



AUDIT INSPECTION UNIT

2007/8 AUDIT QUALITY INSPECTIONS

AN OVERVIEW

8TH DECEMBER 2008

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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One – Introduction

The Professional Oversight Board, part of the Financial Reporting Council, has today published reports on the Audit Inspection Unit's (AIU) inspections for 2007/8 of the following seven audit firms:

BDO Stoy Hayward LLP,
Deloitte & Touche LLP,
Ernst & Young LLP,
Grant Thornton UK LLP,
KPMG LLP and KPMG Audit Plc,
PKF (UK) LLP, and
PricewaterhouseCoopers LLP.

The reports cover reviews of firm-wide procedures and individual audits undertaken by the AIU in the period from April 2007 to March 2008. The individual audits reviewed related to financial years ending between June 2006 and August 2007.

This is the first occasion that AIU reports on the findings of inspections of individual audit firms have been made publicly available and is part of our programme to support the continuous improvement of audit quality. The reports are available from the FRC's website:

<http://www.frc.org.uk/pob/audit/firmreports.cfm>.

The term "major firms" is used to refer to those firms which audit more than ten entities within the AIU's scope, as determined each year by the Oversight Board, and are therefore subject to full scope AIU inspections. There are currently nine such firms, comprising the seven firms noted above, Baker Tilly UK Audit LLP and Horwath Clark Whitehill LLP. The AIU will undertake inspections of the latter two firms (which were not visited in 2007/8) during 2008/9 and reports on its findings will be published during 2009. Firms that audit up to ten entities falling within the AIU's scope are referred to as "smaller firms".

An overview of key findings arising from the AIU's inspection work in 2007/8 at both the seven major firms noted above and at smaller firms is set out in Section Two.

The scope of and background to the AIU's work, including details on the coverage of its 2007/8 inspections, is outlined in Section Three.

A summary of the findings from the AIU's 2007/8 inspections at smaller firms, which are not subject to separate public reporting, is set out in the Appendix.

Two - AIU Inspections 2007/8: Key findings

2.1 Introduction

This Section provides an overview of key findings arising from the AIU's inspection work in 2007/8 at both the seven major firms for which individual public reports have been published ("the seven major firms") and at smaller firms.

2.2 Overview of findings

The AIU considers the quality of auditing in the UK to be fundamentally sound. The AIU public reports indicate that the senior management of the seven major firms are committed to audit quality and have quality control procedures in place which are appropriate to their size and the nature of their client base. The reports confirm that in each case the AIU has recommended to the relevant Audit Registration Committee that the firm's registration to conduct audit work be continued. The AIU believes that its inspection process is both rigorous and challenging for firms and that the progress achieved by the firms in addressing the findings from its inspections in previous years has contributed significantly to an improvement in the overall quality of audit work in the UK.

In relation to its reviews of individual audits undertaken by the seven major firms, the AIU considered the audit work generally to have been performed to a good or acceptable standard. However, the AIU's review of individual audits at each firm identified certain areas in relation to which further improvements need to be made by the firms.

A small proportion of the audits reviewed at the seven major firms were considered by the AIU to require significant improvement in certain areas. Only three of these audits related to entities which were listed on a regulated market¹ and none related to FTSE100 entities. The proportion of audits requiring significant improvement was, however, higher at the "smaller firms".

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 might also apply to other firms. Only a small sample

¹ Within the meaning of Part VI of the Financial Services and Markets Act 2000.

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.

Key findings arising from its inspection work in 2007/8 that the AIU wishes to highlight are set out below. The AIU referred in last year's public report to its principles-based approach to improving audit quality and the importance it attaches to firms observing the principles underlying Auditing Standards and Ethical Standards as well as the specific requirements thereof. A number of the matters referred to below build on this theme.

Audit evidence and related judgments

A key aspect of the AIU's work is the review of significant audit judgments, including the acceptability of accounting treatments adopted, the reasonableness of assumptions used in accounting estimates and judgments relating to the nature and extent of the audit work performed and the adequacy of the audit evidence obtained. While the AIU was generally satisfied with the basis on which significant audit judgments were made, the public reports all comment specifically on issues arising in this area. The areas in which issues arose included the appropriateness of audit judgments relating to valuations, impairment and provisioning; the basis on which reliance was placed by the auditors on the work of third parties; and the adequacy of the audit evidence obtained in relation to material stock balances.

