



AUDIT INSPECTION UNIT

2009/10 ANNUAL REPORT

21 JULY 2010

This report is issued by the Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council. It has been approved for publication by the Oversight Board.

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1 Introduction and key messages

1.1 Introduction

This report provides an overview of the activities and findings of the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), a part of the Financial Reporting Council (“the FRC”), for the year ended 31 March 2010.

The AIU reviews the quality of the statutory audits of listed and other major public interest entities that fall within its scope, as determined each year by the Oversight Board, and of the firms’ policies and procedures supporting audit quality¹.

Firms which audit more than ten entities within the AIU’s scope are subject to full scope AIU inspections. There are currently nine such firms (“the major firms”) as follows:

Baker Tilly UK Audit LLP
BDO LLP
Deloitte LLP
Ernst & Young LLP
Grant Thornton UK LLP

Horwath Clark Whitehill LLP
KPMG LLP and KPMG Audit PLC
PKF (UK) LLP
PricewaterhouseCoopers LLP

Firms that audit between one and ten entities falling within the AIU’s scope are referred to as “smaller firms” in this report. The AIU’s inspections of smaller firms are limited to a review of individual audits falling within its scope².

1.2 Structure of this report

This report is set out under the following sections:

- Section 1 discusses the impact of AIU inspections and provides key messages to the audit profession,
- Section 2 summarises the inspection and other activities undertaken by the AIU in 2009/10,

¹ The Companies Act 2006, as amended, requires the independent inspection of auditors undertaking statutory audits of listed companies and other entities in whose financial condition there is considered to be major public interest. This latter category is determined from time to time by the Oversight Board.

² The Companies Act 2006, as amended, permits the Oversight Board to delegate inspection activities to the monitoring units of the Professional Accountancy Bodies for those firms conducting ten or fewer audits within the AIU scope. The Oversight Board has chosen to delegate the monitoring of firm-wide procedures in relation to these firms.

- Section 3 provides an overview of findings arising from the AIU's inspections at major and smaller firms in 2009/10,
- Appendix A provides information on the AIU's inspection process and basis of reporting , and
- Appendix B details the scope of inspections for 2009/10 as determined by the Oversight Board.

1.3 Impact of AIU inspections

The AIU's inspection process is both rigorous and challenging for firms. The actions taken by firms in response to its inspection findings in previous years have contributed to an improvement in the overall quality of audit work in the UK. This view is supported by the results of follow-up reviews of individual audits undertaken by the AIU, where all or most matters identified previously have been satisfactorily addressed, and by the increased proportion of audits assessed as good with minor improvements required, although it is too early to determine whether this is a trend. Similarly where the AIU has identified that improvements are required in firms' policies and procedures supporting audit quality, the AIU has generally been satisfied with the progress made by firms in addressing these matters. Audit firms take the AIU's findings very seriously and the outcomes from the reviews of individual audits have contributed to decisions regarding the composition of audit engagement teams, and the remuneration of the audit engagement partners.

An important aspect of the AIU's inspections is its ability to gain an overall understanding of how firms are interpreting and applying the requirements of both the Auditing and Ethical Standards, and to suggest changes to the standard setters where it believes these would enhance overall audit quality. In this respect the AIU has worked closely with the Auditing Practices Board ("APB"). This is discussed in more detail in Section 2.9.

The AIU's individual public reports on the nine major firms, published since late 2008, together with its confidential reports on the individual audits it reviews, should provide the directors of companies with valuable sources of information to assist them in assessing the effectiveness of their auditors and the audit process in general. The AIU has issued some 175 reports on individual audits since 2008. The findings from these will have contributed to decisions on the appointment of audit firms.

1.4 Key messages to the audit profession

The AIU's focus is on matters where it believes improvements are required to safeguard and enhance audit quality. Set out below are the key messages arising from

its inspection activities in this regard. While the AIU's inspections are not intended to provide a balanced scorecard, certain matters considered to contribute to audit quality, including actions taken to address prior year findings, are highlighted in this report.

Audit quality: major firms

The AIU's inspections in 2009/10 confirm that major firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base. Nevertheless, improvements to these policies and procedures have been recommended at all firms.

Notwithstanding the quality of firms' policies and procedures, the number of audits assessed as requiring significant improvement³ at major firms (eight audits or 11 % of audits reviewed at major firms excluding follow-up reviews) is too high. Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits.

Policies and procedures however can only go so far in supporting and encouraging desirable behaviours to deliver audit quality. While firms are willing to change these and to provide additional training to staff, such actions will be insufficient without effective behavioural change which is more difficult to achieve.

Audit quality: smaller firms

The AIU continues to find that a higher proportion of audits conducted by smaller firms require significant improvement. Six of the 11 smaller firm audits reviewed in 2009/10 (excluding follow-up reviews) were assessed as requiring significant improvement (2008/9: five of the 11 audits reviewed). Firms should not undertake audits unless they have the appropriate level of resources and expertise to ensure they are performed to an acceptable standard.

The AIU believes consideration should be given to establishing competency requirements specifically for auditors of listed and major public interest entities.

³ Section 3.2 discusses the AIU's assessment of audits requiring significant improvements.

Professional scepticism

Firms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients. The AIU has identified situations where differing and conflicting judgments are accepted by the same firm for clients operating in similar industries. Some firms have processes designed to confirm consistency of key judgments across their client base; these could be considered by all firms, but they also need to be applied effectively.

Auditors should exercise greater professional scepticism particularly when reviewing management's judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.

Quality of audit evidence

Auditing Standards recognise that third party evidence is generally the most reliable form of audit evidence and it should be obtained wherever practicable in relation to important matters. Firms should revisit their audit approaches to ensure that appropriate consideration is given to the availability of such evidence, particularly independent confirmations of balances and that these are more frequently sought.

Going concern

Firms have responded positively to the challenges arising from the economic downturn by issuing a significant amount of guidance to audit teams to assist in their evaluation of going concern. The APB has also been active in the provision of additional guidance to assist auditors in this area.

Notwithstanding this, a number of shortcomings relating to the audit of going concern were identified at both major and smaller firms. While acknowledging that much of the work in this area is done well, audit teams need to ensure that the key factors material to the going concern assessment in each individual case are appropriately considered and resolved.

