

DELOITTE LLP

AUDIT QUALITY INSPECTION

JUNE 2017

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

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2017
The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368.
Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

About the FRC and its Audit Quality Review team

Our objective

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

What we do

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

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

The AQR team

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

Working with Audit Committees (or equivalent bodies)

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

Priority sectors and areas of focus

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

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

Thematic reviews

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

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

Developments in Audit 2016/17

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

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

¹ FRC Plan and Budget 2016/17

Financial Reporting Council

Deloitte LLP

Audit Quality Inspection

Contents

1	Overview	6
2	Key findings requiring action and the firm's response	11
	Appendix A – Audits reviewed in 2016/17	16
	Appendix B – Objectives, scope and basis of reporting	17
	Appendix C – How we assess audit quality	20

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

1 Overview

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

Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm’s audit work. Our findings include matters arising from our reviews of individual audits. We had no significant findings in relation to the firm’s policies and procedures which support and promote audit quality and we recognise the firm’s continuing work to enhance them.

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

Structure of report

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

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

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

Appendix C explains how we assess audit quality.

Scope of our 2016/17 inspection

We estimate that the firm audited 366 UK entities within the scope of independent inspection as at 31 December 2015. Of these entities, our records show that 251 had securities listed on the main market of the London Stock Exchange, including 19 FTSE 100 and 61 FTSE 250 companies.

We reviewed selected aspects of 23 individual audits in 2016/17. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The communications with the Audit Committee (or equivalent) and the audit of revenue were reviewed on nearly all of these audits. The other areas we reviewed across a number of these audits include the audit of impairment, taxation and defined benefit pension scheme balances.

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

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

The FRC issued a single revised Ethical Standard in 2016, effective at a firm-wide level from 17 June 2016 and applicable to individual audits for financial periods starting on or after this date. We discussed the firm's approach to implementing the revised Ethical Standard during our 2016/17 inspection. We will review this area in detail as part of our 2017/18 inspection, along with the firm's implementation of the revised UK Auditing Standards effective for financial periods starting on or after 17 June 2016.³

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

Progress made in the year

The firm has taken the actions they committed to take following our last inspection. Some of the issues driving more adverse quality assessments this year are in similar areas to those reported last year, although some audits reviewed were undertaken before these actions had been carried out. Our main concern continues to be the adequacy of audit teams' challenge of management in key areas of judgment (particularly goodwill impairment) and further immediate action is required to improve audit quality in this area.

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

- Strengthened the evidence of the Engagement Quality Control Review ("EQCR") partner and audit technical reviewer involvement.
- Updated Deloitte's audit methodology to include additional focus on risk assessment and the related audit response (effective from 31 December 2016 year-end audits).
- Introduced more focused coaching for audit teams throughout the audit process.
- Issued more timely and focused guidance and reminders to the audit practice on key audit matters, to facilitate appropriate consideration by audit teams at the key stages of the audit.
- Increased mandatory technical training for qualified staff through to partner level.

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

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

Good practice identified

Examples of good practice we identified in the course of our work include the following, in relation to certain individual audits that we reviewed:

- An effective audit of key management judgments made in relation to uncertain tax provisions, including effective use of tax specialists.
- High quality reporting to the Audit Committee in relation to property valuations.
- The quality of the group audit team’s planning and risk assessment procedures (particularly for significant risk areas) and their level of interaction with component auditors.

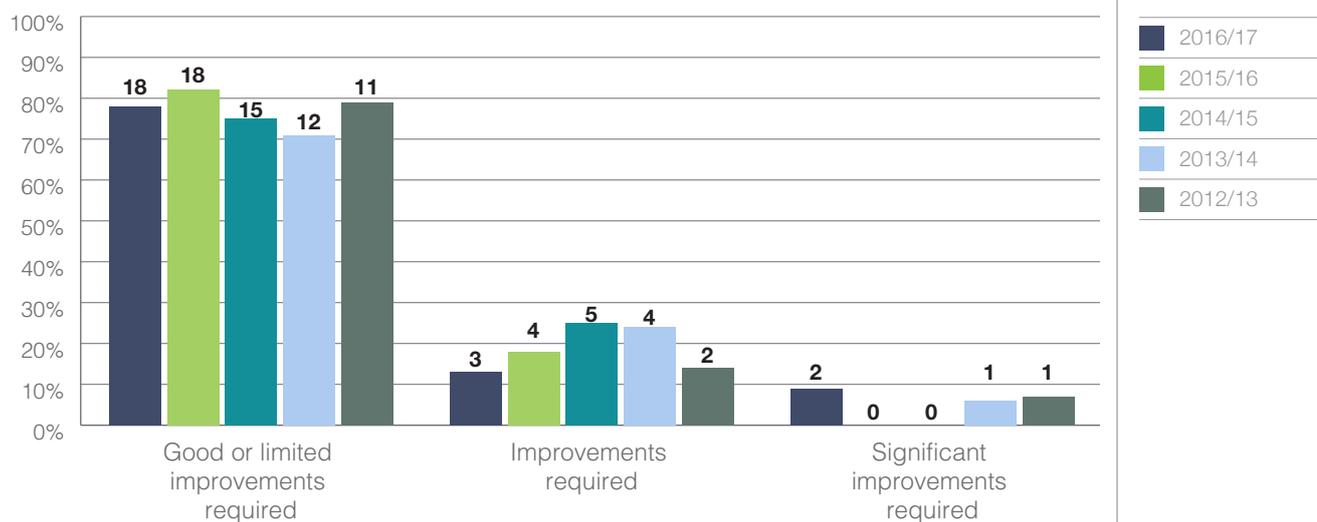
Key findings in the current year requiring action

