



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2007/8 INSPECTION OF PKF (UK) LLP

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.

Contents

	<i>Page</i>	
1	Scope, objectives and background information	2
<hr/>		
2	Findings	7
<hr/>		
	Appendix A - Firm's response	21
<hr/>		

1 Scope, objectives and background information

1.1 Introduction

This report sets out the principal findings arising from the inspection of PKF (UK) LLP (“PKF” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), part of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2008 (“the 2007/8 inspection”). Our inspection was conducted in the period from September 2007 to October 2007 and from February 2008 to April 2008 (referred to as “the time of our inspection”).

It is based on the AIU’s more detailed private report on its inspection of the firm to the Audit Registration Committee (“the ARC”) of the Institute of Chartered Accountants in England and Wales (“the ICAEW”) with whom the firm is registered for audit purposes. The AIU currently undertakes a full scope inspection of PKF at least every two years¹. The 2007/8 inspection was the AIU’s second full scope inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2007/8 report to the ARC, which was finalised in July 2008, recommended that the firm’s registration to conduct audit work should be continued.

This is the first year the AIU has reported publicly on individual firms. In the past the AIU has issued an annual public report in which the principal findings arising from its inspections of the major audit firms in the UK were dealt with on an anonymous and aggregated basis.

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

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 without having arisen in the course of the

¹ The Companies Act 2006, as amended with effect from 6 April 2008 by the Statutory Auditors and Third Country Auditors Regulations 2007, requires that full scope inspections of those audit firms conducting more than ten audits within the scope of independent inspection (as determined by the Professional Oversight Board) are undertaken at least every three years.

AIU's inspection fieldwork at those other firms in the relevant year. Also only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

All findings requiring action set out in this report have been discussed with the firm, together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU within 12 months of its private report on the 2007/8 inspection being finalised.

The Oversight Board undertook to publish all the reports for the 2007/8 cycle of inspections on a single date. The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there is necessarily a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The firm was invited to provide a response to this report for publication. The firm's response is set out in Appendix A.

The AIU acknowledges the co-operation and assistance received from the partners and staff of PKF in the conduct of the 2007/8 inspection.

1.2 Scope and objectives

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 for the users of audit reports to be able to place a high degree of reliance on audit opinions, including whether financial statements show a true and fair view. The AIU's programme of inspections is designed to contribute to the achievement of this strategic outcome.

Our inspections of the major audit firms, on which we report 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.

We review 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

Our 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.

Our 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)² and other relevant requirements under the ICAEW's Audit Regulations³. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken. (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.)

We seek to identify areas in which improvements are, in our 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. We also assess the extent to which the firm has addressed the findings and recommendations arising from its last AIU inspection.

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. Our 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 us for review and cannot be relied upon for this purpose.

² International Standards on Auditing (UK and Ireland). APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

³ 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.

We reviewed the quality of five individual audit engagements undertaken by the firm. These related to listed and other major public interest entities with financial year ends between December 2006 and August 2007. Our reviews covered selected aspects of the audit only.

The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange (“a full listing”) and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice.

To the full extent permitted by law, the FRC, the Oversight Board, the AIU and their employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

1.3 Background information on the firm

PKF is a UK limited liability partnership. It is a member of PKF International Limited which is described as a “worldwide association of legally independent firms”.

PKF has 23 offices throughout the UK. Assurance & Advisory and similar services are managed within each office whereas specialised types of work are managed across offices.

For the year ended 31 March 2007, the firm’s turnover was £114 million, of which £47.4 million related to Assurance & Advisory; the average number of employees was 1,514⁴. There were a total of 148 partners, of whom 58 were authorised to sign audit reports⁵.

⁴ As disclosed in the firm’s annual financial statements for the year ended 31 March 2007. An analysis of Assurance & Advisory turnover between audit and non-audit fees is not publicly available.

⁵ As disclosed in the annual return to the ICAEW as at 31 May 2007.

The firm had no employees, other than salaried partners, who were authorised to sign audit reports.

The AIU estimates that the firm had 36 audit clients within the scope of independent inspection by the AIU as at the 2007/8 reference date of 27 February 2007. Of these audit clients AIU records show that 34 had a full listing or were listed on the AIM market of the London Stock Exchange⁶, including 20 investment trusts or venture capital trusts.

⁶ The firm also had other AIM listed audit clients below the threshold for inclusion within scope.

