



**AUDIT INSPECTION UNIT**

**2005/6 AUDIT QUALITY INSPECTIONS**

**PUBLIC REPORT**

**JULY 2006**





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**This report is issued by the Audit Inspection Unit (AIU) of the UK's Professional Oversight Board (the '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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<b>Contents</b>		<b>Page</b>
<b>One</b>	<b>Scope and Overview</b>	<b>1</b>
<b>Two</b>	<b>Coverage and Focus of Inspections</b>	<b>4</b>
<b>Three</b>	<b>Inspection Process</b>	<b>7</b>
<b>Four</b>	<b>Second Year Inspections – Big Four Firms</b>	<b>11</b>
<b>Five</b>	<b>First Year Inspections – Other Significant Firms</b>	<b>25</b>
<b>Appendix A</b>	<b>Scope of Independent Inspection 2006/7</b>	<b>36</b>
<b>Appendix B</b>	<b>Assessing Audit Quality and Prioritising Recommendations</b>	<b>38</b>
<b>Appendix C</b>	<b>Types of Actions Taken by Big Four Firms</b>	<b>41</b>



## **One – Scope and Overview**

### *1.1 Scope of Report*

This report covers the principal issues arising from the following inspections carried out by the Audit Inspection Unit (AIU) of the Professional Oversight Board (the 'Oversight Board'):

- a. second year inspections at the four largest UK audit firms (Deloitte & Touche LLP, Ernst & Young LLP, KPMG Audit Plc and PricewaterhouseCoopers LLP), referred to in this report as "Big Four firms"; and
- b. first year inspections at the five other UK firms which audit a significant number of entities within our scope (Baker Tilly, BDO Stoy Hayward LLP, Grant Thornton UK LLP, PKF (UK) LLP and RSM Robson Rhodes LLP), referred to in this report as "Other Significant firms".

We reported last year that, in addition to our annual inspections of the Big Four firms, we planned to undertake initial inspections of selected firms outside the Big Four. In accordance with the FRC's Plan and Budget for 2005/6 first year inspections of the Other Significant firms were completed or commenced during the period to 31 March 2006 with two of these inspections being completed after this date.

With a few exceptions, the audits we reviewed related to financial statements for financial periods ended prior to 31 December 2005. This report therefore does not cover reviews of audits of financial statements prepared in accordance with International Financial Reporting Standards (IFRS) nor audits conducted in accordance with International Standards on Auditing (ISAs) (UK and Ireland).

Our report focuses primarily on weaknesses identified rather than areas of strength requiring no action. The inspection findings set out in this report should be read in this context.

### *1.2 Quality of Individual Audits Reviewed*

Our reviews of individual audits should be set in context. The Big Four firms have a dominant market share in the audit of larger listed companies, auditing 99% of the FTSE 100 and 97% of the FTSE 250. Accordingly the Other Significant firms have relatively few audits within our scope and subject to review by us. The level of resources and depth of expertise in specialist areas required to audit the largest and most complex groups influences the extent to which the Other Significant firms seek to compete for such work.

The audits we reviewed at both groups of firms had, in our view, generally been conducted to a high or acceptable standard. There were a small number of audits in both groups which in our view had not been carried out to an acceptable standard.

We concluded that the key audit judgments which we challenged in the course of our reviews were generally both appropriate and soundly based. Where the rationale for such judgments was inadequately documented, our view was reached after taking into account oral explanations provided to us. There continues to be a need for significant improvement in the quality of the firms' documentation of the rationale for key audit judgments made in reaching the audit opinion.

### *1.3 Further progress required in implementing our recommendations*

We reported last year that, while no systemic weaknesses in the Big Four firms' overall quality control systems had been identified, improvements were in our view needed in certain areas. In our second year inspections of the Big Four firms we were encouraged by the seriousness with which issues raised by us had been treated by the firms' leadership and the evidence at senior levels of the impact our work is having within the firms.

The findings of our second year inspections indicated that satisfactory progress had been or is being made by some or all firms in a number of these areas, including the extent and evidencing of the review process undertaken within the firms prior to an audit report being signed. However, only limited progress had been made in other areas. In areas where cultural changes within the firms appear to be required, we recognise that improvement takes time. However, we will expect to see clear evidence of significant improvement in certain areas during our next inspections. These areas include the extent to which the overriding importance of audit quality is reflected in the firms' human resource processes.

All the Big Four firms have the resources and capability to undertake audits on the largest scale. They also have the necessary resources to implement effective systems in response to changes to the regulatory framework on a timely basis. We identified some areas, primarily in relation to the new Ethical Standards, where such systems were not fully effective at all the firms on a timely basis.

### *1.4 Overview of Findings for Other Significant Firms*

Many of the issues identified in our first year inspections of the Other Significant firms were of a similar nature to those reported last year in relation to our first year inspections of the Big Four firms. These issues included, in particular, the need to focus on audit quality in developing the firms' strategies and human resource systems. Due to the nature of their client bases, some of the challenges faced by the Big Four firms do not apply to the same extent to the Other Significant firms; for example, partner succession planning for

audits of large complex groups. The Other Significant firms are also a less homogenous group and the significance of our findings and recommendations varied considerably between the firms.

The level of resources available to the Other Significant firms, though generally appropriate to their size and market focus, is significantly less than those available to the Big Four firms. There were major changes to the regulatory framework for auditing in the UK during the year. It was apparent that the technical and other central resources required to implement these changes on a timely basis had been stretched in some of the Other Significant firms. While some were coping well with the extent of change, and had taken action to increase resources in certain areas, other firms in this group had been slower to respond appropriately to these challenges.

### *1.5 Continued Audit Registration*

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 Big Four and Other Significant firms inspected.

### *1.6 Assessing and Reporting on Progress*

We will carry out further annual inspections at each of the Big Four firms and full or interim inspections at Other Significant firms in the coming year. During those inspections we will be assessing the progress made by each of the firms against the action plans agreed with them this year. We intend to report publicly on our assessment of the progress made by the firms in our next annual report.

## Two – Coverage and Focus of Inspections

### 2.1 *Coverage of Inspections*

We have assumed responsibility for the monitoring of the audits of all listed and other major public interest entities on a phased basis over three years. A description of such audited entities, as approved by the Oversight Board for 2006/7, is set out in Appendix A. Inspections of the Big Four firms commenced in 2004/5 and inspections of the Other Significant firms in 2005/6. Relevant audits undertaken by other firms are within the scope of our work from 1 April 2006.

We undertake annual inspections of the Big Four firms. There are currently only five other firms which audit a significant number of entities within our scope (the “Other Significant firms”). The Other Significant firms will, in future, receive either a full inspection or a (shorter) interim inspection each year. The frequency with which full inspections of individual Other Significant firms are undertaken will reflect the nature of the entities within our scope audited by them (i.e. our assessment of the level of public interest associated with these audits). For this reason some of the Other Significant firms may receive full inspections in most years while others may receive interim inspections in most years (subject to a minimum frequency for full inspections of every third year).

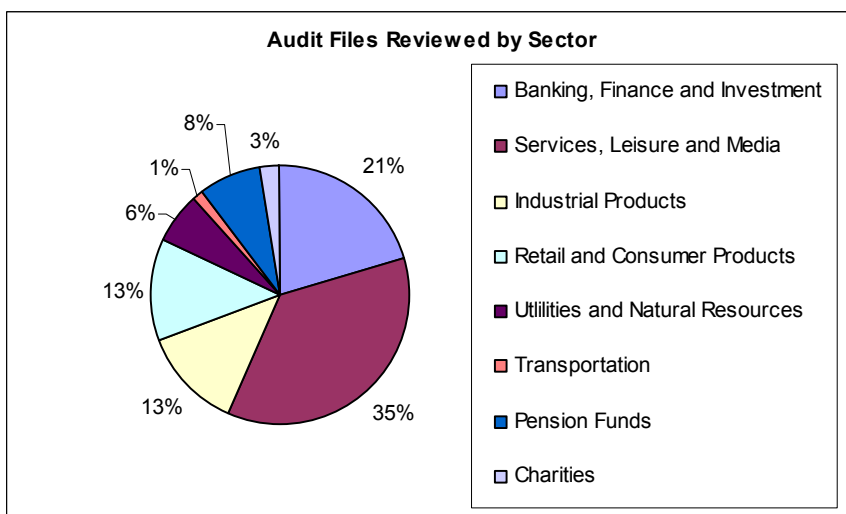
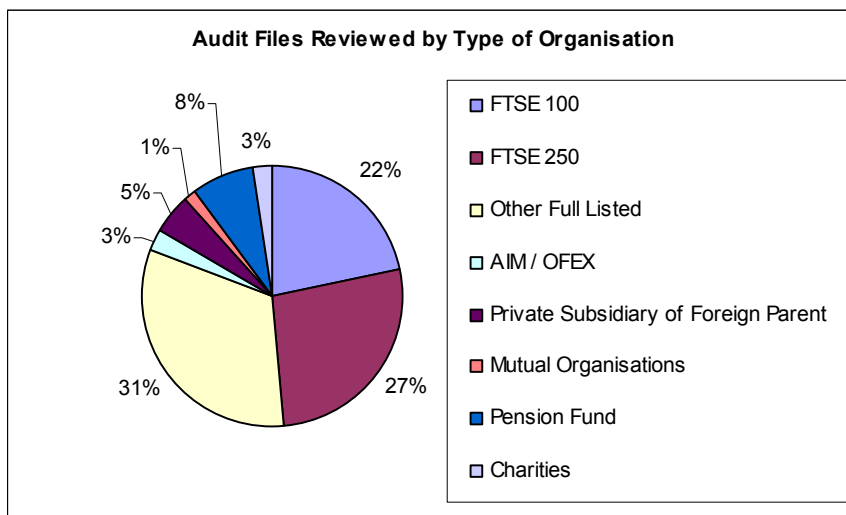
For all other firms which fall within our scope, we will focus our inspection work on reviews of the small number of listed or other major public interest entities audited by them; we will rely, as appropriate, on reviews of their quality control systems and procedures undertaken by the monitoring unit of the professional body with which they are registered. We intend to review a sample of such audits for each of these firms on a three year cycle commencing in 2006/7<sup>1</sup>. Follow-up or more frequent reviews may also be undertaken in individual cases.