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

- Improve the extent of challenge of management in key areas of judgment, in particular impairment reviews and valuation of acquired intangible assets.
- Strengthen the firm’s audit of revenue recognition.
- Make further improvements to the audit of defined benefit pension scheme balances in corporate entities.
- Continue to seek to improve the consistency of the quality of communications with Audit Committees.

Assessment of the quality of audits reviewed

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



Issues driving lower audit quality assessments

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

- Insufficient challenge of the adequacy of management’s impairment model, which was too high level, and insufficient challenge of management’s key assumptions relating to revenues and costs, contingencies and perpetuity growth rates.
- Insufficient procedures performed over revenue and accrued income, and an insufficient audit response to IT control weaknesses.

Root cause analysis

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

The firm has continued to develop its process for identifying the causes for inspection findings and has implemented a number of the recommendations from our thematic report on the subject, including improved training for those performing the RCA and an increase in its scope and depth.

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

Firm's overall response and actions:

We welcome this report from the FRC. We share the FRC's objective of promoting high quality corporate governance and reporting and we support and value the contribution made by the AQR via its audit inspection programme.

We were disappointed that, despite the high standards we set and many areas of improvement in our quality record, the percentage of audits rated as requiring more than limited improvements has remained broadly similar to the previous year and that two reviews resulted in those audits being scored as requiring significant improvement. We are firmly committed to achieving, and indeed exceeding, the FRC's objective that by 2019 90% of FTSE 350 audits reviewed will be assessed as requiring no more than limited improvements. We consider our results over the last 5 years and our continued investment in audit quality programmes indicate that we have built the right platform to do this.

We have implemented all the actions we set out in 2016. We have made further planned investments in our causal factor analysis team this year which creates a greater capacity to identify and respond to audit quality matters in a timely and accurate manner. This is evidenced by the immediate actions we took to enhance our audit procedures in the area of goodwill and intangible assets following the areas for improvement identified in the initial reviews of the 2015/16 cycle that had not been addressed by our previous actions. We established a Centre of Excellence and implemented a centrally controlled mandatory consultation process in relation to impairment reviews for public interest entities with material goodwill balances. Certain actions we take have a natural time lag before effectiveness can be assessed and we proactively monitor the effectiveness of all our actions to ensure that we can take further actions if appropriate. Impairment is an area of focus for our 2017 practice review.

We are pleased to note the positive examples highlighted by the FRC on page 8 on areas of judgment, audit committee reporting and risk assessment and that the changes we made in our quality review procedures which have resolved the issues identified previously.

In addition to the specific programmes we are implementing in response to each area, we will cover each of the matters raised in this report in detail at our Summer Technical Training and we have a variety of other quality related programmes being undertaken. Further, we will monitor the effectiveness of all our audit quality initiatives through our ongoing Audit Quality Monitoring and Measuring programme in which we have continued to invest and enhance each year.

2 Key findings requiring action and the firm's response

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

Improve the extent of challenge of management in key areas of judgment, in particular impairment reviews and valuation of acquired intangible assets

Impairment of assets and valuation of acquired intangible assets are highly judgmental areas, with scope for intentional or unintentional management bias. Audit teams therefore need to appropriately challenge management's assumptions and processes.

Given the level of audit risk and potential impact on the financial statements, we reviewed impairment of assets on the majority of audits that we inspected. For some of the audits we reviewed, reference was made to operational difficulties at the entity and the impairment models contained high forecast growth rates with limited available headroom (and were therefore highly sensitive to potential impairment). We also reviewed the valuations of acquired intangible assets for certain material acquisitions which were based on management's forecasts.

