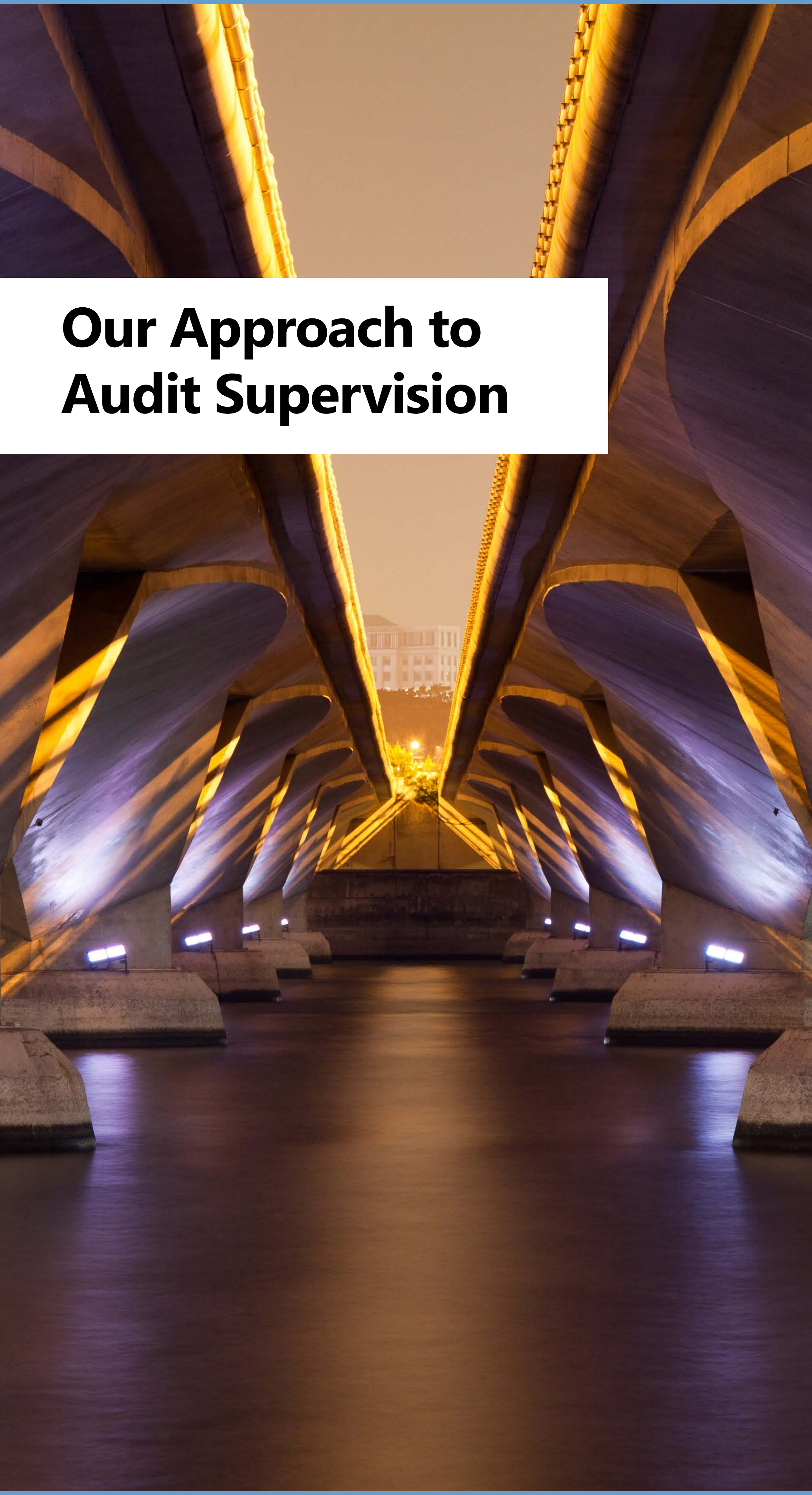
Financial Reporting Council

Our Approach to Audit Supervision



March 2021

We are responsible for the regulation of UK statutory auditors and audit firms and for monitoring developments, including risk and resilience, in the market. We aim, through our supervision and oversight, to develop a fair, evidence-based and comprehensive view of these firms, to judge whether they are being run in a manner that enhances audit quality and supports the resilience of individual firms and the wider audit market. We adopt a forward-looking supervisory approach to audit firms, and we hold firms to account for making the changes needed to safeguard and improve audit quality.

This publication serves two purposes. First, to aid accountability by describing what we seek to achieve by audit supervision and how we intend to achieve it. Second, to communicate to the firms performing statutory audits of public interest entities what we expect of them, in both requirements and practices and what they can expect from us in the course of supervision.
We will update it when we make significant changes to our approach to audit supervision – for example, following the planned changes for the FRC to assume operation of PIE audit firm and auditor registration – and when the FRC transitions to the new regulator: the Audit, Reporting and Governance Authority (ARGA).

