



Financial Reporting Council

DEVELOPMENTS IN AUDIT 2015/16

JULY 2016

FRC Reform – New FRC structure following legislation under which the FRC Board became responsible for exercising powers previously vested in separate operating bodies	2012	
FRC sets strategic objective of promoting confidence in value of audit		
Corporate Governance Code: <ul style="list-style-type: none"> • annual reports and accounts to be 'fair, balanced and understandable' • increased responsibility and transparency of audit committees • audits to be put to tender every 10 years for FTSE 350 companies 		
Auditing Standards: Introduced extended reporting by auditors to enhance the scope and transparency of audit; Auditor to report if the company does not meet the 'fair, balanced and understandable' requirement		
Introduced Audit Regulatory Sanctions Procedure	2013	
Issued best practice guidance on audit tenders		
Thematic review of materiality		
Corporate Governance Code: Increased board focus and reporting on risk, internal control and viability over the longer term	2014	
Re-focused FRC inspection activities in response to Competition and Markets Authority (CMA) recommendations following review of FTSE 350 audit market (which also reinforced 10 year retendering)		
Statement on the FRC's work to enhance justifiable confidence in audit and benchmarking survey on confidence in audit		
Statement on reporting FRC inspection findings in audit committee reporting		
Thematic review of the audit of loan loss provisions and related IT controls in banks and building societies		
New oversight responsibilities assigned to the FRC through the Local Audit and Accountability Act		
Issued first annual report on inspection of Third Country Auditors		
Consultation on implementation of EU Audit Directive and Regulation		2015
External review of efficiency and effectiveness of FRC audit monitoring		
Survey of audit committee chairs		
Audit Quality - Practice aid for audit committees		
FRC's designation as the Competent Authority for audit and realignment of structure to include Audit and Enforcement Divisions	2016	
Corporate Governance Code: Revised requirements and updated guidance on audit committees		
Auditing standards: <ul style="list-style-type: none"> • New principles-based ethical standard • New reporting standard building on extended auditor reporting • New technical auditing standards 		
New audit enforcement procedure		
Second benchmarking survey on confidence in audit		

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The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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OVERVIEW

The FRC’s mission is to promote high quality corporate governance and reporting to foster investment. A secure flow of investment into the UK’s capital markets, underpinned by high quality governance and reporting, helps drive the growth of our economy and our competitiveness.

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We have set our vision for audit in the UK: that audit is trusted to provide reliable assurance on the public reporting of financial performance, and in doing so, to promote good governance and facilitate the effective allocation of capital.

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Melanie McLaren, Executive Director, Audit



Introduction

Since 2012 the FRC has developed a strategic objective to promote justifiable confidence in UK audit, seeking to ensure that the lessons for audit from the financial crisis are learnt.

From June 2016 as a consequence of the UK implementation of EU legislation¹, the FRC’s role has been formalised in legislation as the UK’s Competent Authority for audit. We have responsibility for oversight of UK statutory audit, ensuring audit regulatory tasks are carried out. By agreement, we will be supported by and oversee the regulatory activities of the audit professional bodies who are integral to achieving our strategic objective.

This regulatory framework will continue to apply as the UK responds to the outcome of the referendum on the UK’s membership of the EU. We will pay close attention to the decisions now taken by the Government and Parliament, and continue to work in collaboration with our key stakeholders, particularly investors, business and the professionals we regulate, in order to ensure our work continues to support economic growth and the effective functioning of the capital markets. The FRC will continue to play its part in representing the interests of the UK internationally.

¹ The revised EU Statutory Audit Directive and Audit Regulation (ARD)



Our regulatory strategy

Following a review of the effectiveness of our monitoring activities in 2015, and our designation as the Competent Authority, we have set out in our 2016/19 strategy that we will seek to establish a regulatory stance that promotes continuous improvement in standards of reporting and auditing. We have set out six key aims for audit in the UK:

- 1) Audit and auditors are trustworthy, act with integrity, serve the public interest and consistently meet the objectives of audit and auditing standards;
- 2) Audit is subject to appropriate oversight within a clear regulatory regime;
- 3) Roles and responsibilities of auditors and audit committees are clear, and aligned with the interests and needs of investors;
- 4) Audit is a sustainable business with adequate capacity, and sufficient levels of competition and choice;
- 5) Audit innovates to meet changing business and economic circumstances to improve audit quality; and
- 6) Global audits are effectively managed and overseen and quality is consistent across international work.

Promoting continuous improvement will not reduce the need to take tough action when necessary. We retain our focus on being proportionate in our actions, focusing on areas of higher risk to the public interest.

We will continue to emphasise the importance of justifiable confidence in audit and transparently report our observations and findings. This report summarises the current 'state of play' as seen by stakeholders and the FRC; what has already been achieved and what still needs to happen. It is supplemented by a more detailed report of our audit related activities and evidence gathering: *Developments in Audit 2015/16*.²

² <https://www.frc.org.uk/Our-Work/Audit/Report-on-Developments-in-Audit.aspx>

Assessment of confidence in audit

Key influences on confidence in audit include:

- There is evidence that, as a result of regulatory changes, **audit firms are seen as more independent and competing for audit engagements on quality grounds.** This is largely prompted by UK market innovations - retendering and revised ethical requirements; developments in corporate and auditor reporting; recasting the auditor's relationship to the audited entity through promotion of the role of the audit committee; and introducing some independent oversight arrangements to the firms. However, concern remains that the FTSE 350 audit market is concentrated across the Big Four firms.
- Prospective changes from the EU ARD have also bolstered confidence. **Mandatory rotation will be introduced and non-audit service provision tightened.** UK implementing legislation is effective from June 2016. In contrast, there are concerns by some that the audit profession is becoming less attractive as a result of increased public and regulatory scrutiny, driving a compliance mindset which, in the longer term, may risk the development of judgement skills and impact the level of talent and quality within the profession.
- **Overall - based on FRC's audit monitoring activity results and those of the RSBs, together with other indicators such as the comments of audit committee chairs - audit quality in the UK is improving.** Looking specifically at our 2015/16 risk-based monitoring of audit quality of FTSE 350 audits, we assessed 77% (prior year 70%) as requiring no more than limited improvements. Auditors must not be complacent and must strive for continuous improvement in quality. We consider that at least 90% of FTSE 350 audits should fall into that category.

- **The large firms are beginning to improve the effectiveness and efficiency of audit through the transformative use of technology** which should prompt further competition on quality. Corporate reporting and auditing will almost certainly be transformed. Our 2016/19 strategy seeks to establish a regulatory stance that promotes continuous improvement in standards of reporting and auditing and we will work closely with all stakeholders to consider the implications of the fast changing environment.

Two years ago we commissioned independent research from YouGov to benchmark the level of confidence in audit in the UK.³ That survey showed that those that were close to audit and had carried it out or commissioned it had confidence in it. Those who were not close, including some investors and other stakeholders, did not share such high levels of confidence. This year, we commissioned YouGov to undertake a follow up survey.⁴ Based on YouGov's report, it appears that stakeholders have a clearer understanding of what audit is and a higher level of confidence in it. However, greater public interest in developments in audit and high profile adverse developments such as corporate failure soon after an audit opinion is given, damages trust in audit, undermining some of the positive progress.

On balance, there is a justifiably higher level of confidence in audit as a result of changes to independence requirements and the promotion of competition on the grounds of quality. However, there is still considerable room for improvement. There are threats to confidence and there are opportunities too.

³ <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Research-Report-Improving-Confidence-in-the-Value.pdf>

⁴ <https://www.frc.org.uk/Our-Work/Audit/Report-on-Developments-in-Audit.aspx>

Chart 1 – The YouGov survey report sets out the following findings:

- It is clear that amongst the individuals interviewed for this study there is a sense of a higher level of confidence in audit than was seen in the 2014 report. A number of the areas mentioned previously have received direct attention in the intervening time period and while many of the amendments are recent or have yet to be fully adopted, the changes they herald are mostly viewed positively, if not without some concerns.
- At the heart of confidence is the relationship between audit firms and the companies they audit. Confidence exists when auditors are felt to remain independent of ‘client’ companies, have the skills and mindset to audit to a high level, are guided by a combination of relevant principles and rules, and operate in a fair and open market. Each of these four areas have seen some attention over the past couple of years and while not comprehensively positive, the balance is that improvements have been made.
- However there is still a sense that an expectation gap remains between what audit does and what certain groups believe it does or indeed would like it to do. For this relatively engaged group, they see this being addressed through the expanding remit of audit but this in itself also causes concern for some respondents over increasing complexity, concerns over liability, false certainty to non-financial or non-audited data, and other issues. There is a fine line to tread here including a need for increased guidance.
- The relationship between auditor and client company is central to many of the concerns expressed. The report finds that, while being a trusted adviser to a company is seen by firms and companies as potentially beneficial, investors question whether the auditor will challenge management and report their concerns.
- In general, new and forthcoming changes around capping non-audit services and mandatory retendering or rotation are welcomed but the fear is that the increasing complexity of audit for larger businesses and Public Interest Entities (PIEs) means that the dominance of the Big Four will not change.
- The future of audit looks to respondents as though it will be increasingly based on technology and data analysis capabilities. This raises further concerns about how smaller firms will be able to compete, what the role is for the auditor, and how regulators and standard setters will be able to keep up.
- The FRC is praised by many for the work it has done in recent years and the role it is playing both nationally and internationally. The view amongst some is that a more positive role, looking at what is being done well, would be beneficial.

Audit tendering, rotation and audit fees

Under the UK Corporate Governance Code, since 2012 FTSE 350 companies should retender their audits every ten years. This concept was then taken forward in a CMA Order.⁵ The UK implementation of the statutory audit directive and regulation requires a ten year retendering period for Public Interest Entities (PIEs)⁶ and for the first time introduces mandatory rotation of auditors, after a maximum term of twenty years.

We carried out a survey of audit committee chairs and asked whether the company had been involved in a tender process during the previous twelve months. Over 200 responses to this survey were received. The sample indicated that 17% of companies had conducted an audit tender, with 75% of these resulting in a change of auditor. Our own analysis from published annual report information shows similar levels of change following an audit tender.

In late 2015 we repeated an exercise we had previously carried out in 2009 and 2011, reviewing the audit proposals submitted by firms in respect of a number of specific tenders. In 2015 there was a much greater emphasis on audit quality than in either 2009 or 2011. We were told that the selection process focused on independence, the

judgement and scepticism of key audit partners and evidence of internal and external quality reviews. Our discussions with audit committee chairs also confirmed that tendering is considered “business as usual” and it was good to hear from audit committee chairs that price was not a determining factor in the decision.



All stakeholders agree that independence is key within audit.

There is a significant resource and skills gap between the so-called Big Four and other audit firms...;

There is also a worry amongst a few that the cost of retendering may be too great for smaller audit firms to incur, leading to an even greater divide within the market.

In some cases the mid-tier audit firm just said, ‘It’s not worth it. We know we’re not going to win it...’



[YouGov survey]

The UK audit tendering requirements and new EU rotation requirements mean that many audit committees have put their audit out to tender. There is evidence of competition on the basis of audit quality even though choice is often limited.

Audit tendering and rotation has had no impact on market concentration in the Big Four audit firms, albeit that more firms now audit the largest banks. There are initial indications that there may be further concentration to come in the PIE audit market. The FRC is encouraging enhanced contingency planning to respond to the potential failure of one of the firms.

Chart 2: Concentration of auditors of FTSE audits

	Big Four firms (%)				
	31/12/11	31/12/12	31/12/13	31/12/14	31/12/15
FTSE 100	99.0	99.0	98.0	98.0	98.0
FTSE 250	95.2	94.4	96.0	96.8	96.8
Other UK main market	68.7	66.3	68.1	69.7	71.1
All main market	78.4	78.3	78.8	79.9	83.2

⁵ <https://www.gov.uk/cma-cases/statutory-audit-services-market-investigation>
⁶ Those listed on a regulated exchange, unlisted banks and unlisted insurers

Despite high levels of tendering and rotation, there remains a significant concentration of the larger capital market audits being undertaken by the largest audit firms (chart 2). Since the change to the UK Corporate Governance Code in 2012, the Big Four share of the FTSE 350 market has risen, from 96.7% to 97.4%. In the banking sector however all four of the firms are now involved in FTSE 350 audits compared to three previously.

Such concentration means that the failure of any one of the firms would have a disproportionate impact on the functioning of the capital markets. The FRC will be encouraging the firms, profession and other regulators to develop enhanced contingency plans.

As retendering and rotation is introduced for all PIEs there are indications that some of the audit firms with very few PIEs are considering whether they wish to continue to participate in that market.

Audit remains a core activity for audit firms. Our information is that audit fees remain stable as a percentage of firm-wide fees at 21% for Big Four firms (2014: 21%) and 27% for other firms with PIE audit clients (2014: 28%). Our own analysis (chart 3) confirms that the increase in tendering activity is not putting undue pressure on audit fees. Aggregate audit fee income for the Big Four increased by 4.6% in 2014/15 (chart 3). Non-audit services for audit clients have increased outside of the Big Four more significantly than within the Big Four, year on year.

Audit remains a core activity for firms. There is evidence of limitations on non-audit services affecting Big Four firms.

Chart 3: Audit firm fee income analysis

Growth rate %		2013/14	2014/15
Total fee income	Big Four firms	4.3	6.7
	Non Big Four firms	14.9	4.7
Audit fee income	Big Four firms	0.1	4.6
	Non Big Four firms	9.2	2.7

The impact of tendering activity on auditor concentration, audit fees, together with the indication of an increase in focus on audit quality in the auditor's promotion of their services to audit committees, remains an area of focus for us. We will continue to monitor developments in this area.

Audit committees

YouGov highlight that the nature of the relationships between auditor and the audited company is central to many of the concerns expressed as to confidence in audit. The UK Corporate Governance Code changes in 2012 and now the ARD place the responsibility for that relationship with the audit committee. The audit committee appoints the auditor, ensuring the audit meets their expectations in respect of independence and quality. The FRC has sought to support audit committees in discharging their responsibilities.⁷

Our survey of audit committee chairs confirmed that they remain overwhelmingly positive in respect of audit quality, rating it at 5.9 out of 7 compared to 5.8 in the previous year. Investors tell us that they value extended audit committee reporting alongside extended auditor reporting.

We encourage:

- Better communication by auditors to audit committees, particularly when there have been changes in the scope of work planned; and
- More transparent reporting by audit committees of the outcome our audit quality review findings.

We have emphasised this in the new guidance on audit committees and will continue to monitor developments in disclosures.

Extended auditor reporting

Extended auditor reporting was introduced in 2012 for FTSE 350 companies, alongside extended audit committee reporting, to provide greater transparency and insight to investors. In January 2016 we issued a report on the experience of the first two years:

- Investors welcomed the information included in extended auditor reports, and particularly for companies where less independent information is available;
- In general, auditors have continued to move away from generic language and descriptions of risk, making their reports more relevant and insightful; and
- The reports which have earned the greatest praise from investors tend to be well structured, signposting key information and often make innovative use of graphics, diagrams and colour.

Areas where auditor's reports could be further enhanced include:

- Being more explicit about the auditor's view on the appropriateness of management estimates and providing greater transparency about assumptions made by management and the benchmarks used by auditors in making key judgements;
- Providing more complete information about the sensitivity ranges used in audit testing;
- Giving greater insight into the auditor's assessment of the quality of an entity's internal controls informing their significant risk assessment;
- More frequent inclusion of commentary about what the auditor found as a result of the work done on risks of misstatement;

The UK Corporate Governance Code changes in 2012 and now the implementation of the EU Statutory Audit Directive and Audit Regulation (ARD) place an emphasis on the role of the audit committee in leading the appointment of the auditor and assessing audit effectiveness and quality. Good progress is being made, particularly in audit tendering and rotation. Audit committee chairs are overwhelmingly positive about audit quality.

The UK's initiative in extended auditor reporting has contributed to confidence through improved transparency. The UK initiative is being taken forward internationally.

⁷ Examples include the Audit Quality Practice Aid published on 29 May 2015 and the FRCs guidance on audit committees updated on 26 April 2016 and our discussion document on how to carry out an audit tender which will be updated in 2016/17



New standards for auditor independence and ethics are being implemented in the UK and across the EU to address perceptions of cosiness in the auditor / audited relationship and to limit threats to auditor objectivity. Effective, co-ordinated, proportionate, principles-based implementation to meet the desired outcomes will be a major challenge. Our experience is that there are instances where there is an inappropriate focus by auditors on the letter rather than the spirit of requirements.

- Explanations of changes to the audit approach, materiality or risk assessment over time; and
- More consistent information about ‘performance materiality’, how it is derived and how it impacts on the audit.

We recognise that these have to be balanced against the potentially competing demands for auditor’s reports to be clear and concise.

Corporate Governance Code⁸ and the associated Guidance on Audit Committees⁹ to reflect the new legislation on audit committees and auditor appointments.

The changes are designed to address the perception of auditors being too close to those they audit, by introducing requirements on retendering and rotation and reducing the scope for threats to the auditor’s objectivity by limiting the provision of non-audit services and requiring more careful consideration of such services from the likely standpoint of an independent third party.

Auditor independence and ethics

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The catalysts for improved levels of confidence are, broadly, all related to auditor independence.

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[YouGov survey]

As part of our role as the UK Competent Authority for audit, we have recently issued revised UK Auditing and Ethical Standards. The revised standards reflect our own review of ethical matters, changes from ARD and developments in international standards. We have also issued revisions to the UK

We are a principles-based regulator, and in revising the Auditing and Ethical Standards we have adopted an approach where we set principles to deliver required outcomes, which are supported by more detailed requirements, many from the ARD.

The revised standards take account of findings from our audit quality reviews. In 2015/16 we reported a key finding relating to independence and ethics in five of the six firm specific reports.¹⁰ We will be looking to the firms, as they implement the new standard, to adopt a robust and sceptical approach particularly to the provision of non-audit services and threats to auditor objectivity.

8 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf>

9 [https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-\(2\).pdf](https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-(2).pdf)

10 <https://www.frc.org.uk/Our-Work/Audit/Audit-Quality-Review/Audit-firm-specific-reports/Audit-firm-specific-reports-2016.aspx>

Audit Firm Governance Code

Since 2010, the ten largest audit firms are covered by the voluntary Audit Firm Governance Code (AFGC) which seeks to ensure that there is independent oversight of audit quality and that risks to the firm are managed in the public interest. This is particularly important as audit revenues are around 21% of firm-wide revenues. During 2015/16 we reviewed the operation of the AFGC and particularly the role of independent non-executives (INEs). Our review identified that the AFGC is achieving its aims although the role of the INE should be clarified and re-emphasised and greater investor engagement is desirable. We also highlight that it is important to have oversight of UK audit in international structures. A revised AFGC will be issued in July 2016.

