



**AUDIT INSPECTION UNIT**

**2006/07 AUDIT QUALITY INSPECTIONS  
PUBLIC REPORT**

**JUNE 2007**





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**This report is issued by the Audit Inspection Unit ('AIU') of the UK's Professional Oversight Board ('Oversight Board'). It has been approved for publication by the Oversight Board. The Oversight Board is part of the Financial Reporting Council ('FRC'), the UK's integrated independent regulator for financial reporting, auditing and corporate governance.**

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## Contents

		<i>Page</i>
One	Introduction and overview	1
<hr/>		
Two	Response to prior year recommendations	7
<hr/>		
Three	Current year findings and recommendations	9
<hr/>		
Four	First year inspections at smaller firms	21
<hr/>		
Appendix A	Scope of independent inspection 2007/8	24
<hr/>		
Appendix B	Overview of inspection process	26
<hr/>		



## **One – Introduction and overview**

### **1.1 Introduction**

This report summarises the findings of the inspection visits carried out for the year ended 31 March 2007 by the Audit Inspection Unit ('AIU') of the Professional Oversight Board ('Oversight Board'), a part of the Financial Reporting Council ('FRC'). Section 1.6 below provides an overview of the key findings.

### **1.2 Structure of this report**

This report is set out under the following sections:

- Section 2 deals with the progress made by the nine firms where we have undertaken full scope inspections in addressing our prior year recommendations;
- Section 3 sets out the findings from our 2006/7 inspection visits to the nine firms;
- Section 4 sets out our findings following our review of audits undertaken by the smaller firms;
- Appendix A describes the categories of listed and major public interest entity audits that fall within our scope for 2007/8; and
- Appendix B provides an overview of the inspection process.

### **1.3 Background**

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes which contributes to this aim is that the users of audit reports can place a high degree of reliance on the audit opinion, including whether financial statements show a true and fair view. The AIU's programme of inspection visits is designed to promote high quality auditing and thereby contribute to this strategic outcome and the FRC's overall aim.

The AIU monitors the quality of the audits of listed and other major public interest entities that fall within its scope as determined each year by the Oversight Board. A description of such entities for the current year, 2007/8, is set out in Appendix A. However, it should be noted that any overseas registered companies falling within the categories set out in Appendix A are excluded from our scope.

The AIU monitors firms' compliance with the regulatory framework for auditors in the UK which, for the period under review, comprised the following:

- The Auditors' Code;
- International Standard on Quality Control (UK and Ireland) 1 ('ISQC 1');
- International Standards on Auditing (UK and Ireland) ('ISAs (UK and Ireland)');

- Auditing Practices Board ('APB') Ethical Standards and Ethical Guidance issued by the relevant professional body; and
- The UK Audit Regulations and Guidance.

The AIU's responsibility extends beyond monitoring compliance with the specific requirements of the UK regulatory framework and includes an assessment of significant audit judgments.

In addition to the work of the AIU, the monitoring units of the professional accountancy bodies in the UK, who register firms to conduct audit work, remain responsible for monitoring audit work outside our scope (i.e. the audits of entities which do not have any listed securities and those in whose financial condition there is not otherwise considered to be a major public interest). We wish to acknowledge the co-operation we have received from both the Quality Assurance Directorate of the Institute of Chartered Accountants in England and Wales ('ICAEW') and the Audit Monitoring Unit of the Institute of Chartered Accountants of Scotland ('ICAS') in planning and undertaking our inspection visits.

#### **1.4 Coverage of inspections**

During 2006/7, we undertook full scope inspection visits, comprising the review of firm-wide procedures and individual audits within our scope, at nine firms, eight of which were registered by the ICAEW. The remaining firm was registered by ICAS. At the date of this report, our inspection visits to these firms had been completed and our private reports to the Audit Registration Committee ('ARC') of the ICAEW or ICAS, as appropriate, had been finalised or were well advanced. The nine firms were:

- Deloitte & Touche LLP, Ernst & Young LLP, KPMG Audit Plc and PricewaterhouseCoopers LLP at which we carried out our third inspection visit, having carried out our first visit in 2004/5; and
- Baker Tilly UK Audit LLP, BDO Stoy Hayward LLP, Grant Thornton UK LLP, PKF (UK) LLP and RSM Robson Rhodes LLP at which we carried out our second inspection visit, having carried out our first visit in 2005/6. Grant Thornton UK LLP and RSM Robson Rhodes LLP have subsequently announced they intend to merge their practices from 1 July 2007.

We also carried out inspection visits at seven smaller firms<sup>1</sup>. For these firms, we focus our work on reviewing the small number of listed or other major public interest entities audited by them. We rely on the monitoring unit of the professional body with whom they are registered for the review of the firms' quality control systems and procedures. The findings from our reviews at the smaller firms are set out in Section 4. Five of the smaller firms we visited were registered by the ICAEW and the remaining two were registered by ICAS.

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<sup>1</sup> The first such review took place in 2005/6 but is combined with reviews undertaken in 2006/7 for public reporting purposes.

The expansion of our coverage of firms in 2006/7 to include the smaller firms completes the implementation of the programme of independent audit inspections as envisaged in the Review of the Regulatory Regime of the Accountancy Profession published by the Department of Trade and Industry ('DTI') in January 2003, to which reference was made in the FRC's plan and budget for 2006/7.

The audits we reviewed related to financial statements for financial periods ended prior to 31 December 2006, the majority of which were prepared under International Financial Reporting Standards ('IFRS') for the first time. 2006/7 was also the first full year in which firms were required to undertake their audit work in accordance with the ISAs (UK and Ireland)<sup>2</sup> and comply with the requirements of the Ethical Standards<sup>3</sup>. As such we consider 2006/7 was a challenging year and acknowledge the considerable efforts made by the firms to respond to the challenges these changes presented.

Our reports on the audits we reviewed focus primarily on weaknesses identified rather than areas of strength. The inspection findings set out in this report should be read in this context.

During 2006/7 two of our inspection visits of the Big Four firms, by agreement with the firms concerned, were conducted jointly with staff from the US Public Company Accounting Oversight Board ('PCAOB'), but led by our inspection teams. Our inspections of the other two Big Four firms are likely to be conducted on a similar basis with the PCAOB during 2007/8. (In 2005 we undertook a joint review of BDO Stoy Hayward LLP with the PCAOB). We believe that effective co-operation with overseas audit regulators in the conduct of audit inspections, where appropriate, is in the interests of all parties involved including the firms themselves. It facilitates cost effective regulation and avoids unnecessary duplication of work.