Foreword by the CEO

Sir Jonathan Thompson
Chief Executive Officer, FRC

Auditors play a vital role in upholding trust and integrity in business by providing opinions on financial statements. The FRC's objective is consistently high audit quality so that users of financial statements can have confidence in company accounts and statements.

The FRC has revamped our approach to the way we supervise the largest audit firms through the creation of three teams – Audit Firm Supervision, Audit Market Supervision and Audit Quality Review (within the Supervision Division). Each of these teams have clear mandates to focus upon audit quality and firm resilience through their supervisory activity. Another key feature of our work is an emphasis on creating a culture of challenge in the firms.

This paper sets out the FRC's approach to the supervision of audit firms. Regular engagement with firms is a key part of ensuring good practice is disseminated and any concerns and issues can be raised as early as possible and rectification plans agreed.

That is in everyone's interest, not least the public interest.

Introduction

The FRC's purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit, and by holding to account those responsible for delivering them. We are the UK's statutory audit regulator. This means we:

- issue ethical, audit and assurance standards and guidance;
- inspect the quality of audits performed at public interest entities (PIEs[1]);
- set eligibility criteria for auditors and oversee delegated regulatory tasks carried out by professional bodies such as qualification, training, registration and monitoring of non-public interest audits; and
- bring enforcement action against auditors, if appropriate, in cases of a breach of the relevant requirements.

Overall, we seek to promote high audit quality and a resilient UK audit market.

In March 2021 the Department for Business Energy & Industrial Strategy (BEIS) published a consultation document, *Restoring Trust in Audit and Corporate Governance*, which proposes broader supervisory powers for the FRC/ARGA covering auditors, audit committees and directors. The legislation that follows the consultation process will create ARGA and provide it with further powers. This publication focuses on our current audit supervisory activities under existing powers in relation to firms that audit PIEs (PIE audit firms). The recognised supervisory bodies (RSBs) play an important role in the regulation of non-PIE audit firms and contribute to the regulation of the PIE audit firms. Appendix 1 summarises the delegation of certain statutory responsibilities from the FRC to the RSBs.

Overall, we seek to promote high audit quality and a resilient UK audit market

[1] Public interest entity – in the UK, PIEs are defined in the Companies Act 2006 (Section 494A of the Companies Act 2006.) as:
- Entities with a full listing (debt or equity) on the London Stock Exchange (Formally "An issuer whose transferable securities are admitted to trading on a regulated market". In the UK, "issuer" and "regulated market" have the same meaning as in Part 6 of the Financial Services and Markets Act 2000.)
- Credit institutions (UK banks and building societies, and any other UK credit institutions authorised by the Bank of England)
- Insurance undertakings authorised by the Bank of England and required to comply with the Solvency II Directive

1. Our approach to supervision and what we expect from firms

To ensure that the FRC's judgement is based on robust evidence, we have teams with relevant skills and experience. Our conclusions on audit inspections, and our thematic and firm-wide work, involve the judgement of our most senior and experienced staff. Supervisors reach judgements on the risks to audit quality and resilience at a firm and the actions needed to address those risks.

Our supervisory approach is forward-looking – identifying and prioritising what firms need to do to improve audit quality and enhance resilience and holding them accountable for delivering it. We seek to be transparent in our clear articulation of our expectations and concerns in private communications with the audit firms and other stakeholders, and in our public reporting.

We focus our risk-based supervision on those firms that have the largest share of the UK PIE audit market and thus where weaknesses in the firm would have the greatest impact on overall audit quality. In this way, we aim to be consistent in approach, build trust and also be proportionate.

Firms have an obligation under their professional bodies' membership rules to cooperate with the competent authority, so firms should be open, honest and straightforward in their dealings with us, taking the initiative to raise issues of possible concern at an early stage.

We engage with the senior leadership, independent non-executives and, where applicable, audit non-executives of the firms, using this dialogue both to ensure that we take account of all relevant information, and to communicate clearly what actions we think a firm should prioritise in order to promote audit quality and a resilient audit market. We do not expect firms to approach their relationship with us as a negotiation, including discussions on our assessment of an audit following an inspection. But, in coming to our judgements we will review the evidence presented by firms and listen to their views.

We seek to identify and spread good audit practice in order to help improve standards across the sector

We seek to identify and spread good audit practice in order to help improve standards across the sector: for example, we publish thematic reviews and report good practice points found in our inspections.

In line with our transparency objective, set out above, we report publicly (for the firms with the greatest public interest) on the work that falls within our current statutory remit. We report privately to smaller firms and in areas where our powers are more limited, summarising these results in our annual publication, *Developments in Audit*.

Our three supervisory teams

Our supervision of PIE audit firms, under our statutory responsibilities, is carried out by three teams, working closely together and in cooperation with colleagues in our professional oversight team, responsible for oversight of the regulatory activities of the RSBs, and our regulatory standards and enforcement divisions.