Audit quality monitoring



On the whole the AQR is seen in a good light and is felt to have had a positive impact on the quality of the audit process.



[YouGov survey]

During 2015 the RSBs carried out 1,402 monitoring visits, the results of which show an increase in the proportion of most positive outcomes.

In 2015/16 the FRC inspected 113 audits, with a range of characteristics, across ten firms. Many UK PIEs have global reach and are audited by global teams, with the UK audit partner as leader of the group engagement taking overall responsibility for the work. Investors tell us that they want confidence that standards are consistently applied across the group. We monitor

the adequacy of the oversight of, and involvement in, group audits of UK audit firms. For large global audits, we look at the reporting and other communications between the UK group auditor and the overseas subsidiary audit teams. We do not usually obtain an understanding of the quality of the audit working papers of the overseas auditors.

We observed an increase in the number of audits assessed as good or only requiring limited improvements from 67% last year to 76% in our 2015/16 inspection. Only two audits were assessed as requiring significant improvements (2014/15 10 audits), our lowest category, and there were fewer findings overall.

For the FTSE 350 audits, which following CMA recommendations¹¹ we inspect on average every 5 years, our assessments were similar, with 77% categorised as either good or requiring limited improvements (70% in 2014/15).

If we were to exclude the typically more straight forward investment trust audits, 72% (2014/15: 68%) of other FTSE 350 audits were assessed as either good or requiring limited improvements. In future we intend to refocus our inspections so as to cover FTSE 100 every 4 years, FTSE 250 excluding investment trusts every 5 years and FTSE 250 investment trusts every 7 years.

The five areas which account for approximately 74% of the findings reported are:

- Fair value and value in use measurements (24%) - with issues relating to the audit of impairment testing and investment property valuations featuring prominently;
- Revenue recognition (20%);
- Audit committee communication (14%);
- Internal controls testing (9%); and
- Independence and ethics (7%).

Oversight of the audit firms by independent executives is now established. We will be re-emphasising the importance of the role independent executive's play in enhancing audit quality and monitoring the firm's assessment and mitigation of reputational risk.

In its 2015/16 risk-based monitoring of audit quality at the largest audit firms the FRC assessed 77% of FTSE 350 audits it inspected as requiring no more than limited improvements, compared to 70% in 2014/15. We consider that no more than 10% of FTSE 350 audits should fall into that category.

The audit firms need to take effective action to address the root cause of our findings, particularly on the audit of assets and liabilities measured at fair value and revenue recognition.

¹¹ https://assets.publishing.service.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf

There were seven banks and eight insurers in our sample, one of which was a Global Systemically Important Financial Institutions (“G-SIFI”). Two of the 15 were assessed as requiring improvement and one of the 15 was assessed as requiring significant improvement. There were no common themes identified through our inspection work of financial institutions in 2015/16.

We asked the firms to carry out root cause analysis on our findings with the key objective of improving audit quality through a clearer understanding of how audits can be performed better. We also asked the firms to develop an action plan to address their findings and to include details of this exercise in our public reports on each firm. We noted a number of differences across the firms in terms of the resources allocated to the process and the scope of the analysis. We have encouraged the firms to build on progress to date in this area for 2016/17. Most of the themes identified related to the knowledge, degree of care or behaviours of individuals on audits. Other themes included the level of engagement of the audit by the partner and manager or the adequacy of the firm’s audit processes in supporting the audit engagement team. We will be issuing a thematic report on the root cause analysis process later in 2016.

We are seeking continuous improvement and have encouraged the firms to avoid complacency; the firms are engaged with understanding the findings of our reviews and finding sustainable solutions. Our strategy includes a target for continuous improvement as we would like to see at least 90% of FTSE 350 audits assessed as good or requiring limited improvements by 2019 in our monitoring programme.

Our current perspective on audit quality is currently based on a sample of reviews of high risk audits at the largest audit firms. In future, as a consequence of ARD, we will be inspecting a broader range of audits at approximately 50 firms. Nonetheless our findings may not be representative of the

quality of other audits undertaken by those firms nor of the quality of work done by other firms. We wish to have a broader range of evidence from which to be able to draw more general conclusions as to the quality of audit in the UK and we will work with the RSBs to develop this.

Some UK listed entities are incorporated overseas and may be audited by auditors outside of the EU. If the system of auditor oversight in those jurisdictions is assessed as being equivalent to that in the EU, then we do not carry out additional monitoring in respect of those audits. For “third country auditors”,¹² we carry out registration and monitoring.

In 2015/16 we inspected six audits at six third country audit firms. While the small sample has led to a variable assessment over each of the last three years, in 2015/16 only 17% were assessed as requiring no more than limited improvement. We are undertaking follow up procedures at the firms assessed as requiring significant improvement in 2015/16 to ensure that, where necessary, robust action plans for future audits or other remediation actions have been put in place.

Access is not always granted for third country inspections. For example, in our 2013/14 inspection of third country auditors we were unable to inspect one bank audit in Qatar. Where we are not able to gain access we will continue to highlight this on our website.¹³

In future, commensurate with our role as Competent Authority for audit, we wish to be able to take a broader perspective of UK audit quality. We will report on our findings of reviews of a larger number of firms and we will work with the RSBs to assess and report on the quality of audits monitored by them.

Achieving a view of audit quality outside of the UK has its challenges and we are not always able to gain access to carry out independent reviews of third country audits.

¹² Auditors of companies incorporated outside the EEA that have issued securities on EU regulated markets, which in the case of the UK means the main market of the London Stock Exchange
¹³ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Inspections-of-Third-Country-Auditors-Annual-Report.pdf>

Enforcement

The trend by the professional bodies of closing more sanctioning cases than new cases being opened has continued from 2014 into 2015 (2015: 120 new cases, 122 cases closed). In neither year have matters been referred to the FRC for consideration.

In 2014 and 2015 we opened six audit-related investigations and saw a significant number of older cases settled or closed. As of 31 March 2016 there were 15 ongoing audit-related cases where statutory audits were under investigation by the FRC. Since 1 April 2016 we have announced four further cases in connection with audit matters.¹⁴

From June 2016 our audit enforcement will be predominantly through a new statutory-based Audit Enforcement Procedure¹⁵ which replaces the Accountancy Scheme. Some non-PIE audit investigations and sanctions will be retained by us and most will be done by the RSBs with our oversight. We will seek to be thorough and proportionate and recognise that there is a need for investigations and cases to be concluded as soon as possible.

Technology in support of quality



Those who are closest to the day-to-day workings of audit... comment on the increased use of technology, and increased automation, in the audit process. Largely, this is felt to be beneficial.



[YouGov survey]

We expect technology to transform corporate reporting and the assurance of it over time. Within the limits of current reporting and audit requirements, the audit firms are already to varying degrees making significant investment in audit methodologies which exploit technology to improve effectiveness and /or efficiency. For example using data analytics and controls screening. We are currently carrying out a thematic review on the use of data analytics and are also considering whether audit standards remain fit for purpose in their approach to audit evidence gained through the use of technology.



Given the increase in technology, it will be essential for auditors to have a good understanding of the IT systems used in organisations, and to be adequately trained and able to use these.



[YouGov survey]

Confidence in audit is promoted by a demonstrable ability to hold auditors to account. A sound enforcement regime is therefore vital. There are challenges in balancing the public need for speed and proportionate and fair treatment of those under enquiry or investigation. Nonetheless we are targeting a speedier conclusion than previously.

The firms are beginning to improve the effectiveness and efficiency of audit through the transformative use of technology which should prompt further competition on quality. We are considering the implications for our standards and monitoring work.

¹⁴ May 2016 – Deloitte’s audit of the Serco group for financial years ended 31 December 2011 and 31 December 2012; and KPMG’s audit of Ted Baker plc for financial years ended 26 January 2013 and 25 January 2014; and June 2016 – KPMG’s audit of HBOS for the financial year ended 31 December 2007; and PwC’s audit of BHS for the financial year ended 30 August 2014

¹⁵ <https://www.frc.org.uk/Our-Work/Publications/Professional-Discipline/Audit-Enforcement-Procedures.pdf>



The FRC's future activity

Drawing on the current evidence of audit quality and confidence in audit, in the year ahead the FRC will focus on:

- making a success of our competent authority status, in liaison with the RSBs, to promote audit quality;
- working with auditors, audit committees and investors to communicate good practice and promote continuous improvement;
- underpinning confidence with sound and effective enforcement;
- continuing to promote audit quality internationally, recognising the international nature of UK markets and investment; and
- keeping pace with, and facilitating where possible, changes in audit and its use of technology in improving the effectiveness and quality of audit.



**DEVELOPMENTS
IN AUDIT
2015/16**

DEVELOPMENTS IN STANDARDS AND GUIDANCE ON AUDIT

This Section provides an overview of developments in and changes to the FRC's Standards and Guidance on audit.

Extended auditor reporting

In 2012 the FRC made coordinated changes to Auditing Standards in the UK and Ireland and to the UK Corporate Governance Code. These changes set the requirement for boards to ensure that the annual report of a company should present a fair, balanced and understandable assessment of a company's position and prospects.

The same changes required audit committees to report formally on their activities and 'extended auditor's reports' were introduced for premium listed companies (and those voluntarily complying with the UK Corporate Governance Code). These changes were part of our response to the financial crisis, which many commentators felt had exposed the limitations of a traditional 'binary' audit report. Our intention in making these reforms was to provide transparent reporting to allow users of financial statements to begin to unpack the audit process and draw on the auditor's insight and understanding of the audited entity. This included providing a

better understanding of the key risks being addressed by the audit, the extent of the work done in response to those risks and the nature of the key judgements being made.

Our reforms were not intended to be prescriptive beyond the core subject matter that had to be covered. Indeed it was hoped that by setting a small number of high level requirements, auditors would innovate in the way in which they presented this information in their reports. Extended auditor's reports were required, therefore, to provide an overview of:

- Those risks of material misstatement identified by the auditor which had the greatest effect on the audit strategy, resources required and the work of the engagement team;
- The application of the concept of materiality; and
- The scope of the audit, including how it responded to the risks of material misstatement and the application of materiality.

Experience of two cycles

The UK has now had two complete cycles of extended auditor reporting, which have been the subject of significant interest both within and outside the UK. The success of our experience in the UK has now seen the adoption of a similar model at the international level as that introduced by the FRC. As a result, for the first time, the FRC has been able to adopt the International Standard as the basis for ISA (UK) 700: Forming an Opinion and Reporting on Financial Statements. Regulators in other capital markets, including the United States, have looked at the impact of our reforms as they consider whether to make similar changes.

We have completed and published two reviews of extended auditor's reports, in 2015 and 2016. Our second review in 2016 was based on analysis of auditor's reports from 278 (80%) of the largest premium listed companies in the UK (FTSE 350), supplemented by taking the views of key stakeholders including investors, audit practitioners, analysts and academics. The evidence and feedback we collected over these two years indicated that all of these various groups welcomed our reforms. This is reflected in the existence of annual 'investor awards' by The Investment Association which recognise best practice and high-quality and transparent reporting.

Our sample covered reports produced by all the main audit firms and our analysis compared the different approaches. Auditors had innovated significantly and had sometimes gone beyond the strict requirements of the Standards to deliver more informative and impactful reports. Investors felt that they were being given deeper insights into the audit process and the nature of the assurance being provided.

Across the two years we found significant innovation in the following areas:

- A move away from the use of generic language to more entity specific (and therefore more informative) descriptions;
- Effective disclosures around materiality, including the benchmarks used and basis of the calculation;
- Disclosure of the magnitude of unadjusted differences being reported to the audit committee;
- Reporting of detailed audit findings with respect to identified risks – in year one this was limited to comparatively few 'best in class' reports. In year two the prevalence of this reporting increased. Many investors would like to see it become the norm;
- Experimentation with detailed explanation of the audit scoping process;
- A good alignment between the information included in the auditor's extended report and in audit committee reports;
- Improved presentation of auditor's reports through the use of diagrams and graphs;
- Addressing going concern disclosures in auditor's reports; and
- Locating the auditor's overall opinion at the beginning of the report rather than at the end.

Many investors feel further enhancements could still be made, and we continue to believe that this should be the basis for further meaningful engagement between auditors, audited entities and users of financial statements. A balance will need to be struck between the benefits of further innovation and any related costs. The areas where many investors told us they felt more could be achieved include:

- Further improving the discussion of the auditor's application of materiality and why a particular benchmark or level was chosen;

The UK has now had two complete cycles of extended auditor reporting, which has been the subject of significant interest both within and outside the UK. Investors have welcomed the changes to reporting. International Standards of Auditing have introduced similar requirements to those set by the UK. Regulators in other capital markets, including the United States, have looked at the impact of our reforms as they consider whether to make similar changes.

- More frequent disclosure of performance materiality and how it impacts on the work done by auditors;
- A more dynamic assessment of changes over time, including year-on-year comparisons of changes in areas such as the approach and identified risks;
- More detail on the range and sensitivities used in testing, particularly those which relate to management estimates; and
- Many investors stated that they would also like to see good practice at the premium listed end of the market spread to smaller audited entities, where anecdotal evidence suggests there continues to be a more generic and boilerplate approach to reporting.

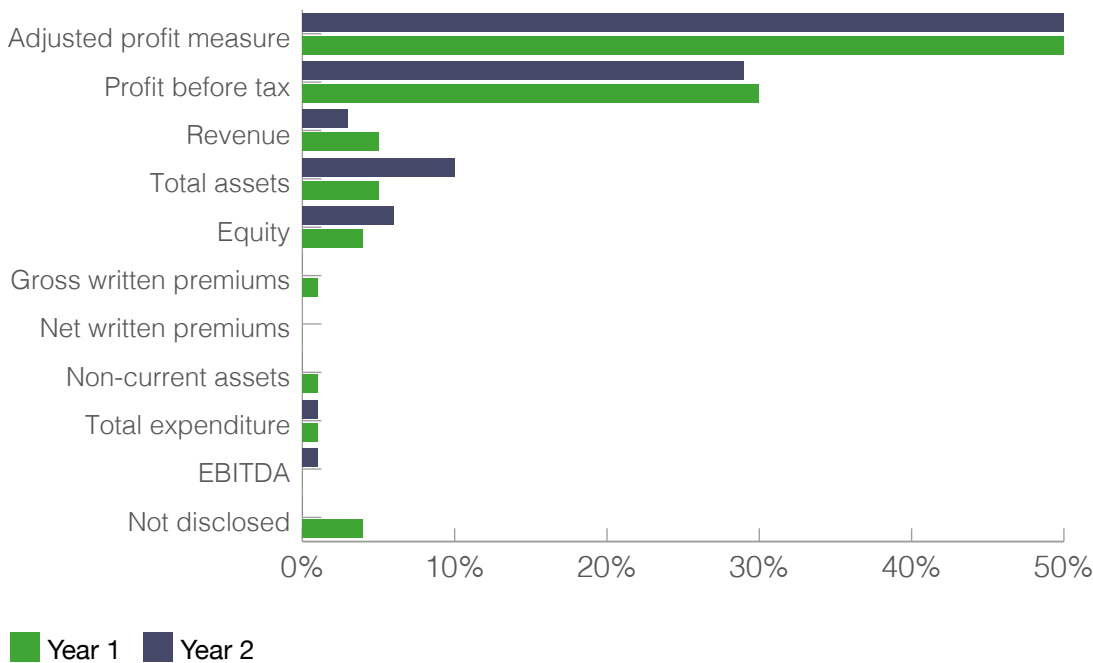
Other analysis

The information published by auditors now provides investors and other stakeholders with an overview of practice in the market and benchmarking information for comparison. As an example, we were able to produce a high level analysis of the different measures auditors use to derive materiality (chart 4), which demonstrates the prevalence of the use of adjusted profit measures by the majority (but not all) audit firms.

Of course the appropriateness of using an adjusted profit measure to set materiality is dependent on the adequacy of consideration of the adjustments themselves. Opacity around these judgements is one of the aspects of materiality which has been a cause for concern for investors, who often find it difficult to understand why different auditors adjust for items which others do not. Given the prevalence of this benchmark, we have asked our inspection team to monitor closely the auditor’s consideration of adjustments made to profit before tax.

Given the prevalence of adjusted profit as a benchmark, we have asked our inspection team to monitor closely the auditor’s consideration of adjustments made to profit before tax.

Chart 4: Materiality benchmarks



June 2016 changes

Very recent changes to UK Auditing Standards have increased the number of entities required to have an extended auditor report, including smaller listed bodies and other PIEs (such as some unlisted insurance entities and credit institutions).

In respect of going concern in particular, changes have been made to further clarify the auditor's responsibilities, including a requirement to conclude on the appropriateness of management's use of a going concern basis in the preparation of the financial statements and to report by exception on longer-term viability statements where they are prepared under the Corporate Governance Code.



Changes to FRC Ethical Standards

The last year has seen a major revision to the FRC's Ethical Standards. Much of the publicity that went with this linked the changes to the ARD. However, we had already started to review ethical matters, drawing on findings provided by our monitoring and enforcement work. The results of this review have been incorporated into the wider changes needed to comply with the new legal requirements.

When we meet with investors, many of them tell us the high value they place on auditor independence, which is vital to underpin confidence in audit. Adherence to the principles of independence, objectivity and integrity is fundamental to delivering high-quality, robust audits that stakeholders can trust.

Our focus in the past year, therefore, has been to provide a clearer focus on these principles and to link them more explicitly to the requirements that an auditor needs to comply with when delivering an audit. This means that ethical considerations should not just be part of a process, but are central to delivering the mindset that an auditor needs to adopt when undertaking an audit to ensure the ethical outcomes required by the Ethical Standard.

The ARD is the European Commission's response to the financial crisis. There is significant focus, therefore, on measures which protect auditor independence and mitigate the risks posed by situations where an auditor's independence can be compromised through conflicts of interest. The ARD prohibits the provision of a range of non-audit services by the auditor which would bring with them a risk that an auditor might subsequently have to audit something that they or their firm had been instrumental in creating (a self-review threat). For those non-audit services that are permitted, they cannot cost more than 70 per cent of the audit fee on a rolling three year basis, unless required by EU or national law or regulation.

We have made significant enhancements to Ethical Standards based on principles and reflecting our experience from audit quality reviews and enforcement matters and the requirements of the ARD.

Although the requirement for an auditor to be independent to accept an audit engagement is not a new one, the ARD has placed a further condition on the assessment of auditor independence. Issues which may compromise the independence of an auditor should be considered from the perspective of an objective, reasonable and informed third party – if such a third party might reasonably consider that the auditor’s independence had been compromised, then they can no longer be considered independent to carry out the audit engagement.

Personal independence requirements are also extended as a result of the ARD, with a wider network of people covered, along with people they are closely connected to. Although some may consider these additional requirements to be onerous, they are designed to address threats to independence and, of equal importance, the perception of threats to independence, which can quickly undermine confidence in an auditor.

If an auditor enters into a situation where they act as an advocate of management of an audited entity, this poses a major risk to independence. If an auditor has advocated a particular approach or position in respect of any issue that affects the financial statements, there is a resulting risk of self-review which may mean that the auditor does not approach that part of the audit with the same degree of independence and objectivity. That is why, in revising the Ethical Standards, we have emphasised the importance of an auditor needing to be aware and to reassess any risk that arises as a result.

We have also redrafted the requirements applying to advocacy to make clear that they are not subject to hard black lines based on particular circumstances. The risk posed by advocacy can be one of perception and therefore the auditor needs to consider whether an objective, reasonable and informed third party would conclude that the auditor’s independence had been compromised. Although it has never been appropriate to consider certain situations to

be ‘safe’, our monitoring and enforcement work found that auditors sometimes did, for instance, only consider that independence would be compromised when appearing before a court or tribunal on tax matters, but not before that point.

We understand that the overlapping ethical requirements in European and national legislation, as well as that contained in standards and codes issued internationally and by professional bodies, can be complex. This is why we took the decision, in revising the FRC Ethical Standards, to incorporate all ethical, legal and regulatory requirements into a single, comprehensive document.

A further area of change resulting from the ARD, to Auditing Standards rather than Ethical Standards, is the need for an additional report from the auditor to the audit committee. The report will require the auditor to explicitly confirm their independence to the audit committee. This, coupled with the need for the audit committee to grant approval for the provision of non-audit services, will offer a stronger mechanism to protect against risks to independence.

Further international developments

At the international level, the International Ethics Standards Board for Accountants (IESBA) has begun a series of consultations to revise its international code of ethics. This is based on five fundamental principles: integrity; objectivity; professional competence and due care; confidentiality; and professional behaviour. The UK professional bodies each require their members to adhere to the international code, with some additions. Similarly the FRC Ethical Standard builds on these requirements in circumstances where a group auditor proposes to use a network firm to audit an overseas subsidiary.

Other 2016 changes to FRC Auditing Standards

The FRC has recently issued revised Auditing Standards. The changes are not just requirements of the ARD, they also reflect changes made to international standards by the International Auditing and Assurance Standards Board (IAASB). Many of the changes were driven by the conclusion of three IAASB projects covering enhanced auditor reporting, auditing disclosures in the financial statements and the auditor's responsibilities for other information included in the annual report.

The FRC also draws lessons from our monitoring and inspection work to propose changes to international standards, a number of which are covered by the IAASB's recent consultation on its forward work programme. Proposals to enhance ISA 600: Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) respond to the FRC's concerns, identified through the FRC's monitoring activities, of weaknesses in group audits where subsidiaries have been established as 'letterbox companies' over which auditors may not have gained adequate assurance. The FRC has also strongly encouraged the IAASB to undertake a project to revise ISA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures. This standard will be of particular importance for the auditors of banks and other financial institutions as they deal with the implementation of IFRS 9: Financial Instruments which will come into force for periods commencing on or after 1 January 2018.

Audit Firm Governance Code

In May 2015 the FRC published the results of its review of the operation and implementation of the Audit Firm Governance Code (AFGC). The review concluded that the AFGC had improved the quality of governance at the largest UK audit firms and made a number of suggestions on potential enhancements.

Based on the feedback received for this consultation, the FRC published, in December 2015, a draft revised AFGC. The main changes proposed in the draft are intended to:

- Sharpen the AFGC's purpose and ensure audit quality is clearly embedded therein;
- Promote a clear focus on audit quality in the work of the Independent Non-Executives;
- Strengthen investors' engagement with the firms;
- Improve transparency in the firms' reporting against the AFGC;
- Promote the adoption, on a comply or explain basis, of some aspects of the Corporate Governance Code which we consider to be most applicable to audit firms, on a comply or explain basis; and
- Promote the adoption of independent challenge within the governance of the firms' international networks.

The consultation period is now closed. The majority of responses were supportive of the proposed changes. Some concerns were raised, for example in respect of changes to the minimum number of independent non-executives and whether the changes were disproportionate for smaller audit firms. The need for improved investor engagement was also highlighted. A revised AFGC is due to be issued later in July.

Smaller listed and AIM quoted companies

The FRC seeks to regulate in a proportionate way. The focus of the current government on delivering savings to businesses through deregulation is also something that we have given careful thought to in revising the Ethical Standards. Smaller entities may have a greater reliance on their auditor as a source of advice and as a way of raising the quality of their corporate reporting and compliance with legal and regulatory obligations. Investors we have spoken with have also pointed out that smaller entities may well be of a lesser degree of public interest than a company listed on a regulated market. With this in mind, we consulted on and have since implemented a series of reliefs for smaller entities. These reliefs relate to areas where the FRC Ethical Standard is more stringent and the reliefs offer a way of dealing with these requirements in a proportionate way.

The FRC recognises that smaller listed and AIM-quoted companies are important in generating future growth in the economy. In June 2015 we published a report on “Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies” which set out a series of proposals for improving the quality of corporate reporting. The report marked the conclusion of our review into the challenges faced by companies and their advisers on the preparation of the annual report. Included in this report were the results of our thematic review into the processes of audit firms in reviewing the financial statements of these companies.

Our review found that, while audit firms generally had appropriate policies and procedures in place to ensure that financial statements were adequately reviewed before publication, there was a lack of rigour by some audit teams in following these policies and procedures. We therefore made a number of recommendations relating to:

- the quality control procedures of firms and the level of technical review as financial statements are finalised;
- reporting to the audit committee on disclosure misstatements and the auditors’ evaluation of the competence of management; and
- the rigour of the final consistency checks on the financial statements as they are finalised.

We also wrote to each audit firm that we reviewed to set out our specific findings on their processes. Each firm has responded to us detailing proposed changes to their process and procedures. They have also developed initiatives with their staff and clients in order to raise awareness of the importance of high quality reporting in this sector of the market. We expect that these changes will help to have an impact on the quality of reporting.

The FRC has implemented a number of initiatives to make improvements to the quality of reporting by smaller listed and AIM-quoted companies. For example, we sent a letter to the Finance Directors of all such companies in November 2015 setting out the key areas of focus that would help increase the quality of annual reports. Auditors clearly have an important role to play in highlighting these and other areas of improvement to companies and we will continue to monitor the effectiveness of their procedures. In June 2016 the FRC published an overview of the feedback it has received and an update on progress to date against the proposals.¹⁶

The FRC has implemented a number of initiatives to make improvements to the quality of reporting by smaller listed and AIM-quoted companies including auditor-related matters.

¹⁶ <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Update-on-Discussion-Paper-Improving-the-Quality.pdf>

ROLE OF THE AUDIT COMMITTEE

In this Section we discuss the role of the audit committee, which is pivotal to audit quality. In 2012 the FRC introduced, through the UK Corporate Governance Code, responsibilities for the audit committee to appoint the auditor; retender the audit at least every ten years; ensure auditor independence; and assess audit effectiveness. In 2015/16 we continued to assist audit committees in discharging these responsibilities. The ARD also reinforces the key role of the audit committee in these areas.

Audit committee chair survey

For the second year, a survey was undertaken of audit committee chairs to understand their experience of audit quality. The survey in the first year was led by KPMG and sponsored by the Professional Reputation Group¹⁷ (PRG). This year, the FRC supervised the process to add an extra layer of independence to the process.

Surveys were sent to all FTSE 350 audit committees and a further selection of listed companies outside of the FTSE 350 was included to provide a reasonably sized sample for the six largest audit firms. Response rates were up on the first year, with just under 50% completing the survey sent to them. Completion rates were not uniform across the firms, however, and so the number of responses received was not in proportion to the firms' market share. In total, just over 200 responses to this survey were received.

Audit committee chairs were asked a total of eight questions on audit quality and were asked to rank their responses on a scale of 1 to 7, with 1 being the lowest and 7 the highest. There was also an opportunity to make comments against each question. The questions were the same as those asked in the previous year in order to facilitate easy comparison between years.

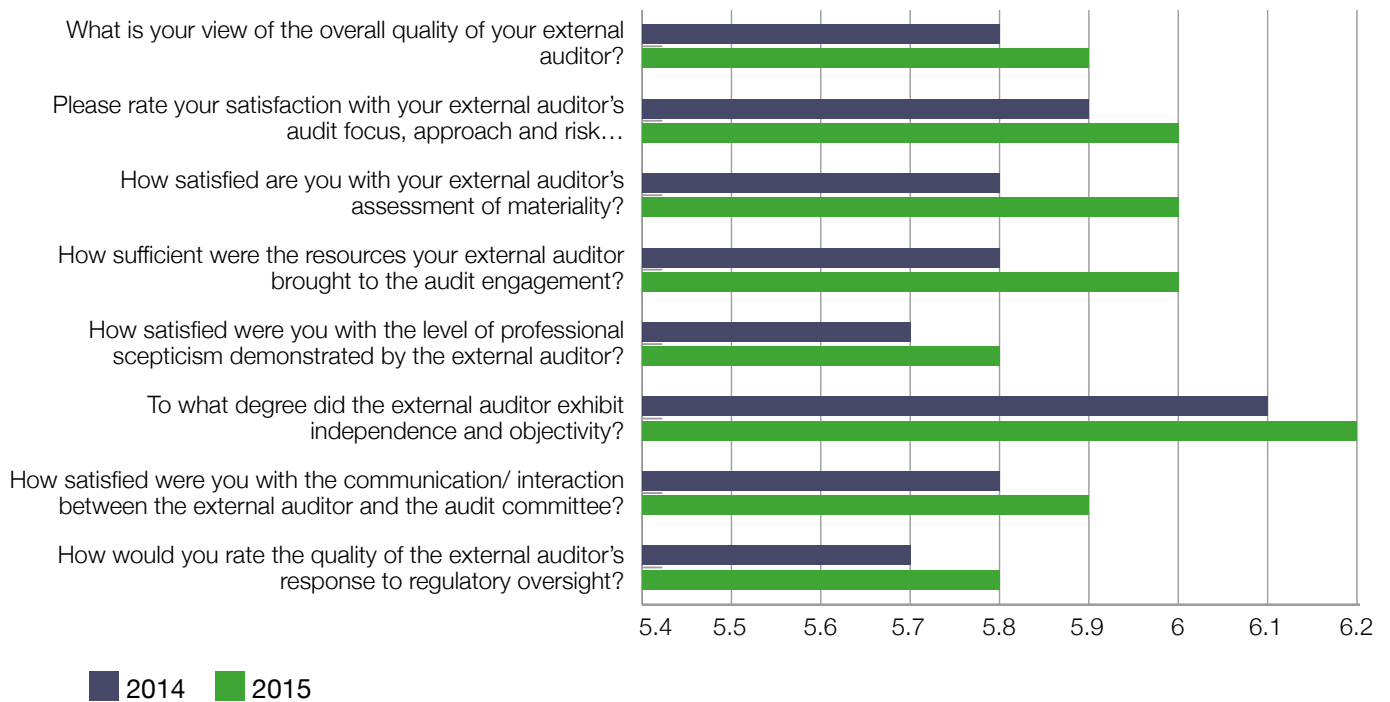
Feedback on audit quality was overwhelmingly positive, with the majority giving their auditor a score of 6 or 7 for most or all of the questions. Very few scored their auditor less than 3 on any question.

There was a slight improvement from 2014 in the ratings for each question, as can be seen in chart 5.

Feedback from over 200 audit committee chairs was overwhelmingly positive in respect of audit quality.

¹⁷ A forum for the six largest audit firms in the UK to debate topical issues that impact on the reputation of the firms collectively and by extension of the professions. The six firms are BDO, Deloitte, EY, Grant Thornton, KPMG and PwC. The PRG has designed an audit quality indicators initiative based on the internal control systems, business and operating models, and client base of the Big 6 audit firms

Chart 5: Comparison of mean scores per question 2014 and 2015



The results demonstrate that FTSE 350 audit committee chairs generally view the quality of their current auditors in a positive light. There has been an improvement on last year's figures. It is notable, however, that the lowest overall scores for a second year are for the questions on professional scepticism and the auditor's response to regulatory oversight, which suggests that there is still some work for the firms to do in this area.

Although it was possible to observe some differences between firms, these were very small and there were no clear conclusions to be drawn in relation to this data.

In their comments, audit committee chairs amplified the answers they gave. The majority were positive statements on their experience with the appointed audit firm. A number referred to the quality of the audit engagement partner as being crucial to their assessment of the quality of the audit. Several discussed the importance of independence to both the company and the audit firm, with some saying explicitly that they gave none or very little non-audit work to the external auditor.

Audit committee chairs were also asked to comment on other criteria they use to assess audit quality outside of the headings in the questionnaire. These included:

- Surveys of management and finance staff on their views of the performance of the auditors;
- The extent to which the auditor can demonstrate knowledge of the business and the key risks facing it;
- Perceived calibre of the individuals on the audit team;
- Continuity within the audit team; and
- The extent to which the auditor can add value, for example by pointing the company's management towards instances of best practice in corporate reporting,

We will consider the extent to which these factors can be built into future guidance to audit committees.

In the light of the increase in tendering activity, this year the survey also asked whether the company had been involved in a tender process during the previous twelve months. 34 companies (17% of the sample) indicated that the company had conducted an audit tender. Of these, 75% resulted in a change of auditor.

Those who had been involved in a tender process were asked to rate the actual difficulty of the exercise in comparison with their expectations, with 1 being much more difficult than expected and 7 being much easier. The overall mean score across all firms was 4.7. There were relatively few comments in this section, but a few pointed to difficulties arising from independence restrictions. This can impact on the number of audit firms who were prepared to tender. A number whose companies had changed auditor reported that a “fresh pair of eyes” and a new perspective had been beneficial; one audit committee chair whose company had retained the existing auditor noted that the tender had led to the retained firm “raising their game”.

Tendering and concentration

Audit tender proposals

Over the last few years, tendering activity in the UK audit market has increased significantly due to a number of factors:

- Changes to the UK Governance Code which requires that FTSE 350 companies, for year ends commencing after 1 October 2014, should put the external audit contract out to tender at least every ten years.
- The CMA Order, following its predecessor, the Competition Commission's investigation into competitiveness in the audit market, requiring FTSE 350 companies, for years commencing from 1 January 2015, to put their statutory audit out to tender every ten years.

- ARD reform, from 16 June 2016, will introduce mandatory audit tendering every ten years and rotation after twenty years for PIEs (with permitted variations across EU member states).

In late 2015 the FRC repeated an exercise it had previously carried out in 2009 and 2011, reviewing the audit proposals submitted by firms in respect of a number of specific tenders, and speaking to the audit committee chairs of those companies to understand their perspective. We reviewed a total of 42 proposals for the fifteen tenders selected. We noted a number of differences from what we had observed in either of the previous exercises.

Most importantly, there was a much greater emphasis on audit quality than in either 2009 or 2011. Almost every proposal included references to audit quality, with several going into considerable detail about how the firm maintained quality and what quality actually meant in this context. A number of proposals also stressed that the firm would provide a “robust” or “challenging” audit. This is welcome and is not something we have observed previously.

The majority of proposals made reference to AQR reports although relatively few included links to the reports themselves on the FRC website. Instead, the firms would summarise the key points from the reports and in some cases would detail the remedial work being performed to address any weaknesses identified. Firms would typically present the AQR findings in as positive a light as possible and we saw evidence that some firms would do so in a misleading way – for example by combining “1” and “2A” categories in order to claim that a large majority of audits reviewed were awarded the “top grade”.

Firms often stressed the quality of the partner and, sometimes, the rest of the team. There was also an emphasis on “cultural fit” and, especially for companies based in the regions, local knowledge and connections.

Proposals now focus more on audit quality.

The use of technology and data analytical tools featured in a number of proposals. The firm would typically present their approach as a unique selling point. It was clear, however, that much of this technology is at an early stage and it remains to be seen what precise impact it has on the audit.

There was very little evidence of cross-selling of non-audit services. Many proposals talked instead about the importance of independence and some provided detailed explanations of how the firm proposed to ensure that all non-permitted services had ceased by the time that the first audit commenced.

More broadly, proposals appeared more professional than previously and there was evidence of greater central co-ordination. Light-hearted content was far less common than previously, although it had not disappeared entirely.

Several of the audit committee chairs we spoke to had reviewed AQR reports before finalising their shortlist of firms to be invited to tender. Others had requested detailed

explanations of how a firm was addressing specific AQR findings.

The quality of the prospective audit partner, and in some cases the wider team, was also seen to be of paramount importance. Audit committee chairs spoke of wanting a robust and decisive partner and one with detailed knowledge of the industry in which the company operated.

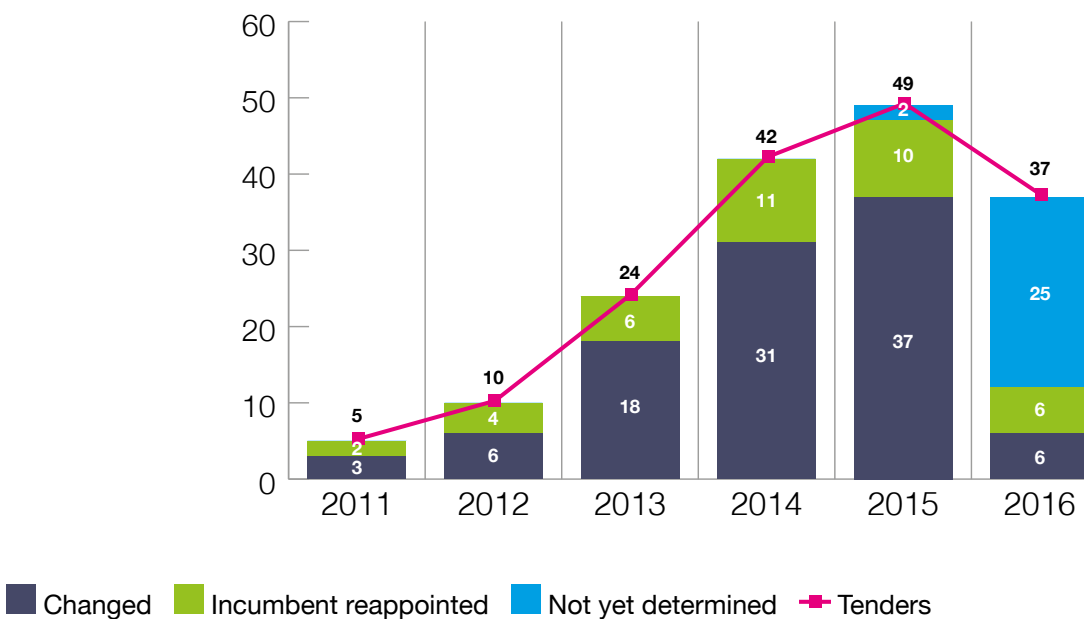
Tendering activity and impact on concentration

When the FRC changed the UK Corporate Governance Code in 2012 to introduce tendering, some of the largest companies had retained the same auditor for over 100 years. Since the introduction of the new provision in 2012 our analysis (chart 6) indicates that there have been in excess of 150 tenders in the FTSE 350. This contrasts with around 14 tenders per year in the period from 2007 to 2011.¹⁸ For those tenders since 2012 concluded by 2015, publicly available information shows that approximately 75% resulted in a change of auditor.

