Financial Reporting Council

PwC 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 2018/19, 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

PwC 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 PricewaterhouseCoopers LLP ("PwC" 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 PwC, 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 of 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 472 UK entities within the scope of independent inspection as at 31 December 2015. Of these entities, our records show that 254 had securities listed on the main market of the London Stock Exchange, including 32 FTSE 100 and 66 FTSE 250 companies.

We reviewed selected aspects of 27 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 valuations and impairments, tax and other provisions.

We are now publishing the names of entities whose audits we reviewed periodically on our website.[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 has taken a number of 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 most of the key findings we highlighted in last year's report. However, we continued to identify some findings in relation to the audit of impairments and tax provisions and some of the firm's independence procedures. 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 an emphasis on keeping a sceptical mind-set and further embedding data analytics for use in the audit of revenue and journals.

- Effective coaching and review procedures – there has been a focus on how audit teams embed effective coaching in the audit, and on identifying areas of best practice in reviews by senior audit team members.

Good practice identified

Examples of good practice we identified across a high proportion of audits in the course of our work include the following, which we believe have contributed to the overall quality of the audits we have reviewed:

- On group audits, the extent of involvement in the direction and review of the work of component auditors and the evidence of that involvement.

- The interaction with the firm's specialists, including their attendance at meetings with management's experts, and involvement in arriving at a range of estimates and benchmarking key assumptions.

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.

– Effective use of data analytic techniques in the audit of revenue and journals.

– The quality of the firm's 'significant matter' summaries of the audit procedures performed and key audit judgments made for higher risk areas of the audit.

– The quality of written communications with Audit Committees.

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 evidence of appropriate consideration and challenge in relation to the valuation of assets and impairment reviews.

– Enhance the quality of audit evidence to support the level of tax provisions.

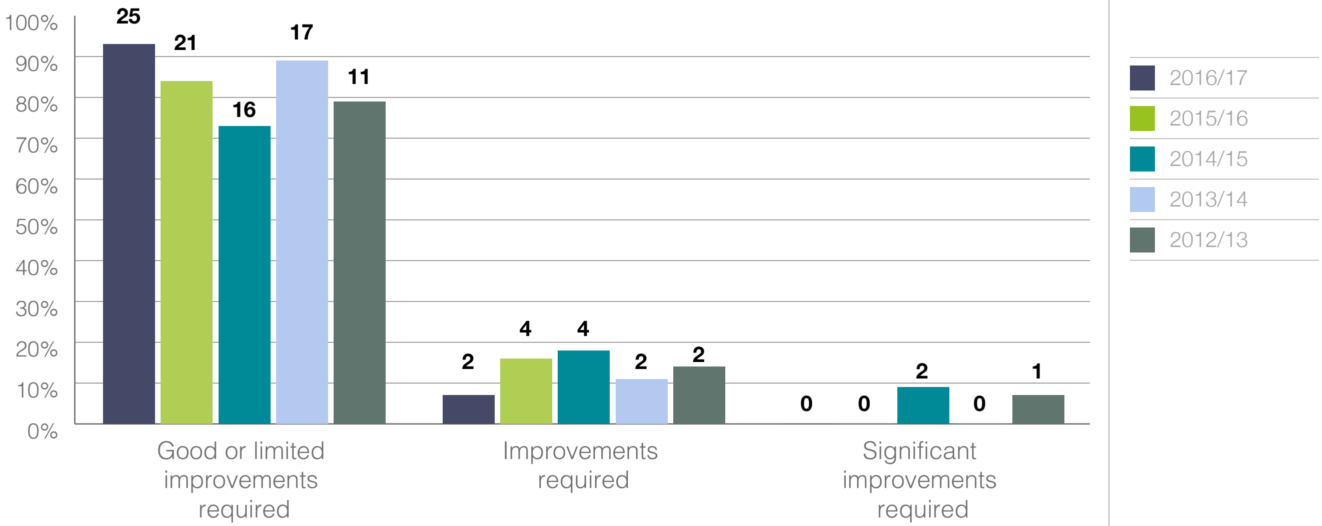
– Improve the assessment of key assumptions supporting other provisions.

Review of firm-wide procedures

– Further strengthen the firm's monitoring of compliance with ethical requirements.

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.



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.

Issues driving lower audit quality assessments

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

- There was insufficient evidence of the audit team's consideration and challenge as to why no brand value was included for most of the acquisitions in the year.

- There was insufficient consideration or evidence of challenge in relation to the basis of uncertain tax provisions and insufficient evidence obtained to support the level of use of Internal Audit testing of IT general controls.

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 improved training for those performing the RCA and an increase in its scope and depth.