The three teams work closely together to develop an overall view of the key issues for each firm. We also work together to develop our plans for future supervision work. For example, issues identified as occurring regularly in audit inspections are considered as topics for thematic reviews; assessment of the effectiveness of a firm's implementation within its methodology to meet new auditing standards informs the scope of audit reviews; and concerns identified by a supervisor of a particular firm can be assessed for wider impacts by a piece of cross-market work.

Audit Firm Supervision

Audit Firm Supervision (AFS) is responsible for our overall supervision of the firms, drawing together the results of work undertaken by the other two teams as well as other areas of the FRC. It will lead our work on registration of PIE auditors and audit firms after the FRC takes over that function, planned for 2022.

Audit Market Supervision

Audit Market Supervision (AMS) takes a cross-market approach to areas of importance to audit quality and firm resilience, including the firm-wide inspection work to ensure compliance with the International Standard on Quality Control (ISQC 1). Staff have a range of backgrounds (governance, risk management, internal audit, culture, regulation, and audit) representing the broad subject matter within the team's remit.

Audit Quality Review

Audit Quality Review (AQR) is made up of suitably qualified and skilled staff with previous audit experience, including sector and IT specialists. It undertakes inspections of PIE audits, but also (by separate arrangements) Crown Dependency and major local audits undertaken by the PIE audit firms. AQR also performs full scope inspections of the National Audit Office, third-country audits and certain Crown Dependency audit firms.[2]

Governance

Our supervisory work is overseen by the FRC Board, supported by the Supervision Committee of the Board, to which it delegates some of its responsibilities. The Board is made up of non-executives and the chief executive. All Board members are appointed by the Secretary of State for Business, Energy & Industrial Strategy.

The Board's role is to provide strategic leadership of the FRC within a framework of prudent and effective controls that enable risk to be assessed and managed. The Board sets the FRC's strategic aims, ensures that the necessary financial and human resources are in place for the FRC to meet its objectives, and reviews management performance. The Board also sets the FRC's values and culture, and ensures that its obligations to its stakeholders and others are understood and met.

Working with other parts of the FRC

Our supervisory activities, including audit selection, identification of areas of focus and potential thematic reviews, are informed by regular dialogue with the Audit & Assurance team (responsible for setting auditing and ethical standards) and the Economics, Strategy & Analytics team (which provides market intelligence that informs our selection of audits to inspect and priority sectors).

As well as gaining technical auditing advice from the Audit & Assurance team, our staff are supported on corporate reporting issues by dialogue with the Corporate Reporting Review team, which reviews the directors' reports and accounts of public and large private companies (subject, where necessary to protect confidentiality, to suitable safeguards).

Our overall supervision of the firms draws together the results of work undertaken by all three teams as well as other areas of the FRC

[2] The focus of this document is on the PIE audit work undertaken by UK PIE audit firms.

In turn, the findings from our inspection work provide feedback and evidence for the Audit & Assurance team in their considerations regarding future developments in both UK auditing and ethical standards and their work to influence the development of international standards.

The Audit & Assurance team also has regular roundtables with the ethics partners of the largest firms and hosts technical advisory groups to provide a forum for discussion of topical issues for the wider audit market.

Our work can also lead to formal investigations into individual audits or the quality control arrangements in place at a firm. This is undertaken by the FRC's Enforcement Division (see Section 4 for more information).

The Professional Oversight Team is responsible for overseeing the work that the RSBs undertake in respect of audit quality of non-PIE audits at the PIE audit firms and audits at the non-PIE firms (see box). Among other activities, it 'shadows' the inspection work of the RSBs' quality assurance teams.

All these interactions form part of a rich feedback loop between standard setting, supervision and enforcement across the profession.

There is a rich feedback loop between standard setting, supervision and enforcement

Working with other regulators

Communication with other regulators, in both the UK and internationally, is important for our work as explained below.

Communication with other regulators is important for our work

Recognised Supervisory Bodies (RSBs)

As well as being chartered accountancy membership organisations, the RSBs (ICAEW, ICAS, CAI, ACCA) – recognised under statute – are delegated certain tasks by the FRC and perform an important role in the regulation of audit, including inspecting audits of entities that are not PIEs at both the PIE and non-PIE audit firms.

Prudential Regulatory Authority (PRA)

We share information with the PRA, primarily to inform the PRA of audit issues which may be relevant to its supervision of banks and insurers. Reciprocally, our risk assessment and audit file selection process is informed by information received through regular dialogue with the PRA. The FRC and the PRA meet regularly to discuss risks in the sector and share experiences in respect of financial services accounting and auditing.

Financial Conduct Authority (FCA)

We collaborate with the FCA (and the PRA) on matters related to individual entities and the wider financial markets. During the COVID-19 crisis we have issued joint guidance[3] with these other regulators on corporate reporting and audit.

International Forum of Independent Audit Regulators (IFIAR)

The largest UK audit firms are part of global networks with member firms in many other jurisdictions. Audit is regulated at a national level and IFIAR brings together independent audit regulators from around the world. The FRC is a member and actively contributes to its activities. IFIAR regularly engages with the global network firms to influence their continual improvements to audit quality. It enhances the capabilities of its members through consultation, training, and a collaborative, knowledge-sharing network. The ultimate goal for this collective activity is to improve audit oversight worldwide and advance sustainable, high-quality audits.

[3] Covid guidance can be found here: https://www.fca.org.uk/news/statements/fca-and-frc-joint-statement-reminding-companies-extended-financial-information-timelines-continue

The FRC also has regular bilateral conversations with other international audit regulators in key financial markets so that we can share good practice, discuss emerging and evolving concerns, and develop ways to support audit quality and promote audit market resilience. We also undertake joint inspections of the audits of entities of mutual interest.

2. Focusing on those firms that have the greatest impact

Our audit inspection programme has always been risk-based and focused primarily on those firms carrying out audits in which the public interest is greatest. We review the largest seven firms annually, which together audit approximately 2,000 PIEs, including all UK-incorporated FTSE 350 entities. Around 30 firms audit the remaining (circa 200) PIE audits, based on the current definition of a PIE. Of these firms, only a few audit a significant number of PIEs and these are inspected at least every three years. The remainder audit fewer than five PIEs and we inspect those firms at least once every six years.

Taking a similar, proportionate approach, we vary the intensity of our forward-looking supervisory work across three tiers of PIE audit firms.

Tier 1 firms are usually on an annual AQR inspection cycle and have an allocated supervisor. We also assess firm-wide audit quality controls (ISQC 1) annually and carry out other cross-firm thematic reviews. Tier 2 firms either have several PIE audits (e.g. ten or more) and/or other risk factors apply, for example based on growth plans or specific risks to audit quality. Tier 2 firms are typically on a three-year cycle for individual inspection and firm-wide work. However, we may accelerate both individual reviews and the frequency of firm-wide work to address risks. The remainder of the PIE audit firms fall into Tier 3. These firms are usually on a six-year cycle of individual inspection and firm-wide work, which may be accelerated if appropriate.

Each year in our supervisory letter, firms are informed as to which tier they have been assigned, which provides a broad indication of the level of supervisory activity to expect. We will write to inform all firms auditing PIEs of their initial tier in April 2021 and firms will be aware of likely future changes to their tier allocation.

The following table summarises our approach across the three tiers. More details on the various activities noted in the table are provided in Section 3.

	Tier 1 firms	Tier 2 firms	Tier 3 firms
Effective date	1 October 2020	1 April 2021	1 April 2021
Current allocation of firms (subject to change as the market evolves)	Largest seven firms[4]	A further five to seven firms, based on our risk assessment. Firms with more than ten PIE audits are likely to be in this tier	Remaining PIE audit firms
Supervisory activity			
Engagement Framework of regular meetings	Full	Independent non-executives (INEs), senior partner and head of audit meetings only	No

[4] BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, Mazars LLP and PwC LLP

To be proportionate, we vary the intensity of our forward looking supervisory work

	Tier 1 firms	Tier 2 firms	Tier 3 firms
Audit inspections	Usually annual (typically at least five audits)	Typically a three-year cycle (two or three audits) Annual risk-based sample of firms	Three or six-year cycle plus ad hoc to address risks (one or two audits)
Firm-wide work on audit quality controls (ISQC1)	Annual (topics addressed in rotation over a three-year cycle)	Smaller firms programme as part of AQR audit inspection; may be extended at our discretion	Smaller firms programme as part of AQR audit inspection
Review of root cause analysis (RCA) and action plans	Yes	In depth in year of AQR audit inspection plus annual updates	Three-year cycle – yes Six-year cycle – no
Supervisory pillars	Full scope	At our discretion	No
Pre-appointment meetings	Yes	Head of audit only	No
Risk reporting protocol	Yes	Yes	No
Conveying supervisory messages			
Annual supervisory letter	Tailored, annual, September 2021 onwards	Tailored, annual, end 2021 onwards	Generic, annual, end 2021 onwards. Risk-based additional tailored elements based on monitoring activity
Firm-level reporting	Public	Private	Private
Individual audit inspection reports[5]	Yes	Yes	Yes
PIE auditor registration			
PIE audit firm and auditor registration (planned from 2022)	Yes	Yes	Yes

[5] Provided to the audit firm and the audit committee chair of the entity.

3. Supervisory activities

This section describes how, in practice, we supervise firms in Tier 1. Tier 2 and Tier 3 firms are subject to some elements, as set out in the table in Section 2.

Our supervisory work comprises the following types of activity

Engagement framework of regular meetings

Our supervision involves engagement with firms at all levels of seniority. At a senior level, key role holders should expect regular dialogue with us, either in groups or on an individual basis.