2 Findings

2.1 Overview

We reviewed material relevant to assessing the “Tone at the Top” at the firm, as well as a number of other processes that demonstrated the importance attached to audit quality within PKF. In particular, the firm’s internal licensing system⁷ for audit engagement partners and the link to the firm’s audit monitoring process reinforce the importance of audit quality within the culture of the firm.

Overall, in our view, the firm has in place policies and procedures in all relevant areas which are subject to our review that are appropriate for its size and the nature of its client base. However, we have highlighted certain areas for improvement in this report. The firm’s audit quality monitoring process has been comprehensively revised and enhanced since our last full review.

In relation to reviews of individual audits, we have generally reported our findings by reference to significant matters arising on one or more audits. In view of the relatively small number of the firm’s audits reviewed by us, it is not appropriate to report principally on the basis of themes arising or issues of a similar nature identified across a number of audits.

We were pleased to find that there had been an overall improvement in the audit teams’ application and understanding of the Auditing Standards relating to audit risk and fraud since our last inspection.

We were generally satisfied, subject to our comments in section 2.4.3, with the basis on which significant audit judgments were made on the five audits reviewed by us. In our view, audit work was generally performed to a good or acceptable standard. The overall findings arising from our review of individual audits are set out in section 2.4; these include areas where improvements are, in our view, needed in order to enhance audit quality. In our view, three of the audits we reviewed, one of which related to an entity listed on a regulated market⁸, required significant improvements in certain areas.

The firm has implemented all the recommendations we made last year. Some matters such as maintaining the rotation database remain ongoing processes. Certain issues recurred in individual audits reviewed, although some of the reviews covered a period

⁷ PKF requires an audit partner to have been granted an internal licence before acting as the audit engagement partner for any audit client. See section 2.2.2.

⁸ Within the meaning of Part VI of the Financial Services and Markets Act 2000.

before last year's report was finalised. This was mirrored in the results of the firm's internal audit quality monitoring. While the firm's training covered all the recurring issues, it does not appear to have resolved a number of them. This may be due to the timing of the annual audit update but nonetheless we understand that to assist with compliance in these areas the firm is considering procedural and/ or other changes.

The principal findings arising from our review of the firm's policies and procedures supporting audit quality and the quality of the individual audits selected by us for review are set out below under three broad headings: quality control (section 2.2); independence and ethics (section 2.3); and audit performance (section 2.4).

2.2 Quality control

This section covers our review of the following aspects of the firm's system of quality control for audit engagements:

- 2.2.1 Leadership, strategy and communications
- 2.2.2 Performance evaluation, promotions and remuneration
- 2.2.3 Other human resource matters
- 2.2.4 Client risk assessment and acceptance/continuance
- 2.2.5 Consultation and review
- 2.2.6 Audit quality monitoring

2.2.1 Leadership, strategy and communications

The activities of the firm are carried out under the control of the Managing Partner. Certain responsibilities are delegated to committees such as the Risk Management Committee and the Assurance and Advisory Standards Committee (AASC).

The firm also has a Board, which is responsible for monitoring and is ultimately responsible for the firm's overall performance.

We held meetings with the Managing Partner as well as other key personnel, who all emphasised the importance placed on audit quality. We reviewed the strategic and business plan of Assurance & Advisory, as well as relevant internal and external communications, where formalised, and the firm's processes relating to quality.

The firm has a values statement, which has an appropriate focus on audit quality. However, it has few formal internal or external communications relevant to audit

quality. In particular, it does not produce an annual report with its statutory accounts and has to date not published a transparency report in advance of the statutory requirement to do so taking effect. Training is the main formal method of communication of matters relevant to audit quality but we were also made aware of some informal methods.

The material reviewed demonstrates that the firm's strategy and communications to staff give appropriate prominence to the importance of audit quality.

2.2.2 Performance evaluation, promotions and remuneration

Annual performance reviews are carried out for all partners and staff with performance being assessed against each of the firm's business drivers.

Objectives set are based on expected performance against the business drivers and in relation to audit can be linked to the relevant documented roles and responsibilities.

We reviewed the performance evaluation procedures and a sample of appraisals for audit managers and partners; all included specific commentary concerning producing quality work. In the case of partner appraisals this was often with reference to achieving a certain standard for internal quality reviews.

The salary review process for staff is a separate process which is not linked directly to the appraisal process. In respect of partners, the firm has both salaried and equity partners. For all partners, although there is no explicit and direct link between partner appraisals and the setting of salaries/ profit shares we were informed that the Managing Partner does review appraisal results at the same time as setting salaries/ profit shares for the following year.

