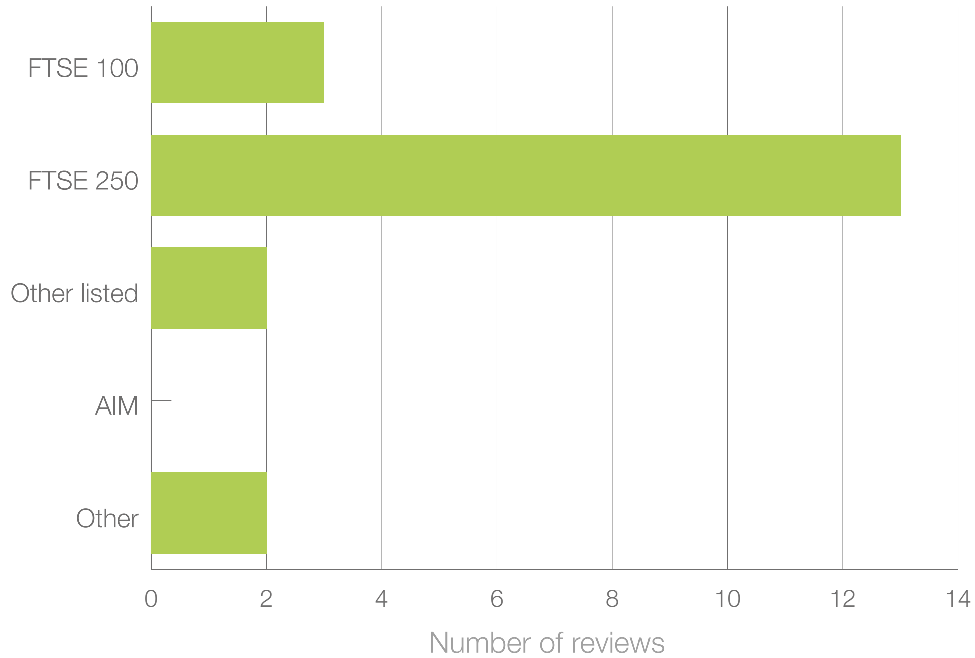
Audit Quality Review
FRC Audit and Actuarial Regulation Division
June 2017

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	The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with Relevant Requirements as defined in the Statutory Audit and Third Country Auditor Regulations 2016 (SATCAR). A full list of the Relevant Requirements is set out at Regulation 5(11) SATCAR, and includes amongst other requirements, applicable legislation, the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies. The standards referred to in this report are those effective at the time of our inspection, or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.
Audits in the scope of our inspection	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.
	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 38 such audits.
	EY 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.

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
Inspection findings included in our public report	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.
Independence	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.
Purpose of this report and Disclaimer	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.

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.

Financial Reporting Council

FINANCIAL REPORTING COUNCIL
8TH FLOOR
125 LONDON WALL
LONDON EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk