



DEVELOPMENTS IN AUDIT 2015/16 AN OVERVIEW

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		

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.



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.



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.

We have also issued revisions to the UK 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



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



[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 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.





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" report¹⁶ 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.¹⁷

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.

¹⁶ <https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-2016.pdf>

¹⁷ Our Annual Report and Accounts for the current year will be published later in July 2016

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