Firm's overall response and actions:

We welcome the AQR's external perspective on the quality of our audit work and associated policies and procedures, and we value their insight. We use this, together with the findings from our own quality control processes, to further enhance the consistency with which we deliver high quality audits.

We have completed root cause analysis (RCA) on the inspection findings outlined in this report and have identified a number of specific causes which contributed to individual inspection findings. We have summarised our response to each in the following pages of the report under each of the key messages.

In addition to investigating the root causes behind the AQR's findings, our RCA also considers other inspection findings, such as those arising from other external regulatory inspections as well as our own internal assurance quality review processes. This wider RCA work has identified overarching behavioural themes grouped together under Coaching, Supervision and Review.

Appropriate coaching and review are behaviours which underpin the quality of all our audit work and a number of actions have been taken in previous years to stress their importance. Coaching, supervision and review was a theme running through our 2016 technical training programmes as well as being a theme of other regular communications to the practice. We continue to identify these themes in our RCA work. As a consequence we have identified additional actions that we will undertake in the current year to build on the work already done, and that continued focus will be required going forward.

As part of this emphasis on the behavioural and team working aspects of undertaking audit work, our RCA has also identified an opportunity to emphasise two further supportive mechanisms of audit quality in particular, being Project Management and Personal Responsibility:

- Effective project management assists our engagement teams in managing client delivery and executing an effective audit. Whilst our budgeting, resourcing and client information sharing tools are used right across the practice, further investment in project management techniques and enhanced tools will help address audit phasing challenges and coordinating with client timelines. We have initiated a review of engagement team project management skills and behaviours to identify any potential enhancements to support the delivery of quality audits and related reporting.

- Every team member has an individually assigned role on an audit. Undertaking audit activities, from planning through to finalisation requires all individuals to take responsibility for the quality of their work and to be accountable for the delivery of their role. We will enhance the annual performance evaluation process for audit team members to give more focus on how they have delivered quality audits.

We are confident that these activities, together with the more detailed actions in respect of the key findings set out in section 2 of this report, will ensure our focus remains on delivering the highest quality audits.

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 evidence of appropriate consideration and challenge in relation to the valuation of assets and impairment reviews

The valuation of assets and impairment reviews rely on key assumptions made by management. These are often judgmental and the resulting valuations and potential impairments can be sensitive to small changes in those assumptions. Audit teams should obtain sufficient and appropriate evidence to assess the reasonableness of those assumptions and provide an appropriate level of challenge to management.

Given the level of audit risk and the potential impact on the financial statements, we reviewed the audit of valuations or impairments on most of the audits that we inspected. The audit work was often performed to a good standard, but we did identify findings on some of the audits including the following examples:

- In relation to the valuation of properties, insufficient evidence that corroborating information for some of the changes in market values (e.g. in relation to recent comparable transactions) was obtained to support management's expert's explanations for the extent of the changes.

- Insufficient evidence of the audit team's consideration and challenge as to why no brand values were recognised on the majority of acquisitions in the year.

- For impairment reviews, insufficient challenge of the discount rates used by management and insufficient evidence that the audit team had adequately challenged whether a cash-generating unit was significant and should therefore have been separately disclosed in the financial statements.

Firm's actions:

Our focus is on understanding and improving the consistency with which our engagement teams demonstrate professional scepticism, apply our methodology and, where appropriate, interact with our valuation specialists and experts.

Professional scepticism, including the challenge of management, has been embedded alongside coaching, review and supervision as a core theme in our assurance training programme. This training has been supported by refinements in our guidance and the publication of a '12 point' auditing estimates practice aid. We plan to continue the focus on professional scepticism with our audit teams throughout 2017 and beyond, emphasising the requirement to fully evidence our consideration of key assumptions and our challenges to management.

The audit team's understanding and evidence obtained in one year may not be fully reflected on subsequent years' audit files in respect of matters that are still relevant. We will remind teams of the need to roll forward appropriate evidence from one year to the next, having reconsidered its relevance on each occasion. This is particularly important following a first year audit.

The level of involvement of audit specialists and experts is determined by the engagement team, and for asset valuation is based on the nature and complexity of the valuation. Our teams' interaction with specialists are identified by the AQR as an area of good practice. In December 2016 we delivered audit support training to our valuations specialists to share the inspection findings and re-emphasise interaction protocols with engagement teams to drive consistency.

Enhance the quality of audit evidence to support the level of tax provisions

The level of tax provisions is often judgmental and relies on assumptions made by management. Audit teams should consider management's assumptions and compare these to available audit evidence and, where appropriate, challenge management in relation to the basis of those assumptions and the related disclosures.