## **1.5 Analysis of audits reviewed by us**

In the year to 31 March 2007, we completed the review of 103 audits of listed or other major public interest entities. This compares with 77 such audits reviewed by us in 2005/6 and 27 such audits in 2004/5.

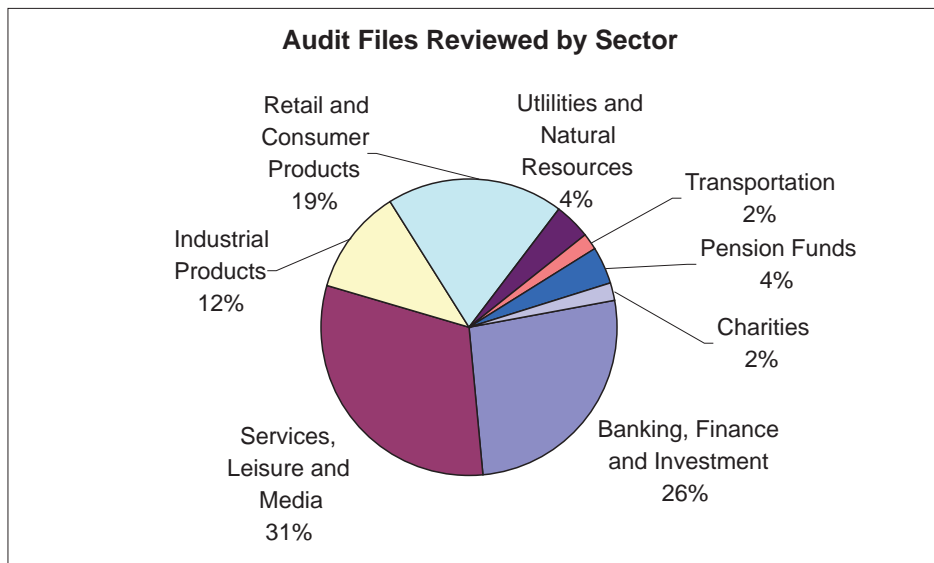
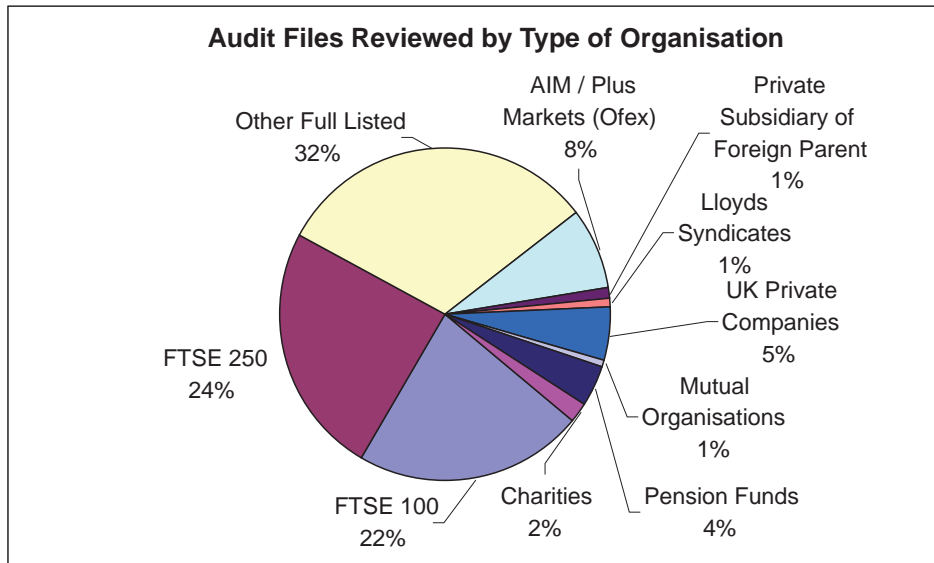
The 31 March 2007 figures reflect a one-off acceleration of the planned programme of audit reviews and consequently we envisage reviewing a lower number of audits in 2007/8.

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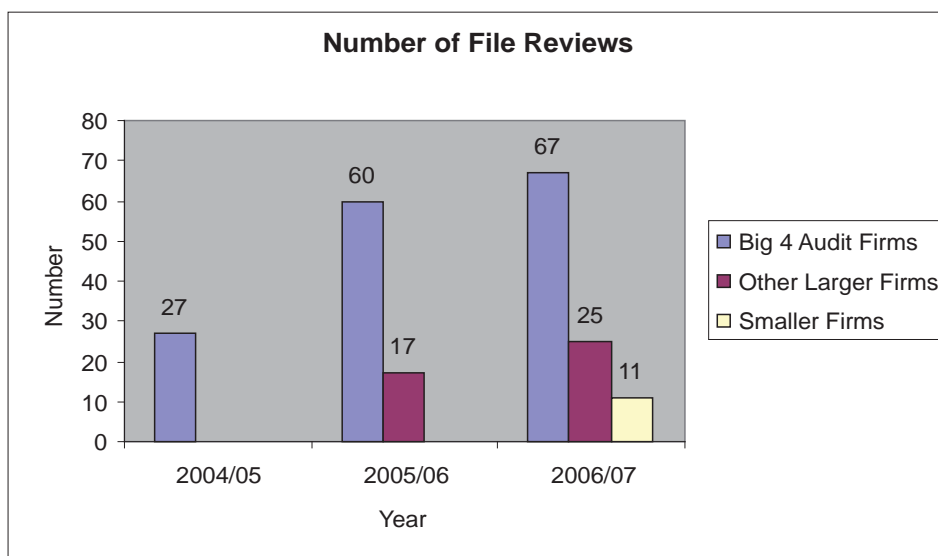
<sup>2</sup> All references in this report to ISAs (UK and Ireland) are to International Standards on Auditing (UK and Ireland) which came into effect for audits of financial statements for periods commencing on or after 15 December 2004.

<sup>3</sup> All references in this report to Ethical Standards are to the APB Ethical Standards which came into effect for audits of financial statements for periods commencing on or after 15 December 2004.

An analysis of the audits we reviewed in 2006/7 is given below by type of organisation and by sector:



An analysis of the number of audits we have reviewed over the past three years by type of firm is given below:



## 1.6 Overview of findings

In overall terms significant progress has been made by all firms in addressing our prior year recommendations, after taking account of the extent and nature of the recommendations made and the number of inspection visits undertaken. It is pleasing to note the positive response by all firms to our recommendations, with very few instances where no action had been taken at the time of our subsequent visit to implement a prior year recommendation.