The AIU continues to believe that the thought processes underlying significant audit judgments need to be properly evidenced at the time and that failure to do so increases the risk of them being incomplete or misguided and of inappropriate audit judgments being made as a result. Firms need to continue their efforts to achieve improvements in this key area which, in the AIU's view, is central to the principles-based approach to auditing in the UK.

Risk assessment

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including those risks which require special audit consideration (such risks are termed "significant risks"). A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

The AIU raised issues relating to the identification of significant risks at most firms, concerning either the appropriateness of the firm's guidance or the application of that guidance on individual audits. The AIU

also raised issues at a number of firms relating to the evaluation of the design and implementation of related internal controls.

While the AIU noted that improvements had been achieved in this area at a number of firms, it considers that there is scope for further improvement at all firms to ensure that the requirements of Auditing Standards relating to risk assessment procedures are fully complied with.

Analytical review

The AIU continues to identify weaknesses at most firms in the use of analytical procedures to obtain audit evidence. In the majority of cases the issues identified by the AIU related to a failure to set appropriate expectations and/or thresholds for investigation of variances from those expectations, together with insufficient corroboration by the audit teams of explanations obtained. In a number of audits, the AIU concluded that there were significant weaknesses in analytical procedures performed to obtain audit evidence.

The AIU notes that most firms have appropriate guidance on how to undertake analytical review procedures and that this has been recently enhanced at some firms. The issue primarily relates to the application of the firms' procedures and supporting guidance in practice. The AIU considers this to be an area where continued efforts to achieve improvements are required.

Reporting to those charged with governance

Appropriate communication with audit committees or other relevant governance bodies contributes to the quality of an audit and assists both parties in discharging their responsibilities effectively. Generally the AIU considered the quality of reporting to audit committees by firms to be of a good standard. However, the AIU has observed that where the corporate governance arrangements, particularly the role of the audit committee, is less formalised this can adversely impact on the quality of communications with those charged with governance.

Audit challenges arising from the "credit crunch"

The AIU undertook an assessment during 2007/8 of how the seven major firms were responding at a firm-wide level to the audit challenges arising from the "credit crunch". The public reports contain a brief commentary on how each firm responded. Overall the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising. However, the AIU's assessment of

these responses was, in most cases, made prior to 31 December 2007 in order to assess their likely impact on audits relating to this major reporting date. It therefore did not address audit challenges associated with the more recent turmoil in the financial markets or how the firms responded at an individual audit engagement level.

Ethical Standards

While the AIU identified very few clear breaches of the specific requirements of the Ethical Standards at the seven major firms, it identified certain areas where the underlying principles of the Ethical Standards were, in its view, not being fully observed by some of the firms. A number of examples are set out below.

The number of issues relating to independence requirements under the Ethical Standards which the AIU identified at smaller firms was higher. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional requirements under the Ethical Standards for listed entities. Independence issues identified by the AIU at smaller firms included long association with the audit client, involvement in the preparation of the client's financial statements and fee dependency. Further details are provided in the Appendix.

Long association with audit clients

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the audit engagement partner is required to rotate after having served for a maximum period of five years and "key audit partners"² (KAPs) are required to rotate after seven years.

The AIU has previously commented on the adequacy of firms' systems for monitoring compliance with the specific rotation requirements for audit engagement partners and KAPs. While the AIU considers that there is still work to be done in some cases to improve the completeness and integrity of rotation databases, the AIU was generally satisfied with the progress the firms have made in this area.

The AIU noted that there has generally been an increase in the number of partners identified as KAPs, although there is some variation in practice between the firms particularly in relation to specialist partners involved in major listed group audits. The change in the definition of a KAP (now referred to as a "key

² Partners other than the audit engagement partner who are responsible for key audit decisions or judgments.

partner involved in the audit"³) under the revised Ethical Standards issued in April 2008 should, in the AIU's view, provide firms with a catalyst to review their identification of KAPs on major listed group audits.