The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work remain responsible for the monitoring of audit work outside our remit (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). All of the Big Four firms and four of the Other Significant firms are currently registered by the ICAEW, with the remaining Other Significant firm being currently registered by the ICAS. We wish to acknowledge the co-operation we have received from both the ICAEW Quality Assurance Directorate and the ICAS Audit Monitoring Unit in planning and undertaking our inspections.

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

In the year to 31 March 2006, we completed or substantially completed reviews of 77 audits of listed and other major public interest entities (2004/5: 27). An analysis of these audits is given below.



## 2.2 Focus of Inspections

Our remit is to monitor the quality of auditing. We do not focus solely on compliance with the requirements of the existing UK regulatory framework (although we recognise that audit quality is closely linked to this). By monitoring and promoting improvements in audit quality, we contribute to the FRC's overall aim of promoting confidence in UK corporate reporting and governance. We prioritise the recommendations to firms arising from our work on the basis of our assessment of their actual or potential

impact on audit quality. Should our work identify areas in which changes to auditing, ethical or quality control standards appear to be needed to promote audit quality, we bring this to the attention of the FRC's Auditing Practices Board which has responsibility for setting UK standards for auditors.

We seek to identify areas where improvements are needed to enhance audit quality and, subsequently, to reach agreement with the firms as to the appropriateness of actions proposed by them to achieve these improvements. As a result, our reports place greater emphasis on weaknesses identified than areas of strength requiring no action. The findings set out in our public report should be read in this context.

### *2.3 The Challenge for Firms*

Our work is intended to be challenging for the audit firms and their partners. We expect the firms to acknowledge areas requiring improvement identified through the inspection process and commit to taking appropriate action to address them.

We will continue to discuss with individual firms how the inspection process can be improved on both sides in future years. We are pleased to report that such discussions held following our 2004/5 inspections resulted in improvements being implemented for 2005/6. Inspections of firms which demonstrate a positive attitude to regulation, focusing on the substance of issues arising and engaging in a constructive dialogue as to the actions required to address them, are generally completed in a shorter timescale and ultimately at lower cost.

### *2.4 Co-operation with Overseas Audit Regulators*

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. During 2005/6 one of our inspections of the Other Significant firms, by agreement with the firm concerned, was conducted jointly with staff from the US Public Company Accounting Oversight Board (PCAOB), but led by our inspection team. Our inspections of certain other major firms are likely to be conducted on a similar basis with the PCAOB during 2006/7.

## Three – Inspection Process

### 3.1 *Purpose and UK Regulatory Framework*

The aim of the Financial Reporting Council is to promote confidence in corporate reporting and governance. Our programme of audit inspections promotes high quality auditing, one of the FRC's core objectives in pursuit of this aim. Our responsibility extends beyond monitoring compliance with specific requirements of the UK regulatory framework and includes an assessment of the key audit judgments made.

An important part of our role, however, is to monitor compliance with the UK regulatory framework which, in the period under review, comprised the following:

- The Auditors' Code;
- International Standard on Quality Control (UK and Ireland) 1 ("ISQC 1") (effective from 15 June 2005);
- UK Auditing Standards and other APB pronouncements;
- APB Ethical Standards and ethical guidance issued by the relevant professional body; and
- The UK Audit Regulations and Guidance.

The APB's Ethical Standards for auditors apply to audits of financial statements for periods starting on or after 15 December 2004 and firms therefore needed to put the necessary changes to their firmwide procedures in place during 2005. The International Standards on Auditing (UK and Ireland) ("the ISAs") issued by the APB also apply to audits of financial statements for periods starting on or after 15 December 2004, with the APB Statements of Auditing Standards applying to earlier audits. The UK Audit Regulations and Guidance were revised during 2005 to reflect changes in the UK regulatory framework, including the implementation of ISQC 1, the ISAs and the APB's Ethical Standards.

### 3.2 *Audit Quality*

Our understanding of the concept of audit quality, how we assess it during our inspections and the basis on which we prioritise our recommendations to firms are set out in Appendix B. An FRC-wide project on audit quality, to which the Oversight Board is providing significant input, is currently in progress. We will be reviewing our approach, in due course, in the light of the output from this project which is to be published by the FRC.

### **3.3 *Reviews of Firmwide Procedures***

Our reviews of firmwide procedures address all aspects of firms' systems of quality control, including their internal 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 (the "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 more senior roles.

We review the basis on which audit partners are appointed to lead major audits, act as a key audit partner or as the independent quality control reviewer, and the procedures for rotating them off major audits to mitigate familiarity threats. We also review the firms' human resource systems more generally; the competence and motivation of audit personnel is, in our view, the most important element in achieving high quality audits.

The regulatory framework requires that firms have in place an annual quality review which includes reviews of a selection of completed audits. Firms use different terminology to describe this review process but we have referred to it as the Audit Quality Review (AQR). The number of audits reviewed in an AQR is usually significantly higher than the number subject to external monitoring but the reviews are typically conducted in less depth than our audit file reviews. We review how the firm conducts its AQR, how effective the process is, the overall findings (comparing these with our own findings) and any remedial actions taken or planned by the firm.

### **3.4 *Reviews of Individual Audit Engagements***

We carry out in depth reviews of individual audit engagements giving us a sound basis on which to assess the quality of each audit reviewed. Our work programmes are structured around the requirements of Auditing Standards. They are tailored by each inspection team to ensure both that reviews are sufficiently focused on the major risk areas identified for each audit and that an appropriate level of coverage of the requirements of Auditing Standards is achieved across all reviews carried out at each firm. Our inspection teams challenge audit partners, where appropriate, regarding the basis on which key audit judgments were made. We believe that challenging audit judgments in this way is a key feature of an effective review of audit quality.

The AIU's focus in relation to financial reporting issues identified 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 arising 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 us where appropriate as an integral part of our work. We may refer financial reporting issues arising to the FRC's Financial Reporting Review Panel (FRRP) where we consider that there is sufficient doubt as to whether the accounting treatment adopted and/or disclosures provided comply with

the relevant accounting framework (IFRS or UK GAAP). Such issues are then considered in accordance with the Panel's Operating Procedures.

### 3.5 *Private Reporting*

We prepare detailed reports on each audit engagement we review; these reports are provided to the audit teams concerned and copied to senior management within the firm's audit practice. The key issues arising across our reviews of individual audit engagements, and those arising from our review of firmwide procedures, are set out in our formal private report to the firm and to the audit registration committee of the professional body with which the firm is registered.

Our private reports include prioritised recommendations to the firms concerned together with responses and an action plan from the firms. As described in Appendix B, we prioritise the issues and our recommendations to the firms on the basis of our assessment of their actual or potential impact on audit quality.

### 3.6 *Public Reporting*

Current policy is to issue an annual public report setting out the overall findings and conclusions arising from our inspections (with some segmentation between firms) but not to publish any part of our reports on individual inspections<sup>2</sup>. The Oversight Board is currently consulting as to whether any changes to these arrangements for public reporting should be made for the future<sup>3</sup>.

### 3.7 *Improving the Inspection Process*

In line with the FRC's Regulatory Strategy document (December 2005), we have due regard to the Better Regulation Task Force principles of proportionality, targeting, consistency, transparency and accountability insofar as these principles are relevant to our work.

During the year we undertook an improvement project, involving nearly all AIU staff, in order to identify areas in which our monitoring approach and procedures could be improved in the light of our experience to date and feedback from firms. As a result, certain changes have been or are being implemented in order to improve the targeting of our work, ensure that it is proportionate to the risks we have identified and promote greater consistency within and between our inspection teams.

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<sup>2</sup> These arrangements were agreed between the DTI, the FRC and the CCAB when the Oversight Board and the AIU were set up.

<sup>3</sup> *Reporting on Audit Quality Monitoring* (June 2006), available on the Oversight Board's section of the FRC website.

We are committed to a process of continuous improvement and value constructive feedback from all firms subject to inspection as to how the inspection process might be further improved.

## **Four – Second Year Inspections – Big Four Firms**

In this section we explain the principal themes and issues arising from our second year inspections of the Big Four firms. We also report on the extent to which the recommendations arising from our first year inspections in 2004/5 had been implemented on a timely basis.

Not all these themes and issues apply to every firm and, where they do apply to more than one firm, there will inevitably be differences in degree. Where the theme or issue applies to all four firms we have stated this and, similarly, where an issue applies to only one firm we have made this clear. In other cases it should be assumed that the issue applies to some, but not all, firms or the degree to which it applies varies markedly across the firms.

### *4.1 Actions Taken by the Firms to Implement our Recommendations*

#### *4.1.1 Overall Assessment of Actions taken*

While satisfactory progress had been or is being made by some or all firms in implementing our recommendations in certain areas, only limited progress had been made in other areas. We recognise, however, that the firms had limited time since the completion of our first year inspections to implement our firmwide recommendations. In addition, the timing of many of the individual audits we reviewed was such that it would not be reasonable to expect actions taken by the firms to have had a significant effect on these audits.

We consider that there are many areas in which further action needs to be taken by some or all the firms and that there is scope for improvement in the timeliness with which actions are taken by some firms. However, we recognise that in certain areas, where cultural changes within the firms appear to be needed, there is no “quick fix” available to the firms. Where this is the case, the firms should be seeking to achieve continuous improvement over a longer period. We have been encouraged by the seriousness with which issues raised have been treated by the firms’ leadership teams. We found clear evidence at senior management level of a much greater focus on the importance of audit quality; this needs to be translated into substantive changes in practice, in particular in relation to human resource processes.

Our reviews of individual audits included one or more follow-up reviews at each firm of audits reviewed in our first year to assess whether our recommendations had been implemented in the following year’s audit. The firms were not made aware in advance of our intention to carry out such follow-up reviews. In nearly all cases, we found that appropriate actions had been taken to implement our recommendations. Our reports on individual audits make it clear to audit teams that we expect issues raised to be appropriately addressed in subsequent audits. We will continue to undertake a number of follow-up reviews each year to confirm that appropriate action has been taken on the audits concerned.

#### *4.1.2 Summary of Actions Taken*

A summary of the types of actions taken by the Big Four firms to implement our first year recommendations is set out in Appendix C.

#### *4.2 Leadership and Human Resources*

##### *4.2.1 Emphasis placed on audit quality by the firms' leadership*

We identified a strong emphasis on the importance of audit quality in communications from the leadership of all the firms, including a clear message that the recurring deficiencies identified during our initial inspections needed to be addressed. In some cases, however, further action was needed to reflect more clearly this commitment to quality in the published strategy of the audit practice or the overall objectives of the firm; we recommended that this be addressed by the firms concerned.

##### *4.2.2 Partner and staff appraisal process*

There was clear evidence of improvement at one firm in the extent to which the appraisal procedures established for partners and staff were followed in practice. In other cases, however, we again identified significant failings in this area.

At one firm, only 4 of the 15 partners we reviewed had properly completed the standard appraisal documentation and the objectives against which partners were being assessed were unclear. At another firm a year-end appraisal form had not been completed for the majority of senior managers and managers on the audits we reviewed even though the appraisal process should have been completed by the time of our review.

We recommend that all firms convey a clear message that a failure to follow the firm's standard policies and procedures for partner and staff appraisals and objective setting will be regarded as unacceptable in future. Improvements implemented in order to achieve greater focus on the importance of audit quality, in line with our recommendations, will not be effective if the procedures established by the firms are not followed in practice.

##### *4.2.3 Emphasis placed on audit quality in appraisals and the setting of objectives*

Only limited progress had been made by some of the firms in ensuring that quality indicators are an integral and visible part of their human resources system. In particular there is insufficient visibility of quality indicators in the documented goals and objectives set for partners and senior staff and the basis on

which their performance is assessed. The documentation we examined indicated that commercial considerations and measures continued to be a driver of performance assessment.

Only one firm had a detailed process in place both to identify quality performance indicators and ensure that its partners were explicitly assessed against them as part of the appraisal process; the link between the quality ratings achieved by the firm's partners and their overall assessment, however, was unclear in some cases. While another firm had developed quality performance indicators, it did not assess individual partners against them; there was little evidence in the appraisal documentation we reviewed of an increased emphasis on audit quality at this firm.

We have made further recommendations in this area to all the firms; we will expect to see evidence of substantive improvements being implemented by them during our next inspections.

#### *4.2.4 Partner promotions*

We reported last year that quality considerations did not appear to feature prominently in the firms' partner promotion processes. There was evidence of a greater focus on audit quality considerations this year in the partner promotion process at one firm. At some firms, however, we would have expected to see more visible evidence that the ability to deliver quality audits is a key requirement for promotion to audit partner. This issue is closely linked to the need for the firms to embed quality indicators in their human resources system as a whole (section 4.2.3 above). We have recommended, where appropriate, that specific actions are taken to ensure that assessment of partner candidates' track record in relation to audit quality, and their level of achievement in relation to relevant technical and personal competencies, is given much greater visible focus in the partner promotion process.

One firm had taken action to establish and review regularly appropriate development plans for new partners in response to our first year recommendations. We recommend that other firms take similar action, where formal action plans are not already in place, to ensure that the identified development needs of successful candidates are addressed.

### *4.3 Ethical, independence and client continuance policies and procedures*

#### *4.3.1 Partner rotation*

We referred in our previous report to the need for the firms to maintain comprehensive systems and procedures to ensure that they can actively manage and closely monitor succession planning for their audit clients and meet the challenge of the new partner rotation requirements. There were significant variations in the extent to which individual firms had risen to this challenge on a timely basis. All firms had

recognised the need for central rotation databases to facilitate effective monitoring of compliance with these requirements and to identify where safeguards are required. However, the timeliness with which appropriate action had been taken to achieve this objective differed significantly between the firms.

One firm had a comprehensive central rotation database, populated with the relevant data, in place at the time of our review. A second firm also had a central database in place but with some further work needed to populate it fully. Progress was significantly slower at the other firms and they were therefore principally reliant on information recorded in individual business units or on individual audit files. We have made specific recommendations to the firms that the necessary action be taken to implement and fully populate a comprehensive central rotation database as soon as possible.

One of the firms had not prepared detailed internal guidance at the time of our review on the new rotation requirements in support of its revised policies. We recommended that this firm issue such detailed guidance as a matter of priority.

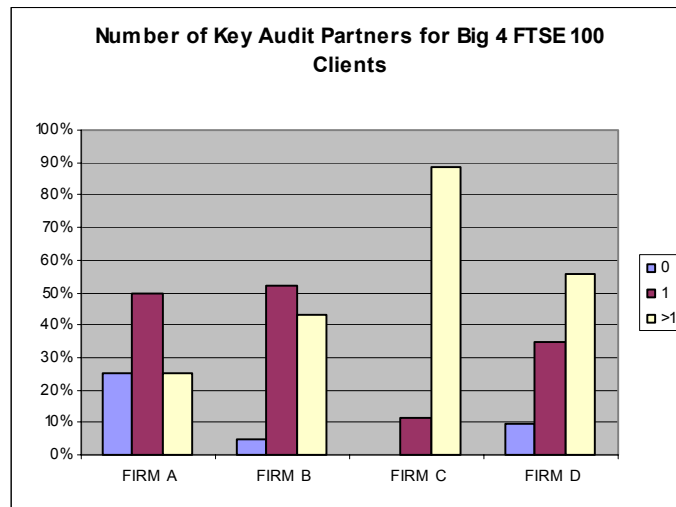
#### *4.3.2 Identification of key audit partners*

We requested all the firms to provide us with data on the number of key audit partners (KAPs)<sup>4</sup> identified on their FTSE 100 audit clients. The purpose of this request was to enable us to assess whether the basis on which such partners are being identified is appropriate for the purposes of applying effectively the partner rotation requirements for KAPs under the Ethical Standards.

The data provided indicates that some firms have identified KAPs on more of their major clients than other firms. For those FTSE 100 clients where no KAP has been identified we recommend that the relevant firms keep under review whether this is appropriate given the particular circumstances of the audit clients concerned.