Use of specialists

The increasing use of internal specialists, especially by major firms, to evaluate valuations performed by client specialists and to assist in the audit of other complex audit areas such as taxation and pension balances contributes to improving the quality of audit evidence obtained in these areas. Where firms make use of internal specialists they must ensure that this work is properly integrated with the work of the main audit

team. In particular, it should be clear from the audit files how the audit team has responded to any matters arising from the work of specialists.

Provision of non-audit services to audit clients: Ethical Standards

Ethical Standards require firms to identify areas of potential risk to independence such as the provision of services other than the audit to an audit client. Firms need to embrace more fully the principles underlying the Ethical Standards which require threats to be mitigated by appropriate safeguards if the work is to be undertaken. Firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide that necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence.

Surveys⁴ of fee income show that the ratio of non-audit fees to audit fees for audit clients in the UK has declined over the years. However the rate of decline has been small in recent years and the AIU is concerned that one major firm has embarked on a growth strategy where a key driver is the development of non-audit services to be provided to audit clients.

Areas of AIU focus

Building on its experience in 2009/10, the AIU's inspections in 2010/11 will focus on the impairment of goodwill and intangibles, together with going concern, fair value accounting estimates, compliance with the Ethical Standards, segmental reporting, revenue recognition and fraud. These areas of focus reflect the challenges auditors face in the current economic downturn and changes in financial reporting. There will also be an increased focus on banking audits.

Revised Auditing Standards

Major firms appear to be making the necessary changes to both their audit methodologies and supporting IT systems to accommodate the requirements of the Revised Auditing Standards ("Clarified ISAs") which take effect for audits with December 2010 year ends. The AIU will assess the overall state of preparedness of firms for the implementation of the Clarified ISAs as part of its 2010/11 inspections.

⁴ "Key Facts and Trends in the Accountancy Profession " issued by the Oversight Board in June 2010.

2 Summary of activities

2.1 Introduction

This section provides a summary of the AIU's inspection and other activities undertaken in 2009/10.

2.2 Follow-up of prior year findings

An important aspect of the AIU's inspection activities is to monitor the progress made by firms against agreed action plans. The results are noted in Section 1.3.

The AIU also undertakes follow-up reviews in relation to individual audits to assess the extent to which its findings have been addressed in the following year's audit. The AIU's findings in relation to follow-up reviews are noted in Section 3.2.

2.3 Coverage of inspections

In 2009/10, the AIU completed full scope inspections, comprising a review of policies and procedures supporting audit quality and individual audits within its scope, at the "Big Four" firms⁵ and PKF (UK) LLP. Public reports summarising the findings from the inspections at these firms will be published later in 2010.

The AIU currently inspects all Big Four firms on an annual basis. These firms audit approximately 80% of the entities within the AIU's scope, including over 95% of UK incorporated FTSE 350 companies.

In 2009/10 the AIU altered the frequency and timing of its inspections at the other major firms in line with its risk-based approach. This will result in inspections at these firms being undertaken and reported on over an extended period of approximately two years. Inspections of Baker Tilly UK Audit LLP, BDO LLP, Grant Thornton UK LLP and Horwath Clark Whitehill LLP (all of which were inspected in 2008/9) will therefore next be reported on in 2011 or 2012.

Inspections were also carried out at eleven smaller firms, where the AIU's inspection comprised reviews of one or more audits of listed or other major public interest

⁵ The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

entities. A separate report on the findings from these inspections will be published later in 2010.

At the request of the Audit Commission, the AIU also undertook an inspection on a contractual basis covering its policies and procedures supporting audit quality and selected individual audits. The audits reviewed included those undertaken by its Audit Practice and those conducted by firms appointed by the Audit Commission (“Appointed Firms”). Audits undertaken by four Appointed Firms were reviewed in 2009/10.

Additionally, the AIU undertook for the first time an inspection of the National Audit Office on a contractual basis covering its policies and procedures supporting audit quality and selected individual audits. Public sector inspections are discussed in more detail in Section 2.5.

2.4 Analysis of audits reviewed by the AIU

In the year to 31 March 2010, including reviews performed under contractual arrangements with the Audit Commission and the National Audit Office, the AIU completed the review of 109 engagements, compared with 99 in 2008/9.

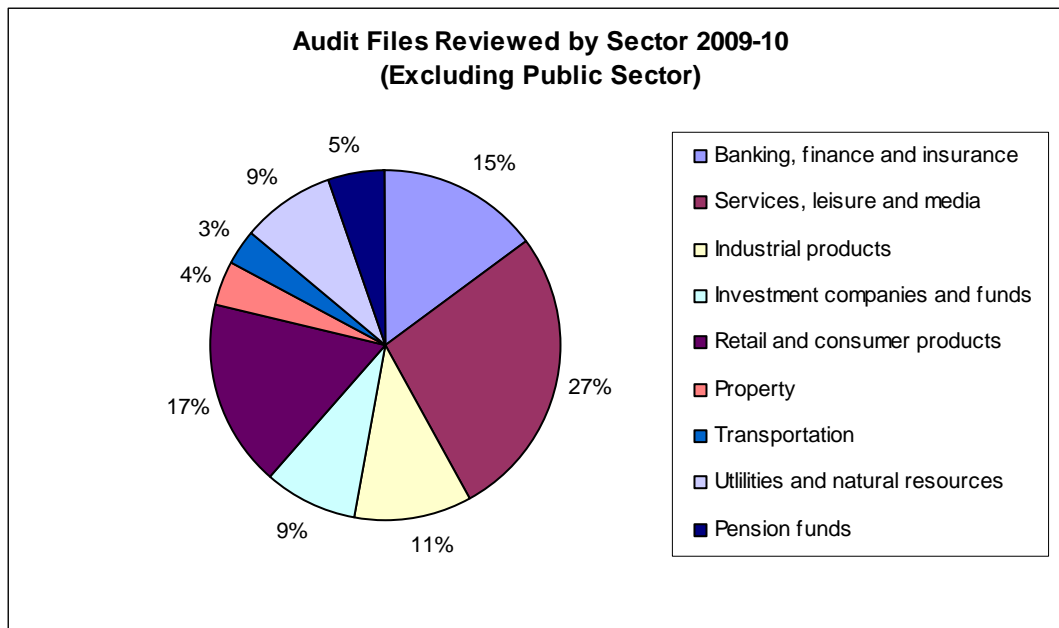
An analysis of audit engagements by type of firm is set out in the following table.