The AIU has previously commented on the issue of long involvement on large group audits by the audit engagement partner. Such long involvement, which will have been in varying capacities and often continuous, may not be precluded by the Ethical Standards but nonetheless gives rise to familiarity threats. In the AIU's view, firms continue to give insufficient consideration to the independence threats arising and, as a consequence, have often not applied appropriate additional safeguards to mitigate them. While the AIU believes that the new definition of a "key partner involved in the audit" under the revised Ethical Standards should help to address this issue, it considers that firms nevertheless need to look beyond the specific requirements under the Ethical Standards and to take a more principles-based approach in assessing the threats arising from such long involvement.

Rewarding KAPs for selling non-audit services to audit clients

The AIU identified that some firms permit senior specialist personnel from outside the audit function who are involved in audits, including those identified as KAPs on those audits, to be rewarded for selling non-audit services or for their performance to be evaluated based on their success in selling non-audit services.

While the Ethical Standards do not explicitly address this issue, in the AIU's view the underlying principles of the Standards indicate that such KAPs should be treated in the same way as other audit partners responsible for key audit decisions or judgments and that they should not be rewarded for selling non-audit services to the audit clients concerned.

Direct assistance from internal audit staff

The AIU identified that some firms have policies and practices which permit the use of staff from a client's internal audit department to perform external audit procedures directly for the audit team.

While Standards permit firms to place appropriate reliance on the work of clients' internal audit functions, they do not specifically address the use of internal audit staff to provide direct assistance to the external auditors in this way.

³ The definition has been extended to include partners who are responsible for the audit of material subsidiaries, in accordance with the requirements of the EU Statutory Audit Directive (Directive 2006/43/EC), and to make it clear that it covers non-audit professionals such as tax partners who are responsible for key audit decisions or judgments.

In the AIU's view, the practice of including staff from clients' internal audit departments in external audit teams may be inconsistent with the underlying principles of the Ethical Standards because it is not possible for such staff to be independent of their employers. The AIU considers that firms should review the appropriateness of this practice and what safeguards should be applied to address the threats to their independence arising.

Three - Scope and background

3.1 Background

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing 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 inspections visits is designed to promote high quality auditing and thereby contribute to this strategic outcome.

The AIU's inspections of the major audit firms, on which it reports publicly, 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 AIU reviews firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Independence and ethics
- Audit methodology

The AIU's reviews of individual audits place emphasis on the appropriateness of significant audit judgments exercised in reaching the audit opinion, as well as the sufficiency and appropriateness of the audit evidence obtained.

The AIU's inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing

Practices Board (APB)⁴ and other relevant requirements under the Audit Regulations⁵. The standards referred to in the AIU's reports for 2007/8 are those effective at the time of the AIU's inspection or, in relation to its review of individual audits, those effective at the time the relevant audit was undertaken. (The APB issued revised Ethical Standards in April 2008 which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

The AIU seeks to identify areas in which improvements are, in its view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. The AIU also assesses the extent to which the firm has addressed the findings and recommendations arising from its last AIU inspection.

The AIU provides the Audit Registration Committee of the relevant professional accountancy body in the UK, who register firms to conduct audit work, with a report on each major firm containing a number of findings in relation to how the firm can improve audit quality, together with an overall recommendation on whether the firm's audit registration should be continued. These reports provide the basis for the AIU's public report on each firm. In addition, the AIU reports separately to the Audit Registration Committees on its findings from reviews of audits at smaller firms.

The AIU's inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by the AIU for review and cannot be relied upon for this purpose.

The AIU does not carry out a detailed technical review of the audited financial statements in reviewing individual audits. 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. Audit judgments on financial reporting issues are, however, challenged by the AIU, where appropriate, as an integral part of its work.

If the AIU identifies a significant concern during the course of a review of an individual audit as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable

⁴ International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

⁵ The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

accounting framework, it may draw the matter to the attention of the FRC's Financial Reporting Review Panel ("FRRP"). Such matters are then considered in accordance with the FRRP's Operating Procedures. In 2007/8 the AIU drew the FRRP's attention to matters arising in relation to the financial statements of three entities whose audits it had reviewed.

Similarly, if during the course of its inspections the AIU identifies a significant concern as to the conduct of an individual or firm it may draw the matter to the attention of the FRC's Accountancy and Actuarial Discipline Board ("AADB"). In 2007/8 the AIU drew no such matters to the attention of the AADB.

The monitoring units of the professional accountancy bodies in the UK 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.