We also reviewed the partner admission/ promotion procedures and a sample of relevant papers for two partner candidates. In both cases the ability of the candidates to achieve high quality audits was given sufficient focus.

2.2.3 Other human resource matters

Audit training and communications

The firm maintains a database detailing all courses offered. In addition each office has a Departmental Training Coordinator, responsible for sharing details of courses with relevant members of staff in his/her office.

There is mandatory audit training for junior staff prior to qualification and for all staff in respect of independence and ethics every two years. Annual workshops for audit partners are mandatory and the firm has now decided to hold these twice a year, which we view as a positive development. For qualified audit personnel there is a mandatory annual audit update. The course is repeated on a number of dates and is usually held in the spring. Aside from absences due to illness and other longer term leave we were advised that this course was fully attended in 2007.

Other courses in specialist areas are also held and attendance by certain individuals may be required for internal licensing purposes.

Attendance on all courses is monitored and the firm has a facility to suspend access to the electronic audit system for non attendance.

We reviewed a sample of training material. The content of the courses addresses new requirements and development needs arising from internal quality monitoring and external regulation, and appears to be comprehensive. However, given the number of recurring issues arising, particularly from the annual quality monitoring, the training does not appear to have resolved a number of them. This may be due to the timing of the annual audit update but nonetheless we understand that the firm is considering procedural and/or other changes to assist with compliance in these areas.

Technical issues are evaluated by the firm as they arise. Depending on the message to be conveyed, the urgency and the target group the firm will appropriately disseminate the material.

Credit Crunch communications

Audit risks arising from the "Credit Crunch" including going concern matters were communicated to audit personnel via various means between November 2007 and January 2008. We reviewed these communications and found them to be appropriate to the firm's client base.

Audit engagement partner licences

PKF operates an internal licensing system for partners requiring an internal licence to be granted before a partner can act as the audit engagement partner for any audit client.

When a partner applies annually for his/her licence(s) a number of confirmations must be given and the process is also linked in to the firm's annual quality review process in that it assesses the competence that has been self certified in the licence application. There are both generic licences and client specific licences and in each case there are different categories of licence.

Where an audit engagement partner has received an unsatisfactory grade in the annual quality review his/ her licence may be made conditional on an extended engagement quality control review to be carried out on the relevant audit(s).

New partners, whether recruited externally or promoted internally, will automatically have extended engagement quality control reviews.

In our view, this process and its link to the annual quality review enhances overall audit quality.

2.2.4 *Client risk assessment and acceptance/ continuance*

Firms are required to have policies and procedures in place to provide them with assurance that client integrity, compliance with ethical requirements and their competence, capabilities and resources are considered before they decide whether to accept or continue an audit engagement.⁹

The firm's clients are categorised as either 'normal' or 'higher than normal' risk. The firm also categorises clients by type, for example AIM listed or fully listed. The associated risks in all cases are dealt with in a number of ways, including assignment of an engagement quality control reviewer, specific focusing of the audit work and/ or by the fact that only certain audit partners hold the relevant audit licence to audit these clients.

The firm has acceptance procedures for all new clients and for new assignments for existing clients. Higher risk businesses require the approval of the Senior Partner or Managing Partner (or their alternates). In addition continuance of an audit engagement has to be considered at both the planning and completion stages of the audit.

⁹ International Standard on Quality Control (UK and Ireland) 1, paragraph 28

We reviewed the firm's policies and procedures in respect of acceptance and continuance and a sample of new client forms. Client continuance is documented on audit files and was reviewed as part of our reviews of individual audits. We concluded that the firm had complied with its policies and guidance.

2.2.5 Consultation and review

Engagement quality control reviews

Firms are required to have policies and procedures in place requiring an engagement quality control review to be undertaken for all audits of financial statements of listed entities and other audits meeting specific criteria.¹⁰ The firm refers to such reviews as "safeguard reviews" and this terminology is used in this report.

Safeguard reviews are required by the firm in a comprehensive number of situations, exceeding the requirements of the relevant standards. These include all audits within the scope of independent inspection, audit clients falling into a certain category based on size or type of entity or where the risk might be assessed as higher than normal risk.

The review is carried out by an independent partner who has a relevant internal licence.