To inform our overall supervisory activity, develop and maintain productive relationships with the firms and hold senior individuals at the firms to account, we have a programme of regular meetings, known as the engagement framework. For each Tier 1 firm we hold twice-yearly meetings as follows:

- INEs (without the attendance of partners or staff from the firm)
- Audit non-executives (for firms that have operationally separate audit practices, without the attendance of partners or staff from the firm)
- Firm Leadership (the individual in the senior partner/chief executive role, or equivalent)
- Audit Leadership
- Ethics Partner
- Risk Leadership (the individual in the chief risk officer role, or equivalent)

To maintain our proportionate approach, the programme is reduced for Tier 2 firms at which we meet with INEs, firm leadership and audit leadership only. We do not meet routinely with senior management of Tier 3 firms, except in the course of audit inspections.

Audit inspections

We select individual audits for inspection from a firm's audit portfolio balancing several factors including: the size of the entity, the risk associated with the audit, how recently we inspected audits of that entity previously and the grading of those inspections, and random selections. We aim to inspect audits of all FTSE 350 companies at least every five years.

In recent years, our audit inspection activity has become more focused on the audits where we might be more likely to find significant issues with audit quality and where the lack of high-quality corporate reporting will have the most adverse impact.

Factors that may indicate high audit risk include where the group or entity:
- is in a high-risk sector or geography.
- is experiencing financial difficulties and/or has a volatile share price and high short-selling interest.
- has balances with high estimation uncertainty; or
- where the auditor has identified governance or internal control weaknesses in previous years.

The risk to audit quality also increases where audit teams are required to assess and conclude on complex issues of judgement, for example:
- materiality becomes a key factor in determining the significance of audit judgements for entities that have low profitability;
- headroom on impairment assessments may be lower and the entity's balance sheet may be more sensitive to changes in key assumptions; and
- going concern assessments are less clear cut.

Key role holders should expect regular dialogue with us

We maintain the flexibility and discretion to alter the specific file reviews and overall number of inspections in response to the changing market environment and where the nature of the company and its audit poses new or difficult challenges.

Our inspectors do not review an entire audit but rather focus on areas of higher risk. Our reviews of individual audits place emphasis on the appropriateness of key audit judgements made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained.

Following each inspection, we form a view on the quality of the audit work we have examined and provide an overall assessment for each audit.
1 – Good;
2 – Limited improvements required;
3 – Improvements required; and
4 – Significant improvements required.

The outcome of each review is reported to the audit firm and to the audit committee chair of the audited entity.

The quality and consistency of individual audit inspection work is supported by our two-stage quality control (QC) process (including a panel of senior AQR staff and then executive review by a director). At both stages there is an independent review of the evidence used to support the assessment rationale and challenge of the inspection team on their findings and conclusions.

Final decisions on gradings of individual reviews rest with the director of AQR (or with the executive director supervision where the director of AQR has been directly involved in the quality control process as the Executive Reviewer). The director of AQR can seek advice from the FRC's senior advisers[6] and members of the FRC Advisory Panel[7] for example on reviews where grading decisions are complex and/or finely balanced. By exception, firms can request that gradings are reconsidered independently of the FRC staff who were involved in the inspection and original decision.

Firm-wide reviews of audit quality controls (ISQC 1)

ISQC 1 sets out the quality control requirements for firms that perform audits, reviews of financial statements and other assurance and related engagements. It requires the firms to establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance;
- Monitoring.

Our reviews of individual audits place emphasis on the appropriateness of key audit judgements

[6] Details of the FRC's senior advisers can be found here - https://www.frc.org.uk/about-the-frc/structure-of-the-frc/frc-s-senior-advisors
[7] Details of the FRC's Advisory Panel can be found here - https://www.frc.org.uk/about-the-frc/structure-of-the-frc/frc-advisory-panel

Our inspection of these policies and procedures for Tier 1 firms is undertaken on a cyclical basis, focusing on different elements over a three-year cycle. We benchmark the firms' policies and procedures against their peer group firms to identify good practice elements as well as areas for improvement. We also perform testing of the operational effectiveness of the quality control procedures in place.

The quality and consistency of ISQC 1 inspection work and other monitoring and thematic work is supported by a similar quality control and peer-review process to that employed for inspections of individual audits, together with oversight from the executive director supervision and the FRC's Board Committees.

Significant findings from this inspection activity are reported annually in the public reports on each Tier 1 firm and privately to firms in other tiers. Themes arising are reported in our annual *Developments in Audit* report.

Review of root cause analysis, action planning and quality improvement plans

A key part of our supervision aims to promote a culture of learning and improvement within firms in relation to audit quality. Detailed root cause analysis (RCA), implementation of robust actions on a timely basis to address findings and integration of those actions into a quality improvement plan (QIP) are all important elements of an audit quality improvement mechanism. We assess each firm's RCA and other lessons learned from quality matters arising and monitor and assess the sufficiency and appropriateness of action plans in place to address them.