3.2 Coverage of Inspections

During 2007/8, the AIU undertook full scope inspection visits, comprising a review of firm-wide procedures and individual audits within its scope, at the seven major firms noted in Section 1.1. These firms are all registered to conduct audit work by the Institute of Chartered Accountants in England and Wales. Full scope inspections of Baker Tilly UK Audit LLP and Horwath Clark Whitehill LLP, which were not visited in 2007/8, will form part of the AIU's inspection programme for 2008/9.

The AIU also carried out inspection visits at nine smaller firms. For these firms, the AIU's work comprised reviews of one or more of the small number of listed or other major public interest entities audited by them.

Staff from the US Public Company Accounting Oversight Board participated in certain aspects of the AIU's 2007/8 inspections of PricewaterhouseCoopers LLP and Deloitte & Touche LLP, by agreement with the firms concerned. All matters raised in the AIU's public reports, however, are based solely on work carried out by the AIU.

At the request of the Audit Commission, the AIU also undertook an inspection visit comprising a review of its firm-wide procedures and five individual audits. This inspection visit was undertaken on a contractual basis as entities audited by the Audit Commission are outside the scope of audit regulation. The Audit

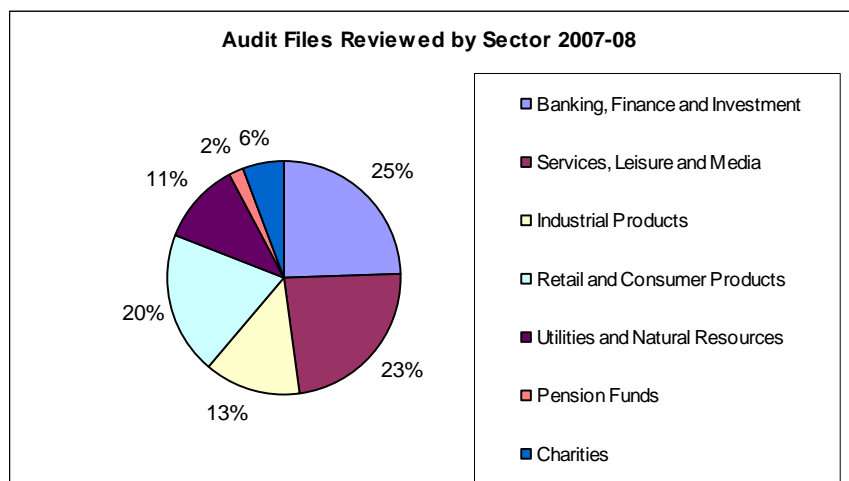
Commission has provided a high level summary of the review findings in its Audit Practice Annual Quality Report.

3.3 Analysis of audits reviewed by the AIU

In the year to 31 March 2008 the AIU completed the review of 90 audits undertaken by audit firms (compared with 103 in 2006/7)⁶ as set out by firm type in the following table.

Firm type		File reviews 2007/8	File reviews 2006/7
Major firms {	Big four firms	60	67
	Other major firms	20	25
	Smaller firms	10	11
	Total	90	103

An analysis by sector of the audits reviewed by the AIU in 2007/8 is set out below:



3.4 Reporting

The Oversight Board consulted on changes to the reporting arrangements for the AIU in June 2007 (“Reporting on Audit Quality Monitoring-Implementing a New Approach”). The results of that consultation and the Board’s policy conclusions were published on 5 December 2007.

⁶ Includes three file reviews commenced in 2006/7 and completed in 2007/8. The equivalent figure for 2006/7 was 11.

A key change to the reporting arrangements was that the AIU would no longer publish one annual report on generic themes and findings but rather high level public reports on individual audit firms. Such reports would only be published for those firms where the AIU had undertaken a full scope inspection. The content of these reports would be based on the findings set out in the AIU's more detailed private reports to the respective audit registration committees. This change took effect for the 2007/8 inspection cycle and marks an important development in increasing the transparency of the AIU's work.

Another significant change was the introduction of new reports on individual audits reviewed by the AIU for those reviews which commenced after 1 January 2008. While these reports are addressed to the relevant audit engagement partner, the Oversight Board's expectation is that they will be provided by the firms to the relevant client's audit committee. This is a further important contribution to enhancing the transparency of reporting on the AIU's inspections of the work of the UK's audit profession.