We reviewed the application of the safeguard review procedures as part of our work on individual audits. In three audits we found that, although the review was evidenced at the completion stage of the audit, there was no evidence that the reviewer was involved at the planning stage. The firm's guidance was revised in July 2007 to require the reviewer to evidence his review at the planning stage. Some, but not all, of the audits that we reviewed took place prior to the introduction of this policy.

Pre-issuance technical reviews

The firm requires the financial statements of public interest entities and other AIM listed companies to be reviewed by the Technical Department before the audit report is issued. For this purpose, the firm defines 'public interest entities' as those where the audit may be subject to review by the AIU.

We reviewed the output of these technical reviews as part of our review of individual audits. In the financial statements for three of the audits we reviewed, we noted certain

¹⁰ International Standard on Quality Control (UK and Ireland) 1, paragraph 60.

errors and omissions which raises concerns over the quality of the firm's review processes.

2.2.6 *Audit quality monitoring*

Firms are required to have monitoring procedures in place, including reviews of a selection of completed audit engagements, to provide them with assurance that their system of quality control is adequate, operating effectively and complied with in practice. Such monitoring is required to be undertaken at least annually.¹¹ The firm refers to these monitoring procedures as Internal Quality Control Reviews (IQCR) and this terminology is used in this report.

The IQCR comprise office visits to consider "whole firm" processes and to review individual audits.

The reviews are carried out by a designated team, independent of the offices visited, and the process is overseen by the firm's Assurance & Advisory Standards Committee (AASC). All offices are visited each year and the individual audits reviewed, selected centrally using a risk matrix, cover at least one audit file for each audit partner authorised to sign an audit report. The firm has no employees, other than salaried partners, authorised to sign audit reports. A total of 62 audits were reviewed as part of the 2007/8 IQCR process.

Each file is given one of five grades "A-E", with a grade "D" or "E" being regarded as unacceptable.

We reviewed the IQCR process and the 2007/8 results. The firm's process has been comprehensively revised and enhanced since our last full review. The firm uses a standard questionnaire to facilitate its IQCR. We identified two areas which the firm's questionnaire did not cover, being group audits (where the work of other auditors is used) and fair value measurements and disclosures.

As part of the 2008/9 IQCR the firm has decided to further enhance the IQCR process by revisiting a sample of prior year reviews to ensure that weaknesses identified have been addressed.

PKF's international organisation has a professional standards committee and quality reviews are carried out on a country by country basis. The UK firm has not recently been

¹¹ International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations.

reviewed as part of this process. However, the report to the firm's Risk Management Committee on the findings of the IQCR process is provided each year to the international organisation's professional standards committee.

2.3 Independence and ethics

2.3.1 Ethical policies and consultation

Firms are required to have policies and procedures in place designed to achieve compliance with the Ethical Standards issued by the Auditing Practices Board together with relevant ethical pronouncements issued by the professional body with which the firm is registered.

PKF's ethical policies and procedures in relation to audit work comply with the requirements of ethical standards and in certain instances exceed them.

We reviewed changes made to the firm's ethical policies since our last visit and believe that the policies and procedures have been strengthened as a result of these changes.

The relevant training comprises an "e-learning" course with an exam, carried out every two years. All partners and staff have to confirm that they have read the first section of the material and all audit partners and staff have to go through the remaining sections and the exam. This process was completed towards the end of our inspection.

Ethical concerns or queries are raised directly with the firm's Ethics Partner. The results of consultations that are relevant to individual audits are required to be documented in the audit file, including the basis for the conclusion reached and any actions to be taken.

2.3.2 Compliance monitoring procedures

All partners and staff are required to complete an annual declaration form covering their fit and proper status, independence, confidentiality and money laundering. Any exceptions reported (including missing forms) are collated by the compliance manager and provided to the Ethics Partner for review, follow up and clearance. The process began in May 2007 and was completed in September 2007.

We reviewed a sample of declarations relating to audit managers and partners and noted that any exceptions were included on the collated list of exceptions. We also

reviewed the list of exceptions and noted that all matters had been considered, followed up where necessary and appropriate actions taken prior to the completion of the process in September 2007.

In addition, the firm maintains a register of business relationships and, prior to the September 2007 sign off, the Ethics Partner reviews the updated register for any concerns arising.