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<sup>4</sup> The definition of a key audit partner under the Ethical Standards excludes the audit engagement partner but includes all other partners involved in the audit at group level and responsible for key decisions or judgments on significant matters or significant risk factors.



#### 4.3.3 Former audit engagement partners becoming “Relationship Partners”

We drew attention in our previous report to the practice at some firms of the former Audit Engagement Partner (AEP) assuming a “relationship partner” type role (terminology varies) after being rotated off the audit. While such partners are not categorised as being part of the audit engagement team, their seniority, experience and depth of contacts with clients can give rise to the perception, and perhaps the reality, that they continue to exert influence on the audit.

While the former AEP does not undertake such a role at some of the firms, the practice continues to some extent at other firms. Any such relationship partners must demonstrably have no involvement in the audit; attendance at Audit Committee meetings, for example, is in our view inconsistent with this requirement, even if such attendance is limited to a relatively short period after the change of AEP takes place.

We also queried the effect of the practice in some firms of the current AEP sometimes fulfilling two roles, for example also acting as a relationship partner. The AEP is not permitted under the Ethical Standards to have any objectives relating to the sale of non-audit services to the client, regardless of which role the objectives are stated to relate to. Where the AEP also has a further role in relation to the client, therefore, we recommended that the responsibilities involved are clearly defined such that the selling of non-audit services to the client is clearly excluded.

#### 4.3.4 Non-audit services

We identified a number of issues in relation to compliance with the ethical requirements relevant to the provision of non-audit services to audit clients.

There appeared to be evidence at some of the firms that accounting services, relating to tax accounting and related disclosures, may have been provided to listed companies. Ethical requirements in force at the time provided that accounting services should only be provided to listed companies in an emergency situation.

There was also a failure by some firms to record properly in their own files the nature of non-audit services provided, identify the independence threats arising and why safeguards in place were considered to be effective. In one case there was little evidence that the self-review threat posed by undertaking a substantial project in connection with a client's IFRS conversion process had been fully assessed by the audit team.

In some cases the requirement that firms' remuneration and evaluation arrangements do not involve setting objectives for audit team members relating to the sale of non-audit services, and/or rewarding them for so doing, had not been properly applied in practice. Some firms were effectively defining audit services for this purpose more widely than is envisaged under the Ethical Standards (the audit of financial statements and audit-related services provided in accordance with legal or regulatory requirements). We recommended, where appropriate, that firms clarify what constitutes non-audit services and non-audit revenues for this purpose.

There was also a lack of clarity at some firms as to the distinction to be drawn between selling activities and other activities which may properly be recognised in the determination of partner remuneration. Where a firm's partner remuneration policies recognise the quantum of "revenues managed" by individual partners, care needs to be exercised to ensure that the application of the policy in practice does not result in audit partners being rewarded for selling non-audit services to their audit clients.

Certain comments we noted on appraisal forms at some firms, and the manner in which some of the forms had been completed, indicated in our view that the individuals concerned believed that their success in the selling of non-audit services remained an important aspect of their overall evaluation, notwithstanding that the firm's documented policies state otherwise. The firms' policies need to be reflected in the way that their audit partners and staff act in practice. Firms should be aware of the importance that we attach to this matter.

#### *4.3.5 Client acceptance and continuance*

All the firms have relatively sophisticated client acceptance and continuance procedures in place. However, we identified a need for certain improvements at some of the firms in relation to the procedures themselves, the effective communication thereof to audit teams and/or their application in practice.

A weakness identified at some firms continues to be insufficient linkage between the risks identified through the client acceptance/continuance process and the planning and execution of the audit, including

in relation to some clients identified as higher risk. We have made specific recommendations concerning this matter to the relevant firms and will expect, in our inspections next year, to see evidence of significant improvement in this area.

#### **4.4 Audit Performance**

We commented last year on a number of issues arising from our reviews of individual audits. In some of these areas, there was only limited evidence of substantive improvement in the audits we reviewed this year. The timing of many of the audits we reviewed, however, was such that it would not be reasonable to expect actions taken by the firms (such as making appropriate changes to their procedures or providing additional guidance or training) to have had a significant impact. We will expect to see more tangible improvements in our 2006/7 reviews and to be in a position to determine whether actions taken are having a positive impact on audit quality in practice.

A follow-up review at one of the firms indicated that a number of issues which we had raised with the audit team in relation to the previous year's audit had not been addressed by them in the following year. In this case, given the timing of the relevant work, we did not consider that there were valid reasons for this. We regard a failure to appropriately address our recommendations as a serious matter and recommended that the firm strengthen its central monitoring processes to ensure that appropriate actions are taken on all individual audits reviewed by us. The findings of our other follow-up reviews, the scope of which is limited to assessing whether issues previously raised have been appropriately addressed, were satisfactory.

##### **4.4.1 Audit evidence and related audit judgments**

Issues identified at individual firms in relation to audit evidence and related audit judgments included:

- Certain key risks identified at group level not appropriately addressed in the planning and execution of detailed audit work at individual component level;
- Insufficient audit evidence in relation to the existence and/or cost of material stock balances;
- Inappropriate reliance placed on analytical work which provided little substantive audit evidence; and
- Insufficient audit evidence in respect of a material impairment provision and the recoverability of significant debtors.

#### *4.4.2 Audit judgments in relation to financial reporting issues*

In reviewing key audit judgments made in relation to financial reporting issues on individual audit engagements, we again often had to seek oral explanations from partners and staff in relation to significant matters. We found no overall improvement in the standard of documentation of the rationale for such judgments. We have recommended that the need to address this matter properly is reiterated within the firms, particularly at audit partner level. A cultural change appears to be needed on the part of certain audit partners and firms should consider how this can best be achieved.

We referred issues arising in relation to the financial statements of two entities whose audits we reviewed during the year to the Financial Reporting Review Panel. These issues concerned:

- The appropriateness of deferring certain costs within stocks.
- The adequacy of the disclosures made, particularly in relation to pension costs.

Other areas in which audit judgments relating to financial reporting issues were challenged included:

- Fair values in acquisition accounting.
- Recognition of deferred tax assets.
- The need for a post-balance sheet event to disclosed.

#### *4.4.3 Compliance with Auditing Standards*

We identified recurring areas of non-compliance with certain Auditing Standard requirements at all firms. Each firm was provided with a summary analysing these matters. We made specific recommendations to the firms, taking into account the effect of the adoption of the ISAs (UK and Ireland), as to how these matters should be addressed.

We comment in sections 4.4.7 – 4.4.9 below on issues relating to audit documentation, reliance on other auditors' work and reporting to Audit Committees. Other issues identified at individual firms included a lack of evidence that:

- Audit procedures had been planned in sufficient detail in some areas;
- Some substantive audit procedures had been undertaken for all material balances and classes of transactions;

- Analytical procedures had been performed at the planning and/or overall review stages of the audit;
- Audit sampling methods and sample sizes used were appropriate;
- The competence and objectivity of experts whose work was used had been assessed;
- Sufficient audit work had been undertaken in relation to going concern status and post balance sheet events; and
- Sufficient audit work had been undertaken in relation to laws and regulations.

A high level review of the revised audit methodologies developed by the firms to implement the requirements of the ISAs (UK and Ireland) was undertaken at each of the firms. We will be reviewing the firms' revised methodologies in more detail, and their application on individual audits, during our next inspections.

#### *4.4.4 Engagement team review procedures*

The review of audit working papers is a critical element of a firm's quality control procedures. The timing of these review procedures is important, as they need to be carried out in sufficient time to ensure that the partner and manager can adequately consider the key issues prior to reporting them to the Audit Committee and signing the audit report. In addition, there needs to be sufficient time to address review points.

There was an overall improvement at some firms in the evidence of appropriate reviews of audit working papers being carried out on a timely basis. At one firm, however, the only evidence of partner and manager reviews being undertaken continues to be a single sign-off on a completion checklist. In addition, such sign-offs were sometimes not completed until after the date of the audit report. We have recommended that this firm review its current policy in the light of the relevant requirements of ISA 220 (UK and Ireland) and instruct its partners and staff to properly document their reviews on the audit files.

#### *4.4.5 Technical reviews and consultation*

For listed company and other major public interest audits, it is important to have an adequate level of technical input to the review of the client's financial statements. In our view, the risks associated with the adoption of IFRS by UK listed companies further increase the need for such input, particularly for larger listed clients. We indicated last year that we believed some firms needed to have a greater level of technical input to reviews of their listed clients' financial statements.

At one firm, we noted that certain key aspects of the financial statements of certain major clients were not subject to a general technical review as the reviewers lacked relevant specialist industry knowledge. The firm undertook to require these aspects to be reviewed by a specialist to supplement the general technical review already required. We also recommended that procedures for the clearance of technical review points before the audit opinion is issued be clarified by the firm.