Appendix – Inspections at smaller firms

1 Background

This appendix provides a summary of the AIU's inspection work at smaller firms who conduct audits of listed or other major public interest entities. As at 31 March 2007 there were approximately forty such smaller firms, ranging in scale from larger national firms to smaller regional practices. The AIU's work at smaller firms was limited to a review of one or more audits.

In 2007/8 the AIU visited nine smaller firms and reviewed ten individual audits. (In 2006/7 the AIU visited seven smaller firms and reviewed eleven individual audits.)

2 Principal findings

The extent of issues identified by the AIU on the audits it reviewed at smaller firms was generally greater than at the larger firms. This may partly reflect the fact that eight of the smaller firms visited in 2007/8 had not previously been subject to an AIU inspection.

In particular, the incidence of independence issues arising was greater at smaller firms. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional independence requirements for audits of listed entities, given the limited number of listed entities audited by such firms.

In the AIU's view, the majority of the ten audits it reviewed at smaller firms required significant improvements in certain areas. The sufficiency of audit evidence and compliance with independence requirements were the main areas where improvements were required.

The principal findings arising from the AIU's inspection work at smaller firms are set out below. The issues commented on below are either considered to be individually significant or are common to a number of firms.

2.1 Independence issues

Independence issues identified by the AIU at smaller firms fall into three main categories: long association with the audit client, assistance with the preparation of the client's financial statements and fee dependency. Further details are set out below.

Long association with audit clients

On two audits of listed entities, the AIU identified that the requirements of the Ethical Standards in relation to the rotation of the audit engagement partner were not being properly complied with. On one of those audits, the AIU also identified that the manager had been involved for 17 years and that there was no evidence that the firm had considered whether appropriate safeguards were in place, as required by the Standards.

On an audit of a significant unlisted entity, the AIU identified that the audit engagement partner, the firm's chairman, had acted for this client (the firm's largest) for in excess of ten years. In such situations the AIU expects firms to ensure that the safeguards in place are strengthened over time in line with the increasing threats to independence and ultimately that firms should have a succession plan in place.

Assistance with preparation of financial statements

The AIU identified one audit of a listed group where the firm had provided assistance with the preparation of the statutory accounts of all the subsidiaries. The AIU considered that the assistance provided was not permitted under the Ethical Standards for listed entities.

Fee dependency

In relation to a significant charity audit, the AIU noted that fees earned from that client and related entities exceeded 10 percent of the firm's total fee income. In such situations the Ethical Standards require the firm to arrange for an external independent quality control review of the audit to be carried out. The AIU noted that while the firm had an external reviewer in place, the individual concerned had acted in this role for in excess of eleven years. The AIU considered, in light of this, that the firm needed to refresh the external review role. More generally the AIU considers that in situations of this nature firms need to consider and observe the principles underlying the Ethical Standards as well as the specific requirements thereof.

2.2 Adequacy of audit evidence

In a number of instances, the AIU was unable to conclude that sufficient audit evidence had been obtained to support certain account balances and audit judgments. These included the adequacy of work undertaken on the profit and loss account and the sufficiency of the testing of controls where the audit approach placed reliance on their operating effectiveness.

The AIU will be undertaking follow-up reviews of the following year's audits in two cases where it had concerns as to the sufficiency of the audit evidence obtained to support material account balances.

2.3 Reporting to those charged with governance

On most of the audits reviewed, the AIU identified instances where the reporting to those charged with governance did not meet all the requirements of Auditing Standards. Shortcomings identified included the failure to communicate a firm's independence in writing and insufficient communication of audit planning and audit findings. In some cases, there was a lack of clarity over to whom the communications should be made, with communications being made for example to an individual rather than the audit committee or the directors as a whole.

2.4 Audit risk and fraud standards

On most audits reviewed the AIU identified a number of deficiencies in the evidence on file to demonstrate that the requirements of the audit risk and fraud standards had been adequately addressed. Common issues included an inadequate assessment of the risks of material misstatement at the assertion level, a lack of clarity over the identification of significant risks, insufficient consideration of fraud risks and a failure to evaluate the design and implementation of controls over significant risks. Compliance with the requirements of the audit risk and fraud standards continues to be challenging for smaller firms.

2.5 Audit report

On four audits the AIU identified that the audit report was dated before all necessary work had been completed. In each case a number of amendments were made to the annual report after the audit report date, in some cases several weeks after that date.

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