The number of tenders has increased significantly since 2012.

Audit firms and companies are becoming used to tendering, which is increasingly seen as a business as usual activity.

Chart 6: Tender activity



¹⁸ https://assets.publishing.service.gov.uk/media/5329db4240f0b60a7600001a/evidence_relating_to_the_selection_process_tendering_annual_renegotiations_and_switching.pdf

To date, there is no indication that the increase in tendering has reduced concentration in the audit market. Indeed, since the change to the UK Corporate Governance Code, the Big Four share of the market has risen. Only two firms outside of the Big Four (BDO and Grant Thornton) are represented in the FTSE 350 (chart 7).

There is no evidence that concentration in the market is decreasing. Indeed, the Big Four share of FTSE 350 audits has increased.

Chart 7: Concentration of auditors of FTSE audits¹⁹

	Big Four firms (%)					Next five firms (%)					Other firms (%)				
	31/12/11	31/12/12	31/12/13	31/12/14	31/12/15	31/12/11	31/12/12	31/12/13	31/12/14	31/12/15	31/12/11	31/12/12	31/12/13	31/12/14	31/12/15
FTSE 100	99.0	99.0	98.0	98.0	98.0	1.0	1.0	2.0	2.0	2.0	0.0	0.0	0.0	0.0	0.0
FTSE 250	95.2	94.4	96.0	96.8	96.8	4.8	5.6	4.0	3.2	3.2	0.0	0.0	0.0	0.0	0.0
Other UK main market	68.7	66.3	68.1	69.7	71.1	23.9	24.8	23.7	21.4	21.5	7.4	8.9	8.2	8.9	7.4
All main market	78.4	78.3	78.8	79.9	83.2	16.8	16.5	16.0	14.5	11.0	4.8	5.2	5.2	5.6	5.8

Of 15 tenders whose proposals we reviewed, none involved a firm outside of the Big Four. We explored the reasons for this when we spoke with the audit committee chairs, who noted that:

- Some companies considered that they were simply too large and/or had operations in too many territories for a firm outside of the Big Four to be able to audit effectively. In one or two cases an initial discussion had been held with a non-Big Four firm which had indicated that it would decline to bid on those grounds. This was particularly the case with large financial institutions.
- In other cases the company had been keen to include a non-Big Four firm but, to their disappointment, the firm declined to participate in the tender even though the company was almost entirely UK-based and with relatively straightforward operations. Various reasons were given, including a lack of capacity; no prior

relationship with the company; and scepticism that the firm would be treated as a serious contender.

- In one case, we were informed that plans to invite a non-Big Four firm to the tender process had been abandoned following a review of the FRC's AQR reports.

Audit fees

More frequent tendering could lead to downward pressure on audit fees and risk a drop in quality if the auditor chooses to carry out less work in order to maintain profit margins on the audit. Our previous exercise in 2011 showed that audit fees fell by an average of 14.5% following an auditor change and in some cases much larger cuts were in evidence. At the time we were told by all audit firms that pressure on fees was extremely high. More recently, however, we have been told that the position has stabilised.

¹⁹ For the purposes of this chart, where a listed company is audited by a firm from the Crown Dependencies it has been given the same classification as its UK counterparts

A review of the published accounts of companies who have undertaken a tender since 2012 appears to bear out this anecdotal evidence. In the FTSE 100, the average reduction in fees following a change of auditor is less than 1%. Where the incumbent is reappointed, the reduction was higher at just over 2%. Reductions in the FTSE 250 were higher at 8% although this was distorted to some extent by two or three outliers.

All of the audit committee chairs we spoke to indicated that price was not a significant factor in the decision. A number took a specific decision to run the tender on a price blind basis, with the envelopes containing the proposed fees opened only after the final decision had been made. We welcome this development as it encourages the focus to be on quality during the tendering process.

A couple of audit committee chairs acknowledged that the winning firm might be asked to reduce the fee slightly to match a lower bid. Others said that they would not put any such pressure on the firm.

In almost every case the proposed fees were all quite similar and did not differ significantly from the current fee. Where a fee cut was proposed, the audit firm typically detailed how it would be achieved and explained why this would not impact on quality. In a handful of cases the audit fee actually rose.

Several audit committee chairs indicated that they would be unlikely to select a firm proposing a major reduction in fees as they would be concerned that corners would be cut.

The general increase in growth rates for audit firm income also suggests that fees are not under undue downward pressure (chart 8).

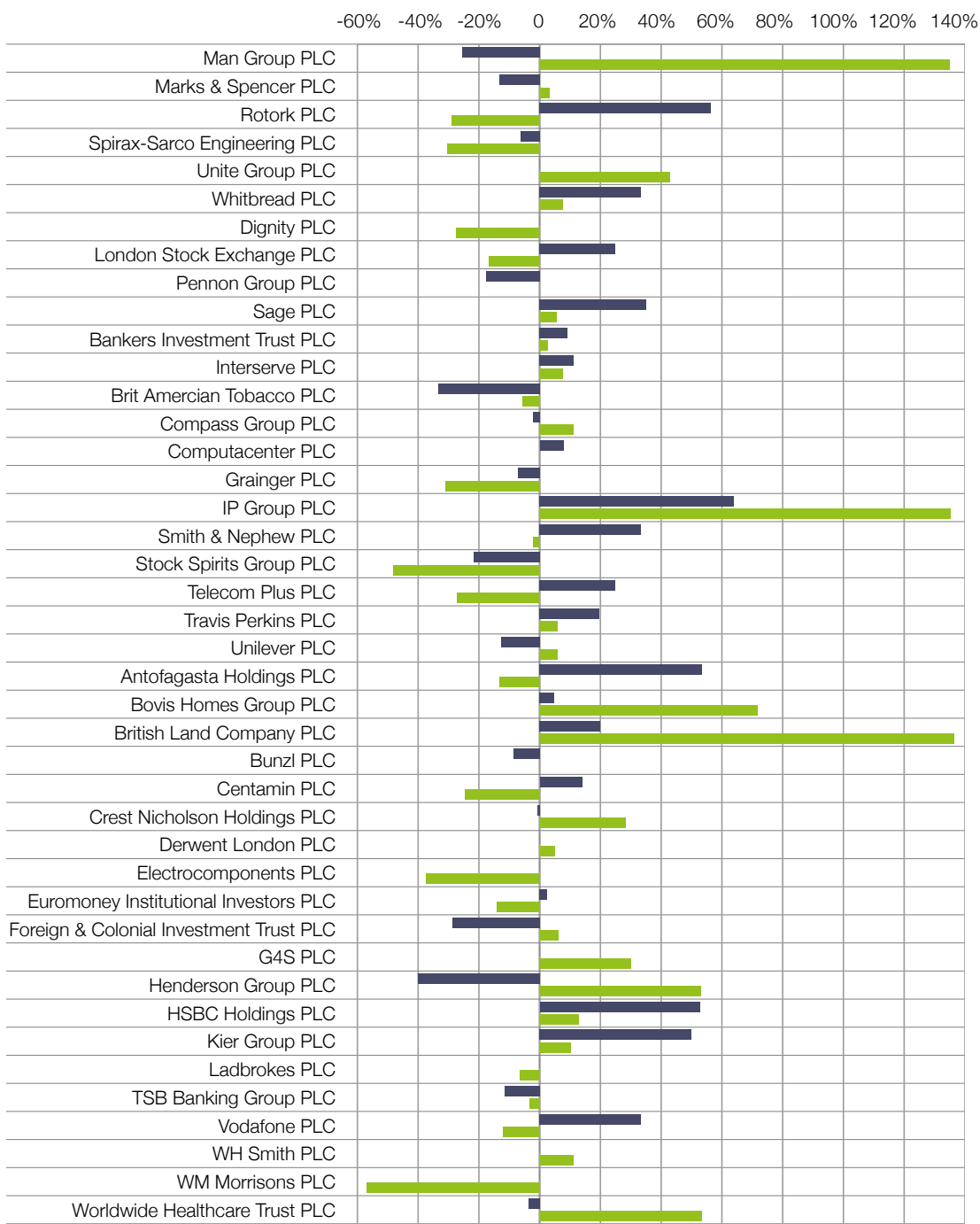
Chart 8: Growth rate of fee income

Growth rate %		2013/14	2014/15
Total fee income	Big Four firms	4.3	6.7
	Non Big Four firms	14.9	4.7
Audit fee income	Big Four firms	0.1	4.6
	Non Big Four firms	9.2	2.7
Non-audit work to audit clients fee income	Big Four firms	0.8	5.5
	Non Big Four firms	11.8	13.2
Non-audit work to non-audit clients fee income	Big Four firms	6.3	7.6
	Non Big Four firms	17.4	3.9

Materiality

None of the proposals we looked at included a rise in materiality thresholds (and several proposed doing extra work in some areas). However, a review of the annual reports of companies which have recently conducted an audit tender identified significant rises in materiality in a handful of cases (chart 9).

Chart 9: Movement in audit fee and materiality on change of auditor



There appears to be less pressure on fees than in the past and tenders rarely now result in such significant cuts to the audit fee.

We have seen some examples of significant increases in materiality following a change in auditor. We will continue to monitor this.

These changes may not be an accurate comparison of year on year materiality. Significant changes in materiality levels could be a result of company performance variances, restructuring of the group or auditor led changes such as amended risk

assessment or a fresh look at the appropriate benchmark or thresholds. However, there does appear to be some indication that cases are arising where a change in auditor may lead to significant changes in materiality levels set. We will continue to monitor this.

■ Audit fee
■ Materiality

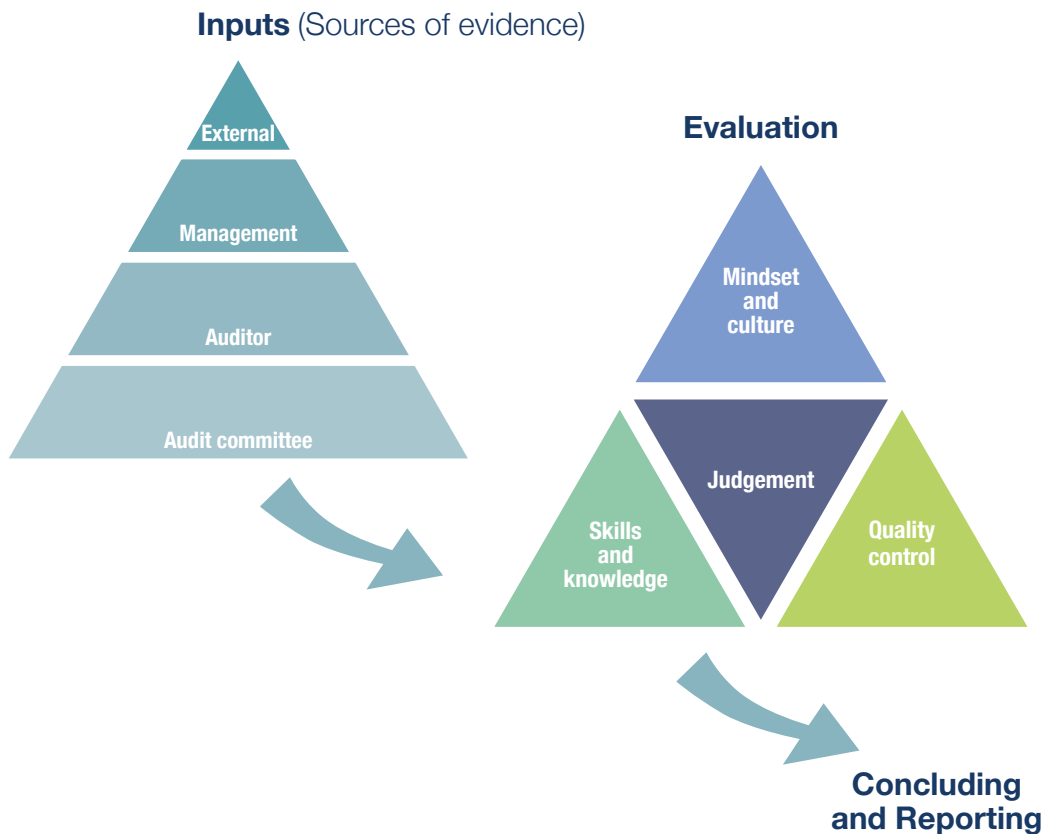
Working with audit committees to assess audit quality

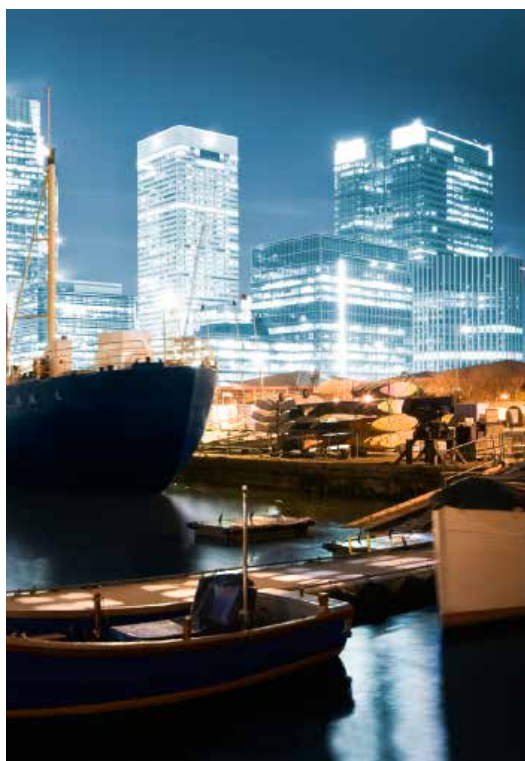
Our regular liaison with audit committee members and chairs showed that although members had a clear understanding of their responsibilities, some said that they would welcome some practical guidance material intended to support discussions about audit quality. This was particularly the case among audit committee members who had not themselves been an auditor. In response we developed: Audit Quality – Practice aid for audit committees, published in May 2015. It provides guidance on assessing audit quality in a way that can be integrated within the committee’s own assessment process; which underpins the chair’s report included in the annual report, and the committee’s regular consideration of the effectiveness of their auditor.

The Practice Aid provides audit committees with an overview of audit quality, highlighting those factors a Committee may wish to consider when undertaking an assessment. This overview is supported by details of the sources of available evidence to support the committee’s work, including any audit quality inspection reports and thematic reports issued by the FRC. Further material describes the key professional judgements that an auditor might make in the course of an audit, and how a committee might go about assessing those judgements with the aid of some practical examples.

Committee members also asked us what they might consider when scoping a review of auditor quality and effectiveness. The Practice Aid sets out how they might make an assessment covering: Skills, Character and Knowledge; Mindset and Culture; and Quality Control.

Chart 10: Overview of an assessment





Audit committee reporting on AQR findings

The revised guidance on audit committees issued in April 2016 states that the separate section in the annual report describing the work of the committee should include the significant issues that the audit committee considered, including: “Where a company’s audit has been reviewed by the FRC’s Audit Quality Review team, the committee should discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take. This discussion should not include disclosure of the audit quality category.”

The guidance confirms the advice previously provided to audit committees by the FRC in November 2014 following the CMA’s recommendation that audit committees of FTSE 350 companies who have been subject to an AQR inspection should disclose the principal findings. In developing the revised guidance we took account of the experience to date in respect of the reporting by audit committees on AQR findings. This experience indicated that the disclosures made by audit committees were generally not at the level envisaged by the CMA recommendation and in particular lacked specificity in relation to the nature of the findings and the actions taken by both the auditor and the audit committee.

A number of audit committees commented on inspections where there were limited findings or the findings in our view were considered to be less significant. For those inspections where the findings were considered to be more significant we noted that audit committees did not necessarily report any findings.

While acknowledging that this is an evolving area we expect that the revised guidance will give further impetus to audit committees to consider the significance of any findings arising from an AQR inspection and what, if any, disclosures should be included in their report.

In many cases, disclosures made by audit committees on AQR inspection findings were generally not at the level envisaged by the CMA recommendation and in particular lacked specificity in relation to the nature of the findings and the actions taken by both the auditor and the audit committee.

For those inspections where the findings were considered to be more significant we noted that audit committees did not necessarily report any findings.

MONITORING OF AUDIT QUALITY

This Section provides an overview of our ongoing monitoring activities and findings in 2015/16.

Audit quality monitoring

Our monitoring activities comprise inspections of firms and their audits as required by statute and those that are performed on a contractual basis. We also supplement our monitoring of firms with thematic reviews.

The following table provides an overview of the number of audits inspected across each inspection category.

AUDITS INSPECTED: OVERALL		
Inspection Category	2015/16	2014/15
UK and Crown Dependency audit firms	113	105
Third Country Auditors	6	4
Local Audit	12	11
National Audit Office	6	6
Total audits inspected	137	126

UK and Crown Dependency audit firm inspections

In 2015/16 the inspection of UK audit firms included audits within the FRC's inspection scope (Major Audits²⁰) and those inspected on a contractual basis on behalf of the Crown Dependency Regulatory Authorities.²¹

One further inspection on behalf of the Crown Dependency Regulatory Authorities was also undertaken in 2015/16 at a Crown Dependency audit firm.

²⁰ The Companies Act 2006 requires the independent inspection of UK auditors undertaking statutory audits of listed companies and other entities in whose financial condition there is considered to be a major public interest

²¹ The Regulatory Authorities in Jersey, Guernsey and the Isle of Man have entered into contractual arrangements with the FRC to inspect certain auditors of companies incorporated in the Crown Dependencies with securities admitted to trading on a regulated market in the EEA. These inspections seek to ensure the Crown Dependency auditor oversight arrangements could be considered equivalent to those in place in EEA member countries

The following tables provide, by firm and category of entity, an analysis of the 113 individual audits inspected in 2015/16 (together with comparatives) at UK and Crown Dependency audit firms. The audits inspected include 13 Crown Dependency companies (2014/15: nine companies).