We were satisfied with the manner in which firms responded to the implementation of IFRS and accordingly have made no recommendations in relation to this in this report. This reflects the significant level of resources allocated and the robustness of the approach taken by firms to the challenges presented by the implementation of IFRS.

Section 3 contains 21 recommendations to the profession arising from our current year findings. We will be monitoring progress made by the firms in addressing these recommendations during our next inspection visits.

The implementation and application of the ISAs (UK and Ireland) was a key area of focus of our inspection visits. We have made recommendations in relation to both the firms' methodologies and systems and the training required for staff to ensure compliance with the requirements of the ISAs (UK and Ireland), particularly in relation to the audit risk and fraud ISAs (UK and Ireland)<sup>4</sup>. These

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<sup>4</sup> The audit risk and fraud ISAs (UK and Ireland) refer to ISAs (UK and Ireland) 315, 330 and 240.

particular ISAs (UK and Ireland) contain a significant number of new requirements and further work is required by all firms to fully embed these requirements within their audits.

While there has been an improvement in the overall quality of documentation on the files we reviewed, there has been no clear improvement in the sufficiency of documentation to support key audit judgments. If key judgments are not properly recorded at the time, there is a substantial risk that the rationale may be incomplete and that it will not be possible for our inspectors to see from the documents on file the rationale behind judgments. Also, if the firms' own audit files do not contain a comprehensive record of the key judgmental aspects of the audit alongside compliance-related information, this may be detrimental to the on the job training of audit staff. We remind the firms that a focus on key audit judgments is central to the principles-based approach to auditing in the UK.

We try to ensure that our own inspections are principles-based and therefore a number of our recommendations to firms relate to the principles underlying the objective of a particular standard rather than the specific requirements thereof. Firms sometimes argue that in making such recommendations we are inappropriately 'extending' or 'going beyond' the relevant standards. This is not in our view consistent with calls for principles-based regulation. We consider such recommendations to be fully consistent with a principles-based approach to improving audit quality.

## **1.7 Conclusion**

On the basis of our work, we consider the quality of auditing in the UK to be fundamentally sound. Subject to the agreement of satisfactory action plans by firms in response to our recommendations, we anticipate recommending the continued audit registration of all firms for which we undertake full scope inspections.

In relation to the smaller firms reviewed, the scope of our work was limited to the review of one or more audits falling within our scope. We provided the findings from those reviews to the monitoring unit of the relevant professional body for inclusion in their overall report on the firm to the respective Audit Registration Committee. Accordingly, it is the monitoring unit who make a specific recommendation in relation to the continued audit registration of these firms.

## **Two – Response to prior year recommendations**

### **2.1 Introduction**

In this section we comment on the responses made by the firms to the recommendations arising from our inspection visits in 2005/6. For each recommendation we have considered whether it was fully implemented, partially implemented or not implemented. We have also considered whether there were application issues arising from implementation (i.e. where a recommendation has been implemented but has not achieved the desired effect or there is a degree of non compliance with a newly introduced policy). We have reported this assessment to each firm in their respective private reports.

We also comment in Section 2.3 on the firm's responses to the recommendations contained in last year's public report.

### **2.2 Private report recommendations - overall themes**

In 2005/6 we made a large number of recommendations to the firms. This represented a significant increase on the prior year as a consequence of the expansion of the number of firms visited from four to nine and the broader range of audit files reviewed.

It is pleasing to note the positive response by all firms to our recommendations, with very few instances in which no action had been taken to implement them.

While the incidence of recommendations only partly implemented was greater for some of the firms inspected for the second time, this can be attributed to the higher number of recommendations arising from initial inspection visits and the nature of the changes required to key processes such as appraisals and the annual audit quality review. The cyclical timing of such processes, which did not necessarily coincide with our inspection visits, also affected the progress that had been made.

In some cases, while recommendations were fully implemented, we noted that there were application issues. The number of application issues varied across the firms, with no clear differentiation between those firms that had been reviewed twice and those that had been reviewed three times. The nature of the application issues covered a wide range of areas with no particular issues standing out as providing common themes across the firms.

In all cases, we are satisfied with the progress made by the firms in responding to our recommendations after taking into account the number of times we have visited and the extent and nature of the recommendations made. In the majority of cases, the firms were timely in responding to our recommendations, and were able to demonstrate during our most recent visit that significant progress had been made in addressing our recommendations.

Section 3 of this report sets out the key findings arising from our 2006/7 inspection visits. Where relevant we have commented on issues relating to the prior year recommendations.

#### Examples of key actions taken by individual firms

Greater prominence given to audit quality in firm strategies and communications.  
Revision of partner appraisal forms and processes.  
Finalisation of rotation policies and guidance.  
Development and implementation of rotation databases.  
Methodology revisions to address ISA (UK and Ireland) requirements.  
Development of/revisions to standard forms to improve standard of documentation on file.  
Extensive revisions of Audit Quality Review (AQR) programmes and guidance.  
International AQR results made available to audit leadership.

### 2.3 Public report recommendations

In addition to the recommendation made in the private reports, last year's public report contained a number of recommendations. As part of this year's inspection visits, we asked the firms to provide us with a response setting out the relevance of these recommendations to the firm, and the actions they had taken where applicable. Overall we were satisfied with the responses provided by the firms, with only limited instances where we considered that further action was required by a firm to give effect to a recommendation.

## **Three – Current year findings and recommendations**

### **3.1 Introduction**

In this section we comment on the key findings from our most recent inspection visits, the progress made in addressing issues and, where appropriate, make recommendations. In selecting the areas for inclusion in this report we have considered the significance and extent of issues across the nine firms with a focus on issues arising for the first time. Some of the issues set out below, however, have been raised in previous reports. The areas we have chosen to comment on are set out under the following broad headings:

- 3.2 Leadership and human resources
- 3.3 Ethical and independence issues
- 3.4 Audit performance
- 3.5 Monitoring of audit quality

### **3.2 Leadership and human resources**

#### *3.2.1 Appraisal processes*

We have invested considerable effort in reviewing the firms' partner and staff appraisal processes and in particular how audit quality indicators have been incorporated into the processes. Last year we made a number of recommendations in this area and it is pleasing to see the significant progress made. Some firms have given priority to revising their partner appraisal processes, with staff processes yet to be reviewed. Others have changed their processes but it is too early to assess the effectiveness of the changes due to the timing of our inspection visit not coinciding with the appraisal cycle. However we observed that the timeliness of the completion and approval of appraisal documentation and other procedures for both partners and staff continued to be a problem at a number of firms.