Firm type		File reviews 2009/10	File reviews 2008/9
Major firms	Big four firms	68	54
	Other major firms	12	25
Smaller firms		13	13
Total excluding public sector		93	92
Public sector	Audit Commission	4	7
	Audit Commission – appointed firms	7	-
	National Audit Office	5	-
Overall total		109	99

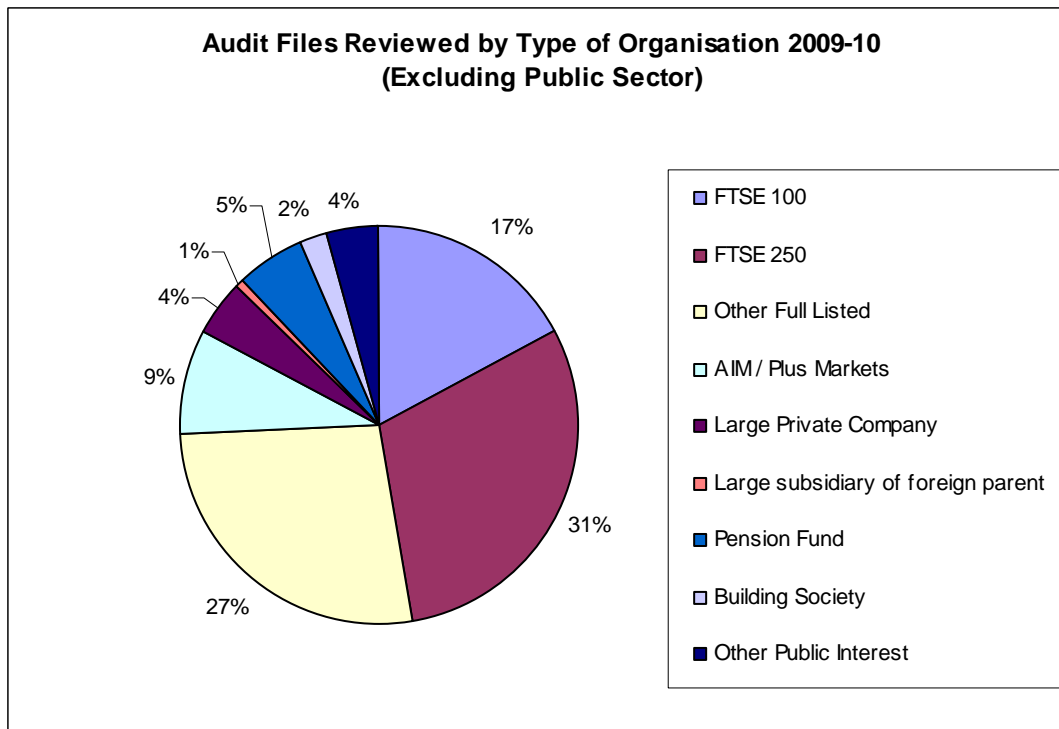
The above totals include 12 follow-up reviews (2008/9: 11 follow-up reviews).

The audits reviewed in 2009/10 had financial years ending between June 2008 and August 2009, the majority of which were either 31 December 2008 or 31 March 2009 year ends.

An analysis by sector of the audits reviewed by the AIU in 2009/10 is set out below:



An analysis by type of organisation of the audits reviewed by the AIU in 2009/10 is set out below:



In the six years since the AIU commenced its inspection activities in 2004, it has reviewed in excess of 500 audits, including the audits of 99 FTSE 100 and 124 FTSE 250 companies⁶.

The AIU has developed a risk model covering listed companies, including AIM, which it uses to inform its selection of files to be reviewed each year. The majority of audit files selected for review by the AIU were those identified as higher risk within the risk model.

The AIU refined its file selection and review processes in response to the challenges presented by the economic downturn and introduced “focused” file reviews in 2009/10, directed at high risk audit areas. The audit of going concern, the potential impairment of goodwill and other intangibles and fair value accounting estimates and disclosures were the areas of focus in 2009/10.

Focused file reviews will continue to be undertaken in 2010/11 with particular regard being given by the AIU to audit issues relating to segmental reporting, revenue recognition and fraud. The AIU will continue its focus on going concern, asset impairments and fair value accounting estimates as well as compliance with the requirements and underlying principles of the Ethical Standards.

The overall number of audits reviewed in 2010/11 is expected to be similar to that achieved in 2009/10.

2.5 Public sector inspections

Audits of public sector entities fall outside the normal scope of the AIU’s inspections⁷. In recognition of the contribution that independent inspection activities make to promoting and improving audit quality, the Audit Commission contracted the AIU to undertake annual inspections of its Audit Practice from 2007/8. From 2009/10 the Commission requested the AIU to extend the scope of its inspections to include those audits undertaken by the major accounting firms on their behalf (“Appointed Firms”).

The AIU also undertook inspection activities at the National Audit Office (“NAO”) in 2009/10.

⁶ The reference to FTSE 100 and FTSE 250 relates to the status of the company at the time the audits were reviewed by the AIU.

⁷ The AIU’s inspections at the National Audit Office include the monitoring of the performance of its statutory audit work on behalf of the Professional Oversight Board as required by section 1229 Companies Act 2006. The statutory audits reviewed are outside the AIU’s normal scope of inspection.

The cost of these inspections is met directly by the bodies concerned. They are undertaken in the first quarter of each calendar year, the period in which the AIU undertakes less inspection fieldwork at the major firms. They therefore contribute to the overall efficiency and cost-effectiveness of the AIU's inspection activities as well as recognising the public interest in audits of public sector bodies. In addition the AIU welcomes the opportunity to broaden the range of its inspection activities and benefits from the experience and knowledge gained from the public sector.

The AIU does not currently report publicly on these inspections. An overview of the findings of the AIU's inspection at the Audit Commission is published in its Audit Practice's Annual Quality Report. The NAO also intends to publish an overview of the AIU's findings.

2.6 Oversight of inspections by the professional bodies

On behalf of the Oversight Board, the AIU undertakes certain oversight activities in relation to inspections undertaken at smaller firms by the monitoring units of the professional bodies. It approves the inspection methodology used to assess a firm's policies and procedures supporting audit quality and the assignment of inspectors to undertake this work. The AIU also approves the monitoring units' inspection reports on each firm.