AUDITS INSPECTED: OVERALL		
Firm Category	2015/16	2014/15
UK Audit Firms		
Deloitte LLP	22	20
Ernst & Young LLP	20	16
KPMG LLP/ KPMG Audit Plc	22	20
PricewaterhouseCoopers LLP	25	22
Big Four firms	89	78
RSM UK Group LLP	1	-
BDO LLP	8	8
Crowe Clark Whitehill LLP	-	5
Grant Thornton UK LLP ²²	8	8
Mazars LLP	1	5
Joint audit adjustment ²³	-	(1)
	107	103
Crown Dependency Audit Firms		
KPMG Channel Islands Limited	6	2
Total audits inspected	113	105

AUDITS INSPECTED: BY TYPE		
Type Of Entity	2015/16	2014/15
FTSE 100	17	14
FTSE 250	49	40
FTSE 350	66	54
Other full listed	21	29
AIM	10	8
Non-listed banks	4	4
Building societies	1	3
Large private companies	6	1
Pension funds	2	3
Charities	1	2
Collective investment funds	1	-
LLPs	-	1
Mutual	1	-
Total audits inspected	113	105

²² Includes one review in 2015/16 where the FRC has launched an investigation into the audit under the Accountancy Scheme. As a result a final report on this review was not prepared and a final assessment of the audit was not completed

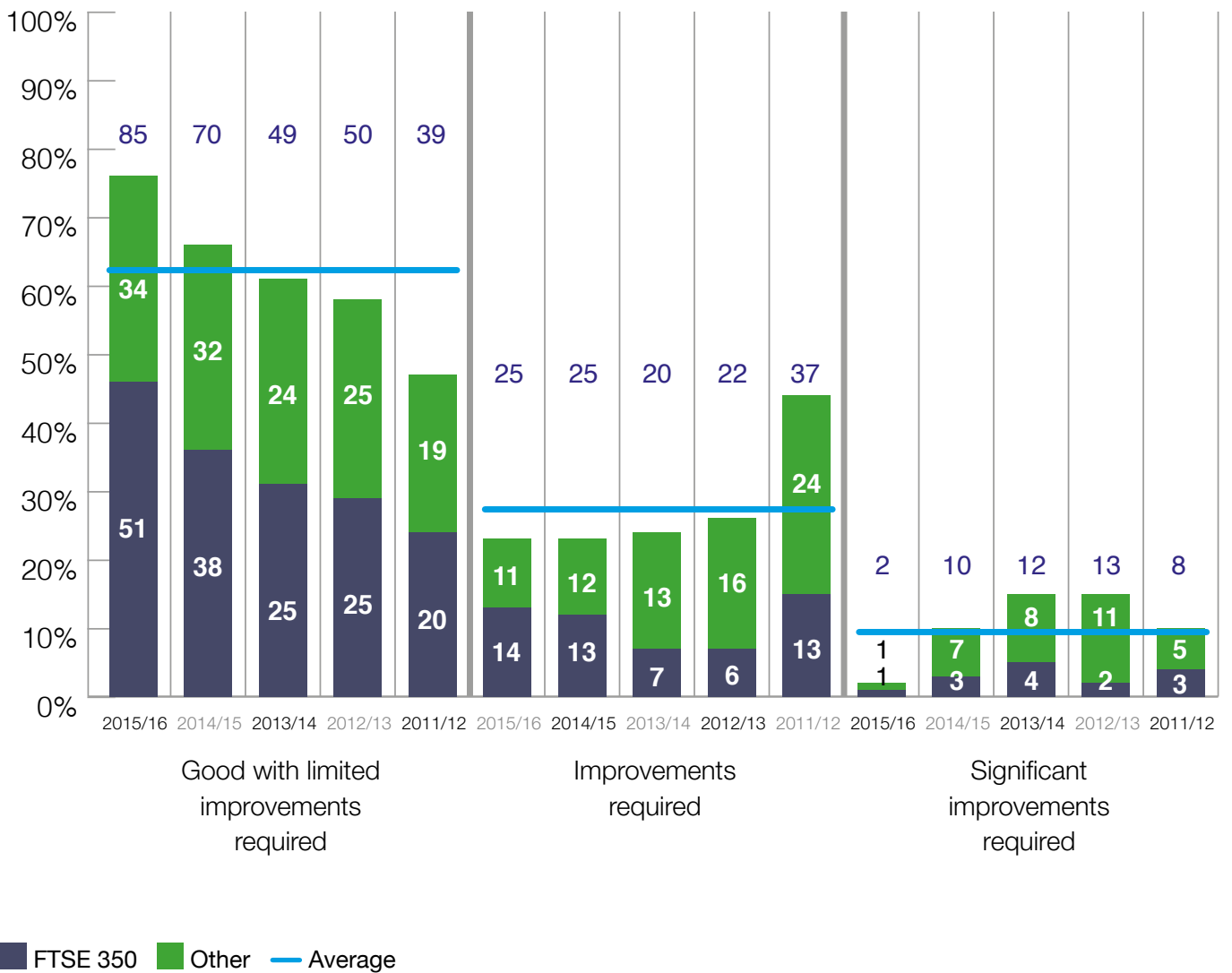
²³ This adjustment is necessary as one audit inspected in 2014/15 was audited by two separate firms

The number of audits inspected continues to increase, primarily at the Big Four firms. This is largely driven by an increased focus on FTSE 350 audits and reflects our response to the Competition and Markets Authority (CMA) recommendation that all FTSE 350 audits should be inspected on average once every five years.

UK and Crown Dependency audit firms: assessment of audit quality

The following chart (chart 11) provides an overview of the assessment of the quality of UK and Crown Dependency audit work inspected in 2015/16, with comparatives for the previous four years. The chart also shows the five year average for each of the reported audit quality categories.

Chart 11: Audit quality categories: All UK and Crown Dependency audit firms



Through our monitoring of audits undertaken by UK and Crown Dependency audit firms, we have observed:

- Improvement in the quality of audit work in 2015/16, with 76% of UK and Crown Dependency audits assessed as either good or only requiring limited improvements. This compares with 67%, 60%, 59% and 46% respectively in each of the preceding four years;
- The quality of FTSE 350 audits assessed in 2015/16 was similar with 77% categorised as either good or requiring limited improvements (70%, 69%, 68% and 56% respectively in the previous four years);
- The proportion of FTSE 100 audits assessed in 2015/16 as either good or requiring limited improvements was 65%. This compares with 50% in 2014/15. These results, while lower than those for the FTSE 350 as whole, reflect the greater complexities of FTSE 100 audits typically when compared with most FTSE 250 audits. Notwithstanding this, these results indicate a greater improvement in our assessment of audit quality for FTSE 100 audits inspected;
- A higher number of investment trust (or similar) audits were inspected in 2015/16 (28 compared with 12 in 2014/15). Audits of such entities tend to be more straightforward than the general population of audits inspected. A higher proportion were assessed as either good or requiring limited improvements (89% in 2015/16 compared with 83% in 2014/15). The higher proportion of audits of this nature inspected in 2015/16 would appear to be a factor in the improvement in the overall inspection results; and
- Only two audits were assessed as requiring significant improvements. This compares with 10 in the prior year. There were no common factors underlying the assessment of audit quality. No FTSE 100 audits were assessed as requiring significant improvement.

Analysis by firm

The following chart (chart 12) provides, on an individual firm basis, our assessment of the quality of the individual audits inspected. This analysis relates to the six firms where a separate inspection report was published in May 2016 and therefore does not include all audits reflected in the overall chart above.

In respect of the Big Four firms the analysis covers the last five years. For BDO LLP and Grant Thornton UK LLP these firms have only been subject to annual inspections since 2014/15. The analysis provided therefore covers the last three inspection periods with the earlier inspection covering a two year period (2011-13).



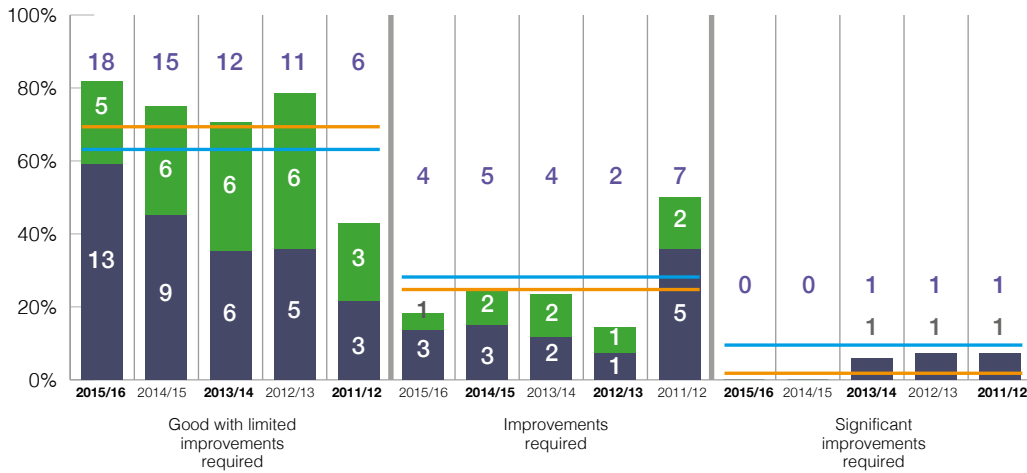
Improvement in the quality of audit work was observed in 2015/16, with 76% of UK and Crown Dependency audits assessed as either good or only requiring limited improvements. This compares with 67%, 60%, 59% and 46% respectively in each of the preceding four years.

A higher number of investment trust (or similar) audits were inspected in 2015/16 (28 compared with 12 in 2014/15). Audits of such entities tend to be more straightforward than the general population of audits inspected. A higher proportion were assessed as either good or requiring limited improvements (89% in 2015/16 compared with 83% in 2014/15). The higher proportion of audits of this nature inspected in 2015/16 would appear to be a factor in the improvement in the overall inspection results.

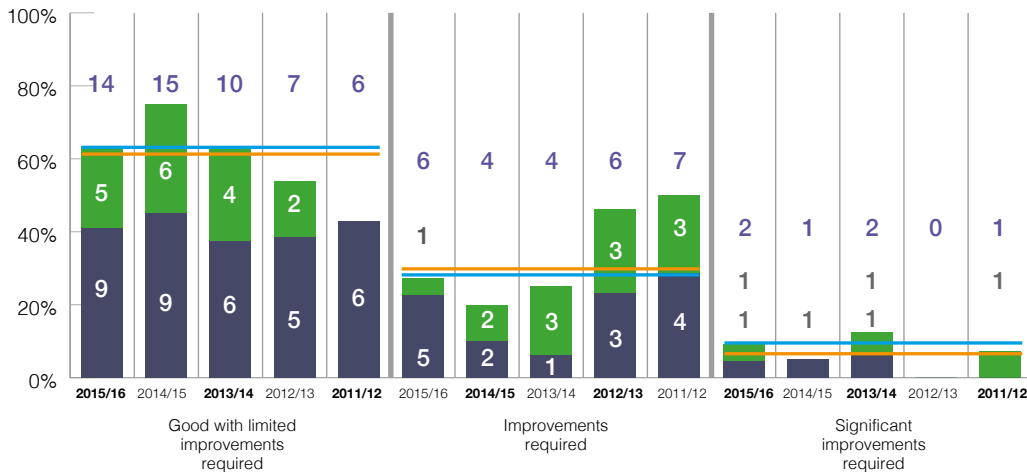
Only two audits were assessed as requiring significant improvements.

Chart 12: Audit quality categories: by firm

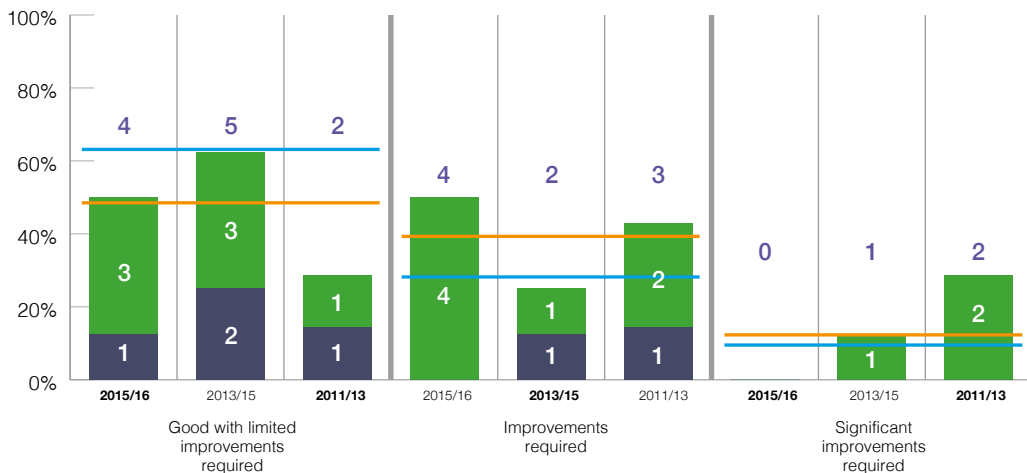
Deloitte



KPMG

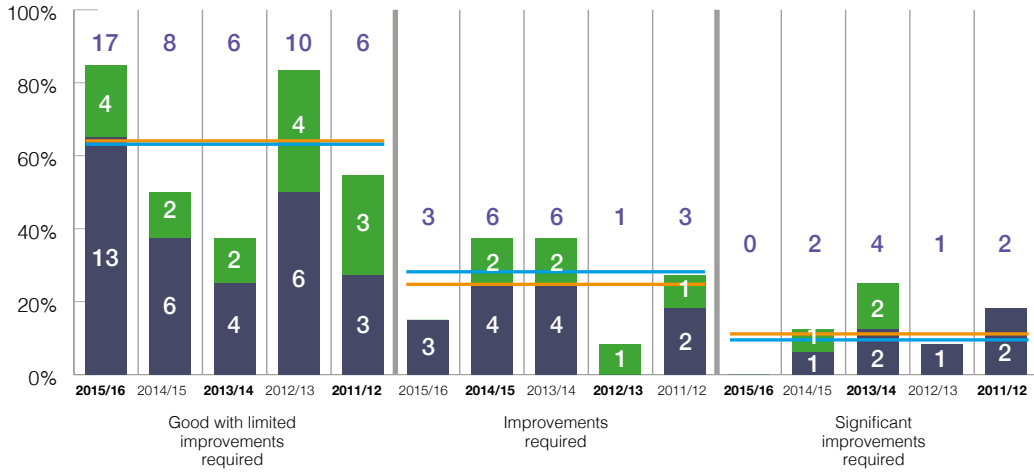


BDO

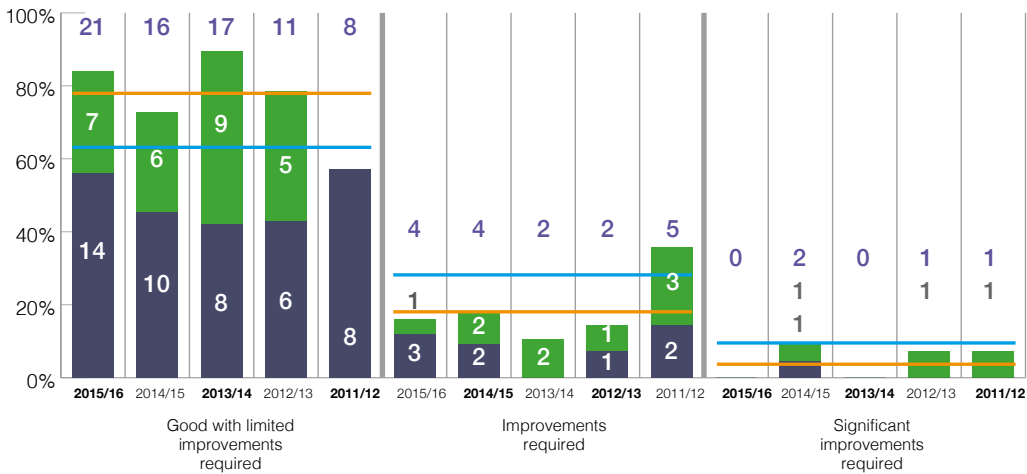


■ FTSE 350 ■ Other — Five year average – all firms — Five year average – individual firm

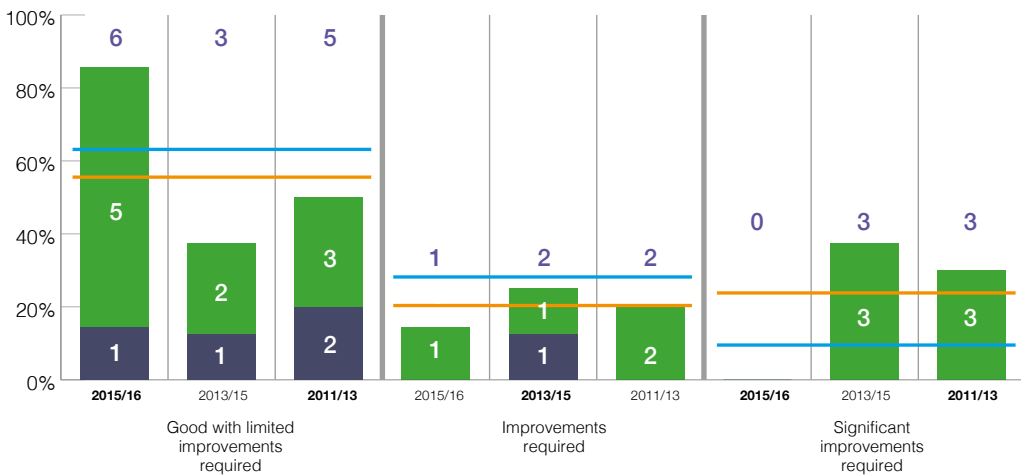
EY



PwC



GT



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.

The five year averages (both the overall five year average and the firm’s own five year average), however, are inevitably determined with a larger sample and are less volatile and therefore more reliable in assessing the audit quality of individual firms.

FTSE 350 inspection results

Our strategy for 2016/19 includes a measurement of improvement in audit quality such that at least 90% of all FTSE 350 audits inspected are assessed as either good or requiring limited improvements.

- The results to date show that good progress is being made towards our objective that 90% of FTSE 350 audits should be assessed as either good or requiring limited improvements.

- Performance against this target has improved at all firms, with one exception.
- The number of FTSE 350 audits inspected increased at the Big Four Firms but declined at both BDO LLP and Grant Thornton UK LLP. The latter two firms perform a limited number of FTSE 350 audits. As a consequence only one FTSE 350 audit was inspected in 2015/16 at these firms compared with three and two respectively in the prior year. The reduction in the number of audits inspected and the higher predictability of selection may be a factor influencing these results.