Notwithstanding these issues there was clear evidence that audit quality is an increasingly important element of the appraisal processes, with the results of internal and external monitoring processes being fed directly into individual appraisals with a consequent impact on remuneration. We provided feedback to the firms on the quality of the audit files we had reviewed.

We recommend that firms continue to build on the changes made to their appraisal processes and focus on ensuring their timely completion. For those firms where we have recommended further changes to their appraisal processes, we have emphasised that these be given priority in the coming year.

### 3.3 Ethical and independence issues

#### 3.3.1 *Partner rotation monitoring*

In our previous reports we have referred to the need for firms to maintain comprehensive systems and procedures to facilitate the monitoring of partner rotation. We are pleased to note that steady progress has been made across the firms in developing and implementing databases appropriate to the needs of the firms. Most progress has been made at those firms we have visited three times. While we appreciate the significant effort firms have made in establishing databases, issues remain at some firms over the accuracy and completeness of the data, and the appropriateness of monitoring procedures to ensure that the accuracy of the data is maintained.

Across most firms, further work is required in capturing data in relation to both Key Audit Partners (KAPs)<sup>5</sup> and the involvement of Other Partners and Senior Staff (OPSS)<sup>6</sup> on large group audits. For some firms further guidance is required to assist in the identification of KAPs and particularly OPSS. The latter is perhaps the area in which most work is required across the firms to ensure that they meet the requirements of Ethical Standards and we comment further on this below.

We recommend that firms continue to give priority to the development and implementation of appropriate systems and procedures to facilitate effective monitoring of compliance with the rotation requirements.

#### 3.3.2 *Identification of KAPs and OPSS*

At one firm, partners in specialist fields such as Tax, IT or US GAAP who are involved in large group audits are routinely considered to be KAPs. At other firms, similar specialists are rarely considered to be KAPs. At one firm for instance, there was only one client across all its FTSE 100 clients where there was a tax KAP. Whilst the circumstances will differ from client to client, it is not clear why there is such a divergence in designation across the firms. Notwithstanding this, where a specialist partner was not considered to be a KAP it would be our expectation that they would be classified as an OPSS for the purposes of rotation monitoring. This did not however necessarily appear to be occurring in those firms with a lower incidence of KAPs. As a consequence there appeared to be a number of specialist partners involved in group audits that are not subject to the rotation requirements or other appropriate safeguards applicable to listed entities.

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<sup>5</sup> In respect of listed entities, an audit partner, or other person performing the function of an audit partner, of the engagement team (other than the audit engagement partner) who is involved at the group level and is responsible for key decisions or judgements on significant matters, such as on significant subsidiaries or divisions of the audit client, or on significant risk factors that relate to the audit of that client. KAPs must rotate after seven years of service.

<sup>6</sup> In respect of listed entities, partners responsible for significant affiliates (but not as key audit partners) or staff involved in the audit in senior positions. After seven years of service on the audit, the safeguards to mitigate the threats to their independence and objectivity must be reviewed.

We recommend that firms review their policies and procedures to ensure that appropriate and consistent consideration is given to the involvement of specialist partners on audits and that these are appropriately designated as either KAPs or OPSS.

### 3.3.3 *Safeguards in relation to long involvement*

It is common for the audit engagement partner on large groups to have had considerable involvement with the group over the years in differing capacities. Such long involvement, while not precluded under the Standards, can give rise to familiarity threats. In our experience firms tend to take a rules-based approach in this area rather than considering the broader principles underlying the Standard and accordingly often do not give appropriate consideration to the overall length of involvement of engagement partners on group audits. In our view, there should be consideration on group audit files setting out the full extent of involvement of the audit engagement partner and any KAPs on the audit and an assessment of the threat extended involvement poses, together with details of any safeguards applied.

Appropriate safeguards in these circumstances need to go beyond the requirement that all audits of listed entities have an Engagement Quality Control Reviewer.

The APB is currently reviewing the requirements of the Ethical Standards in this area.

We recommend that firms review their approach to this area to ensure that appropriate documented consideration is given to the total length of involvement of the audit engagement partner and KAPs over the years and that appropriate safeguards are in place where necessary.

### 3.3.4 *Partners joining audit clients*

There was one instance in which a partner left the firm to become the finance director of a major listed audit client. Whilst there was a two year gap between the partner's last involvement on the audit and joining the client, it was not initially clear to us whether the partner had been in the firm's 'chain of command' in the two years prior to joining the client and therefore whether the requirements of the Ethical Standards had been complied with. We were subsequently provided with a detailed rationale as to why the partner's various roles within the firm during this period did not constitute involvement in the chain of command. However this issue highlighted the need to have policies and guidance in place to give clarity as to what constitutes the chain of command in a firm. This is particularly relevant for the larger firms where senior partners often undertake a number of oversight or management roles across the firm.

We recommend that all firms ensure that they have appropriate policies and guidance in place defining what constitutes a partner being in the chain of command and that this is clearly communicated to all partners.

### 3.3.5 *Non-audit services: threats and safeguards*

Ethical Standards require the audit engagement partner to consider the potential threats to the firm's independence and objectivity from the provision of any non-audit services and what safeguards, if any, exist to mitigate those threats, prior to any decision to undertake non-audit services for a listed audit client. The rationale for a decision to undertake such services for an audit client, including any safeguards adopted, should be documented.

At one firm we noted a number of instances where the audit files did not adequately document the relevant threats arising from the provision of non-audit services nor the safeguards that might have been applied to mitigate those threats.

We recommend that firms ensure that the threats and safeguards arising from the provision of non-audit services to audit clients are appropriately documented on file as required by the Ethical Standards.

### 3.3.6 *Assistance with the preparation of accounts for listed companies*

Many firms have accounting packages which can be used to assist clients in the preparation of their financial statements. With one exception, firms accepted that these packages cannot be used to assist listed clients or their significant affiliates in the preparation of their financial statements. One firm considered that the way in which it used its accounting package to assist in the preparation of the financial statements of significant affiliates of listed entities comprised a typing service and not an accounting service. We disagreed with the firm's view and the firm has now agreed to cease this practice.