2.7 International liaison

Independent audit regulation continues to develop and expand internationally. As part of the FRC's ongoing commitment to liaise with other independent audit regulators, the AIU meets on a regular basis with similar organisations. It also participates in the International Forum of Independent Audit Regulators ("IFIAR") plenary meetings, working groups and audit inspection workshops and plays a leading role in the European Group of Auditor Oversight Bodies ("EAOB").

Changes to the way firms are structured, in particular the emergence of Europe-wide firms, has required the AIU to work closely with other regulators. At the initiative of the AIU a college of regulators has been established to ensure that effective inspections can be organised on a pan-European basis where appropriate. This was particularly the case with KPMG, where a European firm was formed initially with the merger of the UK and German firms but which has subsequently been expanded. Similar changes have occurred with Ernst & Young where the UK firm is now part of a wider Ernst & Young European firm.

During 2009/10 the AIU also met a number of other regulators including those from Canada, Denmark, Finland, Greece, India, Japan, Norway, Spain and Sweden. The AIU values the opportunity to meet other regulators to learn from their experiences and considers that assisting other regulators in developing their inspection activities contributes to the AIU's overall objective of promoting audit quality.

The AIU is frequently asked to demonstrate its inspection methodology and supporting IT systems to other regulators. In the AIU's view, use of a common inspection methodology would assist in ensuring greater consistency and comparability of inspection activities internationally.

2.8 Extended audit services

Following the announcement by Rentokil plc that its external auditor would be undertaking some work previously undertaken by internal audit, the AIU met the firm concerned and representatives from the company to understand better the nature of the services to be provided. Based on these discussions and the evidence provided, it appeared to the AIU that these services were more in the nature of an extended audit rather than traditional internal audit. The AIU identified potential threats to independence from these services and asked the firm to explain the safeguards that would be established to maintain auditor independence.

The AIU also undertook a survey of the auditors of FTSE 350 companies in November 2009 followed by meetings with individual firms to establish the extent to which such extended audit services were provided. The results of this exercise revealed that "extended audits" were undertaken in about 5% of companies and that other services with some similar features were provided to another 12% of companies. The arrangements for the extended audit work varied. In some cases the work was subject to a separate engagement letter and billing arrangements but in other cases it was treated as part of the audit engagement.

The findings from the AIU's work have informed the APB feedback and consultation paper referred to in Section 2.9. The AIU will continue to monitor developments at firms in this area as part of its inspection activities including the application and effectiveness of safeguards in practice.

2.9 Liaison with the APB

An important aspect of the AIU's inspections is its ability to gain an overall understanding of how firms are interpreting and applying the requirements of both the Auditing and Ethical Standards, and to suggest changes to the standard setters where

it believes this would enhance overall audit quality. In this respect the AIU has worked closely with the APB. A number of insights from its inspections have been taken account of by the APB in its feedback and consultation paper⁸ to be published in late July 2010.

These insights included the need to take greater care when considering the threats and safeguards where non-audit services are provided to audit clients, or whether the services should be provided at all and the fact that the role of the Ethics Partner may not be operating as originally intended.

The results of the AIU's survey on the provision of extended audit services as discussed in Section 2.8 were also taken into account by the APB.

The AIU will continue to work closely with the APB with a view to ensuring that the findings of its inspections are taken into account in the standard setting process.

2.10 Collaboration with the Financial Services Authority ("FSA")⁹

There is a strong mutuality of interest between the FRC and the FSA in many aspects of governance including the role of audit. In this regard the AIU has had discussions with the FSA as to how to improve information sharing arrangements. In particular the FSA is currently exploring with the AIU how it can share the insights obtained from its more intensive supervision in the case of individual regulated firms. For example if the FSA were to identify that there had been particularly aggressive approaches to asset valuations or impairment, it would be of interest to the AIU to consider whether the auditors have been sufficiently robust.

The AIU welcomes the opportunity to work more collaboratively with the FSA to improve the overall quality of audits of financial institutions. This is also consistent with the AIU's increased focus on this area. The AIU's scope of inspections now includes all banks incorporated in the UK. A sample of banks will be selected for inspection in 2010/11.

⁸ "The Provision of Non-audit Services by Auditors".

⁹ The future role and structure of the FSA are under review. The AIU will continue to work closely with the FSA and with any other body that assumes the relevant current responsibilities of the FSA.

2.11 AIU reports issued

The AIU has published individual public reports on its inspection findings at the major firms since late 2008, together with confidential reports on the individual audits it reviews. The latter reports, some 175 since 2008, are issued to the auditors who are expected to provide them to the directors of the relevant companies on a confidential basis. The AIU reports should provide a valuable source of information to assist directors in assessing the effectiveness of their auditors. The AIU welcomes feedback from directors as to how these reports may be improved for that purpose.

2.12 Basis of AIU funding

The AIU operates as a discrete unit within the Professional Oversight Board of the FRC. It has a staff of approximately 20 full time equivalents. The direct costs of the AIU's inspection activities falling within its normal scope are funded by the relevant professional accountancy bodies.

Inspection activities outside the AIU's normal scope, such as those relating to public sector bodies as set out in Section 2.5 above, are carried out on a contractual basis and the bodies concerned meet the AIU's relevant costs.