The audit of tax was an area of particular focus for us this year and we reviewed this on most of the audits we inspected. We found that there was generally a good level of involvement from tax specialists in these audits. However, we identified the following findings on some of the audits:

- Insufficient supporting evidence or challenge regarding the level of certain tax provisions.
- Insufficient evidence supporting certain long-standing tax provisions, in particular the extent to which audit evidence from prior years had been brought forward or re-considered in the current year.
- Insufficient challenge regarding the adequacy of disclosures relating to the judgments made and related sensitivities for the tax provisions.

Firm's actions:

Where appropriate, engagement teams leverage the expertise and experience of tax specialists to audit the more complex tax activities of audit clients. Effective integration of our tax specialists into the audit team results in tax assumptions being more effectively compared to available audit evidence. Our audit of tax training, provided in late 2016 and early 2017, responded to the findings from the 2016/17 inspection processes, including focusing on improving the consistency of integration of specialists into our teams.

We have reminded engagement teams of the need to ensure sufficient evidence is brought forward and retained to support opening balance positions, particularly with respect to long standing tax provisions. As part of this dialogue we have re-emphasised the need to re-challenge the basis for such long standing provisions.

Improve the assessment of key assumptions supporting other provisions

Other provisions also often involve a high degree of judgment and estimation by management. Audit teams should therefore critically assess the appropriateness of key assumptions supporting them.

On some audits, there was insufficient evidence that certain key management assumptions supporting the level of provisions remained appropriate. These included a claims provision, a provision for onerous contracts, a rehabilitation provision and a provision against loans.

Firm's actions:

The nature of provisions is such that the available evidence varies greatly. Evidence to support a simple provision is typically less complex than the evidence to support a finely balanced management judgment in a multi element provision. Furthermore, where a provision spans multiple reporting periods the audit team must also consider relevant evidence accumulated over the period since its recognition.

Ensuring clarity of evidence over appropriate key assumptions and providing a clear summation of evidence obtained to support complex judgments will always be challenging for engagement teams. On a real time basis, our 2016 summer and autumn training programmes responded to this finding by emphasising these challenges to engagement teams.

Further strengthen the firm’s monitoring of compliance with ethical requirements

Insufficient monitoring of compliance with the firm’s independence policies and procedures, in order to identify or prevent breaches, could compromise the firm’s independence and objectivity. The firm maintains a log of breaches of ethical requirements. Most of the identified breaches related to the holding of prohibited investments and the commencement of non-audit services for audited entities in advance of obtaining the audit partner’s approval (similar to last year). They also included cases where the firm’s Ethics Partner was not consulted on a timely basis regarding the level of independence threats associated with non-audit fees for listed entities exceeding audit fees.

The firm has updated its procedures, issued new guidance and undertaken central monitoring to ensure its systems for recording financial interests of partners and staff, and for identifying prohibited investments, are kept up-to-date. However, instances of the systems not being updated on a timely basis, resulting in partners and staff holding prohibited investments, have continued to be identified. The firm should therefore take further action to ensure that the systems are properly updated on a timely basis.

Some of the holdings of prohibited investments had not been self-declared and were identified through the firm’s personal independence testing, which covers a sample of partners every year. The firm is planning to extend this testing to also include a sample of staff.

The breaches relating to late approval of non-audit services by the audit partner continued to be identified as part of the firm’s internal quality review process. The firm should reconsider the adequacy of its procedures to prevent non-audit services being provided until the audit partner’s approval is obtained.

Firm's actions:

Compliance with ethical requirements continues to be a key priority for the firm. With the provisions of the new Ethical Standard becoming effective during 2017, we have taken the opportunity to provide training and update guidance to partners and staff throughout the firm using both firmwide and line of service education channels that emphasises the importance of ensuring that PwC complies fully with the relevant ethical requirements. We also enhanced our partner consequences management framework, applicable from 1 July 2016, to further formalise the impact of independence breaches.

Impermissible investment holdings and personal independence testing

The responsibility for ensuring that the data in our systems accurately reflects client structures rests with the audit engagement partner. By June 2016 all assurance staff completed mandatory training on the importance and necessity of maintaining accurate client information in our core systems. We also increased the frequency with which our central monitoring control over the accuracy of the data in the system operates, focused on the accuracy of engagement information for new public interest audit clients. We will continue to review the operation of this control, and consider what further action may be needed in order to ensure our systems are updated and maintained on a timely basis.

We continue to review the volume and results of the personal independence testing performed, and personal independence testing of a sample of staff commenced in March 2017.