At another firm, we noted that the audit team had undertaken extensive work in relation to the re-drafting of the notes to the financial statements of a listed entity. In this case, the audit team considered that they were providing accounting advice rather than accounting assistance and that this was a by-product of the audit. We disagreed with this view and considered that the provision of tailored wording and numbers (sourced from the accounting records) for incorporation into the financial statements created a significant self-review threat and was therefore inconsistent with the principles of the Ethical Standards. While the firm concerned had a policy expressly prohibiting the provision of accounting services to listed entities and their significant affiliates, we considered that the wording of this policy could be interpreted as permitting the type of assistance noted above.

We recommend that firms review their policies and procedures in relation to the provision of accounting assistance and advice to ensure that these are consistent with both the specific requirements and the underlying principles of the Ethical Standards.

### 3.3.7 *Referral fee*

In one case we noted that a referral fee was paid to a former partner of a firm for an introduction that led to the firm securing a significant audit engagement.

Although highly unusual, we acknowledged that this payment was in accordance with a legal agreement between the firm and the former partner, and had been appropriately approved by the managing partner. However, the relevant ICAEW Ethical Guidance applicable at the time required this fee to be disclosed to the client, and this had not occurred. We recommended that the firm retrospectively disclose the fee in writing to the client and we understand that this has now occurred. The matter is now being considered by the ARC of the ICAEW.

## 3.4 **Audit performance**

### 3.4.1 *Audit judgments*

An important element of our file review process is the assessment of significant audit judgments. During the course of the year we challenged a number of significant judgments including those relating to acquisition accounting, revenue recognition, goodwill impairment, pension valuations and deferred taxation, as well as judgments relating to the audit approach adopted such as the extent of testing of controls. We were generally satisfied with the appropriateness of the judgments made. In one case we were unable to satisfy ourselves as to the appropriateness of the treatment of certain revenue streams under UK GAAP. In another case, it appeared to us that a change in accounting policy relating to the use of discount rates attributed to the move to IFRS was in fact attributable to the correction of an error under UK GAAP. In both these cases the audit firm considered the impact of any potential changes and concluded that they would not have been material.

In some cases we were not satisfied with the approach taken to the testing of internal controls and recommended that the approach be reviewed for subsequent audits.

Across most firms we continued to raise issues over the quality of documentation on file to support the judgments made. In our view there has not been any clear improvement in the overall quality of documentation on file in relation to significant audit judgments. We comment more fully on this below.

We recommend that firms reiterate to audit partners and staff the importance of ensuring there is sufficient and appropriate evidence on file to support significant audit judgments.

### 3.4.2 *Audit documentation*

Our previous annual reports have explained why we consider the quality of audit documentation to be important. Insufficient documentation of work undertaken, evidence obtained or the rationale for key judgments exercised pose significant risks for audit quality. As stated in ISA (UK and Ireland) 230

(Revised), appropriate audit documentation prepared on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached.

Many of the issues raised in our file review reports relating to the clarity or sufficiency of audit documentation were initially raised in the context of apparent deficiencies in the audit evidence obtained to support conclusions reached or judgments exercised. We have been assured by the relevant audit teams in these cases that the deficiencies relate to the documentation of the evidence obtained and not the sufficiency or appropriateness of the evidence. While we have given the audit teams the benefit of the doubt where in our judgment this is likely to have been the case, we have made it clear that such deficiencies are nevertheless important and need to be rectified.

It has been suggested by some that the approach we adopt to our reviews involves an inappropriate focus on audit documentation. We do not accept that our approach can be validly characterised in this way. Firms are well aware of the need for improvements in this area and the messages conveyed to their own partners and staff have clearly reflected this. We acknowledged last year the efforts being made by the firms in this area and that it would take time for their effectiveness to be demonstrated. We are therefore pleased to report that there was evidence of an overall improvement in the quality of audit documentation on the files we reviewed this year, with the exception of documentation relating to key audit judgments which we have commented on separately above.

We recommend that firms continue to give a clear message to their partners and staff on the importance of good quality audit documentation and the need for ongoing improvement in this area.

### *3.4.3 ISAs (UK and Ireland) implementation*

The move to ISAs (UK and Ireland) was a key area of focus of the 2006/7 inspection process. Firms were asked to provide us with a mapping of their methodologies against the ISAs (UK and Ireland). We reviewed this mapping to identify any gaps or inconsistencies in the firms' methodologies. For most firms, their methodology is based on that in use by their international firms which is itself based on the ISAs issued by the International Auditing and Assurance Standards Board rather than the ISAs (UK and Ireland). Changes to methodologies therefore need to be agreed internationally which can involve a long lead-time.

In most cases adopting the ISAs (UK and Ireland) required only limited changes to the firms' methodologies. The exceptions are the audit risk and fraud ISAs (UK and Ireland) and we have commented below on the considerable number of issues arising which related to these.

In most cases, firms had made appropriate changes to their audit manuals and guidance. However, these had not necessarily been embedded in their audit systems and standard documentation.

We recommend that firms give further consideration to the changes required to their audit systems and standard documentation to ensure that the ISAs (UK and Ireland), particularly the audit risk and fraud ISAs (UK and Ireland), are fully embedded in practice.

#### 3.4.4 *Audit risk and fraud ISAs (UK and Ireland)*

ISAs (UK and Ireland) 315, 330 & 240 (the audit risk and fraud ISAs (UK and Ireland)) are important because they are new and introduce a significant number of additional requirements. We identified across all firms a range of issues relating to these ISAs (UK and Ireland). Most of the issues we identified related to the application of the firms' methodologies. However at some firms we questioned whether the methodology ensured that all risks of material misstatement at the assertion level were identified, whether there was an appropriate link between the risks identified at the assertion level and the response to those risks, and whether the design and implementation of controls in relation to significant risks were appropriately assessed. We have made specific recommendations to the firms concerned in this regard.

The degree of changes made to firms' methodologies varied. The extent to which additional standard working papers were developed to capture and ensure compliance with the specific requirements of the audit risk and fraud ISAs (UK and Ireland) varied significantly across the firms.

One key aspect of ISA (UK and Ireland) 315, covering the identification of significant risks, appeared to be interpreted differently by the firms. Very few significant risks (other than the presumed risk of fraud relating to revenue recognition) were identified by one firm, whereas at other firms it was common for a number to be identified. While the particular circumstances of the audit will influence the number of significant risks identified, we considered that this did not wholly explain the difference in the number of significant risks identified across the firms. We therefore recommend that firms review both their criteria and the training given to staff in the identification of significant risks.

Examples of areas where recurring issues arose in applying the audit risk and fraud ISAs (UK and Ireland) are set out in the following table. Each of these issues was not necessarily present at all firms.