The audit of this area was still a major contributing factor to audit quality assessments on eight audits, including four where we assessed that more than limited improvements were required to the quality of the audit work. We identified the following concerns in relation to the extent of challenge of management by audit teams, or evidence thereof, on one or more audits:

- Insufficient evidence of challenge of management's assumptions over forecast cash flows supporting goodwill impairment reviews and intangible assets arising on acquisition. This related in particular to key assumptions over market share, pricing initiatives and operational improvements, discount rates, new business development and growth rates. Also, in one case there was insufficient challenge of management over the adequacy of an impairment model which contained a high level of contingencies; and in another an insufficient audit response to known historical budgeting inaccuracies.
- On the same audits, we had concerns over the adequacy of the auditors' consideration of sensitivity analysis for key assumptions.
- Insufficient audit procedures to assess the carrying value of certain intangible assets, particularly customer relationships.

The extent of challenge of management in relation to areas of judgment was raised as a key finding in our report last year. In the current inspection, we are concerned with both the number and significance of issues still arising in this area, particularly regarding the adequacy of audit work over goodwill impairment reviews. The firm needs to take further immediate action to address our concerns and to prevent similar issues arising on future audits.

Firm's actions:

We took immediate action when it became apparent that we needed to enhance our audit procedures in the area of goodwill and intangible assets despite our focus on the audit of management estimates in our 2016 Summer Technical Training.

We have developed an Impairment Centre of Excellence and have mandated its involvement in all public interest entity audits with a material goodwill or intangibles balance for years ending on or after 15 December 2016. The specialists within the Impairment Centre of Excellence, in addition to having significant experience auditing complex impairment issues, have had specialist training to be able to identify and respond to the issues raised in this report.

We will evaluate the success of our revised consultation approach, and assess whether to expand it or amend it, during the course of our 2017 internal quality review process.

Our Summer Technical Training in 2017 will include interactive workshops on this area including sharing anonymised findings from internal and external review to illustrate the types of challenge and extent of audit evidence that teams should seek to achieve in this area.

Strengthen the firm's audit of revenue recognition

Revenue is an important driver of an entity's operating results. Audit teams should therefore obtain sufficient and appropriate audit evidence in response to identified risks, including the risk of fraud, associated with the entity's revenue recognition practices.

We reviewed the audit of revenue on the majority of audits that we inspected and identified the following issues, each of which relates to a different individual audit:

- On a group audit where substantive analytical review procedures were used to obtain audit evidence for approximately 40% of group revenues, differences identified between expected and actual revenue figures were not always fully investigated and management explanations not fully corroborated to supporting evidence.
- Insufficient audit procedures in relation to accrued income and in response to identified IT control weaknesses.
- Appropriate audit evidence was not obtained over the completeness and accuracy of the underlying data used in the audit testing of unbilled revenue.
- Insufficient testing of key assumptions underlying certain contractual revenue streams.

Firm's actions:

These findings relate to individual issues specific to the audits reviewed, on which we have taken action to address the findings. However, revenue remains a critical focus of concentrated effort for our audit practice and we take the findings very seriously.

A key theme of the enhancements to our methodology in 2016, which were deployed after these engagements were completed, was to enhance our risk assessment procedures and, as a result, encourage our auditors to develop more robust responses to the largest most critical account balances, with a natural focus on revenue. This included the removal of capped sample sizes for very large balances and facilitation of a combination of test of details and substantive analytical procedures to enable more comprehensive audit responses to be designed.

This theme will continue in 2017 when our Summer Technical Training will showcase our investment in analytic tools applied to the audit of revenue. The focus on revenue will be further reinforced at this time, when we bring together our training on the accounting and auditing of revenue as we prepare to audit the implementation of the new revenue standard IFRS 15 'Revenue from Contracts with Customers' which is effective for periods beginning on or after 1 January 2018.

As with all changes of this nature, effective deployment of methodology enhancements is covered by our quality monitoring activities and will be an area of focus in our internal practice reviews in 2017.

Make further improvements to the audit of defined benefit pension scheme balances in corporate entities

Defined benefit pension scheme balances in corporate entities are often significant to the financial statements. Material adjustments arising from new valuation techniques can present audit challenges, as can the management of pension funds by custodians which are separate to the entity. Adequate procedures must be undertaken to obtain audit evidence for these balances and related disclosures.