2.3.3 *Rotation policies and monitoring*

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 engagement partner and engagement quality control reviewer are required to rotate after having served for a maximum period of five years and key audit partners (KAPs) are required to rotate after seven years.¹²

In addition to meeting the specific rotation requirements under the ethical standards, PKF has partner rotation requirements for non-listed public interest entities and other large (based on level of turnover or gross assets) audit clients. 'Public interest' for this purpose as defined by PKF may extend further than those audits which may be subject to review by the AIU. During the year the firm extended their rotation policies further to cover any situation where the partner and manager have both been involved for ten years or more. In this case either the partner or the manager has to be rotated off and cannot return to any role with that client for the subsequent five years. In certain circumstances an independent partner, similar to an engagement quality control review partner, may be appointed as an alternative.

The firm maintains a rotation database in order to facilitate the monitoring of rotation. All audit clients are included on the database and it is periodically updated. The IQCR process is used to consider gaps in the database, cases of long service and the need for rotation. In addition the Ethics Partner reviewed the entire database this year for specific exceptions, which were followed up and resolved.

¹² APB Ethical Standard 3, paragraphs 5, 6, 12 and 16. "Key audit partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

We reviewed the rotation database and the output of the Ethics Partner's review. We noted a number of apparent departures from the underlying principles of the ethical standards, which on investigation had been appropriately dealt with.

2.4 Audit performance

This section covers findings arising from our review of the firm's audit methodology and our review of individual audits. Our findings are set out under the following headings:

- 2.4.1 Audit methodology
- 2.4.2 Assessing and responding to risk
- 2.4.3 Audit evidence and related judgments
- 2.4.4 Communicating with Audit Committees
- 2.4.5 Audit finalisation

Any findings relating to quality control and independence are covered in sections 2.2 and 2.3 respectively.

2.4.1 *Audit methodology*

The audit methodology used by the firm is a computerised system of work programmes covering the entire audit process. It includes help screens and is supported by the firm's other databases. The computerised system was developed in the UK and was designed to reduce the amount of paper used rather than to be a paperless system.

The system (as tailored for international use) is used by PKF International member firms in seven other countries. Updates to the system are driven primarily by the needs of the UK firm and are distributed to international users shortly after release in the UK.

Whilst the firm's methodology has been mapped to the requirements of UK Auditing Standards and includes the complete text thereof, in our view there are certain areas, in particular group audits and the audit of fair values, as detailed below, where the work programmes do not facilitate compliance by audit teams with the requirements of a particular Standard or aspects thereof.

Group audits

The firm's work programmes have to be used in conjunction with other material and databases in the audit of groups which does not facilitate the execution of certain aspects of group audits.

The firm has standard planning and completion questionnaires to be sent to other auditors whose work is relied upon and work programmes which include a number of tests relating to the audit of the consolidation. However, it did not have standard wording for reports from other auditors and did not have any work programmes that easily allow audit teams to consider aspects of group auditing, such as the planning relating to the group rather than just the parent, the management of instructions to and reports from other auditors, the exceptions reported from other auditors and overseas auditors' compliance with additional requirements applicable in the UK.

The firm has provided us with a revised policy in respect of group audits, provided training to audit partners and staff and will be considering how or if to integrate this policy with the firm's computerised system in the future.

Audit of fair values

Whilst the firm's methodology contains guidance relating to the audit of fair values, the work programmes do not specifically assist audit teams to evidence their understanding of an entity's own process for determining fair value measurements, disclosures and relevant controls. Consequently there is a risk that not all aspects of fair values will be picked up in the audit steps.

2.4.2 *Assessing and responding to risk*

Auditing standards require the identification and assessment of the risks of the financial statements being materially misstated, including which of these risks require special audit consideration (such risks are termed "significant risks")¹³. 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.

¹³ International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108

Design and implementation of controls

There has been an overall improvement in the audit teams' application and understanding of the Auditing Standards in relation to audit risk and fraud since our last inspection. However, certain areas requiring further improvement were identified on four of the audits that we reviewed, in particular in relation to evaluating the design and implementation of controls over significant risks.

2.4.3 *Audit evidence and related judgments*

We reviewed a number of significant audit judgments and, subject to comments made below, were generally satisfied with the basis on which the judgments were made. However, in some cases, there was room for improvement in the evidencing of the underlying thought processes involved in considering matters of judgment.

Overall sufficiency of audit evidence

We had significant concerns about aspects of one of the audits that we reviewed. In our view, there was insufficient evidence on the audit file to support certain amounts and disclosures in the financial statements and material late adjustments to the financial statements.