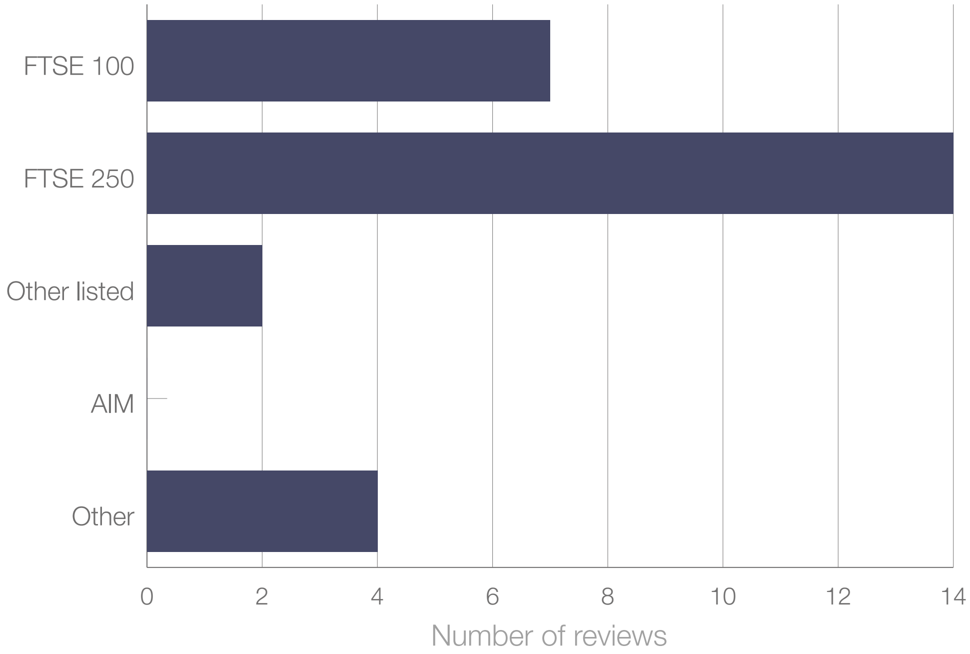
Timely approval of non-audit services

While approval processes were not followed in some instances, all related to the provision of permissible non-audit services. We continue to focus our efforts in this area. For example, by early September 2016 all staff and partners had completed two firmwide independence training modules, both of which emphasised the importance of the timing of obtaining engagement leader approval before commencing non-audit services. In addition we will ensure that this requirement continues to be reinforced in our ongoing training and communications programmes on the provisions of the new Ethical Standard.

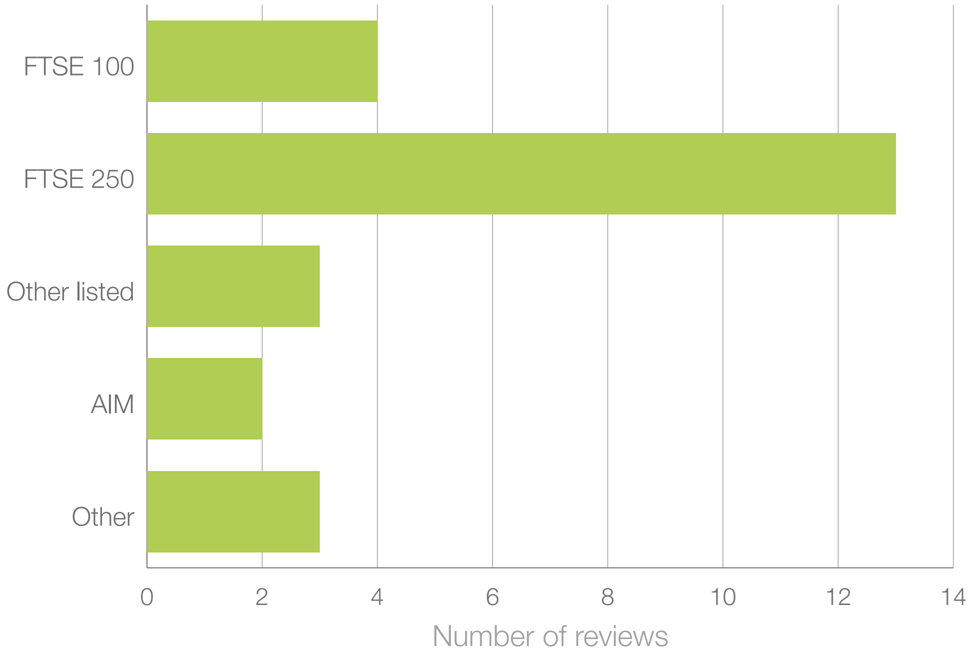
Audit Quality Review
FRC Audit and Actuarial Regulation Division
June 2017

Appendix A – Audits reviewed 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 eight such audits, including two FTSE 100 companies.
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.

Matter	Explanation
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.
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.

Matter	Explanation
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.

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