We identified the following concerns on audits where we reviewed the work performed relating to defined benefit pension scheme balances in corporate entities:

- Insufficient evidence of appropriate challenge by the audit partner and the engagement quality control reviewer in concluding on a material reduction in a pension deficit.
- Audit teams either not obtaining direct independent confirmation of investments from scheme custodians or not receiving this on a timely basis.

The firm has taken certain actions in response to similar or related issues we raised last year but should consider whether further action is needed.

Firm's actions:

We note the matters raised above relate to the audit of pension balances within corporate entities and not to our audits of pension schemes themselves.

In relation to the single audit referred to above, we do not consider this a pervasive matter, rather a specific set of circumstances, but we continue to incorporate challenge of management as critical in our training materials and guidance.

We have improved our procedures to ensure confirmations are obtained from asset custodians where appropriate. In December 2015 we introduced a detailed practice aid dedicated to all areas of corporate pension balance auditing together with increased training.

We have also mandated consultation with our Pension Audit Centre of Excellence for years ending on or after 15 December 2016 and refreshed the practice aid. This ensures our corporate audit teams have access to our experts in the audit of pension balances.

A number of the AQR's reviews were undertaken before the changes have taken effect. We will monitor the effectiveness of the actions through our continuous Audit Quality Monitoring and Measuring Programme.

Continue to seek to improve the consistency of the quality of communications with Audit Committees

Audit Committees have a key role to play in overseeing the effectiveness of the audit. High quality communications with Audit Committees are therefore essential to safeguard audit quality.

We reported last year on a need to improve the quality of communications with Audit Committees on certain audits; but also that we had seen a number of examples of good quality communications on other audits. We again saw both examples of good quality communications and cases where improvements were needed in this area.

We refer in the overview section of this report to high quality reporting in relation to property valuations.

Issues arising on one or more audits included:

- The sufficiency of reporting on key areas of judgment, in particular in relation to impairment assessments and pension balances.
- The adequacy of the reporting on internal control deficiencies, including the audit response.
- A lack of clarity regarding the reporting on the audit approach to revenue.

Firm's actions:

We take our responsibilities for reporting to the Audit Committee very seriously. There is a natural follow on that if there is a failure in the underlying audit work we will inevitably fall short in our reporting on those areas. The majority of issues noted above link directly to the points earlier in this report.

We will continue to stress the critical importance of reporting matters to the Audit Committee in the training we deliver and in the enhanced procedures we have established, in particular around key management estimates and judgments. We have issued refreshed Audit Committee reporting templates to the practice reflecting the observations of the reviews to ensure audit practitioners continue to focus on this critical aspect of our role.