3 AIU inspections 2009/10: overview of findings

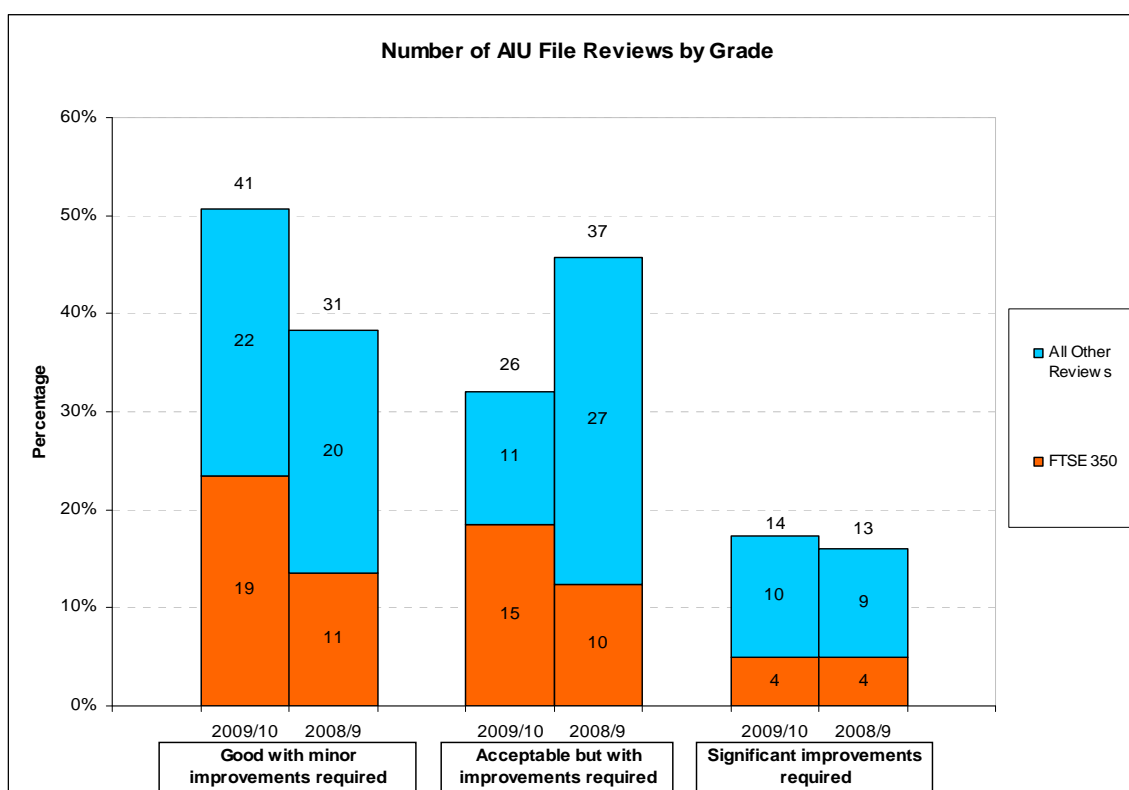
3.1 Introduction

This section provides an overview of the principal findings arising from the AIU's inspections in 2009/10 at major and smaller firms, including an overall assessment of the individual audits reviewed.

3.2 Assessment of audits reviewed

The AIU reviewed selected aspects of 93 audits in 2009/10 (2008/9: 92 audits) at major and smaller firms, including 12 follow-up reviews (2008/9: 11 follow-up reviews).

The AIU assesses the quality of each audit it reviews and arrives at an overall grade. The AIU's file review gradings at major and smaller firms excluding follow-up reviews (81 audits in both 2009/10 and 2008/9) are summarised in the table below.



While the above table indicates that a higher proportion of audits were assessed as good with minor improvements required in 2009/10, the AIU is disappointed that the number and type of audits that required significant improvements are largely consistent with the prior year.

Where an audit is assessed as requiring significant improvements, this may indicate that the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of judgments in relation to key aspects of an audit, either individually or collectively, or alternatively very significant concerns in relation to other aspects of an audit. This assessment however does not necessarily imply that an inappropriate audit opinion was issued.

All 14 audits requiring significant improvements were listed or AIM companies including two FTSE 100 and two FTSE 250 companies. (2008/9: 13 audits, of which 11 were listed or AIM companies, including two FTSE 100 and two FTSE 250). The adequacy of evidence to support key audit judgments and the signing of audit reports before all required work had been completed were the principal reasons for these audits being assessed as requiring significant improvement.

The AIU notes that a disproportionate number of the audits (six audits) assessed as requiring significant improvements were undertaken by smaller firms. This finding is consistent with the prior year (2008/9: five audits). This is an indicator that certain firms are undertaking listed or other public interest audits without having the necessary resources and expertise. As a consequence, the AIU believes consideration should be given to establishing competency requirements specifically for auditors of listed and major public interest entities.

In relation to the 12 follow-up reviews undertaken in 2009/10 (2008/9: 11 follow-up reviews), the AIU considered that all or most matters identified previously had been satisfactorily addressed in the subsequent audits. In respect of these individual audits, it is therefore clear that improvements in audit quality have been achieved. The challenge for all firms is to maintain these improvements across all audits.

3.3 Principal findings: overview

The principal findings from the AIU inspections in 2009/10 are discussed below, distinguishing between those relating to the AIU's areas of focus and other matters. Findings arising from the review of individual audits relate to the AIU's inspections at both major and smaller firms, while findings related to the policies and procedures supporting audit quality relate to the AIU's inspections at major firms only. A number of the matters noted below reflect the importance the AIU attaches to firms observing the principles underlying Auditing and Ethical Standards as well as the specific requirements thereof.

The AIU considers that the senior management of the major firms have quality control procedures in place which are generally appropriate to the size of the firms and the

nature of their client base. Although some improvements are required at all firms, the AIU is satisfied with the planned actions to address them. As a result they do not affect the AIU's recommendation to the relevant Audit Registration Committee that each firm's registration be continued.

The application of quality control procedures to individual audits, however, requires improvement at all firms.

3.4 Principal findings: areas of AIU focus

In response to the challenges arising from the economic downturn, the Oversight Board announced in March 2009 that the AIU would have particular regard during its 2009/10 inspection to audit issues relating to going concern, fair value accounting estimates and disclosures, and the impairment of assets including goodwill and other intangibles.

In addition to these areas, the 2008/9 AIU Overview Report referred to a number of challenges for auditors and indicated that these would be reported on as appropriate in 2009/10. These were the challenges arising from the economic climate, changes to auditing standards, fraud risks, determination of materiality and group audit arrangements.

The AIU's findings from its inspections in 2009/10 in relation to these matters are set out below.

3.4.1 Economic climate

In recognising the pressures firms faced in responding to the challenges of the economic downturn, and the need to achieve efficiencies in the conduct of their audit work, the AIU cautioned firms last year to guard against the short and long term risks to audit quality. It noted that short term risks to audit quality included inappropriate reductions in the extent of audit procedures to achieve cost savings or placing additional demands on audit partners or senior staff. Long term risks to audit quality included prolonged reductions in investment in audit, including recruitment, training or audit systems, or any inappropriate behavioural changes due to a realignment in personal objectives.