### Examples of recurring issues in applying the audit risk and fraud ISAs (UK and Ireland)

<p>Inadequate assessment of the magnitude or likelihood or potential impact of risks identified.</p> <p>Inadequate distinction on file between significant and other risks.</p> <p>Inadequate communication of significant risks to subsidiary auditors.</p> <p>Poor linkage between significant risks identified as part of group planning and the related responses to those risks undertaken at a subsidiary or divisional level.</p> <p>No or inadequate evaluation of the design and implementation of controls relating to significant risks.</p>	<p>Poor linkage between significant risks and the procedures designed to address them.</p> <p>The risk of fraud related to revenue recognition not identified as a significant risk, nor the presumption that it is a significant risk rebutted on the audit file.</p> <p>Inadequate consideration of the risk of management override.</p> <p>Inadequate documentation of fraud risk discussions.</p>
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We recommend that firms review the effectiveness of the guidance and training given to staff to ensure that appropriate procedures to identify, assess and respond to audit risks are undertaken, in accordance with the requirements of the audit risk and fraud ISAs (UK and Ireland).

#### 3.4.5 Analytical review

ISA (UK and Ireland) 315 states that auditors should perform analytical procedures as a risk assessment procedure and that in performing such procedures the auditor should develop expectations about relationships that are reasonably expected to exist.

Across the firms we encountered shortcomings in the preliminary analytical review procedures. In many cases expectations were not set and often it appeared that the findings were not linked into wider risk assessment procedures.

Similarly for substantive analytical review, we identified a number of instances across the firms in which expectations were not set in advance or in some cases reliance was placed on budget information without any justification on file as to the appropriateness of such information. There was also a tendency for explanations from the client to be documented on file without any further corroboration.

We recommend that firms ensure that future training in relation to analytical review emphasises the importance of establishing appropriate expectations at the outset, the need to corroborate explanations and that preliminary analytical review should be an integral part of the risk assessment process.

#### *3.4.6 Group audits and reliance on other auditors*

We have raised a number of issues in relation to the use of other auditors on large group audits. One such issue is the failure to assess adequately the competence of the other auditors. The fact that the other auditor may be a network firm does not negate the need for firms to give appropriate consideration to their competency. While the use of common methodologies and cumulative knowledge built up over the years are helpful indicators of competence, we believe that consideration should also be given to the relevant results of global AQR processes. We are pleased to report that one firm has now agreed to make available to its audit teams the results of international AQR reviews undertaken which are relevant to the particular audit while in the case of another firm a global AQR summary has been provided to business unit leaders and risk management partners. At a third, the audit engagement partner is notified if the audit file of a subsidiary or affiliate in another jurisdiction has been reviewed in the AQR process and been deemed to be unacceptable. We believe these are very positive responses to our previous recommendations and recommend other firms give serious consideration to similar initiatives.

It is common practice for members of the group audit team to periodically visit key overseas affiliates to attend closing meetings with management. Documentation in relation to these visits however is often limited and does not necessarily convey the contribution each meeting makes to the overall quality of evidence. We therefore recommend that firms emphasise the importance of appropriately documenting such meetings during visits to key overseas affiliates.

We also noted instances in which clearance opinions received from auditors of key affiliates were not signed off in accordance with the group instructions. For example the opinions were signed off in accordance with local GAAP rather than that applicable for group reporting. In these situations we would have expected an assessment by the group auditors of the impact of this divergence to have been evidenced on file. We recommend that the firms ensure they give appropriate consideration to the implications of other auditors failing to report in accordance with the group instructions.

#### *3.4.7 External experts*

Across the firms we continue to identify a range of issues arising from the reliance placed on the work of external experts such as actuaries and property valuers. While there is a requirement that audit teams consider the competence and objectivity of experts, this tends to be poorly done, and often accepted as a given where a large or established firm is used. Similarly it is not uncommon for limited procedures to be performed when reviewing the work and underlying assumptions used by the expert. Often firms will use their own specialists to undertake this work; in these cases the evidence on file of the work they undertake could be improved.

We recommend that firms reinforce to audit teams the need to assess appropriately the competence and objectivity of all external experts, where their work is relied upon as part of the audit, and to evidence properly on file their assessment of the sufficiency and appropriateness of that work.

#### 3.4.8 *Internal specialists*

It is increasingly common on large audits for audit teams to rely heavily on internal specialists for key areas of work. Examples of this include valuation specialists for certain fair value measurements, disclosures and impairment reviews, actuaries for pension valuations, treasury specialists for derivatives accounting, IT specialists for design and implementation review work and general computer controls work and taxation specialists. While appropriate use of such specialists should enhance the quality of the audit, we have observed a tendency for audit teams to take less ownership of the areas covered by the specialists, and to accept the work undertaken without adequate review or consideration of the appropriateness and adequacy of the audit evidence obtained. A good example of the latter is where the only evidence on file of the review of tax by tax specialists is a brief summary memorandum with no supporting working papers.

It is particularly important that audit teams cover the gaps that the use of internal specialists can create by, for instance, confirming the integrity and consistency of the data used. Clearly agreeing terms of reference with the specialists at the outset of the audit would clarify respective responsibilities and assist in maximising the benefit from their use.

We recommend that firms review their processes for engaging internal specialists to ensure that the specialists are fully integrated into the audit process, that respective responsibilities are clear, the work undertaken is appropriately documented and that the audit engagement team can demonstrate ownership of that work.

#### 3.4.9 *Reporting to audit committees*

In last year's report we identified certain areas in which we considered that improvements were required in the quality of reporting to audit committees. These included:

- Communicating audit planning information;
- Reporting how key risk areas communicated at the planning stage had been addressed and the conclusions which were drawn in relation to them;
- Reporting on certain key areas of judgment which, in our view, the audit committee needed to be made aware of; and
- Reporting all unadjusted differences identified.

Generally the standard of reporting to audit committees in the current year was of a high standard, particularly in relation to FTSE 100 entities. While we continued to identify instances, for all types of entities, where either the planning information or all unadjusted errors above the clearly trivial level

had not been communicated, the overall quality of reporting has improved. We noted, however, a number of cases in which disclosure omissions were not communicated to audit committees and there was no documented rationale explaining the reasons for this.

We recommend that firms emphasise the importance of reporting disclosure omissions to audit committees on the same basis as unadjusted differences identified.