At another firm, we found no evidence on the audit files we reviewed of consultation on complex or contentious matters taking place despite there being issues in respect of which such consultation would, in our view, have been appropriate in accordance with the firm's policy. Appropriate consultation within the firm, particularly with technical and other specialists, is central to achieving a quality audit. We therefore recommend that firms ensure that their internal quality reviews place sufficient emphasis on whether such consultation has both taken place and been appropriately documented on the audit files.

#### *4.4.6 Engagement quality control review*

The requirements relating to engagement quality control reviews (formerly known as Independent Partner Reviews) are set out in ISQC 1 (effective from 15 June 2005). ISQC 1 requires firms to establish policies and procedures setting out the nature, timing and extent of the review and the related documentation requirements. It clearly indicates that a review of selected audit working papers relating to the significant judgments made by the audit team forms part of the review and that the review is to be conducted in a timely manner at appropriate stages of the audit.

While many of the audits we reviewed in the year were undertaken prior to ISQC 1 taking effect, some firms amended their procedures in line with these requirements at an earlier date. We were pleased to note that all the firms had taken action to brief relevant partners on the requirements of ISQC 1, either by holding specific workshops for those involved in undertaking the reviews or by issuing additional guidance on this area.

We noted that one firm had a user-friendly system in place to facilitate the review of working papers relating to key audit judgments. At the other firms, however, there was no evidence in most or all cases, other than a signature on a completion checklist, of a review of selected working papers being undertaken. It appeared, however, from the interviews we conducted with selected reviewers that they were aware of, and had considered the appropriateness of, key judgments made. We recommend that the firms consider whether further action can be taken by them to facilitate the recording and evidencing of these reviews.

While there was evidence from time records at some firms that the time allocated to these reviews is now more commensurate with the responsibilities involved, it is important that guidance given by the firms on the time required for particular types of audit is appropriate and followed in practice. We identified examples both of inappropriate guidance appearing to have been given (resulting in the time spent in

certain cases where the guidance was followed being unreasonably short) and of apparent failures to follow guidance which did appear to be appropriate. At one firm the time records provided the only evidence of the extent of the review carried out and minimal time had been recorded in some cases. Where appropriate, we have recommended that firms reiterate the need for reviewers to record all time spent (including at the planning stage) to demonstrate that the firm's internal guidance is being followed.

The importance of the role performed by partners acting as engagement quality control reviewers needs to be appropriately recognised and valued within the firms. We recommend that all the firms review whether their policies, and their application in practice, appropriately reflect the importance to audit quality of effective engagement quality control reviews.

#### *4.4.7 Audit documentation*

As we stated last year, insufficient documentation of audit work undertaken and the basis on which audit judgments have been made poses risks to quality for the firms. It not only renders internal quality control reviews less effective but also affects the ability of the firm, if challenged subsequently, to justify the conclusions reached. Inadequacies in audit documentation also render our own reviews more difficult, especially as regards the consideration of audit judgments.

The quality of audit documentation varied significantly both between and within firms. While there was no significant improvement in the overall standard of audit documentation this year, there were some examples of good quality audit documentation. These examples primarily related to:

- Audits we reviewed during our first year inspections and re-selected this year to assess whether our recommendations had been implemented in the following year's audit. The documentation was found to be of a higher standard in nearly all such cases.
- Certain audits which had been identified by the firm concerned as high risk.

We acknowledge that the firms have made efforts to achieve improvements in this area, through such means as the provision of additional guidance and/or training. These efforts have been supported by clear messages being conveyed within all the firms regarding the need for improvement. It is too early to assess how effective these actions will prove in practice.

A cultural change appears to us to be needed on the part of some audit partners and staff at all of the firms; audit partners need to lead by example in this area and make it clear to their teams that inadequate documentation of audit work is not acceptable. The fact that higher standards were achieved in certain cases referred to above indicates that improvements can and will be achieved if such a lead is given.

The overall quality of audit documentation found at one of the firms was, in our view, below that found at the others, resulting in a greater need to seek oral explanations from audit teams. In our view, the firm's existing documentation policies may have contributed to this. We recommended that this firm review its policies on audit documentation in the light of the objectives and purposes thereof set out in ISA 230 (revised) (UK and Ireland) issued in January 2006. We are pleased to note that some of the firms have advised us that they intend to revise their documentation policies in line with the requirements of the revised standard in advance of the mandatory implementation date (audits of financial statements for periods starting on or after 15 June 2006).

#### *4.4.8 Group audits and reliance on the work of other auditors*

UK audit firms acting as group auditors express an opinion on the group financial statements and do so, in many cases, by using and relying on the work of another auditor outside the UK. In the vast majority of cases that other auditor is a firm in the same network as the group auditor.

Whilst we have access to the files and working papers of the UK firm acting as the group auditors, we have not had access to the audit files of other auditors outside the UK. In our view such access is sometimes necessary to assess properly the quality of the group audit. This is particularly the case where there is little evidence of what work was undertaken by the group auditor in order to assess the adequacy of another auditor's work.

We made requests in writing to all the firms this year for them to obtain for our review the audit files for an overseas subsidiary or division audited by an overseas network firm. In all cases we were advised by the firms that the relevant overseas network firm would not provide their files for this purpose as the AIU had no authority to require the disclosure of audit files and working papers held by audit firms outside the UK. We intend to explore further with the firms, in the light of the proposed requirements set out in the current exposure draft of ISA 600 (revised) on group audits, why access to audit files held outside the UK cannot be arranged and how this issue can be overcome.

The quality of group audit instructions and supporting guidance varied between firms but there was some evidence of improvement in this area. In the minority of cases where overseas firms were visited by the UK team, there was often little evidence on the UK audit files as to what work was undertaken by them and how assurance as to the reliability of the overseas firm's work was obtained. We have recommended that such visits are properly documented, including the basis for the assessment made of the quality of the work performed and the appropriateness of conclusions reached on key issues.

We identified instances of non-compliance with the Auditing Standard requirements (previously SAS 510 and now ISA 600) relating to assessment of the competence of other auditors and the quality of their work at some firms. In many cases this reflected a clear lack of understanding on the part of individual audit

teams that the requirements apply to network firms as well as non-network firms. We continue to believe that greater use could be made of the results of internal quality reviews in other countries, undertaken by the firms' international networks, in identifying any issues that could affect the level of risk associated with relying on the work of network firms in particular jurisdictions. This type of information is closely guarded within the firms' international networks. We recommend that the firms consider formally requesting access to available information so that appropriate use can be made of it.

#### *4.4.9 Reporting to Audit Committees*

As we stated last year, we view the provision of an appropriate and balanced written report to the Audit Committee as a key element of audit quality. We were therefore pleased to note that the quality of reporting to Audit Committees is receiving a high level of attention at all the firms and that, where necessary, certain improvements have been made in this area since our initial inspections.

We identified the following areas for improvement in relation to certain audits we reviewed:

- Communicating audit planning information to the Audit Committee (this principally related to smaller listed companies where the Audit Committee meets relatively infrequently);
- 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.

We have recommended that the firms concerned take appropriate actions in relation to the specific issues we identified.

#### *4.5 Monitoring of Audit Quality by the Firms*

We again made a number of recommendations for improvements in relation to firms' internal Audit Quality Reviews. We were pleased to note evidence at all firms of greater robustness overall, compared with the previous year, in either the grading of individual audits reviewed or the manner in which certain gradings are viewed by the firm. However, there was evidence at some firms of certain audits for which significant deficiencies had been identified being graded too leniently.

While we appreciate that grading systems tend to be driven internationally, and used to compare firms within the global network, we believe that there are further actions which the firms can and should take to better distinguish between the quality of individual audits reviewed and provide more useful feedback within the audit practice. In our view, some current grading practices may risk sending an inappropriate message to audit partners and staff as to the importance placed by the firm on high quality work; this might undermine other initiatives being taken by the firms to promote and enhance audit quality.

Our recommendations to individual firms in this area included:

- More rigorous application of their grading system so that audits for which significant deficiencies are identified are downgraded accordingly;
- Introducing a mechanism for identifying audits which are genuinely of high quality (as opposed to having a relatively low threshold for the highest grade to be achieved);
- Making better use of data and analysis arising from the review process, relating to performance in individual audit areas, in providing constructive feedback to partners and staff; and
- Better utilising output from the Audit Quality Review for individual partner and staff performance appraisals.

Where significant deficiencies are identified in relation to a particular audit, the firms should determine whether further action is required to confirm the appropriateness or otherwise of the audit opinion issued. There was evidence of improvement in this area this year and greater awareness of the need for such an assessment to be carried out. We recommend, however, that the firms review whether there remains a need for greater rigour to be exercised by them in this area.