The AIU identified instances where major firms appeared to have placed greater emphasis on cost reductions without giving due consideration to the implications for audit quality. These included predetermined targets for transferring audit work from

the UK to an offshore service centre (“off-shoring”) in partner and manager appraisal documentation, and performance objectives which referred to reducing hours to improve recoveries with no specific reference to the need to maintain or enhance audit quality.

The AIU considers that firms should take greater care to ensure that any initiatives of this nature are not misinterpreted by partners and staff and do not have an adverse effect on audit quality. The AIU will continue to monitor developments of this nature and how firms are guarding against the risks to audit quality.

3.4.2 Changes to Auditing Standards

Revised Auditing Standards known as “Clarified ISAs” will take effect for audits in the UK with December 2010 year ends. While the AIU notes that the major firms appear to be making the necessary changes to both their audit methodologies and supporting IT systems to accommodate these changes, it is not yet in a position to form a view on the overall state of preparedness of these firms. The AIU undertook a structured review to assess the state of preparedness of all major firms and met with firms individually to discuss their plans. The results of this exercise will inform the AIU’s 2010/11 inspections.

The AIU understands that some major firms intend early adoption of all or some of the requirements of the Clarified ISAs. This may have a positive impact on audit quality if new requirements are implemented in an appropriate manner.

3.4.3 Fraud risks

Last year the AIU urged firms to consider the adequacy of their fraud risk assessment procedures in light of the economic downturn, including whether risks associated with revenue recognition policies were being properly assessed by audit teams.

Issues in relation to the consideration of fraud risks continued to be identified at most firms. Of particular concern was the failure to identify the risk of fraud related to revenue recognition as a significant risk, despite the presumption in Auditing Standards that this would normally be the case. Where this presumption was rebutted, on occasions the rebuttal appeared unjustified. Another area of fraud risk in which insufficient testing was undertaken was journal entries. These matters suggest that audit teams are not recognising the increased likelihood of fraud arising from the economic downturn consistently.

The relevant requirements in Auditing Standards relating to fraud risks and in particular risks relating to revenue recognition have been in place for a number of years. Despite extensive training, firms generally are not achieving a satisfactory level of compliance. As a result the AIU has included fraud risks and revenue recognition as new areas of focus in its 2010/11 inspections.

3.4.4 Going concern

Firms have responded positively to the challenges arising from the economic downturn by issuing a significant amount of guidance to audit teams to assist in their evaluation of going concern. The APB has also been active in the provision of additional guidance to assist auditors in this area.

Notwithstanding this, a number of shortcomings relating to the audit of going concern were identified at both major and smaller firms. While the work performed was generally of a good or acceptable standard in the majority of audits reviewed, and there was evidence of improvement at some firms, the extent of matters identified in this area remains of concern. On occasion, this may have a direct effect on the audit report - for example, in one audit there was insufficient evidence that ongoing funding would be available and the audit report should have been modified accordingly.

Shortcomings identified in this area included a lack of a formal paper to support the board's assessment of going concern; insufficient review and challenge of the underlying assumptions used in preparing forecast data to support going concern assessments; insufficient procedures to confirm the accuracy of forecasts relating to acquired businesses; forecast data not covering a full twelve month period from the date of the audit report; insufficient consideration of the implications for going concern where major customers experienced cash flow difficulties; and a lack of evidence to confirm the existence of financing facilities.

While acknowledging that much of the work in this area is done well, audit teams need to ensure that the key factors material to the going concern assessment in each individual case are appropriately addressed.

On some audits reviewed, the firms had also reported on working capital forecasts prepared for the purpose of raising new equity or other forms of financing. In cases where such work may be properly undertaken, the firm is likely to have more confidence in the directors' judgments about going concern, but there was sometimes insufficient linkage between the work performed for the purpose of the working capital forecasts and the firm's evaluation of going concern.

The audit of going concern will continue to be an area of focus for the AIU in its inspections in 2010/11.

3.4.5 Impairment of goodwill and other intangibles

The current economic downturn increases the likelihood that goodwill and other intangibles will be impaired as the key assumptions used in assessing potential impairment may need to be revised downwards significantly.

The AIU reviewed a significant number of audits where goodwill and intangibles were material, to assess the quality of audit evidence obtained to support the carrying value of these assets.

While the audit work in this area was generally performed to an acceptable standard, a significant number of issues were identified at both major and smaller firms. In a small number of cases the audit work performed required significant improvement, including two cases where the AIU drew related accounting and reporting matters to the attention of the Financial Reporting Review Panel (“FRRP”).

Issues identified included insufficient evidence obtained to support the appropriateness of key assumptions such as growth rates and discount rates; use of assumptions that were inconsistent with those used in valuing other balances in the financial statements; no consideration of revisions to forecasts; insufficient sensitivity analysis; and insufficient consideration of the adequacy and appropriateness of the disclosures in the financial statements relating to impairment testing.

Different judgments had been made in relation to the impairment of material goodwill balances for two clients of the same firm in the same industry with apparently similar circumstances. On one client the goodwill had been fully impaired while on the other client no impairment of the equivalent goodwill had been recognised. The AIU had difficulty reconciling these judgments.

The above findings suggested that firms are not always applying sufficient professional scepticism in their consideration of the potential impairment of goodwill and other intangibles.

The assessment of the impairment of goodwill and other intangibles will continue to be an area of focus in the AIU’s inspections in 2010/11.

3.4.6 Valuation of assets held at fair value

The economic downturn has caused significant reductions in the valuation of assets held at fair value, including investment properties, other investments and pension fund assets and liabilities, and resulted in increased challenges for companies and their auditors in areas such as the valuation of financial instruments in illiquid markets.

As an area of focus of its 2009/10 inspections, the AIU reviewed the quality of evidence obtained to support judgments in relation to the fair value of assets on a significant number of audits. A number of issues were identified in this area across the firms.

At major firms, specialists were used by the audit teams to evaluate valuations performed by clients or experts engaged by them. Issues identified included the extent of work undertaken by the firm's specialists and how the audit team had responded to matters arising from this work. Instances were also noted where insufficient evidence was obtained to support reliance on valuation work undertaken by external experts. This latter issue was more prevalent at smaller firms who generally do not have internal specialists to assist in evaluating the work undertaken by external experts.