UK and Crown Dependency audit firm inspection findings

At the conclusion of the inspection of an individual audit engagement, findings are reported to the audit firm and to the audit committee to enable them to take action, where appropriate. The number of findings reported will depend on the quality of the audit work and the complexity of the key areas of audit judgement.

Set out below is an analysis of the findings reported in respect of the 113 audits inspected in 2015/16 (2014/15: 105).

Results show that good progress is being made towards the objective that 90% of FTSE 350 audits should be assessed as either good or requiring limited improvements.

Inspection findings: Overview	2015/16	2014/15
Audits where no findings reported	28	7
Audits where findings reported (see analysis below)	85	98
Total number of audits reported on (excluding third country and public sector)	113	105

Analysis of individual audit inspection findings	Number of findings	
	2015/16	2014/15
Fair value and value in use measurements	45	45
Revenue recognition	39	21
Audit committee communication	26	26
Internal control testing	17	18
Independence & ethics	14	10
Group audits	9	18
Audit finalisation	6	4
Inventory	8	13
Recoverability of tax and deferred tax	5	5
Fraud Procedures	5	15
Audit of allowance for loan losses and loan impairments	4	23
Adequacy of review and supervision	4	9
Adequacy of financial statements and disclosures	3	12
Other findings	5	19
Total	190	238

The number of inspection findings reported is now on average less than two per audit inspected. The five areas which account for 74% of the findings: Fair value and value in use measurements (24%); Revenue recognition (20%); Audit committee communication (14%); Internal controls testing (9%); and Independence and ethics (7%).

- The number of audits inspected where no findings were reported has increased from the prior year. This increase is consistent with the inspection results which continue to show a further improvement in the quality of audit work inspected.
- The number of inspection findings reported is now on average less than two per audit inspected.
- Fair value and value in use measurement continues to be the most common area in which we have found matters to be reported.
- The number of findings reported in respect of the audit of the allowance for loan losses and loan impairments has declined significantly from the prior year. The findings in the prior year were higher as a consequence of the banking thematic inspection which included the audit of loan loss provisioning as an area of particular focus.

The five areas which account for approximately 74% of the findings reported are:

- a) **Fair value and value in use measurements (24%)** - This category of finding is broadly defined with issues relating to the audit of impairment testing and investment property valuations featuring prominently;
- b) **Revenue recognition (20%);**
- c) **Audit committee communication (14%);**
- d) **Internal controls testing (9%);** and
- e) **Independence and ethics (7%).**

Fair value and value in use measurements

An appropriate level of challenge of management is important in ensuring a high quality audit of key areas of judgement in respect of fair value and value in use measurements. Effective audit teams will consider management's assumptions and compare these to available audit evidence and, where appropriate, challenge management in relation to the basis of those assumptions.

Consistent with our inspection findings in previous years, insufficient scepticism in challenging the appropriateness of key assumptions remains an important concern. We noted a number of examples where audit teams failed to challenge assumptions concerning profit forecasts, cash flow projections, growth rates and discount rates. The use of suitably experienced staff is essential to address this issue, through assessing and challenging these assumptions and management's other key judgements.

Revenue recognition

Our findings in respect of revenue recognition covered a wide range of revenue types and differing audit procedures but frequently related to insufficient or inappropriate procedures. Examples included the adequacy of substantive analytical procedures, in particular expectations being developed from independent sources and explanations being obtained and corroborated. Other issues included testing that did not cover revenue cut-off and insufficient testing of controls over revenue.

We have also seen firms' increased use of data analytics to audit revenue. We believe that this can be an effective means of auditing revenue but firms should ensure that additional audit procedures are performed to provide assurance over the completeness and, where relevant, the classification of revenue.

Audit committee communication

Timely and robust communications with audit committees is important in assisting them to fulfil their responsibilities in relation to the financial statements. These communications also assist the auditors and audit committees in understanding matters relevant to the audit and considering areas of risk and judgement that may affect the financial statements.

Our findings related to inadequate communication to those charged with governance of changes to the planned audit approach, control weaknesses and inaccurate reporting of the procedures performed in key areas of the audit. We also identified a few examples of late reporting to audit committees and insufficient face-to-face meetings between audit committees and auditors.

Internal controls testing

Testing the operational effectiveness of controls is necessary to provide the auditor with a proper basis on which to place reliance on them. This includes testing controls over IT systems including general IT controls, which relate to the IT environment such as the integrity and security of data, and application controls, which relate to the processing of transactions.

Our principal findings concerned the limited testing of certain controls which did not adequately cover each different type of transaction that the controls were designed to address and reliance on reports generated from IT systems where the completeness of the reports had not been adequately tested.

We also identified situations where substantive procedures had not been enhanced to compensate for the weaknesses in controls testing. It is important for audit teams to increase the level of substantive testing where the planned level of evidence is not obtained from controls testing.

Independence and ethics

A significant proportion of findings arising from our routine inspections of firms continue to relate to independence and ethical issues. We had findings in this regard at five of the six firms we inspected in 2015/16.

Firms are required to have policies and procedures in place to maintain auditor objectivity and independence. Insufficient monitoring of compliance with the firm's policies and procedures could compromise the firm's objectivity and independence.

We identified a number of ethical and independence issues, including a lack of consultation with ethics partners regarding the level of non-audit fees and monitoring procedures being insufficient to identify and report breaches on a timely basis. We were also concerned about the evidencing of appropriate consultation in respect of certain non-audit services where specific requirements and prohibitions apply under the Ethical Standards. A lack of appropriate policies or monitoring procedures relating to partners and staff holding prohibited investments in audit clients, or a failure to apply them consistently in practice, could compromise the actual or perceived independence and objectivity of firms' audit work.

Firms are taking steps to reduce the instances of partners and staff holding prohibited investments. We continue, however, to identify breaches of the Ethical Standards and remain concerned about the lack of progress in achieving significant improvements in this area.

As noted in the Looking Ahead section below, the ARD brings a strengthening of independence requirements with some additional restrictions on the services or extent of services which can be provided to audit clients. Audit firms will need to implement enhanced procedures to ensure compliance with the new standards and to reduce the frequency of issues arising in this area.

Firm-wide inspection findings

Our firm-wide inspection work comprised a review of the firm's policies and procedures supporting audit quality. The following findings were raised at more than one of the six firms in each case.

Technical consultations – These form an important quality control, especially for those audits identified by firms as being of the highest risk. Failure to monitor which engagements are likely to require technical consultations (for example, where the entity is in the FTSE 350) may call into question the quality control over such engagements. We noted a number of examples where firms had either failed to monitor whether an engagement should be subject to technical consultation or where the details of the consultation were not recorded.

Offshore centres – A number of the major firms use offshore audit centres. Their methodology and guidance set a range of procedures that the offshore staff may perform which require little or no audit judgement. We noted examples of audit teams using their own discretion in determining what procedures should be performed by offshore centres. We also saw instances where the work undertaken by offshore staff appeared to require significant judgement (for example, the review and summarising board and audit committee minutes).

Appraisals and recognition of good quality work – A number of firms apply a penalty system for engagement partners achieving poor audit inspection results. We noted limited evidence, however, to indicate that firms reward positive aspects of audit quality. It was also unclear, in a number of instances, whether poor inspection results impact Engagement Quality Control Reviewers.

Partner rotation – It is essential for firms to maintain an accurate and up-to-date database of partner rotations so that engagement partners do not suffer a perceived loss of independence through an overly long association with an audit client.

We continue to identify breaches of the Ethical Standards and remain concerned about the lack of progress in achieving significant improvements in this area.



Firms allocate a substantial amount of resources in monitoring their completed audits.

Firms should allocate an equivalent level of resource to monitoring their overall quality control systems but this is often not the case.

We noted a number of instances where firms either failed to keep an accurate and complete record of partner rotations or failed to identify a partner's involvement with a client in another capacity (for example, working on a significant overseas component or as the Engagement Quality Control Reviewer).

Thematic reviews

Thematic reviews supplement our annual inspections of individual audit firms. In these reviews we look in detail at firms' policies and procedures in respect of specific aspects of audit and their application in practice, to make comparisons between firms with a view to identifying good practice and areas of common weaknesses. The reviews are deliberately narrow in scope, and are chosen to focus on an aspect of audit in greater depth than is generally possible in our inspections, or because our inspection findings have suggested that there is scope for improvement in the area concerned.

During 2015, we undertook thematic reviews to consider audit firms' audit quality monitoring²⁴ and the role of engagement quality control reviewers in the audit as these are two key processes in maintaining and improving audit quality.²⁵ Nine firms participated in these reviews. We also undertook a third thematic review into the use of sampling in audits. The six biggest firms participated in this review.

Firm's audit quality monitoring

The firms' annual monitoring evaluates the effectiveness of both the firms' quality control systems and the quality of completed audits, identifying where improvements can be made. Firms allocate a substantial amount of resources in monitoring their completed audits. Firms should allocate an equivalent level of resource to monitoring their overall quality control systems but this is often not the case.

We were pleased to see that one firm had made a significant effort to increase the level of challenge and improve the robustness of their audit reviews. We were also pleased to see that all firms are developing root cause analysis to understand why the firms' quality standards have not been met, particularly in relation to audits. We will be considering this further in 2016.

Engagement quality control reviews

All firms have established engagement quality control review procedures for public interest financial statement audits. The engagement quality control reviewer (EQCR) should be a suitably qualified person, with sufficient and appropriate experience and authority to independently and objectively evaluate the significant judgements made by the audit team and the conclusions reached in formulating the audit report. Most firms have set adequate criteria for the qualifications,

²⁴ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Firms-audit-qualit.pdf>

²⁵ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Engagement-Quality.pdf>

experience and authority required to be eligible to take on the EQCR role. Whilst we saw a small number of audits where the EQCR had directly contributed to improving audit quality, we were disappointed that in one tenth of audits we reviewed the EQCR had not identified areas where the audit work needed to be improved.

Firms are developing their processes to improve the evidence of the EQCR's review and to assess the effectiveness of the EQCR in achieving the required levels of audit quality.

Audit sampling

Audit sampling is the application of audit procedures to less than 100% of items within a population to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. All firms have established methodologies for the use of sampling to both test controls and to obtain substantive audit evidence. Firms should consider whether the sample sizes calculated are sufficiently responsive to significant risks or the level of reliance being placed on the effective operation of entities' internal controls. They should also remind audit teams that their recommended sample sizes are minimum levels, particularly where sample size caps are used, and that teams should consider whether these should be increased. Firms should consider whether additional guidance is needed where audit teams are permitted to apply sample size caps.

Audit sampling remains an important tool for audit teams. Overall we identified many cases where auditors were using audit sampling appropriately in the audit procedures they performed. We did, however, identify some areas where auditors could improve their use and application of audit sampling. For example, to explain the judgements used in calculating sample sizes, to design control tests that obtain sufficient audit evidence that they are operating effectively throughout the period and to ensure that they obtain

sufficient and appropriate audit evidence for the items tested and carefully evaluate the results, dealing with errors or exceptions in an appropriate way.

Findings from our review of firms' transparency reports

The FRC has produced three reports looking at the content of transparency reports issued by audit firms, covering transparency reports issued in 2012, 2013 and 2014. The latest FRC report was published in March 2015. We will not be producing another report unless we have reason to believe that firms are failing to maintain standards.

Most firms produced a transparency report which meets the requirements and enables users to clearly distinguish one firm from another. We found minimal use of boilerplate statements.

The PRG produced additional Audit Quality Indicators (AQIs) for the first time last year which went beyond the requirements. We welcome such initiatives.

As part of our inspection of audit firms, the AQR looked at the 2015 transparency reports of the biggest six firms. We noted that the AQIs provided useful additional information to those wishing to understand firms' approaches to monitoring and improving audit quality and we are pleased that firms have made a good start in identifying and monitoring AQIs. We would, however, encourage the firms to gather the relevant data on a more consistent basis and follow-up the results more effectively (for example, by seeking to identify the root causes of matters arising).

Third Country Auditor inspections

Third Country Auditors (TCAs) are auditors of companies incorporated outside the EEA that have issued securities on EU regulated markets, which in the case of the UK means

Firms need to better evidence the EQCR's involvement in audits.

Firms have clear policies for use of sampling in audits. We found both good and poor examples of application of those policies in the audits we reviewed.

AQIs are beneficial to readers of Transparency Reports only if they are consistent and provide details of root causes and actions planned to address concerns identified.

the main market of the London Stock Exchange. The regulation of TCAs under the ARD is one of the responsibilities delegated by the Government to the FRC. The regulation includes registering audit firms as TCAs in the UK, and independent inspection of their relevant audit work.

We are required to undertake inspections of TCAs from countries where the European Commission has determined that the system of auditor oversight is not “Equivalent” or “Transitional” to that required within the EU. These are known as “Article 45” TCAs.

The total population of TCAs including those from equivalent or transitional countries is 108 TCAs with 205 issuers with UK traded securities across 45 Countries. At 31 March 2016 there were 45 Article 45 TCAs from 24 countries who audited 61 issuers with UK traded securities.

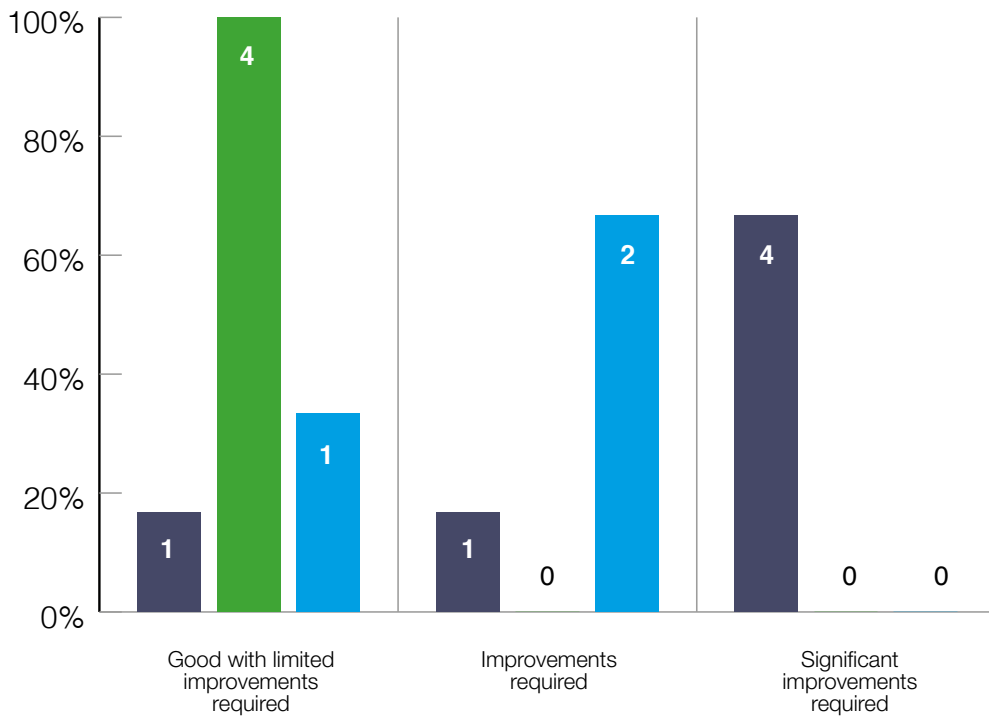
We commenced inspections of Article 45

TCAs in 2013/14. In 2015/16 six audits were inspected, one at each of the following firms:

- Deloitte Haskins & Sells LLP, India;
- Ernst & Young Servicios Profesionales de Auditoria y Asesora Limitada, Chile;
- Ernst & Young, Nigeria;
- Kesselman & Kesselman, Israel;
- KPMG India; and
- KPMG Zambia.

The following chart (chart 13) summarises our assessment of the quality of audits inspected in the last three years.

Chart 13: Audit quality categories: Third Country Auditors



■ 2015/16 ■ 2014/15 ■ 2013/14



The comparability of the results is limited given the different firms and locations inspected each year.

17% of the TCA audits inspected in 2015/16 were assessed as good or requiring limited improvements. We are undertaking follow up procedures at the firms assessed as requiring significant improvement in 2015/16 to ensure that, where necessary, robust action plans for future audits or other remediation actions have been put in place.

Set out below is an analysis of the findings reported in respect of the TCA audits inspected in 2015/16. Of the six audits inspected, findings were formally reported in respect of five audits (four audits in 2014/15).

17% of the TCA audits inspected in 2015/16 were assessed as good or requiring limited improvements. The comparability of the results is limited given the different firms and locations inspected each year.

Analysis of individual audit inspection findings	Number of findings	
	2015/16	2014/15
Fair value and value in use measurements	4	3
Going concern	3	-
Use of experts	2	-
Audit finalisation	2	1
Group audits	2	-
Adequacy of financial statements and disclosures	1	-
Audit of allowance for loan losses and loan impairments	3	1
Bank confirmations	1	-
Fraud Procedures	1	-
Risk assessment	1	-
Total	20	5

Consistent with our UK and Crown Dependency inspections, issues in respect of the audit of fair value and value in use measurements continued to be the most common findings identified from our TCA inspections in 2015/16.

In addition, we raised findings in respect of going concern and the use of experts which were not identified last year.

We found instances where the audit team did not evaluate the company's going concern assessment, and did not sufficiently review and assess the company's future cash flows and financing requirements.

We noted instances where management had relied upon the work of experts but the audit team did not plan and perform sufficient audit procedures to:

- evaluate the competence or objectivity of management's experts;
- assess the underlying information used by them; or
- understand and challenge the key assumptions used.

More generally there needs to be a greater awareness by TCAs that the financial statements must be audited, and reported on, in accordance with International Auditing Standards.

Local Audit inspections

The Audit Commission was abolished on 31 March 2015. Part of its responsibilities were taken on by Public Sector Audit Appointments Limited (PSAA), a transitional body responsible for overseeing the move to the new regime under the Local Audit and Accountability Act. All local authority and health body audits (Local Audits) are now undertaken by private sector audit firms and the audit quality monitoring framework put in place in England under this Act mirrors the arrangements set out in the Companies Act. The new arrangements for regulation of the auditors of the accounts of local authorities and some other public bodies are being implemented progressively. The first audits to be inspected by the FRC under the new structure will be in relation to accounts for the financial year ending 31 March 2018. We will be responsible from monitoring the quality of larger Local Audits and expect to assume these responsibilities from 2018/19.

In addition the FRC has been given delegated responsibility for recognising bodies as Recognised Supervisory Bodies (RSBs) and Recognised Qualifying Bodies (RQBs) for Local Audit purposes. To date ICAEW and ICAS have been recognised as RSBs for Local Audit from 1 November 2015 and CIPFA as an RQB since 1 October 2014.