## **Five – First Year Inspections – Other Significant Firms**

### *5.1 Introduction*

In this section we explain the principal themes and issues arising from our first year inspections of the Other Significant firms. We set out below a number of points which should be borne in mind in relation to our findings from these inspections.

We have included firms within our “Other Significant firms” category on the basis of the number of entities within our remit that they audit. However, the Other Significant firms are not a homogenous group. There are important differences in the firms’ strategies, target markets, central resources and international reach. This was reflected, to some extent, in a large degree of variation between the firms in relation to the significance of our findings and recommendations. These differences also affect the extent to which it is possible for us to present an accurate generic picture of audit quality across all the firms.

These firms have relatively few audits within our scope and the number of audits reviewed by us reflects this. The majority of their audit work relates to clients outside our scope; our findings may therefore not be representative of their audit work as a whole.

These were first year inspections. We recognise that some of the issues we raised with the firms, reflecting our focus on audit quality, have not been raised with them in the past. Firms of all sizes need a certain amount of time to adjust to the challenges of the new regulatory regime.

Where a theme or issue discussed below applies to all the firms we have stated this. Similarly, where an issue applies to only one firm we have made this clear. In other cases it should be assumed that the issue applies to some, but not all, of the firms or the degree to which it applies varies markedly across the firms.

### *5.2 Leadership and Human Resources*

#### *5.2.1 Emphasis placed on audit quality by the firms’ leadership*

While all the firms advised us that audit quality was central to their business strategies, documented evidence that audit quality is an overriding requirement was generally insufficient or lacking. In some cases, promoting and enhancing audit quality was not identified as a key objective within the firms’ strategies. In addition, greater prominence needs to be given to audit quality issues in internal communications from the leadership teams of some of the firms. We have made a number of recommendations to the firms in this area and will expect, in our next inspections, to see the importance of

audit quality being more clearly articulated in both business strategies and internal communications to partners and staff.

#### *5.2.2 Partner and staff appraisal process*

We identified areas requiring improvement in relation to the appraisal process for partners and staff at all the firms. We noted some regional inconsistencies at some firms in the process adopted, with a less structured process being adopted by offices outside London (for example, standard documentation identifying the quality of work as a key performance indicator not being consistently completed). We also noted that formal appraisals were not consistently undertaken for technical and other central staff at one of the firms. We recommended, where appropriate, that firms adopt consistent appraisal practices for all their offices, partners and staff. We also recommended that one firm, which has a less formal appraisal process for its partners than for its staff, establishes a clear timetable for the completion of partner appraisals.

#### *5.2.3 Emphasis placed on audit quality in appraisals, objective setting and the partner promotion process*

There was generally only limited focus on audit quality issues and indicators in partner and staff appraisals, the setting of objectives and the partner promotion process. However, a reasonable balance of comment reflecting audit quality and commercial considerations was noted in the appraisals reviewed at one of the firms. We were unable to identify a clear link between partner remuneration policies and the results of formal partner appraisals at some of the firms. We recommend that all the firms place greater emphasis on audit quality in their appraisal, remuneration and promotion policies, including taking proper account of the findings (both positive and negative) of internal and external quality reviews of audit work.

#### *5.2.4 Technical and other central resources within the firms*

The level of technical and other central resources available varied between the firms. It was apparent that these resources had been stretched at some of the firms as a result of the significant recent changes to the regulatory framework for auditing in the UK. While some were coping well with the extent of change, and had taken action to increase resources in certain areas, other firms had in our view responded too slowly to these challenges. In particular, some firms had not taken appropriate action on a timely basis to revise and upgrade certain of their internal policies and procedures. We recommend that all firms, including those that have already taken action, reassess their technical and other central resource requirements, in the light of both the specific recommendations arising from their inspection and the wider regulatory environment, and take appropriate action to address any shortfalls identified.

### *5.3 Ethical, independence and client continuance policies and procedures*

#### *5.3.1 Implementation of the Ethical Standards*

Some firms had followed a structured process to implement the requirements of the Ethical Standards mapping the requirements to their revised internal policies and procedures. Other firms had not followed such a structured process.

One firm stated that it preferred to rely on requiring staff to read the full text of the Standards themselves and attend internal training thereon. This approach does not, in our view, comply with the requirement under the Standards to establish internal policies and procedures and is unlikely to be effective in practice. We recommended that this firm update its detailed ethical policies and procedures to bring them in line with the requirements of the Standards.

Another firm had issued supplementary guidance on the Standards, supported by training thereon, to its partners and staff. However, its policies manual had yet to be revised in line with the requirements of the Standards at the time of our visit, giving rise to certain inconsistencies with the Standards. We recommended that this firm revise its policies manual in line with the Standards as soon as possible.

#### *5.3.2 Partner rotation policies*

Due to the nature of the Other Significant firms' client base, the challenges arising for them from the new partner rotation requirements are of a different order to those faced by larger firms. The number of audits where a key audit partner might be expected to be identified, for example, is small and, as a result, the collation of such information is generally more straightforward.

We made a number of recommendations in relation to individual firms' rotation policies and supporting guidance and their procedures for monitoring compliance with rotation requirements. A recurring theme was a need to develop or enhance policies and guidance in relation to those unlisted clients for which accelerated rotation requirements should apply.

#### *5.3.3 Non-audit services*

There appeared to be evidence that the following accounting services had been provided to listed audit clients, despite ethical requirements in force at the time providing that such services should only be provided in an emergency situation:

- Payroll function outsourced to the firm;
- Group cash flow statement prepared by the firm; and
- Group tax accounting entries and disclosures prepared by the firm.

We recommend that firms specifically remind their partners of the prohibition on the provision of accounting services to listed audit clients and issue policies and supporting guidance in relation to all types of non-audit services provided to their audit clients.

Firms should ensure that their policies and procedures in this area promote a high level of awareness amongst their partners and staff as to what services may be provided under the Ethical Standards, including those situations where internal consultation is likely to be appropriate, and promote observance of the underlying principles of the Ethical Standards as well as the specific requirements.

We noted that the guidance for partner evaluations in use at some firms did not make it clear that partners can neither be set objectives nor be rewarded in respect of the selling of non-audit services to their audit clients. It appeared that certain audit partners at one of these firms who also had a client relationship partner role may have been set targets in relation to the sale of non-audit services to certain of their audit clients. We recommended that the firms concerned clarify their guidance for partner evaluations in line with the relevant requirements of the Ethical Standards.

We recommend that all firms ensure that the responsibilities involved in any additional client role undertaken by the audit engagement partner are clearly defined such that the selling of non-audit services to the client is clearly excluded.

#### **5.3.4 *Client acceptance and continuance***

The client acceptance and continuance procedures in place at some firms did not focus sufficiently on assessment of the risks associated with clients, with the primary focus appearing to be on independence considerations, possible conflicts of interests and competency issues. At one firm there were no standard procedures in place to assess clients' risk profiles and identify higher risk clients. We recommended that this be rectified with a view to achieving greater consistency and facilitating effective monitoring of higher risk clients. We recommended that another firm issue additional guidance to ensure that proper consideration is given in the risk assessment process to the implications of significant changes in the risk profile of existing clients.

We recommend that all firms review whether their procedures ensure both that there is proper linkage between the risks identified at the acceptance or continuance stage and the planning and execution of the

audit and that additional risks subsequently identified by the audit team are taken into account in assessing whether to continue as auditors for the following year.

#### *5.4 Audit Performance*

##### *5.4.1 Audit evidence and related audit judgments*

Issues identified at individual firms in relation to audit evidence and related audit judgments included:

- Insufficient work in respect of certain material provisions;
- Inappropriate reliance placed on analytical procedures which provided little or no substantive audit evidence;
- Insufficient audit evidence in relation to the existence of material stock balances;
- Insufficient audit work in relation to the completeness of related party disclosures;
- Insufficient audit evidence to support other notes to the financial statements; and
- Over-reliance on management representations relating to certain matters for which no independent audit evidence was obtained.

##### *5.4.2 Audit judgments in relation to financial reporting issues*

In reviewing key audit judgments made in relation to financial reporting issues on individual audit engagements, we often had to seek oral explanations from partners and staff in relation to significant matters. Where there was significant partner involvement in arriving at a particular judgment, the documentation deficiencies were often particularly significant. We recommend that all the firms consider how improvements can best be achieved in this area and that a clear message is conveyed to their partners and staff as to the importance of doing so.

We referred issues arising in relation to the financial statements of one entity whose audit we reviewed during the year to the Financial Reporting Review Panel. The issues related to the adequacy of the disclosures made in relation to a number of material provisions.