In a number of cases, insufficient evidence had been obtained to conclude on the reasonableness of prices used in valuing investments for which there was no active market. In particular, in certain cases it was unclear from the audit files whether the audit teams had obtained an adequate understanding of the basis upon which the prices used had been determined.

The quality of audit evidence obtained to support the valuation of assets held at fair value will continue to be an area of focus for the AIU in its inspections in 2010/11.

3.4.7 Determination of materiality

The AIU noted last year that the economic downturn had given rise to significant variations in financial performance between reporting periods. An implication of this was how significant losses and one-off costs such as those relating to impairments and restructuring should be treated for the purpose of calculating materiality. The importance of firms giving appropriate consideration to the impact of losses and significant one-off items, when calculating materiality for the purpose of determining audit procedures and evaluating misstatements, was emphasised.

Instances were identified where materiality for the purpose of determining the level of audit procedures performed was inappropriately set at the highest level permissible under the firm's methodology or where the level set represented an inappropriately

high percentage of profit before tax. Whilst acknowledging that this is an area of considerable judgment and that certain specialised businesses give rise to particular challenges, firms need to ensure that commercial considerations do not unduly influence the level of materiality set.

Firms must ensure that the rationale for the level of materiality set is clearly articulated on file and adhered to in practice. Where any revisions are required these should be adequately explained.

3.4.8 Group audit arrangements

Group auditors must ensure that they have sufficient involvement in the audit and that they obtain appropriate reports from other auditors undertaking work for group audit purposes. In addition, the group auditor should ensure that their own files contain sufficient audit evidence to support the group audit opinion.

While there was scope for improvement in the performance of group audits at all firms, significant issues were more prevalent at smaller firms in 2009/10. These issues included limited direct involvement in the audit by the group auditor, and the extent and adequacy of additional procedures performed to compensate for this. The less developed nature of any international network arrangements in place often gives rise to particular challenges for smaller firms when undertaking group audits.

3.5 Other principal findings

3.5.1 Audit evidence and related judgments

A key aspect of the AIU's review of individual audits is an assessment of the quality of significant audit judgments, including the nature and extent of the audit work performed. The AIU was generally satisfied with the justification of significant audit judgments reviewed, although issues were often identified in relation to the adequacy of audit evidence obtained or recorded to support the judgments including the level of professional scepticism applied. On occasions detailed explanations were required from the audit team and these sometimes differed from those originally set out on the audit file.

In 2009/10 the AIU paid particular attention to judgments relating to going concern, impairment of goodwill and other intangibles and the valuation of assets held at fair value as noted in section 3.4.

Other areas in which issues were identified included no or very limited attendance at stock counts where stock was a material balance; failure to evaluate properly the work of internal audit where reliance was placed on it; insufficient consideration of related party transactions; and inadequate testing to confirm the reliability of internally generated information.

The sufficiency and quality of evidence supporting significant audit judgments continues to be an area where firms need to make further improvements. In some cases the problem identified derived from a failure to think through the source of audit evidence, and accordingly the matters (such as IT controls) that are relevant to its quality.

3.5.2 Confirmations

There were many instances where confirmations were not obtained directly from banks, custodians or other third parties to confirm the existence of material assets and liabilities. While the difficulty in obtaining reliable responses was often cited as the reason for not seeking such confirmations, third party confirmations provide independent evidence of the existence of assets and liabilities and therefore firms should place a higher priority on obtaining them wherever possible. In addition, where the judgment about any difficulty in obtaining direct confirmation from third parties is based on previous experience with that particular audit client, that evidence should be carried forward as support for the judgment.

3.5.3 Independence and ethics

Policies and procedures designed to ensure that firms comply with the requirements and underlying principles of the Ethical Standards together with their application on individual audits continue to be an important focus for the AIU's inspections.

In most respects major firms have appropriate policies and procedures in place. However these policies and procedures or their application in practice tend to emphasise compliance with the specific requirements of the Standards and do not necessarily give sufficient consideration to the principles underlying them.

A number of issues identified related to the provision of non-audit services. Incomplete identification of the nature and extent of the threats to independence and objectivity, inadequate consideration and application of appropriate safeguards to mitigate these threats, and inadequate communication with audit committees were common issues.

Examples of areas in which the nature of non-audit services provided to audit clients was found to be inconsistent with the principles underlying the Ethical Standards included the provision of actuarial valuation services to a listed audit client; roles performed by a non-audit partner in relation to an IPO; advisory roles performed by senior staff which took on the characteristics of medium term secondments; and involvement in compiling financial policies and procedures manuals impacting on the preparation of a client's financial statements.

Involvement in the preparation of calculations for the purpose of determining the taxation entries in the financial statements, which is prohibited under the Ethical Standards for listed companies, was identified on a number of relevant audits at smaller firms.

Compliance with the requirements and underlying principles of the Ethical Standards will continue to be an area of focus for the AIU in its inspections in 2010/11.

3.5.4 Communicating with audit committees

A range of issues related to the quality of reporting to audit committees was identified across firms. Insufficient communication of significant findings from the audit, including areas of disagreement with the client, and details of unadjusted errors were common areas where improvements were required. Communication of independence matters including the threats and safeguards related to the provision of non-audit services was another such area.

Consistent with prior years, the quality of reporting to audit committees by smaller firms was generally of a lower standard than at major firms, with the failure to communicate matters in writing a key issue.

3.5.5 Audit report signing and dating

A number of instances were identified where the auditor's report was signed prior to the completion of all necessary work. This issue appeared to be more prevalent at one major firm although the pressures at the end of an audit were visible at other firms too. In one case the number and nature of changes made to the financial statements after the date the audit report was signed was significant. This indicated that the firm should have informed the audit committee that they would be unable to complete all necessary work to enable the audit report to be signed on the proposed date of the preliminary announcement.

3.5.6 *Transparency reports*

The Statutory Auditors (Transparency) Instrument 2008 implements a requirement of the Statutory Audit Directive and requires auditors of UK companies with securities admitted to trading on a UK regulated market to publish an annual transparency report. In May 2010 the Oversight Board published the results of its review of the first set of mandatory transparency reports. That review identified a number of common themes and made suggestions for improvements to the quality of future transparency reports.

As part of its 2009/10 inspections, the AIU reviewed the latest transparency reports of five major firms and assessed the contents in light of its inspection findings relating to both the firm's internal quality control systems and their application on individual audits.