Cross-firm review of key supervisory pillars

It is the responsibility of each firm's leadership to manage the firm effectively to ensure audit quality and firm resilience. However, as part of our wider role, we undertake cross-firm projects to assess the effectiveness of the firms' arrangements in the areas listed below. These projects are reported privately to the firms included in the work (usually Tier 1 only), with anonymised, peer-benchmarking data to promote improvements that support audit quality and audit market resilience. Themes arising from this work are also reported in our annual publication, Developments in Audit, to inform the broader population of PIE and other audit firms.

- Governance & leadership

All firms in Tier 1, and the majority in Tier 2, fall within the provisions of the Audit Firm Governance Code (revised 2016). We review the effectiveness of the firms' governance arrangements and consider any risks that these arrangements may pose to audit quality or resilience.

- Values & culture

We expect firms to have a culture that supports audit quality. This includes the firm putting in place safeguards to ensure that cultural factors within non-audit service lines do not impede the audit quality or resilience of the firm. We undertake work to assess and monitor various aspects of the culture at the firms.

- Risk management & resilience

The firms should manage their businesses to ensure that audit services can be provided without interruption. Firms should have robust frameworks in place for risk management – including financial, operational, regulatory and network risks that could all have consequential reputational impacts. Controls should be proportionate to the nature, scale and complexity of the firms' businesses (not just audit) and should be overseen by competent second and third

We benchmark firms' policies and procedures to identify good practice and areas for improvement

We expect firms to have a culture that supports audit quality

'lines of defence' risk management and internal audit functions. We undertake work to assess the effectiveness of these supporting control functions at the firms, the robustness of firms' crisis and contingency planning (including recovery and resolution planning for extreme events) and the adequacy of firms' professional indemnity insurance coverage.

- Financials & KPIs

The firms should manage their cash flows, borrowings and investments in a way that provides sufficient liquidity headroom to withstand both planned periods of high cash utilisation (e.g. annual staff bonuses and partner drawings) and unexpected events that place a material stress upon their future earning capacity or their cash collection. They should develop and monitor appropriate management information to do this. We expect regular reporting from Tier 1 firms on certain management information and will monitor this for evidence of risks to a firm or across the market.

- Operational separation

The four largest audit firms (Deloitte LLP, EY LLP, KPMG LLP and PwC LLP) are transitioning to operational separation of their audit practices, with a final deadline in summer 2024. The FRC published *Principles for Operational Separation of Audit Practices* in July 2020 (updated in February 2021), which these firms have agreed to meet. The objectives of operational separation are to improve audit quality by ensuring that people in the audit practice are focused above all on delivery of high-quality audits in the public interest and to improve audit market resilience by ensuring that no material, structural cross-subsidy persists between the audit practice and the rest of the firm. Each firm has developed a transition plan and many elements of operational separation will be in place well in advance of this deadline.

Our supervision of operational separation is evolving. The early stages are to review the design of the firms' plans and provide feedback to ensure that the plans meet our objectives and principles. As each element of operational separation becomes effective at a firm, we will perform testing to assess the effectiveness of the arrangements.

Other Tier 1 firms may choose to implement certain elements of operational separation over the course of the next few years. We will supervise those firms and provide feedback in a similar fashion.

From 2024 we intend to publish an assessment of the effectiveness of the four largest firms' arrangements for operational separation.

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Pre-appointment meetings for key roles

We expect the individuals stepping into certain key roles at the Tier 1 and Tier 2 firms to attend an interview with the FRC before appointment is confirmed, to ensure that they have the right characteristics and experience for the role and to communicate our regulatory expectations.

- Senior partner/managing partner (CEO role) – Tier 1
- Independent non-executives (INEs) – Tier 1
- Audit non-executives (ANEs) – Tier 1 firms that have implemented operational separation
- Head of audit – Tier 1 and 2
- Ethics partner – Tier 1
- Chief risk officer (or equivalent) – Tier 1

Risk reporting protocol

We have a protocol agreed with the Tier 1 and will extend this to the Tier 2 firms. Firms are required to notify the FRC without undue delay of incidents which occur either in the UK or across the firm's global network which could reasonably be considered to pose a significant threat to the reputation of the UK firm and/or the firm's global network, which are known or should be known by the partners responsible for risk management and which the FRC should be made aware based on an open, honest and straightforward relationship. The firms are also required to report to the FRC any significant financial or operational (including cyber and information security) risks to the firm.

Conveying supervisory messages

As noted above, the outcome of each individual audit inspection is reported to the audit firm and to the audit committee chair of the audited entity. This sets out our assessment, the key findings identified and provides examples of good practice observed where appropriate. We expect firms to address our concerns in subsequent audits, but also to learn lessons from these inspections, take actions to improve audit quality across the firm and to promulgate good practice.

We expect firms to learn lessons from these inspections and take actions to improve audit quality across the firm

Concerns arising from firm-wide inspection of audit quality controls (and, where applicable, from thematic reviews and other supervisory work) are also captured in detailed action plans agreed with the firms.

We publish annual reports on Tier 1 firms, usually in July each year.