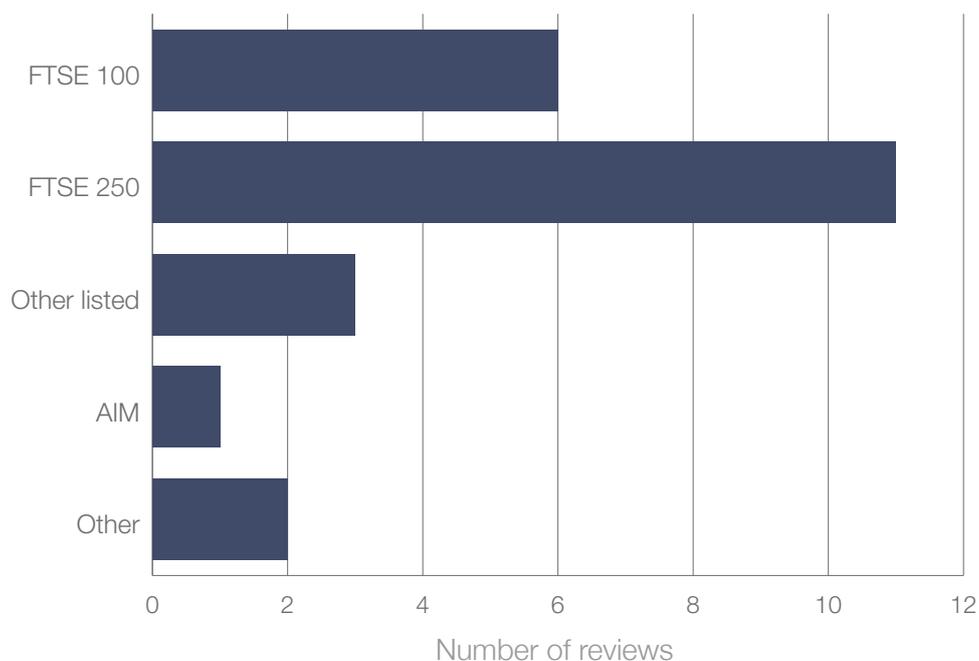
Audit Quality Review

FRC Audit and Actuarial Regulation Division

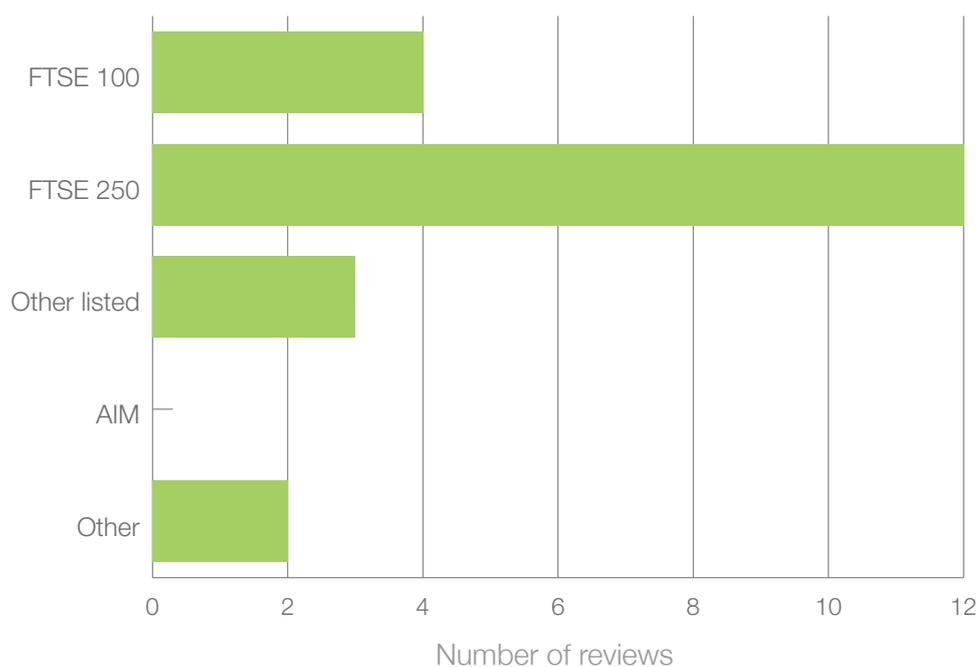
June 2017

Appendix A – Audits reviewed in 2016/17

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



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



Appendix B – Objectives, scope and basis of reporting

Matter	Explanation
Objectives of our inspection	<p>The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with Relevant Requirements as defined in the Statutory Audit and Third Country Auditor Regulations 2016 (SATCAR). A full list of the Relevant Requirements is set out at Regulation 5(11) SATCAR, and includes amongst other requirements, applicable legislation, the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies.</p> <p>The standards referred to in this report are those effective at the time of our inspection, or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.</p>
Audits in the scope of our inspection	<p>Our Audit Quality Review (AQR) team monitors the quality of the audit work of statutory auditors in the UK that audit Public Interest Entities (PIEs) and certain other entities within the scope retained by the FRC (these are currently large AIM entities and Lloyd's Syndicates). Monitoring of all other statutory audits is delegated by the FRC to Recognised Supervisory Bodies under a series of Delegation Agreements. The overall objective of our work is to monitor and promote continuous improvement in audit quality in the UK.</p> <p>In addition to the UK audits in scope, the UK firm audits a number of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area. These audits are inspected by us under separate arrangements agreed with the relevant regulatory bodies in those jurisdictions. The results of these reviews are included in this report. Our records show that, at the time of our inspection, the firm had 45 such audits, including three FTSE 100 companies.</p>
Impact of our risk-based inspection approach	<p>Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected for review and cannot be relied upon for this purpose.</p>

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

Matter	Explanation
Independence	<p>In line with legal requirements for the Competent Authority's independence from the audit profession, the FRC's funding is secure and free from undue influence by statutory auditors. All Board members, FRC decision-makers and AQR inspectors are subject to appropriate cooling-off periods from individual audit firms or the audit profession as a whole, depending on the nature and seniority of their roles. Our non-executives and staff are subject to requirements to avoid conflicts of interest by way of the FRC Code of Conduct and applicable staff terms and conditions and AQR inspectors are additionally required to declare that there are no conflicts of interest between them and the statutory auditor under inspection.</p>
Purpose of this report Disclaimer	<p>This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice. To the full extent permitted by law, the FRC and its employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.</p>

Appendix C – How we assess audit quality

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

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

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

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

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

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

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

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

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

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

+44 (0)20 7492 2300

www.frc.org.uk