Other areas in which audit judgments relating to financial reporting issues were challenged included:

- Accounting treatment of certain grants (akin to operational subsidies) received and the adequacy of the disclosure thereof in the financial statements;

- Recognition of deferred tax assets; and
- The justification as to why no prior year adjustment was made in respect of a change in the accounting treatment of development costs.

#### 5.4.3 *Compliance with Auditing Standards*

We identified recurring areas of non-compliance with certain Auditing Standard requirements at all firms; each firm was provided with a summary analysing these recurring matters. We have made specific recommendations to the firms, taking into account the effect of the adoption of the ISAs (UK and Ireland), as to how these matters should be addressed.

We comment in sections 5.4.6 – 5.4.8 below on issues relating to audit documentation, reliance on other auditors' work and reporting to Audit Committees. Other issues identified at individual firms included a lack of evidence that:

- Sufficient work had been undertaken on identifying and assessing risks as a basis for planning the nature and extent of audit procedures;
- Sufficient audit work had been undertaken in relation to going concern status, laws and regulations and fraud and error;
- The materiality of unadjusted misstatements had been adequately assessed;
- Adequate analytical procedures had been performed at the overall review stage of the audit; and
- The competence and objectivity of experts whose work was relied upon had been assessed.

To differing degrees we identified issues in relation to the extent to which audit manuals and related methodologies at the firms had been fully updated to reflect the requirements of the ISAs. We recommended that these matters be addressed by the firms concerned and that additional guidance on the requirements of the ISAs (UK and Ireland) be provided to partners and staff at certain firms.

We will be reviewing the firms' revised methodologies in more detail during our next full or interim inspections, in conjunction with our review of their application on individual audits.

There are significant differences in the firms' processes for revising their audit methodologies in line with changes in the regulatory framework. At some firms the revisions are developed internationally, with additions then being made for UK-specific requirements. At other firms the methodology is developed and revised in its entirety by the UK firm. The disciplines associated with an international process tend to increase the likelihood of revisions being carried out on a comprehensive and timely basis. There is no

reason in principle, however, why the other firms cannot respond equally effectively to regulatory changes provided that the need to devote appropriate and sufficient resources to achieving this is recognised.

#### *5.4.4 Technical reviews and consultation*

The risks associated with the adoption of IFRS by UK listed companies increase the need for their financial statements to be reviewed by technical specialists within the firms before the audit opinion is issued. The need for consultation with technical specialists on specific issues arising must also be expected to increase.

One of the firms had no requirement in place for a technical review of the financial statements of its audit clients to be carried out. We recommended that this firm review its completion procedures with a view to implementing a requirement for technical reviews of the financial statements of its listed and other major audit clients. We recommended that another firm continue to seek to increase the resources available to it to undertake such technical reviews and provide technical consultation services.

Our recommendations to individual firms relating to consultation procedures more generally included:

- Introducing a requirement for consultation to take place with technical or other appropriate specialists in relation to complex or contentious issues; and
- Keeping a formal record of decisions taken by the internal panel responsible for considering contentious issues, together with the basis on which each such decision was arrived at.

#### *5.4.5 Engagement quality control review (EQCR)*

The requirements relating to engagement quality control reviews (formerly known as Independent Partner Reviews) are set out in ISQC 1 (effective from 15 June 2005). ISQC 1 requires firms to establish policies and procedures setting out the nature, timing and extent of the review and the related documentation requirements. It clearly indicates that a review of selected audit working papers relating to the significant judgments made by the audit team forms part of the review and that the review is to be conducted in a timely manner at appropriate stages of the audit. While many of the audits we reviewed in the year were undertaken prior to ISQC 1 taking effect, some firms' procedures were broadly in line with the requirements of ISQC 1 from an earlier date.

The arrangements established by one of the firms for these reviews involved a small number of technical partners carrying out combined technical and EQCR reviews at the end of the audit. It was evident that the reviewers were not involved at appropriate stages of the audit and that the scope of the EQCR review was more limited than is required under ISQC 1. We recommended that this firm change its policies and

procedures for EQCRs in line with the requirements of ISQC 1, and require these reviews to be conducted by appropriate independent audit partners in addition to the existing technical reviews of the financial statements by the firm's technical specialists.

At some firms there was insufficient evidence in many cases of a review of selected working papers relating to significant audit judgments being undertaken. It appeared, however, from the interviews we conducted with selected reviewers that they were aware of, and had considered the appropriateness of, key judgments made. We recommended that the firms concerned review their policies and procedures for documenting the review of key audit judgments as part of an EQCR and, where necessary, give further guidance on this matter to their reviewers.

The time recorded for these reviews appeared modest for some of the audits we reviewed. We therefore recommend that firms consider whether there is a need for additional guidance regarding the amount of time likely to be required or the importance of fully recording all time spent.

The importance of the role performed by partners acting as engagement quality control reviewers needs to be appropriately recognised and valued within the firms. We recommend that all the firms review whether their policies, and their application in practice, appropriately reflect the importance of effective engagement quality control reviews.

#### *5.4.6 Audit documentation*

Although some examples of good quality documentation were identified in relation to individual audits, the overall quality of audit documentation required improvement at all the firms. The firms acknowledged the need for them to make greater efforts to achieve improvements in this area, which has often been highlighted as an issue by their AQR reviews.

Areas of weakness in relation to the quality of audit documentation which we highlighted at individual firms included:

- The rationale for key audit judgments (discussed in 5.4.2 above);
- The audit team's understanding of the client and the environment in which it operates;
- The assessment of the client's accounting systems and relevant internal controls, including IT related aspects; and
- The audit procedures undertaken and audit evidence obtained.

We regard a greater awareness within the firms of the importance of audit documentation and the various objectives and purposes thereof, as set out in ISA 230 (revised) (UK and Ireland), as central to achieving improvements in practice. We recommend that the firms consider bringing their documentation policies in line with the requirements of ISA 230 (revised) (UK and Ireland) in advance of the mandatory implementation date (audits of financial statements for periods starting on or after 15 June 2006). They should also consider the need for additional guidance and/or training in this area for partners and staff.

#### 5.4.7 *Group audits and reliance on the work of other auditors*

We identified a number of issues in relation to the conduct of group audits and reliance on other auditors' work. Issues arising at one or some firms included:

- Inadequate group audit instructions issued to other auditors; for example, certain areas of audit risk not adequately covered, the group materiality level not clearly communicated, the level above which unadjusted misstatements should be reported to the group audit team not specified;
- Other auditors reporting to the group audit team on material overseas subsidiaries under local, rather than UK, GAAP and GAAS;
- No documented assessment of the competence of other auditors whose work was relied upon or no independence confirmations obtained from them; and
- A lack of evidence of audit procedures undertaken in relation to consolidation adjustments or overall analytical procedures in relation to the group financial statements.

Our recommendations to the firms concerned included issuing further guidance on the timing and content of group audit instructions and the provision of additional guidance and training in relation to a number of other aspects of the conduct of group audits.

We recommend that all the firms review whether their existing procedures and internal guidance for group audits need to be strengthened, having regard to both the recent guidance from the ICAEW's Audit Faculty<sup>5</sup> and the current exposure draft of ISA 600 (revised) issued by the International Auditing and Assurance Standards Board (IAASB) in March 2006<sup>6</sup>.

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<sup>5</sup> *Promoting best practice in group audits* (ICAEW, November 2005).

<sup>6</sup> *The Audit of Group Financial Statements* (IAASB, March 2006).

#### *5.4.8 Reporting to Audit Committees*

We view the provision of an appropriate and balanced written report to the Audit Committee as a key element of audit quality. The quality of reporting to Audit Committees varied both between and within the firms.

We identified the following areas for improvement in relation to certain audits reviewed:

- Communicating audit planning information to the Audit Committee;
- Confirming the firm's independence and disclosing any significant matters that may bear upon the firm's independence and objectivity;
- Reporting all key audit issues arising; and
- Reporting all unadjusted misstatements identified.

We have recommended that the firms concerned take appropriate actions in relation to the specific issues we identified.

#### *5.5 Monitoring of Audit Quality by the Firms*

We identified a number of areas in which we considered that improvements were required to the firms' internal Audit Quality Reviews.

##### *5.5.1 Assessing the quality of individual audits*

One firm graded certain aspects of the audits reviewed but did not collate these assessments by individual audits and some of the firms neither use a grading system for audits reviewed nor draw an overall conclusion on the quality of individual audits.

The procedures adopted by some of the firms did not appear to us to take proper account of the requirements of ISQC 1 to consider whether serious deficiencies existed in audits reviewed in respect of which action should be taken by the firm. In addition, while identifying common deficiencies in particular audit areas which may require action at a firmwide level is a valuable output of the review process, assessing the overall quality of individual audits in a manner that provides incentives for individual partners and staff to improve their performance is, in our view, equally important.