Group reporting

Three of the five audits that we reviewed were international group audits and, in each case, we had certain concerns regarding the group audit work. These included but were not limited to:

- significant matters reported by the subsidiary auditors did not appear to have been adequately considered (2 of the 3 audits);
- certain information requested from the subsidiary auditors was not provided to the group audit team (1 of the 3 audits); and
- some or all of the subsidiary auditors reported under local standards, with no evidence on file that compliance with the additional requirements of UK standards had been considered (2 of the 3 audits).

Audit of provisions

In one audit one of the significant risks identified was the potential overstatement of provisions. Audit work performed on a sample of provisions and accruals, the bad debt

provision and the stock provision did not, in our view, satisfactorily address this risk. The work on provisions and accruals relied heavily on uncorroborated management explanations.

We note, however, that was not identified as a theme arising from the firm's IQCR process and is therefore considered by the firm to be an isolated case.

Analytical review procedures

Recurring issues were identified in respect of aspects of analytical procedures intended to contribute to audit evidence. In relation to three audits that we reviewed, the analytical procedures work did not include the setting of a level at which differences from expected values would be regarded as acceptable, as required by Auditing Standards.

Sampling

The rationale in respect of sample sizes or sampling approach was not evidenced on three of the audit files that we reviewed. In one case journals were scoped out of the population for testing. In another case the material balance remaining after selected items had been tested had not been considered. In a third case the rationale for the size of the judgmental sample had not been evidenced.

2.4.4 *Communicating with Audit Committees*

Auditing standards require the auditor to communicate matters of governance interest arising from the audit with those charged with governance of the entity. Such communications will usually take place with an Audit Committee or similar body acting on behalf of the Board¹⁴. Appropriate communication with the Audit Committee or other relevant governance body contributes to the quality of the audit and assists both parties to discharge their responsibilities effectively.

For all the audits we reviewed formal communication with the Audit Committee or similar body had taken place on a timely basis. However, in two audits we identified certain omissions from the reports made at the planning and/or completion stages.

¹⁴ International Standard on Auditing (UK and Ireland) 260, paragraph 11

2.4.5 *Audit finalisation*

Audit finalisation procedures include a final analytical review of the financial statements as a whole, a review of events occurring after the end of the financial year that may require adjustment of, or disclosure in, the financial statements (“subsequent events”) and consideration of the appropriateness of the going concern assumption in preparing the financial statements.

In our view, the audit finalisation procedures were generally performed to a good standard.

8 December 2008

END OF REPORT

Appendix A – Firm’s response

The firm’s response is on the following page.



Accountants &
business advisers

Audit Inspection Unit
Aldwych House
71-91 Aldwych
London
WC2B 4HN

24 November 2008

Dear Sir,

Public Report on the AIU's 2007/08 Inspection

We welcome the publication of this report on our firm and support the aim of the Financial Reporting Council to promote confidence in corporate reporting. We are pleased to note the AIU's overall view that "the firm has in place policies and procedures in the relevant areas which are subject to our review that are appropriate for its size and the nature of its client base". This reflects the substantial resource we devote to ensuring that we continue to improve the quality of our work.

We recognise that best auditing professional practice is constantly developing and consequently that continuous improvement is necessary on our part. In this context the AIU has identified certain areas for improvement in our procedures. We confirm that these issues have already been addressed. Indeed, the report confirms that in relation to the previous AIU private report "the firm has implemented all the recommendations we made last year" which underlines our commitment to this policy.

We should like to take this opportunity to thank the AIU for the constructive approach they bring to their relationship with us.

Yours faithfully

PKF (UK) LLP

Tel 020 7065 0000

Fax 020 7065 0650 | | www.pkf.co.uk

PKF (UK) LLP | Farringdon Place | 20 Farringdon Road | London | EC1M 3AP | DX 479 London/Chancery Lane

PKF (UK) LLP is a limited liability partnership registered in England and Wales with registered number OC310487.

A list of members' names is open to inspection at Farringdon Place, 20 Farringdon Road, London EC1M 3AP, the principal place of business and registered office. PKF (UK) LLP is authorised and regulated by the Financial Services Authority for investment business activities. The PKF International Association is an association of legally independent firms.

© The Financial Reporting Council Limited 2008

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368.
Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.



FINANCIAL REPORTING COUNCIL
5TH FLOOR
ALDWYCH HOUSE
71-91 ALDWYCH
LONDON WC2B 4HN
TEL: +44 (0)20 7492 2300
FAX: +44 (0)20 7492 2301
WEBSITE: www.frc.org.uk