We send a private annual supervisory letter to each Tier 1 firm in the autumn, clearly outlining our view of relevant risks to audit quality and the resilience of the audit market, and our prioritisation of the actions the firm should take to address them. The letter also describes the supervisory work we plan to carry out in the following year. This will repeat some of the messages in the public report on the firm, but also convey messages relating to our private supervisory work. These letters are tailored to each firm. We ask firms to reply setting out the actions they will take in response to our letter.

Similarly, we send a private annual supervisory letter to each Tier 2 firm, by the end of each calendar year, focused on the work we have done in respect of that firm in the year and any areas of particular concern where we want leadership at the firm to focus in the future.

Our private annual supervisory letter to Tier 3 firms, also sent by the end of each calendar year, will be generic to all Tier 3 firms unless the firm has been subject to an inspection in that year. In all cases, we assess the actions a firm has taken in response to our letters at our next inspection.

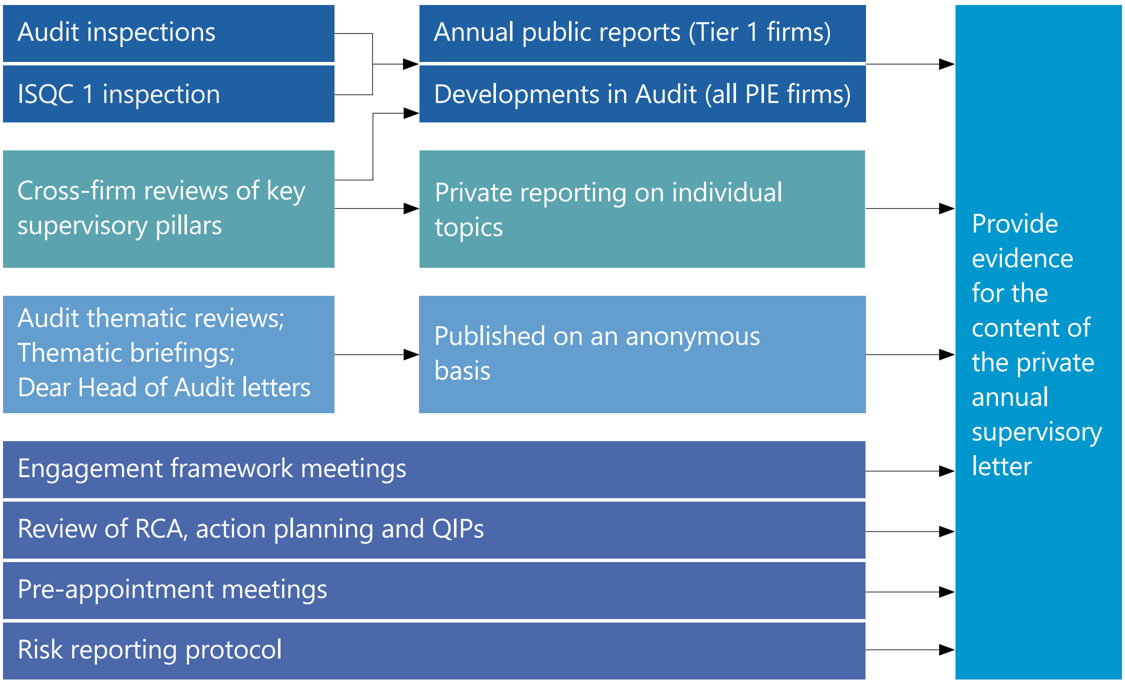
Audit thematic reviews; Thematic briefings; Dear Head of Audit letters etc.

In addition to our direct supervisory activity, we publish other types of information and findings arising from our supervision and inspection work. Although much of the evidence for these publications derives from our work at the Tier 1 firms, the audience for them is wider and the findings and recommendations should be considered by all audit firms, particularly PIE audit firms.

In an audit thematic review, we look at firms' policies and procedures in respect of a specific area or aspect of the audit or firm-wide procedures to make comparisons between firms with a view to identifying both good practice and areas of common weakness. The reviews are chosen to focus on an aspect of audit or firm-wide procedures in greater depth than is generally possible in our review of audits. One objective of our thematic reviews is to encourage the spread of good practices leading to wider improvement in audit quality.

Thematic briefings are similar to audit thematic reviews but are produced over a shorter period, enabling more agile reporting and influencing of audit quality.

We also write to the heads of audit of the Tier 1 firms when we wish to highlight matters of emerging risks to audit quality. These letters are published on our website to enable all audit firms to access the information.



4. Holding firms to account

Much of the broader audit supervision activity undertaken by AFS and AMS builds on our statutory role to oversee and monitor statutory audit. We expect firms to work with us to respond to our concerns, however raised, and remedy any deficiencies.