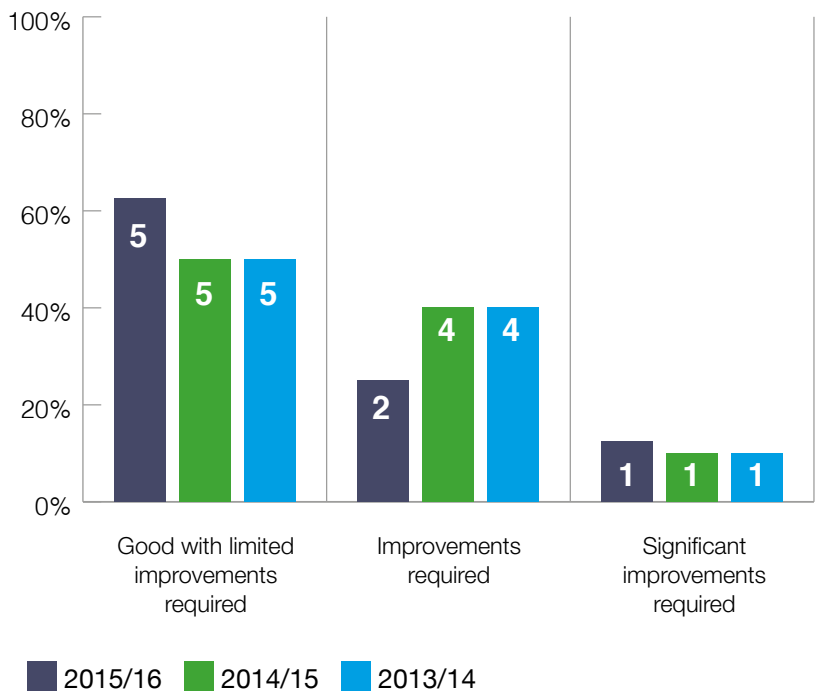
Prior to this we have undertaken inspections of Local Audits, on a contractual basis, on behalf of PSAA (and, prior to 2015, on behalf of the Audit Commission).

12 Local Audits were inspected in 2015/16, covering a mixture of financial statement and value for money audit work (11 in 2014/15 and ten in 2013/14). These three years cover the period in which Local Audits were undertaken only by private sector audit firms.

The following chart (chart 14) summarises our assessment of the quality of the financial statement audits inspected in the last three years.

63% of Local Audits were assessed as requiring limited improvements. No audits were assessed as good.

Chart 14: Audit quality categories: Local Audit



63% of Local Audits were assessed as requiring limited improvements and no audits were assessed as good (compared to 76% of UK and Crown Dependency audits assessed as either good or requiring limited improvements).

The proportion of Local Audits assessed as requiring significant improvements is also higher than for UK and Crown Dependency audits (12% compared to under 2%).

Independent supervision of the Comptroller & Auditor General and National Audit Office inspections

As the Independent Supervisor of the Comptroller & Auditor General, the FRC is required under section 1229 of the Companies Act 2006 to supervise the performance of the statutory audit work undertaken by the National Audit Office (NAO), which forms a small part of the NAO's activities. This inspection, which is undertaken annually, comprised the review of two statutory audits together with a review of the NAO's policies and procedures relevant to this audit work. None of the issues raised on either audit were considered to be significant. The FRC as Independent Supervisor is required to report on the discharge of its responsibilities annually to the Secretary of State and this reporting is within the FRC's Annual Report and Accounts, to be published later in July 2016.

The responsibilities of the Independent Supervisor do not extend to the other work of the Comptroller & Auditor General. However, at his request, we also reviewed four government department and public body audits.



PROFESSIONAL BODIES FOR AUDIT

This Section provides an overview of the FRC's statutory oversight of the regulation of auditors by RSBs and RQB in 2015/16.

Audit firms that wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, an RSB. Individuals responsible for audit at registered firms must hold an audit qualification from a RQB.²⁶

Oversight activities

We followed a risk-based approach to determine both the regulatory elements we should address in a particular year and our relative monitoring effort at the different bodies. In 2015/16, our 12th annual cycle of monitoring, our focus at the RSBs was audit monitoring, continuing professional development (CPD) monitoring and followed up actions taken by the bodies in response to our previous recommendations. At the RQBs, our focus was on student training records and the monitoring of approved training offices.

Our conclusions from our work during 2015/16 were positive and much of the regulatory practice we see at the professional bodies continues to be of a high standard.

The professional bodies continue to devote substantive resources to their regulatory responsibilities and are open to making improvements to their processes. We did however find the following matters in the course of our work:

- There continues to be work for the bodies to do to assist and encourage firms to improve and to ensure that their principals and staff complete the CPD needed to deal adequately with audit and financial reporting changes;

²⁶ The following bodies are both RSBs and RQBs: Association of Chartered Certified Accountants (ACCA), Institute of Chartered Accountants in England and Wales (ICAEW), Chartered Accountants Ireland (CAI), Institute of Chartered Accountants of Scotland (ICAS). In addition, the Association of Authorised Public Accountants (AAPA), a subsidiary of ACCA, is an RSB and the Association of International Accountants (AIA) is an RQB

- More needs to be done to ensure that both students and their employers record and review their practical work experience promptly and accurately; and
- Some FRC recommendations involve change over the longer term and we have sometimes found that progress in making these changes is slower than we would have hoped.

We will publish more detail on our oversight work and our findings within the FRC's Annual Report and Accounts later in July 2016. We comment below on the RSBs assessment of audit quality.

Recognised Supervisory Body audit monitoring findings

Overall audit quality, as assessed by the RSB's monitoring visits, is improving. The table below gives details of the number of audit monitoring visits conducted by the RSBs during the years ended 31 December 2011 to 31 December 2015 and the proportion of registered audit firms that were visited during these years. There was and remains a statutory requirement that the activities undertaken by each registered audit firm should be monitored at least once every six years.

Our conclusions from our work in 2015/16 are positive and much of the regulatory practice we see at the professional bodies continues to be of a high standard.

The professional bodies continue to devote substantial resources to their regulatory responsibilities and are open to making improvements to their processes.

		ACCA	ICAEW	CAI	ICAS	TOTAL
2011	No	373	716	22	56	1,167
	%	16.4	18.5	2.2	23.8	15.8
2012	No	579	691	126	40	1,436
	%	25.1	18.5	12.8	18.1	19.8
2013	No	471	670	169	41	1,351
	%	21.6	18.7	17.4	18.6	19.4
2014	No	398	656	224	39	1,317
	%	19.3	19.1	24.1	18.8	19.8
2015	No	505	615	244	38	1,402
	%	25.5	18.9	27.3	19.1	22.1

The tables below show the assessments for the audit monitoring visits during the years ended 31 December 2013 to 2015. While there are variations across the RSBs in the definitions of the “outcomes”, in each case A & B outcomes refer to compliance, in most respects, with applicable standards. At the other extreme, D outcomes indicate that further regulatory action is required. An N outcome is used where an assessment cannot be provided, such as if the firm wishes to continue with registration but has no audit clients.

ICAEW		2013	2014	2015
A & B Outcomes	No	399	416	420
	%	60	63	68
C Outcomes	No	136	115	83
	%	20	18	14
D Outcomes	No	64	69	48
	%	9	11	8
N Outcomes	No	71	56	64
	%	11	9	10

ACCA		2013	2014	2015
A & B Outcomes	No	323	284	363
	%	69	71	72
C+ Outcomes	No	35	32	43
	%	7	8	9
C- Outcomes	No	13	8	21
	%	3	2	4
D Outcomes	No	100	74	78
	%	21	19	15

CAI		2013	2014	2015
A & B Outcomes	No	61	130	130
	%	39	53	49
C Outcomes	No	27	35	22
	%	17	14	8
D Outcomes	No	70	81	114
	%	44	33	43

ICAS		2013	2014	2015
A & B Outcomes	No	24	21	28
	%	58	54	73
C2 Outcomes	No	6	5	4
	%	15	13	11
C1 Outcomes	No	6	11	3
	%	15	28	8
D Outcomes	No	5	2	3
	%	12	5	8

AUDIT ENFORCEMENT

This Section provides an overview of the cases which have been investigated and taken forward by the FRC under the Accountancy Scheme. In April this year the FRC established an Enforcement Division led by Executive Counsel in preparation for the implementation of the ARD in June and in June issued a new Audit Enforcement Procedure.

Overview of cases involving statutory audits

The FRC has invested considerable resources in enforcement activity over recent years, with a significant number of cases involving statutory audits²⁷. These cases are often complex and can take years to reach a conclusion. Notwithstanding this, since the FRC reform in 2012 there has been a concerted effort to conclude long standing cases.

In total 14 cases involving statutory audits have been concluded over the last five years, of which:

- seven cases were not pursued and were closed with no action being taken by the FRC;
- six cases, a total of 14 respondents, resulted in an admission of misconduct²⁸ and sanction either agreed by the subjects or imposed by Tribunal; and
- one case was contested and resulted in a finding of misconduct by Tribunal and sanctions being imposed.

The following tables set out details of these cases:

Cases closed with no action

Company	Auditor	Investigation announced	Investigation closed
Equitable Life Assurance Society	EY	26-Nov-08	17-Aug-12
Lehman Brothers Holding Inc	EY	16-Jun-10	22-Jun-12
BAE Systems plc	KPMG	25-Oct-10	01-Aug-13
Healthcare Locums plc	BDO	28-Nov-11	26-May-15
Barclays Capital Securities Limited	PWC	16-Dec-11	06-Dec-13
The Berkeley Group Holdings Plc	PWC	16-Sep-13	12-Jun-14
N/A ²⁹	EY	05-Dec-13	26-Sep-14

²⁷ The FRC can start a disciplinary investigation either by referral from one of the professional bodies or of its own accord. This will often follow the receipt of information from other regulators or similar bodies. In the majority of cases, related investigations are being, or have been, carried out by other regulators or similar bodies. These bodies include the Serious Fraud Office, Prudential Regulation Authority, Financial Conduct Authority, Lloyd's and The Charity Commission. In addition, there is often ongoing litigation against the auditors in relation to the matters we are investigating

²⁸ Acts or omissions by a member or member firm in the course of his/her or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a member or member firm or has brought, or is likely to bring, discredit to the member or the member firm or to the accountancy profession

²⁹ This case related to the non-timely disposal of a share-holding in an audited entity and the client in question was not publicised

Outcome of cases pursued

Company	Audit firm / Audit partner	Investigation Announced	Outcome	Date	Sanction	Costs
iSoft Group plc	RSM Robson Rhodes	25-Oct-06	Misconduct admitted Sanction by Tribunal	05-Oct-11	Fine £225,000	£750,000
iSoft Group plc	Glyn Williams	25-Oct-06	Misconduct admitted Sanction by Tribunal	05-Oct-11	Reprimand Fine £15,000	
European Home Retail Plc and Farepak Food & Gifts Limited	EY	04-Jun-07	Misconduct admitted Sanction agreed	12-Dec-13	Reprimand Fine £750,000	£425,000
Worthington Nicholls Group plc	HWCA	02-Oct-08	Misconduct admitted Sanction agreed	09-Apr-14	Severe reprimand Fine £225,000	£225,000
Worthington Nicholls Group plc	Paul Newsham	02-Oct-08	Misconduct by Tribunal Sanction by Tribunal	05-Sep-14	Exclusion for 3 years	
Presbyterian Mutual Society Limited	Moore Stephens	05-Aug-09	Misconduct admitted Sanction agreed	25-Jan-16*	Reprimand Fine £140,000	
Presbyterian Mutual Society Limited	David McClean	05-Aug-09	Misconduct admitted Sanction agreed	25-Jan-16*	Reprimand Fine £20,000	
Cable and Wireless Worldwide plc	KPMG	09-May-13	Misconduct admitted Sanction by Tribunal	04-Dec-14	Reprimand Fine £227,500	£38,896
Cable and Wireless Worldwide plc	James Marsh	09-May-13	Misconduct admitted Sanction by Tribunal	04-Dec-14	Reprimand Fine £39,000	
Pendragon plc	KPMG	09-May-13	Misconduct admitted Sanction by Tribunal	05-Dec-14	Reprimand Fine £162,500	£38,104
Pendragon plc	Gregory Watts	09-May-13	Misconduct admitted Sanction by Tribunal	05-Dec-14	Reprimand	
Manchester Building Society	GT	07-Aug-13	Misconduct admitted Sanction agreed	03-Jul-15*	Severe reprimand Fine £975,000	£85,000
Manchester Building Society	Alastair Nuttall	07-Aug-13	Misconduct admitted Sanction agreed	03-Jul-15*	Reprimand Fine £39,000	
Manchester Building Society	Marcus Swales	07-Aug-13	Misconduct admitted Sanction agreed	03-Jul-15*	Severe reprimand Fine £45,500	

Those cases marked with a * have concluded in 2015/16.

A significant number of older cases have been settled or closed.

Manchester Building Society

A settlement was agreed in July 2015 in connection with Grant Thornton UK LLP, Alastair Nuttall and Marcus Swales, audit engagement partners in relation to the audit of Manchester Building Society.

Those concerned admitted that their conduct fell significantly short of the standards reasonably to be expected of a Member Firm and Member. This followed an investigation into the audit of the fair value hedge accounting, which gave rise to a prior period adjustment in the financial statements of Manchester Building Society for the year ended 31 December 2012.

The parties agreed the following terms of settlement: Grant Thornton UK LLP were fined £975,000, contributed £85,000 to the Executive Counsel's costs and received a severe reprimand; Mr Nuttall was fined £39,000 and received a reprimand; Mr Swales was fined £45,500 and received a severe reprimand.

Presbyterian Mutual Society

A settlement was agreed in February 2016 in connection with the conduct of Moore Stephens in Northern Ireland (Moore Stephens (NI) LLP) and David McClean, audit engagement partner, in relation to the audit of the financial statements of the Presbyterian Mutual Society (PMS).

Those concerned admitted that their conduct fell significantly short of the standards reasonably to be expected of a Member Firm and a Member in that they failed to act in accordance with Fundamental Principle (C) 'Professional Competence and Due Care' of the Institute of Chartered Accountants in Ireland's (CAI) 2006 Code of Ethics for Members as:

- In relation to year ends 2007 and 2008, they failed to obtain an adequate general understanding of the legal and regulatory environment in which PMS operated for the purposes of the audit and, failed adequately to test the assumption on the part of PMS's Board and management that it was complying with its own rules and with applicable legislation and regulation and failed to apply professional scepticism and to obtain sufficient audit evidence to corroborate assurances and representations provided by management (including in particular by recognising or acting upon the need to consider or obtain specialist legal advice); and
- During the 2008 audit, they failed to adequately test management's assertions that the inadequacy of the liquidity levels at the 2008 year end would be remedied and had insufficient evidence to conclude that the going concern assumption was appropriate and that PMS's lack of liquidity had no impact on the audit opinion.

The parties agreed the following terms of settlement: Moore Stephens received a fine of £200,000 (discounted for settlement to £140,000) and a Reprimand; and Mr McClean received a fine of £29,000 (discounted for settlement to £20,000) and a Reprimand.

The amount of the agreed fines took account of the fact that Moore Stephens (NI) LLP is a legally distinct and economically separate entity from Moore Stephens UK Limited and Moore Stephens International Limited.

As of 31 March 2016³⁰ there were a further 15 cases where suspected misconduct in statutory audits was under investigation. The investigation continues up to the point when a Formal Complaint is delivered to the Conduct Committee, when that decision is usually made public.

Company	Auditor	Investigation Announced	Case Status
Cattles plc	PWC	23-Jul-09	Investigation ongoing
Tanfield Group	Baker Tilly	04-Nov-10	Complaint issued 11-Jun-14 Judicial review appeal hearing set for November 2016
Connaught plc	PWC	29-Nov-10	Formal complaint 12-Oct-15
Aero Inventory plc	Deloitte	03-Mar-11	Tribunal hearing held in May/June 2016
Equity Syndicate Management Limited	KPMG	06-Mar-12	Investigation ongoing
RSM Tenon	PWC	13-Aug-12	Investigation ongoing
Autonomy Corporation plc	Deloitte	11-Feb-13	Investigation ongoing
Nichols plc	Grant Thornton	06-Aug-13	Investigation ongoing
The Cup Trust	Hillier Hopkins	09-Dec-13	Investigation ongoing
The Co-Operative Bank plc	KPMG	20-Jan-14	Investigation ongoing
Computer 2000 Distribution Limited	EY	12-May-14	Investigation ongoing
AssetCo plc	Grant Thornton	12-Aug-14	Investigation ongoing
Tesco plc	PWC	22-Dec-14	Investigation ongoing
Quindell plc	KPMG	05-Aug-15	Investigation ongoing
Globo plc	Grant Thornton	21-Dec-15	Investigation ongoing

At the end of 2015/16 there were 15 cases where investigations were ongoing. Since then, four audit-related cases have been opened.

³⁰ This analysis was as of 31 March 2016. In the period from 1 April 2016 to publication a number of additional audit related investigations were announced. Reference is made to these in the overview section

In almost every case, subjects include the audit firm and the audit engagement partner. In some circumstances other senior members of the audit teams may also become subjects. Members employed within the reporting entities are also subjects of the investigation in some cases.

The breadth of the investigation varies. In some cases the investigation is confined to a single area of the financial statements, for example, hedge accounting. In other cases the investigation covers a wide range of issues throughout the financial statements, where it could be concluded that the audit was flawed throughout. Further issues may be identified during the investigation and the investigation may cover more than one accounting year.

Current investigations include the accounting for and audit of:

- impairment of loans;
- assets, including trade debtors, inventories, intangible assets and goodwill;
- long term contracts;
- capitalisation of costs;
- insurance syndicate’s reserves;
- revenue recognition;
- disclosure of a bank’s capital requirements;
- going concern and cash management and cut off; and
- acquisition accounting.

Cases involving independence and ethics concerns

We are currently investigating two cases specifically as to whether the auditor was independent when it conducted its audits

(Grant Thornton in relation to Nichols plc and KPMG in relation to Ted Baker plc).

In many of the other cases currently under investigation it is suspected that, in order to preserve their client relationship, the auditor has either allowed certain inappropriate accounting treatments or failed to obtain sufficient audit evidence.

Audit Regulatory Sanctions Procedure

Following an FRC inspection, the Auditor Regulatory Sanctions Procedure (ARSP) provides the FRC the power to independently determine sanctions against audit firms where an audit firm may have failed to comply with the regulations relevant to statutory audit. The purpose of sanctions for failure to comply with the regulatory framework for auditing is not to punish, but to protect the public and the wider public interest by encouraging improvements in the performance of the audit firm.³¹

Five matters arising from our 2014/15 inspection cycle were specifically considered under the ARSP. During 2015/16 the two matters still being considered at the date of our last AQR Annual Report were concluded without any sanction for the respective firms. In one case, the FRC accepted undertakings from the firm to address the agreed breach of the regulatory framework for auditing.