While the contents of these reports were generally consistent with the AIU's inspection findings, the quality of individual reports could be improved in a number of respects. Areas for improvement included the omission of the required statement regarding the effectiveness of the internal control systems, and a lack of detail in relation to internal reviews of independence. At one firm only positive comments from their AIU Public Report were included, without providing sufficient context to the AIU's overall findings.

Firms should take the opportunity to highlight in these reports the positive aspects of their quality control procedures which distinguish them from other firms, rather than producing reports which merely comply with the minimum requirements of the Statutory Instrument.

3.5.7 *Audit files provided for inspection*

The integrity of the inspection process is dependent upon firms making their audit files available to the AIU as they stand at the date of the AIU's request. It was therefore of concern that one instance was identified where this did not occur. Partners and staff should be reminded that any alteration to files after the date of an AIU request is unacceptable.

Appendix A – Inspection process and basis of reporting

Introduction

This section provides information on the AIU's inspection process and the basis of reporting at major and smaller firms.

Inspection process

The overall objective of the AIU's work is to monitor and promote improvements in the quality of auditing. As part of its work, the AIU monitors firms' compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. The Standards referred to in this report are those effective at the time of the AIU's inspections or, in relation to the reviews of individual audits, those effective at the time the relevant audit was undertaken.

The AIU's inspections of the major firms comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board. The scope of inspections for 2009/10 is set out in Appendix B.

The AIU's inspections of smaller firms are limited to a review of the quality of selected audits of listed and other major public interest entities that fall within the AIU's scope of inspections.

The monitoring units of the professional accountancy bodies in the UK which register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange and whose financial condition is not otherwise considered to be of major public interest. They also review the smaller firms' policies and procedures supporting audit quality.

The review of major firm policies and procedures supporting audit quality undertaken by the AIU covers the following areas:

- Tone at the top and internal communications
- Transparency reports
- Independence and ethics
- Performance evaluation and other human resource matters
- Audit methodology, training and guidance
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Other firm-wide matters

The AIU's review of individual audit engagements and review of firm-wide procedures cover, but are not restricted to, a firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. The reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.

The AIU seeks to identify areas where improvements are, in its view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree an action plan with the firms designed to achieve these improvements. Accordingly, the AIU's reports place greater emphasis on weaknesses identified requiring action by the firms than areas of strength and are not intended to be a balanced scorecard or rating tool. The AIU also assesses the extent to which each firm has addressed the findings arising from the previous AIU inspection.

The AIU's inspections are not designed to identify all weaknesses which may exist in the design and/or implementation of a firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by it for review and cannot be relied upon for this purpose.

When reviewing individual audits the AIU does not carry out a detailed technical review of the financial statements. Such reviews are the responsibility of the FRC's Financial Reporting Review Panel ("FRRP"). The AIU's focus in relation to financial reporting issues is on the appropriateness of audit judgments exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Accounting and disclosure issues identified are therefore raised with firms in an audit context rather than a financial reporting context. However, the AIU challenges audit judgments on financial reporting issues, where appropriate, as an integral part of its work.

If the AIU considers there is sufficient doubt as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, it may draw the matter to the attention of the FRRP. The FRRP considers such matters in accordance with its Operating Procedures.

Similarly, if during the course of its inspections the AIU identifies a significant concern as to the conduct of an individual or firm relevant to the public interest, it may draw the matter to the attention of the FRC's Accountancy and Actuarial Discipline Board ("AADB"). The AADB will then determine whether it should take any action in relation to the matter.

In accordance with its confidentiality operating procedures, the AIU shares certain information with the FRRP and the AADB where relevant to their respective responsibilities.

Basis of reporting

The AIU provides the Audit Registration Committees of the professional accountancy bodies in the UK which register firms to conduct audit work with a private report on its inspections at each major firm¹⁰.

The private reports to the Audit Registration Committees contain findings relating to safeguarding or improving audit quality, together with an overall recommendation on whether the firm's audit registration should be continued. These reports form the basis of the AIU's public reports on each major firm.

The AIU also issues private reports to the Audit Registration Committees on the significant findings arising from its review of individual audits undertaken by smaller firms together with an overall assessment of the quality of the audit. A separate public report summarising these findings, but not identifying the individual firms reviewed, will be published annually from 2010.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year. In relation to reviews of individual audits, the AIU has generally

¹⁰ Baker Tilly UK Audit LLP is currently registered with the Institute of Chartered Accountants of Scotland ("ICAS"). All other major firms are currently registered with the Institute of Chartered Accountants in England and Wales ("ICAEW").

reported its findings by reference to significant matters arising on one or more audits. Where appropriate, the AIU have commented on themes arising or issues of a similar nature identified across a number of audits.

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of 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 by the AIU 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 the AIU's inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there is necessarily a gap between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The AIU also issues reports on the quality of individual audits reviewed by it at major and smaller firms. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide on a confidential basis copies of the reports to the directors of the relevant clients.

Appendix B – Scope of inspections 2009/10

Audits of the following entities were within the scope of the AIU's inspections in 2009/10.

- All UK incorporated companies with listed equity and / or listed debt.
- AIM or Plus-quoted companies incorporated in the UK with a market capitalisation in excess of £50 million.
- Unquoted companies, groups of companies, limited liability partnerships or industrial and provident societies in the UK which have either:
 - Group turnover in excess of £500million; or
 - Group long term debt in excess of £250million and turnover in excess of £100million.
- Unquoted companies or groups which are subsidiaries of foreign parent companies where the turnover of the UK group or company is in excess of £1,000 million.
- Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members.
- Charities with income exceeding £100million.
- Friendly Societies with total net assets in excess of £1,000 million.
- Building Societies with assets exceeding £1,000 million.
- UK Open-Ended Investment Companies and UK Unit Trusts managed by a fund manager with more than £1,000 million of UK funds under management.
- Mutual Life Offices whose "With-Profits" fund exceeds £1,000 million.

UK incorporated companies do not include those incorporated in the Crown Dependencies of Jersey, Guernsey or the Isle of Man.

The above criteria were applied as at the start of the period in identifying entities within the AIU's scope for its 2009/10 inspections. Further details relating to the AIU's scope of inspections, including the criteria applied for the 2010/11 inspections, is available on the FRC's website: <http://www.frc.org.uk/pob/press/pub2260>.



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