#### *3.4.10 Dating of audit reports*

We noted instances in which the audit report was dated prior to the completion of all necessary work. In these cases the audit reports were dated prior to a complete annual report being available for review by the audit teams. This may reflect the pressure on audit teams to date their audit reports on the same date as that of the preliminary announcements.

We recommend that firms ensure that they comply fully with the relevant requirements of ISA (UK and Ireland) 700, and do not date their audit reports until all necessary work is completed, including a review of other information contained in the annual report.

#### *3.4.11 IFRS implementation*

A significant number of the audits that we reviewed in the past year related to entities that prepared their accounts under IFRS for the first time. Across the firms we raised very few issues of significance directly related to the implementation of IFRS.

The absence of issues arising in relation to IFRS implementation reflects the significant level of resources allocated to this by all firms. At one Big Four Firm all their FTSE 100 clients were required to have an IFRS technical review as part of the accounts hot review process. This additional review was performed by specialists from the Global IFRS Group with input from the UK Technical Department. Other firms also extended the extent and coverage of their technical hot review processes.

It was common for audit teams to undertake work in relation to IFRS implementation as a discrete exercise and for this to be documented on separate files. Often this work would be relied upon for the purposes of the opening balances, comparative figures and certain disclosures in the accounts including the IFRS transition note. On a number of files the linkage could have been better between the separate IFRS files and the main audit files where reliance was being placed on that work for year end audit purposes.

Generally we were satisfied with the robustness of the audit approach taken by firms to IFRS implementation and the absence of issues identified reflects this.

### 3.5 Monitoring of audit quality

The internal quality review programmes that each firm is required to undertake remains a key area of focus for our reviews. While we continue to make a number of recommendations for further improvements across the firms, we are generally satisfied that a good level of progress is being made in improving the robustness and effectiveness of the audit quality review ('AQR') processes. Generally the processes adopted by the larger firms are well developed. Key areas in which we consider that further improvements are required include procedures designed to ensure greater consistency in:

- the execution of the reviews;
- the consideration and assessment of the findings from each review; and
- the disposition of the findings/follow-up actions.

Further work is also required on the grading systems used. At some firms, no structured overall grading systems are in use. At other firms the grading system aligns with that used by the global network but the results could be more meaningful for local purposes if further analysis were provided.

At some firms, we compared the overall gradings from the firm's AQR processes with the findings from our own file reviews processes and these appeared broadly consistent. Notwithstanding this, we noted in the case of one firm that several recurring issues arising from our file reviews did not appear to be identified by the AQR process. These related to the requirement to evaluate the design and implementation of controls in relation to significant risks and the incorrect dating of audit reports. We also considered that greater unpredictability was required in the file selection process used at one firm.

We recommend that firms continue to seek to improve the robustness and consistency of their AQR processes including, where relevant, the more effective use of grading systems.

## Four – First year inspections at smaller firms

### 4.1 Background

This year we extended the scope of our work to cover those firms (other than the nine firms where we undertake full scope inspections) that audit a limited number of entities within our remit. These firms ('the smaller firms') vary in scale from larger national firms to smaller regional practices. As at 31 March 2006 there were approximately 40 such smaller firms.

Our work on the smaller firms was limited to a review of one or more audits. We undertook no work on their firm-wide procedures. Rather we placed reliance on the work of the ICAEW's Quality Assurance Directorate or the ICAS Monitoring Unit for these firms, as applicable.

We visited seven smaller firms and reviewed the audits of 11 clients. The type of entities reviewed together with the total number within our scope are summarised in the table below:

Type of entity	Number within scope	Files reviewed
Full listed	56	7
AIM/PLUS Market	5	2
Major unquoted companies	10	-
Pension funds	12	1
Charities	2	1
<b>Total</b>	<b>85</b>	<b>11</b>

### 4.2 Principal findings

The principal findings arising from our reviews are set out below. In considering the findings from these reviews, it should be noted that six of the entities reviewed were investment companies where the audit risks were fairly limited.

#### 4.2.1 Long association

In two instances we identified that the requirements of the Ethical Standards, in relation to the rotation of the audit engagement partner for listed entities, were not being properly complied with. In both cases the individuals concerned were no longer the audit engagement partner, but they continued to have extensive involvement with the clients. In one case the partner concerned was still undertaking a significant amount of detailed audit work. In the other case, the partner's level of contact with the client (which included attendance at audit committee meetings) gave rise to the perception that he continued

to exert influence over the audit. In both cases the individuals concerned have now ceased involvement with these clients.

#### *4.2.2 Assistance with preparation of financial statements*

It is common for smaller firms to provide assistance with the preparation of their client's financial statements. The Ethical Standards permit this for unlisted clients provided appropriate safeguards are in place. For listed clients, firms may not provide such assistance other than in emergency situations. We identified two firms where such assistance was being provided for listed clients. In one case it was clear that the firm had overlooked this requirement, as it had very few listed clients. In the other case the firm had concluded, in our view incorrectly, that the nature of the assistance provided did not constitute an accounting service.

#### *4.2.3 Adequacy of audit evidence*

We questioned whether there was sufficient evidence on a number of files to support key account balances and audit judgments. Examples of this included no external confirmation of significant investment holdings on file and the absence of independent valuation reports to support investment property valuations. The rationale for low levels of detailed testing and the reliance that could justifiably be placed on relevant controls were not always well articulated on the files such that it was difficult to ascertain whether sufficient work had been undertaken. The firms concerned have agreed to reassess their audit approach and to reconsider the adequacy of the evidence they are obtaining.

We considered one of the audits we reviewed to be deficient in respect of the work undertaken on a key risk area. This caused us to question whether the firm had the necessary resources to undertake this audit which was both specialised and high risk. The findings from this review were discussed at length with the ARC who requested that we undertake a follow-up review to assess the firm's response to the issues raised.

#### *4.2.4 Audit risk and fraud ISAs (UK and Ireland)*

For each of the files we reviewed, we identified a number of deficiencies in the documentation on file demonstrating that the requirements of the audit risk and fraud ISAs (UK and Ireland) had been adequately addressed. In some cases the audit methodology had not been sufficiently amended to take account of the additional requirements of the ISAs (UK and Ireland). For a number of these audits a substantive approach was adopted without any consideration of the impact of controls or the processes now required under the audit risk and fraud ISAs (UK and Ireland) to determine the most appropriate audit approach. The audit risk and fraud ISAs (UK and Ireland) pose particular challenges for the smaller firms.

#### 4.2.5 *Audit report dating*

We identified two instances in which the audit report was dated before a complete version of the annual report was available and all necessary work had been completed.