We have made specific recommendations to a number of the firms in this area. We recommend that the firms review whether they are assessing the quality of individual audits in a manner that enables them to take appropriate action in relation to both the audits concerned and the individuals responsible for them, including appropriately recognising and rewarding those who are performing to a high standard.

### *5.5.2 Improving performance*

The results of AQR file reviews at some of the firms, as summarised in the firms' overall AQR reports, indicated that certain issues were recurring from one year to the next with only limited progress achieved in addressing them. However, this appears to have been partly explained at some of the firms by a more robust approach being taken to the reviews, with current year findings not being directly comparable with prior years as a result. We recommend that the firms consider whether changes should be made to the manner in which action plans are determined and followed-up by them in order to achieve more substantive improvements in performance from one year to the next.

### *5.5.3 Composition of review teams*

The independence of those conducting or supervising reviews of individual audits was an issue at some of the firms. In the absence of a need for a reviewer to have specialist industry expertise not available outside the relevant office, it should not normally be necessary to use reviewers based in the same office as the individuals responsible for the relevant audits. The independence of the AQR process may also be compromised if the individual with primary responsibility for it acts as the engagement quality control reviewer for audits within its scope. We recommended that the firms at which these issues arose make appropriate changes to address them.

Appropriate partner involvement in the review process is important, particularly in relation to major audits involving significant audit judgments. We recommended that one firm increase the level of partner involvement, particularly in relation to the review of individual audits at the firm's major offices.

### *5.5.4 Firmwide reviews*

We identified a need for improvement at some firms in relation to the scope of firmwide reviews and/or the reporting, evaluation and follow-up of issues arising. Our recommendations to individual firms in this area included broadening the scope of their firmwide reviews, making changes to the process for reporting the results thereof to senior management and monitoring the implementation of action plans developed to address issues arising.

## Appendix A – Scope of Independent Inspection 2006/7

Audits of the following entities are within the scope of the work of the Audit Inspection Unit (AIU) of the Oversight Board in 2006/7. 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 2006/7, the relevant financial year is likely to have ended in either 2005 or 2006.

- All entities with listed securities (equity and debt). *(Note 1)*
- AIM or Ofex companies with a market capitalisation in excess of £100million. *(Note 2)*
- Unquoted companies or groups of companies in the UK which have either:
  - Group turnover in excess of £500million; or
  - Group long-term liabilities in excess of £250million and turnover in excess of £100million. *(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 £100million. *(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. *(Notes 2 and 6)*
- Lloyd's Syndicates with an underwriting capacity in excess of £250million. *(Notes 3 and 6)*
- Mutual Life Offices whose "With Profits" fund exceeds £1,000 million. *(Notes 3 and 6)*

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 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 Ofex (see below) and not to overseas markets, as at either the previous 31 March (i.e. 31 March 2006 for 2006-7) or, if later, the date of the last published set of accounts.
- Note 2: These measures will be applied as at the previous 31 March, i.e. 31 March 2006 for 2006-7.
- 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: Open-Ended Investment Companies, Unit Trusts, Lloyd's Syndicates and Mutual Life Offices (which are not constituted as companies or friendly societies) were brought within the scope of the Audit Regulations issued by the ICAEW, ICAS and ICAI with effect from 1 August 2005.
- Note 7: 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.

## Appendix B – Assessing Audit Quality and Prioritising Recommendations

### A. The Concept of Audit Quality

The principal output of the audit process is the independent auditors' report on the annual financial statements. Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgments. If the auditors are not independent of the audited entity, the credibility of their report is significantly reduced.

The auditors' communications with those responsible for overseeing the entity's financial reporting process (normally an Audit Committee reporting to the full Board) is a key aspect of the audit process. A quality audit involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board properly to discharge their responsibilities.

These elements of audit quality may be summarised as follows:

Output	Required features
An appropriate audit opinion to shareholders which is:	Independent Supported by sufficient and appropriate audit evidence Supported by objective judgments
A report to those charged with governance which is:	Complete and appropriate to the circumstances

### B. Assessing Audit Quality

Audit quality inspections involve assessing the independence of the auditors, the sufficiency and appropriateness of the audit evidence obtained and the appropriateness of the key audit judgments made. In some cases it may be possible to determine in this way that an *inappropriate* audit opinion was issued. However, we review only information held by the auditors, do not have access to their clients' records or personnel and do not re-perform audit work undertaken by them. While we can form a view, therefore, as to the adequacy of the audit evidence obtained to support the audit opinion, these inherent limitations mean that we are not usually able to confirm the appropriateness of the audit opinion.

Audit quality inspections involve an assessment of the key factors driving audit quality which are *inputs* to the audit process. Using the terminology adopted in ISQC 1 for factors driving audit quality, key elements of the audit process which we assess during our inspections may be summarised as follows:

<b>Factors driving audit quality</b>	<b>Key elements</b>
Leadership	Tone at the top, which supports audit quality through the firm's strategy, objectives and targets, internal communications and reward mechanisms.
Human resources	Competence and motivation of partners and staff, with appropriate training and evaluation; recruitment of staff with appropriate skills and qualifications; allocation of appropriate partners and staff to audits.
Ethical policies and acceptance/continuance of audit engagements	Independence, integrity and objectivity and other ethical policies compliant with the regulatory framework; appropriate risk management procedures in relation to client acceptance and continuance and high risk audit clients.
Engagement performance	Robust and appropriate audit methodology compliant with the regulatory framework; appropriate and timely planning; sufficient time spent on audits; appropriate judgments, rigour and professional scepticism applied on audits; clear understanding of roles of partners and staff on audits; sufficient and appropriate documented evidence supporting audit opinions; review and consultation procedures, including independent partner reviews; regular and appropriate communications with client management, directors and the Audit Committee.
Monitoring	Effective internal Audit Quality Review (AQR) and other monitoring procedures by the firm; appropriate and timely actions in relation to weaknesses identified by the AQR or through the external monitoring process.

### *C. Prioritising Recommendations*

We exercise judgment in assessing the actual or potential impact on audit quality of issues identified in the course of our inspections and prioritising our recommendations to firms accordingly. Factors we take into account, on a cumulative basis, are set out below.

### **Individual Audit Engagement Review Issues**

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#### **Factors Considered**

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- The risk that the identified weakness could have contributed to the issue of an audit report which is inappropriate or not independent or supported by sufficient and appropriate audit evidence and objective judgments;
  - The risk that the identified weakness could have contributed to incomplete or inappropriate reporting to those charged with governance; and
  - The extent to which the identified weakness has affected the audit engagements selected for review.
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## Firmwide Review Issues

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### Factors Considered

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- The risk that the identified weakness could contribute to the issue of an audit report which is inappropriate or not independent or supported by sufficient and appropriate audit evidence and objective judgments;
  - The risk that the identified weakness could contribute to incomplete or inappropriate reporting to those charged with governance;
  - The extent to which the identified weakness is systemic in nature and could affect a range of audits;
  - The existence of effective alternative controls which are likely to mitigate the risks arising from the identified weakness;
  - The recurrence, or otherwise, of the identified weakness from one year to the next.
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## **Appendix C – Types of Actions Taken by Big Four Firms**

A summary of the types of actions taken by the firms to implement our first year recommendations is set out below. The summary describes the nature of the actions taken by the four firms rather than specific actions taken by any one firm. Some of these actions relate to only one firm while others are common to more than one firm.

### *A. Leadership and human resources*

- Key strategic messages, including the overriding importance of audit quality, communicated at workshops/ partner briefing sessions;
- A number of quality performance indicators, against which partners are being assessed, introduced;
- The need to improve the timeliness of partner appraisals and objective setting, and for the firm's procedures to be adhered to in practice, communicated. A review subsequently undertaken to monitor compliance;
- Changes made to the process followed in assessing prospective partners to place greater emphasis on audit quality considerations;
- Action plans put in place for all new partners to ensure that development needs identified in the partner assessment process are addressed; and
- Additional feedback obtained from client Audit Committees on audit quality issues.

### *B. Ethical, independence and client continuance policies and procedures*

- New partner rotation databases implemented to facilitate effective monitoring of compliance with rotation requirements; and
- Revised policies and guidance on rotation of audit partners and staff issued.

### *C. Audit Performance*

- Changes to audit methodology made to address issues raised and a formal process to identify new developments requiring action established;
- Additional guidance/training given covering those Auditing Standards where recurring instances of non-compliance had been identified;

- Guidance issued on the need to assess the independence and competence of other auditors which are network firms; and
- Policy for engagement quality control reviews revised and additional guidance given on the importance of and responsibilities associated with the role.

#### *D. Monitoring of Audit Quality*

- Changes made to the basis on which audits reviewed are graded to increase the robustness of the review process;
- Greater focus on compliance with Auditing Standards in the AQR process through changes to standard documentation and guidance; and
- Greater focus on the importance of good quality audit documentation.





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