A further two matters have been considered under the ARSP in the 2015/16 inspection year. In one case, the matter was resolved without any sanction for the firm. However, changes have been made through the amendments to the UK Ethical Standards which address the concerns raised by the matter. The other matter was referred to the Conduct Committee in May 2016 to consider under the Accountancy Scheme. This matter related to compliance with UK Ethical Standards.

³¹ Further details of the ARSP can be found at: <https://www.frc.org.uk/Our-Work/Audit/Audit-Quality-Review/Auditor-Regulatory-Sanctions-Procedure.aspx>

Complaints and disciplinary procedures of the Professional Bodies

In addition to the sanctioning and enforcement powers exercisable by the FRC in cases which affect the public interest, the RSBs have their own procedures for investigating complaints and instigating disciplinary procedures against members and registered firms who fail to maintain high standards of practice or professional conduct.

The table below shows the number of audit related complaints received by the RSBs between 2013 and 2015. The table sets out the number of new cases, the number of cases passed to the FRC, the number of cases passed to the committee of the body, the number of cases closed in the year and the average time taken to close a case.

		ACCA	ICAEW	CAI	ICAS	TOTAL
Number of new complaints cases	2013	48	87	44	3	182
	2014	31	64	22	3	120
	2015	61	43	13	3	120
Number of cases referred to the FRC	2013	0	0	0	0	0
	2014	0	0	0	0	0
	2015	0	0	0	0	0
Number of cases passed to the committee	2013	8	49	11	2	70
	2014	27	56	21	1	105
	2015	14	29	13	1	57
Number of cases closed in the year	2013	16	61	4	1	82
	2014	31	86	25	2	144
	2015	60	46	12	4	122
Average time taken to close a case (in months)	2013	11.2	13	4.0	3.2	
	2014	5.0	13	3.6	2.9	
	2015	5.1	15	5.7	5.0	

FRC'S 2016/19 STRATEGY AND 2016/17 PLAN

In this Section we discuss our overall strategy and other key developments impacting our audit related activities in the 2016/19 strategy period and particularly in 2016/17.

Strategy

The FRC's strategic objective as set out in the 2016/19 strategy³² is to promote high quality auditing in the public interest and making effective use of the FRC's powers and influence as the UK Competent Authority for audit, responsible for overseeing the audit regime in the UK.

In doing so we have established the following key principles for audit:

- Audit and auditors are trustworthy, act with integrity, serve the public interest and consistently meet the objectives of audit and auditing standards;
- Audit is subject to appropriate oversight within a clear regulatory regime;
- Roles and responsibilities of auditors and audit committees are clear, and aligned with the interests and needs of investors;
- Audit is a sustainable business with adequate capacity, and sufficient levels of competition and choice;

- Audit innovates to meet changing business and economic circumstances to improve audit quality; and

- Global audits are effectively managed and overseen and quality is consistent across international work.

We have set out to: “establish a regulatory stance that promotes continuous improvement in standards of reporting and auditing. This will be based on a careful analysis of what constitutes good practice, and on identifying and addressing the root cause of problems. We will concentrate primarily on collaborating with market participants, focusing on action that helps companies and auditors improve standards. We believe that our approach will be effective in driving up standards without compromising our ability to take tough action when necessary.”

As outlined earlier, our aim is that by the end of the strategy period at least 90% of FTSE 350 audits will require no more than limited improvements as assessed by our monitoring programme.

Our focus is on promoting high quality auditing in the public interest as the UK Competent Authority for audit. We will work towards fostering continuous improvement by working closely with audit firms, the professional bodies and other stakeholders, including investors and audit committees.

³² <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-s-Strategy-for-2016-19.pdf>

In promoting justifiable confidence in audit we will need to increase our efforts to reach out to investors and non-executive directors, particularly those on audit committees. We will tailor material for these audiences and implement greater transparency of our audit monitoring as recommended in the 2015 review of our effectiveness.

Implications for the FRC of the ARD

Our 2016/17 plan³³ emphasises that: “our major task is to establish and make the most effective use of our responsibilities as UK Competent Authority for audit. This will require particular attention and additional resource in 2016/17. We will seek to ensure that the new framework established under the new ARD serves the interests of investors in the reliability of financial statements; and that it supports the UK audit profession in delivering statutory audit to the necessary high standards and with close regard to the public interest.

The EU adopted a revised Statutory Audit Directive and a new audit regulation in June 2014, with changes coming into effect in June 2016. The measures were developed in the aftermath of the 2008 financial crisis with the aim of strengthening the quality of statutory audits in the EU and restoring investor confidence in audited financial statements, in particular those of banks, insurers and large listed companies.

A survey, published in February 2016, by FT Remark, on behalf of EY³⁴, interviewed 100 UK-based FTSE 350 executive equally split between chief financial officers, tax directors and audit committee chairs. The survey concluded that “the new rules are seen in a positive light and are being welcomed”. Those interviewed did see potential risks in terms of transition costs and it was noted that the majority of respondents have yet to implement a full strategic plan.

In a number of respects the EU reforms reflect regulatory arrangements already in place in the UK. Making the necessary arrangements within the FRC, and working with the Department for Business, Innovation & Skills on the legislative framework, has been a major project over the last eighteen months.

There are significant impacts on most aspects of our audit regulatory responsibilities and an overall responsibility for oversight of statutory audit. Our governance and reporting arrangements have been reviewed accordingly. Of course in recent weeks the UK has voted to leave the EU. The regulatory framework will continue to apply as the UK responds to the outcome of the referendum on the UK's membership of the EU. We will pay close attention to the decisions now taken by the Government and Parliament, and continue to work in collaboration with our key stakeholders, particularly investors, business and the professionals we regulate, in order to ensure our work continues to support economic growth and the effective functioning of the capital markets. The FRC will continue to play its part in representing the interests of the UK internationally.

Independence, ethics and auditing standards

The requirements for auditor independence have been significantly strengthened particularly through tightening the restrictions on the provision by large audit firms of non-audit services to their audit clients. These changes are one of the drivers for the major revision of the FRC's Ethical Standards and underlie a number of recent changes to the FRC's Auditing Standards.

Regulation of statutory auditors

The UK implementing legislation provides that for the first time the FRC is the Competent Authority with overall responsibility for audit regulation in the UK and places a statutory responsibility on the FRC to undertake directly most regulation of audits of PIEs.

³³ <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Plan-Budget-and-Levies-2016-17.pdf>

³⁴ [http://www.ey.com/Publication/vwLUAssets/ey-a-change-of-perspective/\\$FILE/ey-a-change-of-perspective.pdf](http://www.ey.com/Publication/vwLUAssets/ey-a-change-of-perspective/$FILE/ey-a-change-of-perspective.pdf)

While the statutory regulation of auditors of non-PIEs will continue to be undertaken by the RSBs, the nature of the relationship between the FRC and those bodies will change, to provide a stronger basis for the FRC to oversee their audit regulatory work. Going forward the responsibility flows through the Competent Authority which has the specific ability to delegate regulatory tasks in respect of non-PIE audits, and with an expectation that in most respects the FRC will delegate. We have therefore developed arrangements for delegation, in consultation with the professional bodies, specifying the conditions under which those delegations are made.

Audit quality monitoring

Key changes affecting the FRC's audit quality monitoring activities are: the prohibition on the delegation of the inspection of auditors of PIEs to the RSBs; and the revised PIE definition.

For a number of years the FRC has taken advantage of the provisions within the Companies Act which permitted the inspection of those firms auditing ten or fewer entities captured by our inspection scope to be delegated to the professional bodies. This enabled us to focus our inspections on the very largest UK audit firms. Post the ARD all firms that audit PIEs (as redefined) will be required to be inspected directly by the FRC.

The definition of a PIE has been revised from just those entities with securities listed on a regulated market in the EU to also include all credit institutions (essentially banks and building societies and insurance undertakings). The FRC has taken the decision to limit our inspection scope to that required under the ARD (i.e. PIEs) and will consider retaining other classes of audit in agreement with the RSBs and/or on public interest grounds. Other categories of audits, such as large pension funds and charities, are no longer included within our inspection scope. We published details of AQR's revised inspection scope on 30 March 2016³⁵.

These changes, when taken together, will increase the number of firms inspected directly by AQR from nine to around 50. The frequency of these inspections will vary, with an inspection required once every three years for the majority of firms. The inspection cycle however can be extended to six years for those firms with only small or medium sized public interest entity audits.

We have also taken the opportunity to review which firms should be inspected more frequently. Currently the Big Four firms together with BDO LLP and Grant Thornton UK LLP are inspected annually with the results of these inspections reported publicly. From 2017/18 two additional firms (Mazars LLP and Moore Stephens LLP) will be subject to annual inspections and public reporting thereon. The revised PIE definition, and in particular the inclusion of unlisted insurance undertakings, has significantly increased the number of audits within our inspection scope that are undertaken by these firms.

Enforcement

Under the previous statutory framework, the Accountancy Scheme operated independently of the professional bodies as part of the bodies' disciplinary arrangements. The FRC as the Competent Authority is required to take direct responsibility for enforcement action where auditors of PIEs breach the relevant requirements laid down in the ARD. The FRC also operates an ARSP for matters flowing from audit quality review.

The FRC has developed a new Audit Enforcement Procedure³⁶ under which liability for enforcement action relates to a breach of a relevant requirement rather than the 'misconduct' test under the Accountancy Scheme. The ARSP is also superseded by the Enforcement Procedure.

The new procedure designed to enable constructive engagement and earlier disposal of matters, through an administrative process, compared to the Scheme.

³⁵ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/AQR-Scope-of-Independent-Inspection-2016-17.pdf>

³⁶ <https://www.frc.org.uk/Our-Work/Publications/Professional-Discipline/Audit-Enforcement-Procedures.pdf>

Other competent authority tasks

The FRC as Competent Authority is able to take decisions with PIEs in determining the application of some aspects of auditor appointment and independence. We will seek to be proportionate and transparent.³⁷

Market monitoring

The FRC, at least once every three years, together with the CMA is required to report to the European Commission on the size and scale of the statutory audit market and the role of audit committees. To facilitate this reporting we will continue to produce our annual key facts and trends document and to develop monitoring of and reporting on market developments, such as through an annual report on audit quality.

Concentration of the audit market means that the failure of any one of the largest audit firms would have a disproportionate impact on the functioning of the capital markets. Accordingly, the FRC will be encouraging the firms, professional bodies and other regulators to develop enhanced contingency plans.

CEAOB

European co-ordination of the ARD implementation is to be carried out by a new co-ordinating body, the Committee of European Auditing Oversight Bodies (CEAOB). The FRC will represent UK interests in its activities including at sub-groups on standards, inspections, enforcement and international equivalence assessments.

Developments in Standards and Guidance in 2016-19

Having issued a substantial body of revised audit-related standards and guidance on 17 June 2016, we will focus on effective implementation in liaison with auditors, audit committees and investors. We have established an advising group to assist in

identifying difficulties of interpretation and will co-ordinate consideration of these through the CEAOB.

In 2016/17 we will focus on updating sector specific guidance to reflect developments in the regulatory environment. We are working on guidance in relation to insurers, pension schemes and charities.

In the UK we use international standards as a base for our own, adding UK specific material as appropriate. We actively support the work of the IAASB, with the FRC's Director of Audit Policy being a member of the Board and an FRC Technical Director being a technical advisor of the Board. Through those roles we will continue to support the IAASB projects, focused currently on the topics of the audit of accounting estimates, quality control, group audits, professional scepticism, risk assessment, integrated reporting and other emerging forms of external reporting, and other topics such as data analytics and agreed upon procedures.

Audit Quality Review

In 2016/17 we will implement fully the agreed recommendations from an external review in 2015 of the effectiveness and efficiency of our monitoring activities. This includes: revamping our report on individual engagements to focus on what matters; making the findings more accessible and relevant to audit committees; more engagement with audit committee chairs before and after our inspection visit; promoting continuous improvements by reporting observed good practice; and by issuing thematic reports to also promote improvement and to "lift the lid" for investors on the audit process.

While our primary focus will be on improving the quality of auditing in the UK we will continue to play a leading role internationally to promote high quality audit across international networks on which UK investors rely.

³⁷ <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Processes-in-relation-to-PIE-Audits.aspx>

Our strategy of focusing on improving audit quality is consistent with that of other regulators internationally. The International Forum of Independent Audit Regulators's (IFIAR's) fourth annual survey of findings indicated that 43% of inspected audits of listed public interest entities had at least one finding. We engage with the Global Audit Quality ("GAQ") working group, which comprises the international networks of the six major audit firms³⁸ to understand their international strategy and role in ensuring audit quality across their international network firms.

IFIAR and the GAQ have entered into a new initiative to improve audit quality globally, with particular focus on effective root cause analysis by the firms and implementation of responsive actions. Progress will be measured over four years against a targeted reduction of at least 25% in the number of listed audits of public interest with at least one finding from inspections reported in the survey by certain IFIAR members.

We influence the development of the effective monitoring and enforcement procedures of our international counterparts through engagement with other national regulators and organisations such as IFIAR and the European Audit Inspection Group ("EAIG") which will develop into a CEAOB sub-group. Such engagement also enables the FRC to learn from the experience of overseas regulators.



Thematic reviews 2016/17

In 2016/17 we will conduct three thematic reviews to consider: the firms' performance of root cause analysis into the findings arising from both external and internal monitoring; the firms' use of data analytical tools in the audit and the firms' processes for achieving consistent audit quality.

Root cause analysis

Whilst there is no requirement in Auditing Standards to perform root cause analysis, firms are devoting more resources in this area to understand why audits have fallen below the standard expected according to internal or external reviews. Our review will consider how audit firms are developing their root cause analysis programmes and will focus on promoting best practice.

Firm's processes for achieving consistent audit quality

This review will consider what processes audit firms have in place to support the audit team in delivering a quality audit, for example, technical reviews of financial statements, internal reviews of audit work, use of specialists on audits. We will also evaluate the responsibilities in the firm for these quality processes.

Firm's use of data analytics in the audit

This is a developing area and audit firms are increasingly setting out in tender documents how they are going to make use of data analytics in the audit process to improve audit quality and bring more insights to management. We will focus on understanding the stage that audit firms have reached in developing their tools in this area and how frequently these are being used by audit teams. We will also look at a selection of audits to see how they are being used in practice. As this is a developing area our report will focus on what is working well so that best practice can be shared. We will use the information to inform the development of standards.

38 KPMG, PricewaterhouseCoopers, EY, Deloitte, BDO and Grant Thornton



Audit oversight

In 2015/16 our audit oversight work will develop to oversee the RSBs in their delegated regulatory tasks under arrangements designed to deliver on a common objective of high quality audit in the UK. The RSBs are thus integral to the achievement of the FRC's strategic objective for audit. We will be liaising with the RSBs on their regulatory plans and reporting to enable to FRC to discharge its oversight obligations.

In particular, our current perspective on audit quality has its limitations as it is drawn from a sample review of high risk audits at the largest audit firms and a small number of concluded audit-related enforcement investigations. We will work more closely with the RSBs going forward so we have a broader range of evidence from which to be able to draw more general conclusions as to the quality of audit in the UK.

Audit enforcement

In 2015/16 we will be focused on progressing the significant number of ongoing audit-related investigations under the Accountancy Scheme and seeking to implement the Audit Enforcement Procedure effectively and efficiently.

Promoting justifiable confidence in audit

This report is the first in a series of annual reports by the FRC setting out the 'state of play' for audit in the UK as seen by stakeholders and the FRC. It aims to set out what has been achieved and what still needs to happen. Our overall assessment is that quality is improving and perceptions of confidence in audit (based on stakeholder feedback) are improving. However, there is no room for complacency and much to do to effect continuous improvement.





UK Statutory Audit and the FRC's role

The FRC's mission is to promote high quality corporate governance and reporting to foster investment. The audit of the annual report and accounts is required in order to provide confidence in corporate reporting. The FRC contributes to justifiable confidence in audit and from 17 June 2016 became the UK's Competent Authority for audit, responsible for overseeing the audit regime in the UK.

In the UK, all companies are required to have an audit if two of the following criteria are met: turnover over £10.2 million, total assets over £5.1 million and over 50 employees. The threshold is determined by the government, based on EU legislation. The Government estimates that around 98,500 statutory audits are carried out in the UK annually.

In addition, based on the latest change to the audit exemption thresholds, the government also expects that other entities not required to undergo a statutory audit will choose to undergo an audit voluntarily. Statutory audits may only be carried out by those qualified with and registered to do so by recognised professional bodies. Total membership of these professional bodies continues to grow steadily. The seven bodies included in our "Key Facts and Trends" report³⁹ have over 342,000 members in the UK and Republic of Ireland and over 497,000 members worldwide. Conversely, the number of registered audit firms continues to fall gradually. The overall number of registered audit firms was 6,331 as at 31 December 2015, a fall of 4.6% since 31 December 2014.

UK Ethical and Auditing Standards and the UK Corporate Governance Code

We develop standards for auditors covering requirements relating to integrity, objectivity and independence as well as reporting and technical standards. We maintain the UK Corporate Governance Code including requirements for and guidance on audit committees.

Oversight of professional bodies for audit

By agreement, we delegate to Recognised Supervisory Bodies (RSBs) the registration, education, monitoring of and enforcement against auditors except where we retain such matters because they pertain to specified Public Interest Entities (PIEs) or have been agreed as being in the public interest. The FRC recognises five RSBs and oversees them in carrying out the delegated activities. There are six bodies in the UK, known as Recognised Qualifying Bodies (RQBs), recognised to offer the audit qualification. RQBs must have rules and arrangements in place to register students and track their progress, administer examinations and ensure that appropriate training is given to students in an approved environment. The FRC oversees the RQBs. We report on our oversight activities in our Annual Report and Accounts.⁴⁰

Monitoring of audit quality

We directly assess the quality of the audits of UK PIEs and the policies and procedures supporting audit quality at those firms that audit them. From June 2016 approximately 1,900 entities are within our scope for inspection across approximately 50 firms (up from nine firms inspected directly by the FRC previously). We also review 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. We carry out audit reviews under contract from the PSAA and the NAO and as the Independent Supervisor of the Auditors General.

Enforcement

We directly investigate and take enforcement action against auditors of PIEs and against members of the accountancy profession in cases of misconduct where it is in the public interest for us to do so. The RSBs investigate and take enforcement action against auditors in respect of other breaches of relevant audit requirements and in other accountancy matters; we oversee them in doing so.

³⁹ <https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-2016.pdf>

⁴⁰ Our Annual Report and Accounts for the current year will be published later in July 2016

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