## APPENDIX A – Scope of independent inspection 2007/8

Audits of the following entities are within the scope of the work of the AIU in 2007/8. The AIU will review a sample of relevant audit engagements at each firm selected for an inspection visit. The AIU will normally review the last completed audit of an entity. In 2007/8, the relevant financial year is likely to have ended in either 2006 or 2007.

- All entities with listed securities (equity and debt). (Note 1)
- AIM or Plus markets (previously OFEX) companies with a market capitalisation in excess of £100 million. (Note 2)
- Unquoted companies, groups of companies or limited liability partnerships in the UK which have either:
  - a) Group turnover in excess of £500 million; or
  - b) Group long-term liabilities in excess of £250 million and turnover in excess of £100 million. (Notes 3 and 4)
- 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. (Notes 3 and 5)
- Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members. (Note 3)
- Charities with income exceeding £100 million. (Note 3)
- Friendly Societies with total net assets in excess of £1,000 million. (Note 3)
- Building Societies with assets exceeding £1,000 million. (Note 3)
- Open-Ended Investment Companies and Unit Trusts managed by a fund manager with more than £1,000 million of UK funds under management. (Note 2)
- Lloyd's Syndicates with an underwriting capacity in excess of £250 million. (Note 3)
- Mutual Life Offices whose "With-Profits" fund exceeds £1,000 million. (Note 3)

If the AIU receives a request from an overseas audit regulator to review the audit of a UK entity or a UK subsidiary of an entity within that regulator's scope, the audit of the UK entity will be deemed to be within the AIU's scope for this purpose. (Note 6)

In addition, the scope of the AIU's work at an individual audit firm may be extended by agreement with the professional accountancy body with which the firm is registered. (Note 7)

## Notes

Note 1: This refers to companies any of whose securities have been admitted to the official list (within the meaning of part 6 of the Financial Services and Markets Act 2000), not to AIM or Plus Markets (see below) and not to overseas markets, as at either the previous 28 February (ie 28 February 2007 for 2007/8) or, if later, the date of the last published set of accounts.

Note 2: These measures will be applied as at the previous 28 February, ie 28 February 2007 for 2007/8.

Note 3: These measures will apply as at the date of the last published set of accounts.

Note 4: This category is intended to include companies or groups of companies that are privately owned, whether directly or through another investment vehicle, trust or overseas holding company. It is also intended to include those companies owned by private equity funds or other institutions. It is not intended to include subsidiaries of any other category in this list.

Note 5: This category is intended to cover major subsidiaries of overseas groups. If there are a number of separate subsidiaries trading in the UK and group consolidated accounts are not produced, this measure will be applied on an individual company basis.

Note 6: This provision is to enable the AIU to respond to requests from overseas regulators should it be considered appropriate to do so, thereby facilitating cost-effective regulation and helping to address client confidentiality concerns expressed by audit firms. Such requests are likely to be rare and will be considered individually by the AIU in consultation with the audit firm concerned. Where they occur, and result in a review of the relevant audit being carried out by the AIU, the AIU will seek to agree the form of reporting with both the overseas regulator and the audit firm concerned.

Note 7: This provision is to enable the AIU to agree a different scope with the relevant professional body if, in a particular case, both parties consider this to be appropriate.

## **APPENDIX B - Overview of inspection process**

### **Introduction**

Set out below is an outline of key aspects of our inspection and reporting process.

### **Reviews of firm-wide procedures**

Our review of firm-wide procedures addresses all aspects of firms' systems of quality control, including their internal audit quality review procedures. Our review procedures recognise the importance of the culture established by the firms' leadership team in promoting audit quality and professional integrity ('tone at the top'). We consider, for example, how the firms' commitment to quality and integrity is reflected in the basis on which partners are appointed, remunerated and promoted to senior roles.

We also review the firms' human resource systems and policies more generally; the competence and motivation of audit personnel being, in our view, a key element in achieving high quality audits.

Another important area where we focus our firm-wide work is the firms' procedures designed to ensure the independence of the firm generally and the audit teams specifically. This includes a review of the firm's systems and procedures for rotation of partners and staff in accordance with the requirements of the Ethical Standards.

The regulatory framework requires firms to have an annual quality review process in place for the review of a selection of completed audits. Firms use different terminology to describe this process but we refer to it in this report as the Audit Quality Review (AQR). We review how firms conduct their AQR, the effectiveness of the process, the overall findings (comparing these with our own findings) and any remedial actions taken or planned by the firm.

### **Reviews of individual audit engagements**

We carry out comprehensive reviews of individual audit engagements to give us a sound basis on which to assess the quality of each audit we review. Our work programmes are tailored to ensure that reviews are sufficiently focused on the major risk areas identified for each audit and cover appropriately the requirements of Auditing Standards. Our inspection teams challenge audit partners on the basis on which significant audit judgments were made. We believe that challenging audit judgments in this way is a key feature of an effective review of audit quality.

Our focus in relation to any financial reporting issues we identify is on the appropriateness of audit judgments exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Financial reporting and disclosure issues arising are therefore raised with firms in an audit context rather than a financial reporting context.

## Reporting

We prepare reports on each audit engagement we review. These reports are provided to the audit teams concerned and copied to senior management within the firms' audit practices. The key issues arising from the reviews of individual audit engagements, and those arising from our review of firmwide procedures, are set out in our private reports to the Audit Registration Committee of the professional body by which the firm is registered.

Our private reports include prioritised recommendations to the firms together with responses from the firms including planned actions. We prioritise the issues and our recommendations on the basis of our assessment of their actual or potential impact on audit quality.

Current policy is to issue an annual public report setting out the overall findings and conclusions arising from our inspection visits but not to publish any part of our reports on individual inspection visits.<sup>7</sup> The Oversight Board is currently consulting on the implementation of a revised reporting model including the publication of high level reports on individual firms.<sup>8</sup>

## Improving the inspection process

We are committed to a process of continuous improvement and value constructive feedback from all firms subject to inspection as to how the process might be further improved. As part of this commitment, we identified the need to improve the IT infrastructure that supports our review processes and accordingly have implemented a new IT system for 2007/8. This will assist in better managing the process and ensuring greater consistency.

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<sup>7</sup> These arrangements were agreed between the DTI, the FRC and the CCAB when the Oversight Board and the AIU were set up.

<sup>8</sup> Reporting on Audit Quality Monitoring -Implementing a New Approach (FRC, June 2007).



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