The FRC's audit investigation and enforcement powers, including issues arising from AQR's inspections of PIE audits and AMS's ISQC 1 inspection work, are now exercised under the audit enforcement procedure (AEP). This procedure was established by the FRC in 2016 following the introduction of the EU Audit Regulation and Directive. Other audit-related investigations have been delegated to the RSBs, but the FRC can reclaim an investigation from an RSB in certain circumstances.

Under the AEP the FRC can investigate statutory audit matters relating to:
- Public interest entities (PIEs);
- AIM-listed companies with a market capitalisation in excess of €200m;
- Lloyd's syndicates.

More details on the AEP can be found via this link (Audit Enforcement Procedure (AEP)) and the latest report on the FRC's investigation and enforcement work can be found here: Annual Enforcement Review

Referral to the case examiner and enforcement

In the event that we identify an issue which, after initial enquiry, in our opinion warrants further consideration, this will be referred to the FRC's case examiner within the Enforcement Division. The case examiner considers whether the information raises a question about whether a relevant ethical or audit requirement has been breached, whether the matter is suitable for resolution through constructive engagement, or whether to refer the matter to the FRC's Board or the Conduct Committee (as its delegate) to decide whether the matter should be referred to the FRC's executive counsel to investigate. Until concluded otherwise the recourse to the Conduct Committee remains open. If an investigation is not opened, the case can be referred to the relevant supervisor for constructive engagement.

Constructive engagement

Constructive engagement is a process introduced by the AEP to deal with cases where the audit quality concerns can be appropriately and satisfactorily addressed, and the risk of repetition mitigated, without the time and expense of full enforcement action. In cases where the case examiner or Board/Conduct Committee are of the view that constructive engagement is appropriate, the case may be referred back to the Supervision Division to undertake constructive engagement with the audit firm to ensure appropriate actions are taken to address our concerns. The constructive engagement process may result in enhanced monitoring and scrutiny over the relevant firm until we believe that the risks relating to the firm's poor conduct have been addressed through a suitable mitigation plan. We may ask for specific action to be taken by the firm to address the issues raised or we may agree that existing audit improvement plans are sufficient or can be amended suitably.

If, after discussing the actions taken by the firm, the supervisors are not satisfied that sufficient progress has been made, the case may be referred back to the case examiner to determine whether further enforcement action may be needed.

Appendix – Respective responsibilities of the FRC and the Recognised Supervisory Bodies (RSBs)

The legislation

The framework for statutory audit oversight and regulation is set out in the following legislation which has been amended to reflect the UK's departure from the European Union: [8]

- EU Regulation 537/2014 on specific requirements regarding statutory audit of public-interest entities.
- Part 42 of, and Schedules 10-13 of, the Companies Act 2006 (the Act). Schedule 10 of the Act sets out the detailed requirements for recognised supervisory bodies (RSBs) and Schedule 11 sets out the corresponding requirements for recognised qualifying bodies.
- The Statutory Auditor and Third Country Auditors Regulation 2013 (SI 2013/1672).
- The Statutory Auditor and Third Country Auditors Regulation 2016 (SI 2016/649).
- http://www.legislation.gov.uk/uksi/2019/177/contents/made The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 (SI 2019/177).
- http://www.legislation.gov.uk/uksi/2020/108/made The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 (SI 2020/108).

Under this framework the FRC is the competent authority with responsibility for the oversight and monitoring of statutory audit.

The FRC

For statutory audit, as well as monitoring PIE and certain other audits, the FRC is responsible for oversight of the regulation of auditors by the RSBs, delegated by the FRC. In particular, we recognise, and can de-recognise, those professional accountancy bodies as statutory audit supervisory bodies.

The RSBs

Specific regulatory tasks the FRC has delegated to the RSBs are as follows:
- Registration
- Audit Monitoring (non-PIE)
- Continuing Professional Development ('CPD')
- Enforcement (non-PIE)

The FRC can recall regulatory tasks from an RSB in certain circumstances, or where those cases (or classes of cases) raise public interest issues.

[8] As amended by: https://www.legislation.gov.uk/ukdsi/2019/9780111188644/introduction the Statutory Auditors, Third Country Auditors and International Accounting Standards (Amendment) (EU Exit) Regulations 2019 (SI 2019/1392); the International Accounting Standards, Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 (SI 2020/335); the Companies and Statutory Auditors etc. (Consequential Amendments) (EU Exit) Regulations 2020 (SI 2020/523); the Statutory Auditors and Third Country Auditors (Amendments) (EU Exit) (No. 2) Regulations 2020 (SI 2020/1247); and the European Grouping of Territorial Cooperation and Limited Liability Partnerships etc (Revocations and Amendments) (EU (Exit) Regulations 2021 (SI 2021/153).

The FRC's professional oversight team monitors the manner and extent to which the RSBs meet the recognition criteria and perform those delegated regulatory tasks. The delegation agreements with the RSBs aim to promote the common aim of enhancing audit quality.

The FRC also has to be satisfied that the recognition of each RSB should continue in light of the revised Schedule 10 of the Act and that each RSB complies with the requirements of its delegation agreement with the FRC.

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